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USE AND EXCLUSIVE CLAUSES IN BANKING INSTITUTION LEASES

Limitations in a banking tenant's use clause protect the rights of other tenants.

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Although the banking industry's crucial role as a financier of US real estate development is well recognized, bankers also benefit the real estate industry in another significant way: Banks are tenants. They lease buildings; they lease space in buildings; and they lease land. For the most part, they are good tenants.

Landlords have usually been happy to acquire a banking institution as a tenant. Except in rare periods, bankers are regarded as especially good credit risks. They usually pay rent on time. They create an aura of respectability and stability for the property. Moreover, they are unlikely to generate unpleasant odors or loud noises or attract rodents or vermin.

A banking institution cannot function unless it can persuade the public that it is financially sound. In the absence of the comfort of deposit insurance, a deposit of money in a banking institution is an act of faith. Customers do not make deposits unless they truly believe they will get their money back plus any interest that the bank has promised. Although deposits dwindled when bank failures frightened the public during several crisis periods, they rebounded when the bad memories waned.

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Public faith in banking institutions was shaken by the bank failures of the Great Depression. When 5,100 banks closed their doors in 1930, 1931, and 1932, bank depositors panicked. They raced to withdraw their funds from other banks that were rumored to be failing. Then, these banks also failed. Not only banks, but many individual depositors were ruined in 1932. The public no longer rushed to deposit money in banks; between summer 1931 and the end of 1932, deposits fell approximately 20%. As banks continued to fail, the suicide rate mounted.

Franklin D. Roosevelt and deposit insurance came to the rescue. The Federal Deposit Insurance Corporation (FDIC) was founded in 1933 and the Federal Savings and Loan Insurance Corporation (FSLIC) followed in 1934. These new federal agencies guaranteed principal and interest for deposits in their member banks. Although the insurance had relatively low ceilings, depositors and bankers alike breathed easier, and the panic ended. Deposit insurance didn't end bank failures, but it comforted depositors whose funds began to flow back into financial institutions. With the splendid comfort that only a federal guaranty can supply, the public was once again willing to trust the banks with their life savings. Better days had returned.

Although rent obligations weren't and aren't guaranteed by the FDIC, bank landlords and creditors benefited and continue to benefit from federal deposit insurance. Of course, bank landlords are not completely insulated from

bank failures. As some landlords discovered during the savings and loan crisis of the late 1980s, federal deposit insurance cannot completely offset fraud, incompetence, poor judgment, or cataclysmic changes in the real estate and bond markets.

In the brave new post-World War II world, the real estate community regarded bank failures as ancient history, and banking institution leases were especially prized because of their appeal to mortgage lenders. A landlord holding a favorable bank lease found it a little easier to finance a downtown office building or shopping center project. Banking institutions were among the most important shopping center financing sources, and, as lenders, they looked favorably on the income stream expected from leases of other banking institutions. Sometimes, the banking institution tenant decided to lend to its own landlord, a double header for the developer.

As postwar banking institutions expanded and sought new branches, they chose to lease rather than to buy. Owned real estate is not a highly prized bank asset. Because there were so many banks, they competed vigorously to lease the best sites. (In 1991, more than 90% of all banks doing business in the world's industrialized nations were doing business in the United States.)

For the past 50 years, commercial banks, savings banks, and savings and loan associations all have sought shopping center locations. Perceived as potential nuclei of future downtowns, shopping centers looked good to bank management. The following factors helped whet the bankers' appetites for shopping centers:

- They were located in growing suburban communities;
- They were near newly developed homes bought by soon-to-be prosperous young couples; and
- Their ample free parking facilities made them convenient for depositors.

Bank branches were placed in all types of centers—regional, community, and neighborhood. They were placed along busy enclosed malls; they occupied partitioned units in open retail small store strips that made up community and neighborhood shopping centers; and they also occupied freestanding buildings close to the highway or street adjacent to the shopping center.

Bank managements' interest in shopping center locations was not exclusive. They didn't abandon the downtowns. Indeed, they also acquired many new downtown locations. Some leased the first floors of suburban office buildings. Others preferred neighborhood shopping districts or freestanding highway locations separated from other tenancies.

