Blake, Cassels & Graydon LLP November 2012

Blakes Bulletin

Real Estate—Commercial Leasing

Confirming Value Through Proper Lease Due Diligence

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The value of income-producing properties, such as office towers and shopping centres, can often be distilled down to the income derived from the property's existing leases. As such, it is absolutely vital to analyze and confirm that the expected income from a property is actually supported by the terms of the leases. Set out below are some lease due diligence considerations that will assist a purchaser in ensuring that it will be able to realize the income stream that it bargained for. For a more general overview of lease due diligence issues (monetary and non-monetary), see our November 2012 article: *Conducting Leasing Due Diligence? Watch for These Nine Lease Provisions*.

BASIC/NET RENT

Leases should be reviewed to confirm that the basic/net rent set out under the lease, including the date and applicable rate of any step-ups (increases), matches that set out in the rent roll, confidential information memorandum (CIM) and other income documentation that the purchaser may be relying on in establishing the value of the property. Based on our experience, discrepancies are very common.

CROSS-CHECK WITH ACTUAL PAYMENTS

The rent set out under the lease should also be compared against a tenant's actual payments. This will help flush out, among other things, whether a tenant is enjoying the benefit of any undocumented rent reduction. At law, a purchaser of a property may be barred from enforcing contracted rental rates where the vendor had orally agreed to reduce a tenant's rent or acquiesced over time through historical acceptance of a lower rental.

AREA

The provisions in a lease regarding the size and measurement of the leased premises should be reviewed against the information contained in the income documentation upon which the purchaser is relying. Vendors should also be asked for any area certificates in their possession or control in order to ensure that the certified area, as well as the measurement standard employed, is in accordance with the lease. This due diligence exercise will help avoid unexpected rent reductions due to the size of a tenant's leased premises being smaller than previously thought.

PROPORTIONATE SHARE

Where tenants are to pay operating costs, realty taxes or other costs on a proportionate share basis, the definition of "proportionate share" should be closely examined in each lease. In particular, the purchaser should ensure that the denominator of the proportionate share fraction excludes any rentable areas whose taxes, maintenance and insurance (TMI) contributions are capped or limited in some manner so as not to permit a full recovery. Without these exclusions, the purchaser may have to cover any TMI shortfalls out of its own pocket thereby diminishing a property's net income. The denominator, as defined in the lease, should also be examined in order to ascertain whether it reflects the sum of the rentable areas *actually used to calculate the rent of each tenant* of the property. In some cases, particularly for office properties, the denominator is defined as being the rentable area of the entire property calculated in accordance with the Building Owners and Managers Association or some other measurement standard. However, this could lead to a recovery shortfall where the rentable area of one or more premises on the property has been capped or reduced in some manner. For example, where the landlord has capped the gross-up used to calculate rentable areas (a very common occurrence where the gross-up would otherwise be a very large number) but the denominator contemplated in its leases does not adjust for same (but, rather, contemplates full rentable area calculations for all premises), a shortfall may occur.

REALTY TAXES

A purchaser should review the realty tax recovery provisions in a lease to ensure they permit a full recovery of taxes from the tenant. Less than full recovery may occur where a lease stipulates that

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the tenant is not to contribute towards realty taxes reasonably attributable to parking, storage and other similar facilities. In retail leases, it is customary to find anchor or major tenant leases which contemplate recoveries based upon separate assessment information or prevailing property tax valuation methodologies. As noted above, where other tenants of the same property are to pay realty taxes on a proportionate share basis, a purchaser should ensure that the calculation of the denominator of the proportionate share fraction permits the landlord to exclude these major or anchor tenants, otherwise a shortfall may occur if the amounts payable by the major or anchor tenant are less than the amounts payable had proportionate share calculations been used.

OPERATING COSTS

The operating cost provisions should be closely scrutinized to determine whether they result in a recovery shortfall. Leases with fixed common area maintenance payments, or capped annual increases, could result in shortfalls for landlords. In a retail context, shortfalls often result where a tenant is only required to contribute to exterior common area costs, whereas other tenants are to pay for interior and exterior costs. Of course, the operating cost inclusions and exclusions expressly described in each lease should also be reviewed to ensure they do not result in any material recovery gaps. They should also be reviewed to confirm the management or administration fee, if any, properly payable under the lease.