BANKING INSTITUTION USE CLAUSES

Landlord negotiators find it harder to understand the need for bank use clauses than to understand the need for specialized retailers' use clauses. They clearly understand that if they draft one specialized retailer's use clause too permissively, the clause can violate a restriction contained in another tenant's exclusive clause. On the other hand, it takes a bit of experience and specialized knowledge to appreciate that they must include limitations in a banking tenant's use clause in order to protect the rights of other tenants.

What can go wrong if the use clause doesn't limit the bank's activities at the premises? If the bank's lease is recorded before the other tenants' leases are recorded and before other tenants' occupancies begin, the banking tenant could sell merchandise and perform services without regard for restrictions in co-tenants' leases. Technically, the bank would have the right to sell food, which would also cause a violation of a subsequent supermarket tenant's exclusive clause. In addition, the bank could sell prescription drugs or books despite the exclusive clauses of the pharmacy and bookstore co-tenants.

A friendly neighborhood branch banker isn't likely to sell produce from the banking floor, but the branch's board of directors might conclude that the unit is not sufficiently profitable, and they might decide to rid themselves of the branch's lease burden by subletting the premises of the disappointing branch or assign its leasehold estate. Although the most logical type of assignee or sublessee for a bank branch is probably another bank branch that could use the physical facilities, the location might not interest any other banking institutions but might appeal to another kind of tenant—perhaps a travel agency, drugstore, or bookstore. An assignment of a bank

premises leasehold to a nonbanking tenant could result in unexpected and disastrous competition for other tenants of a shopping center or downtown office building. It also might involve the landlord in expensive and disagreeable litigation. In most states, bank premises and any other leased premises can be used for any legal purpose unless the lease restricts the use. A landlord needs an effective use clause to protect itself and its other tenants from unexpected and inappropriate competition.

A simple, but usually inappropriate use clause can be created by stating in the lease that the tenant shall use the premises as a bank. But, it's probably a good idea to say much more. The word "bank" doesn't describe which activities can take place on the premises if the lease doesn't define "bank." Another approach would be to list every activity in which the tenant engages at the time of the lease negotiation and prohibit all other activities. However, that approach isn't optimal either, because banking activities change over the years, and they change frequently and considerably.

The change in banking activities has accelerated in recent years. Commercial banks are now anxious to originate mortgage loans and to pay interest on checking accounts. Savings banks and S&Ls now make commercial loans. Many banking institutions now routinely sell mutual funds and other securities, and they offer cash management services and investment banking services. Some banks now sell insurance. Banking will probably continue to change. Twenty-first century banks may sell travel services, computer software, or consulting services. Consequently, a simple use clause that provides that the tenant shall use the premises as a bank doesn't sufficiently prescribe the activities that may take place there. On the other hand, a complex use clause that lists all permitted uses, doesn't provide the flexibility a tenant needs.

To help the landlord avoid conflicts among use clauses and exclusive clauses, landlords should attempt to prohibit the bank from engaging in any new activity that violates restrictive covenants to which the landlord is already bound. Of course, they should bar the bank from violating any restrictive covenants in old deeds and declarations burdening the landlord's title. They should also anticipate the requests for restrictive covenants that new tenants may make in the future and ask the bank tenant to agree not to violate these likely restrictions.

By negotiating use clauses carefully, shopping center landlords were able to attract more than one banking institution to their projects. As the early post-World War II shopping centers were developed, developers learned that commercial banks, savings banks, and savings and loan associations were each governed by different laws, regulated by different bureaucrats, and performed different services. The three types of institutions didn't regard each other as competitors. There was room for more than one type of institution in many shopping centers, and even in the same central business district office building.

To take advantage of tenant banks' willingness to tolerate co-tenancies of other types of banking organizations, sophisticated landlords bargained for careful limits on each banking institution tenant's activities. Use clauses restricted the use of the commercial banker's premises to a commercial bank and the use of a savings banker's premises to a savings bank.

Although distinctions among types of banking institutions have blurred, old habits die hard, and in practice many old distinctions persist today. Some 1990s shopping center banking institutions still tolerate competition from another banking institution tenant in the same shopping center if the competitor does a different type of banking.

Shopping center landlords also need to limit banking institution tenants' uses to promote tenant mix diversity. So, landlords seek further use limitations to make sure that the character of each store in the center differs from the others. Shoppers are attracted to a center by the variety of merchandise categories and depth of the selections. They're repelled by the prospect of traipsing through a long line of stores that look the same.

Landlords should particularly seek to protect the markets of their specialized small tenants. Small service tenants like insurance brokers, securities brokers, travel agents, and real estate brokers have been doing business in shopping centers for the past 50 years. Many serve relatively small markets and depend, at least partly, on the patronage of employees of the other stores and of customers attracted to the center by other

tenants. The small establishments often cannot sustain direct competition from a co-tenant. They need protection against direct competition regardless of whether they have the foresight to negotiate a restriction pursuant to an exclusive clause. Competent landlords seek to protect existing and potential service tenants by negotiating particular restrictions into banking tenants' use clauses. They attempt to bar a banking tenant from expanding its range of services to include a service that conflicts with the principal use of any nonbanking tenant of the shopping center. They also seek to prohibit the banking institution from changing its principal use to the principal use of any co-tenant.

Finally, landlords should control excessive bank giveaway programs and attempt to do so by negotiating additional use clause restrictions. In their perpetual quest for new depositors, bankers have given away pots, pans, alarm clocks, ashtrays, piggy banks, and even television sets.

Bankers believe that giving things away should bother no one. However, bank premiums irritate merchants selling the very same things the banks are giving away. The proprietor of a specialized small store may fret when its core products are subject to direct competition from co-tenants within the center, but they rage when they discover that a bank or savings and loan association is giving them away.

The Tenant's Point of View

Sophisticated banking executives know that markets change and that they must accommodate their institutions to that change. As enthusiastic as they may be regarding the prospects of a new branch, they must always have fallback plans for the leased premises in case the location proves to be a lemon. Too many use clause restrictions could severely impair the bank's ability to compete. If, six years into the tenant's lease term, other banks begin to perform new attractive services, the tenant needs to compete by performing the new attractive services. Sometimes, the best alternative may be to close the branch. The obligation to pay rent for vacant space may be less burdensome than carrying the branch's operating losses.

Nobody is happy to pay rent for unused space. Careful bankers request the right to change the use of the premises if it turns out that conducting a banking business from the premises isn't profitable. Even very sympathetic landlords should respond carefully. A bank's unlimited right to change the use of its premises could create many serious problems for the landlord. The landlord may find itself in violation of other tenants' exclusive clauses if the bank changes the use of the premises and the landlord has forfeited the power to stop the violation.

A landlord may go along with a clause that allows a banking institution tenant to change its use if the tenant's right to do so is subject to the following conditions:

- The right to change the use is exercisable only after the bank demonstrates that the branch has failed to meet carefully defined criteria for profitability after at least three years of operation;
- The bank must submit audited financial statements and an accountant's opinion as evidence of its failure to meet the profit criteria; and
- The branch must have failed to meet the criteria for at least three consecutive years.

Many shopping center or multiuse downtown central business district building landlords believe that even these conditions do not protect them adequately, and they bargain for further restrictions on the bank tenant's ability to expand or change the range of its activities.

To resolve the inherent conflict between the landlord's need for predictability and the tenant's need for flexibility, the use clause could be drafted with four levels of rules:

- At the first level, the tenant is given the right to engage in all services currently regarded as banking services.
- However, at a second level that would override the first level, the tenant agrees not to render any service, sell any merchandise, or engage in any other activity if that activity is the principal use of any other tenant of the shopping center.
- Under a third rule (that would override the second), the landlord agrees that, if it becomes customary for other banking institutions to render a service, sell merchandise, or engage in an activity, the tenant

would be allowed to do so also even if it is the principal use of another tenant of the shopping center.

- The three preceding rules should be subject to a fourth rule: The tenant agrees not to violate any restrictive covenant in another tenant's exclusive clause or in the landlord's title.