OPTIONS TO RENEW/EXTEND

Options to renew/extend contained in a lease should be closely examined to ensure that the rent payable during the option term(s) is acceptable to the purchaser. Options with pre-set rental rates or capped increases could be problematic for a purchaser, particularly where the rates or caps result in a below-market rent. Where option period rent is expressed to be based on some form of fair market rate, the provision should still be closely examined to determine whether the definition of "fair market" contemplates rates for improved or unimproved premises and to ensure it is otherwise acceptable. The existence of any options to renew/extend should also trigger an investigation by the purchaser as to whether any broker commissions would be payable upon exercise of the option by the tenant. Having to pay a commission without recovery in the determined fair market rent will obviously eat into the property's income.

FUTURE PAYMENTS/CREDITS/EXPENDITURES

Leases should also be reviewed to bring to light any unaccounted for future payments or credits for which the purchaser may be liable. These include deposits which are to be returned or credited to the tenant at a later date, yet-to-be-paid allowances/inducements and unexpired rent-free periods. A purchaser should also be cognizant of whether a lease requires the tenant to remove improvements and restore the leased premises back to base-building condition at the end of the term. If the lease does not contain such a requirement, the purchaser may be stuck with the costs of paying for its own removal and restoration and lost rent during such period, with the result that the property's net income will be negatively affected. A purchaser should also be aware of what improvements and equipment a tenant is *permitted* to remove at the end of the term (e.g., generators, supplemental heating/cooling equipment, racking and electrical upgrades). Where such improvements are integral to the functionality or value of the leased premises, the purchaser may find itself out-of-pocket as it will be responsible for replacing the item(s) removed by the tenant.

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Conducting Leasing Due Diligence? Watch for These Nine Lease Provisions

JOHN HUTMACHER

A purchaser of income-earning commercial real property must take steps to confirm the integrity and enforceability of the property's leases. Below is a brief explanation of nine aspects of leases that should be reviewed by the purchaser or its legal advisers during the due diligence period.

1. COMPLETENESS OF LEASE DOCUMENTATION

A review of the lease documentation received from the vendor often reveals that there are missing pages and unsigned or missing amendments and extension agreements. Since the purchaser needs an accurate understanding of the documents forming the entire lease, the vendor should be asked to explain any gaps in the documents and provide any missing items. The information contained in estoppel certificates, which tenants will be asked to sign to confirm financial and other terms of their leases, should match the information contained in the leases. If the purchaser waits until after the due diligence date or the closing date to investigate gaps or discrepancies in lease documentation that were apparent at an early stage, it will likely be too late to do anything about it.

2. OUTSTANDING TENANT INDUCEMENTS

Unexpired free rent and rent abatement periods, payment of leasehold improvement allowances and completion of outstanding landlord's work, if not performed by the closing date, can all affect the purchaser's return from the transaction. If not adjusted for on closing, the purchaser may be responsible for discharging any such outstanding obligations out of its own pocket. Accordingly, outstanding tenant inducements should be identified, confirmed in estoppel certificates and, if appropriate, adjusted for on closing so that the purchaser is not left with unexpected post-closing financial obligations to tenants for which it has not been compensated.

3. OPERATING COSTS

Since a landlord's ability to recover operating costs from tenants in a timely manner is critical, of utmost importance is a careful review of the definition of operating costs to confirm there are no unusual deductions or exclusions. Particularly important is the ability of the landlord to recover costs of capital repairs and replacements. Also, if an administration or management fee is chargeable to tenants, it is often calculated as a percentage of some measure of operating costs, meaning that if the definition of operating costs is restrictive, the same will apply to the landlord's entitlement to collect a management fee on the costs of any carve-outs.