If a bank is the sole tenant in a freestanding building in the shopping center, its right to change the use of the premises presents even more sensitive problems. That building is often the building closest to the highway. The center's appearance and reputation might be impaired by the changed use proposed by the tenant. Conceivably, the appearance of an attractive freestanding bank building could be transformed into a visual nightmare by the garish signs or inappropriate alterations of a razzle dazzle retailer. To protect its equity, the landlord should bargain to limit the permissible new uses as well as the types of signs and alterations that will be allowed if the use is changed.

The lease might specify suitable alternative uses for the freestanding bank building, possibly an office or even a fast food restaurant.

BANKING INSTITUTION EXCLUSIVE CLAUSES

Like other tenants, banks also demand exclusive clauses in their leases. They want to prohibit the landlord from leasing space for another banking institution and to prohibit banking-like activities (like check cashing) to bar competition within the project. One reason that banks locate in a shopping center is the opportunity to attract co-tenants as depositors. At the end of a business day, merchants are likely to deposit the day's receipts in the nearest bank as soon as possible. Even if these depositors later move the funds to other banking institutions by check or wire, the local bank benefits from the overnight deposits.

Another benefit of the shopping center location is the opportunity to attract the center's shoppers and store employees as bank customers. It is easy for a shopper to drop in on a bank in the center on the way to the supermarket. By banking at the same shopping center at which the shopper buys groceries, he or she needs to park the car only once. Of course, the banker knows that a branch usually cannot make it on the patronage of one shopping center community alone. A shopping center environment adds to the branch's profit potential, but, usually, it does not constitute a market by itself.

Some banks bargain for exclusive clauses that go far beyond merely prohibiting bank co-tenancies. Bank lawyers like to ask for exclusive clauses that prohibit any other tenant in the shopping center from engaging in banking or lending services. Clauses like that can get a landlord into big trouble. Retail stores and other non-banking businesses routinely perform many services that resemble banking services.

Here are some modern examples of such services:

- Supermarkets cash checks;
- Small loan companies lend money;
- Stationary stores and drugstores sell money orders;
- Automatic teller machines placed in retail stores can provide some banking services from almost any location;
- Securities brokers provide checking accounts; and
- Sears, Roebuck & Co. sold mutual funds from its department store premises.

A landlord that signs a bank lease with an exclusive clause that prohibits any other tenant in the shopping center from engaging in banking or lending services should be prepared to relinquish plans to lease space to a small loan company or a securities broker. The landlord invites future disputes and potential litigation regarding claims that a supermarket, department store, stationery store, or other retailer is engaging in banking activities prohibited by the bank lease exclusive clause.

Supermarket banking is becoming more popular and more important. Supermarket executives are trying to allocate new space to more profitable purposes than selling low markup food products. Unlike, early supermarkets, contemporary supermarkets routinely sell hardware and clothing. They have created departments that look like independent shops such as pharmacies, bakeries, delicatessens, and butcher shops. Some supermarkets extend the independent shop theme a step further by installing an in-store banking nook. A bank

tenant's exclusive clause that prohibits its co-tenants from engaging in banking-like activities could sabotage a supermarket's plans for a banking nook.

To avoid clashing with a bank tenant that might raise this issue as a way to renegotiate or escape its lease obligations, a shopping center landlord should negotiate for specific department store and supermarket exemptions from a banking institution's restriction against another banking institution. The exemption should clarify that banking services offered from part of a department store or supermarket premises that has no separate access to the common area will not be considered a bank or banking institution within the meaning of the lease.

If a banking institution is adamantly opposed to retailing co-tenants' in-house banking nooks, it should bargain for a specific restriction to bar that practice. Unfortunately for bank negotiators, they rarely have the opportunity to influence a landlord's department store or supermarket lease negotiations. Most shopping center department store and supermarkets leases are executed long before the bank lease negotiations begin, and it's more likely that the department store and supermarket's use clauses will set boundaries for the bank's exclusive clause than vice versa. Above all, a landlord should not agree to a new bank tenant's restrictive covenant against existing co-tenants' banking activities without convincing all existing tenants including the supermarket tenant to accede to the restriction. That landlord might find itself a target of the combined fury of the supermarket and bank tenants.

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