4. EXCLUSIVE USE PROVISIONS

Most prevalent in the retail context, anchor and other tenants with a large degree of bargaining power are sometimes able to negotiate restrictive covenants from the landlord that premises in the project will not be leased to tenants engaging in competitive businesses. These restrictions frequently list prohibited business activities generally and sometimes the business names of prohibited competitors. With many retailers looking to broaden their lines of business beyond traditional areas to gain competitive advantage, purchasers disregarding exclusive use restrictive covenants in leases take unnecessary risk. All restrictive covenants in each lease should be identified and a canvass of each tenant's business activities at the property undertaken to ensure there are no conflicts. Sometimes these restrictive covenants are so broad that they affect lands that may not even be owned by the landlord, making enforcement difficult unless the restriction is registered on title to those other lands. The identification of restrictive covenants will also shed light on what future leasing opportunities are possible and which will not be permitted, having regard to existing restrictive covenants.

5. SIGNAGE AND PARKING RIGHTS

Tenants may be granted the right to use a specified number of parking spaces (sometimes reserved), often on the basis of a ratio of a number of parking spaces per square feet of rented space. Similarly, the landlord may provide one or more tenants with the right to install signage on the face of the building or on podium signage. Important in both the multi-tenant retail and office context, the purchaser should verify that there are no inconsistencies in any of the existing rights that have been granted and confirm that there is sufficient space to accommodate all of the parking and signage entitlements. This confirmation process will also be of benefit to the purchaser in identifying limits on its ability to grant other signage and parking rights to tenants in the future.

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6. TENANT OPTIONS TO PURCHASE

A tenant is sometimes provided with a right in its lease to purchase the property in which its leased space is located. For example, if the landlord has entered into an agreement to sell the property to a third party purchaser, the tenant may have been granted a right of first refusal to purchase the property on the same terms as those upon which the property has been offered to the third party. Sometimes the landlord even has to offer to sell the property to the tenant before offering it to a third party. These rights must be identified during the due diligence period and evidence of waiver by the tenant delivered to the purchaser. Even if waived by the tenant for the transaction at hand, the purchaser will want to take a hard look at the terms of the tenant rights to determine the extent to which the ongoing rights will affect the future marketability of the property and any impact on the purchase price that might be offered by a future purchaser.

7. "GO-DARK" AND RECAPTURE PROVISIONS

The leases should be reviewed to see whether or not they allow tenants to cease operating from the premises (even if they continue to pay rent and abide by all other terms of the lease). In a retail setting, "dark" premises reflect poorly on the project as a vibrant operating location. Where a tenant has the right to go-dark, the lease should be reviewed to ensure that the landlord is able to terminate (recapture). This ability to recapture vacant space will allow the landlord to control re-leasing of the premise.

8. "MAKE-GOOD" PROVISIONS

A purchaser will also want to determine what the leases require each tenant to do at the end of the term of the lease with respect to returning the premises to base building condition. Removal of a tenant's leasehold improvements can be a costly proposition for a landlord, especially where complex cabling or interior walls and staircases have been installed. On the other hand, if a tenant (with or without the landlord's financial assistance) has expended significant resources in rendering premises operational, the landlord might wish to limit the tenant's ability to remove leasehold improvements without the landlord's consent, as the premises could be in a more "ready" form for a succeeding tenancy. Ideally, through the lease, the landlord will exert some measure of control over the tenant in this area.

9. EARLY TERMINATION RIGHTS

Some tenants are able to negotiate early termination rights. If exercised, the purchaser's income stream may be adversely affected. Accordingly, early termination rights should be identified and a purchaser should satisfy itself that it remains comfortable proceeding with the transaction in light of the termination right.

Though the foregoing is not by any means an exhaustive list of the matters that a prospective purchaser should review when conducting leasing due diligence, it is a useful reminder of some of the typical "hot button" issues which every purchaser should consider.

Once the lease-related due diligence is complete, it is critically important to share this due diligence with the people conducting other aspects of the real property due diligence. It is important that the various components of real estate due diligence typically undertaken as part of a transaction not be viewed as independent processes but as intertwined. For example, if the lease review discloses that a particular tenant is entitled to multiple access points to and from the property, it must be confirmed with those conducting title-related due diligence that such points of access exist without any obstruction. If this is not done, a purchaser will miss the opportunity to request the seller to correct the problem at the seller's expense. There are other similar areas of overlap arising out of lease reviews which, if not addressed, could lead to difficulties later for the purchaser.

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November 2012

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Estoppel Certificates – Do They Work?

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As a general matter, estoppel certificates, sometimes referred to as status statements or acknowledgments, essentially set forth and confirm the veracity of a lease and identify its key terms. Rooted in the principle of promissory estoppel, estoppel certificates are intended to "estop" a party who signs the certificate from thereafter asserting a fact inconsistent with what is set out in the certificate.

Although most often requested by potential buyers or lenders in connection with the sale or financing of an owner's interest in a commercial property, it is not uncommon for tenants to request an estoppel certificate from a landlord when negotiating the transfer of their interest under a lease.

While the intended purpose of an estoppel is to permit the addressee to prevent the addressor from subsequently claiming that the circumstances surrounding the lease or tenancy are other than as set out in the certificate, the question arises – do they actually work? Well, it depends.

There are a number of general principles which are applied by the courts in determining whether an estoppel certificate is enforceable. Most significantly, it will have to be shown that the party signing the estoppel intended to affect the legal relationship between it and the recipient of the estoppel (i.e., it understood it was waiving rights otherwise available to it) and that the recipient *both* relied upon the estoppel certificate and changed its course of conduct as a result (i.e., it took some action or refrained from taking some action as a consequence of such reliance). In many cases, one or more of these elements are absent from the fact situation, thereby reducing the effectiveness of the estoppel certificate as a binding instrument.

Estoppel certificates cannot create contractual rights which would not otherwise exist at law or through the existing lease documentation. Courts have held that a unilateral declaration by one party lacks the requisite elements of offer and acceptance necessary for the formation of a contract.

Accordingly, by way of example, where a lease is otherwise unenforceable at law (such as where it does not include the required certainties for a valid lease), the fact that the tenant executed an estoppel confirming the lease will not transform the lease into a binding agreement.

Estoppels also cannot be used to alter or contradict specific, unambiguous terms of a lease. For instance, where a tenant indicates (mistakenly or not) in an estoppel that it does not have any remaining options to renew the term, when in fact one or more remaining options are determinable from the lease documents themselves, the estoppel will not preclude the tenant from later asserting that it continues to have the benefit of the option(s). As such, an addressee will not be able to rely upon misstatements in an estoppel certificate about matters that are discoverable by its own efforts. The practical effect of this is that an estoppel certificate should not be viewed as a substitute to completing one's own lease review due diligence.

An estoppel should also not be used as a means to amend the lease, as there is no additional consideration being given for this "new bargain" which typically only benefits one party. While many leases contain a provision compelling a party to execute an estoppel if requested, courts have held that such a clause does not amount to consideration for any "new bargain" that first appears in an estoppel certificate. And so, a purchaser should not use an estoppel certificate to amend a tenant's exclusivity or add relocation or redevelopment rights in favour of the new landlord.

Similarly, where a lease calls for an attornment – upon which a mortgagee wants to rely – the mortgagee is better advised to negotiate some form of a subordination, non-disturbance and attornment agreement (SNDA) with a tenant than to place such effecting language in the tenant's estoppel. If a lease amendment is needed, or a new covenant is required, it should be made into a proper permanent agreement and not just a provision in a tenant estoppel.

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In light of the foregoing, is there any value in obtaining estoppel certificates? For purchasers and lenders of commercial real estate, estoppel certificates are useful to "smoke out" ongoing or potential landlord/ tenant disputes that cannot be gleaned from the lease documentation or in any other convenient way. This will help avoid "walking into a lawsuit".

Estoppel certificates also afford an opportunity to have the tenant confirm its own understanding of the terms of the lease. This includes a confirmation of the documents that comprise the lease, as well as the rent payable under the lease. Purchasers and lenders can then flush out any discrepancies by comparing the estoppel information against the lease documents, rent roll, confidential information memorandum and other due diligence materials available to the purchaser or lender.

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Vacant Space on Closing: Head Leases and Vacancy Agreements

THOMAS VON HAHN

Here is the scenario. A developer wants to sell a strip mall that has just been completed but is only partially leased. Your company wants to purchase the asset and the only way it can get the deal is if it agrees to a purchase price which takes into account the income from the property as if it were fully leased. The seller will agree to provide a head lease with respect to the remaining unleased space.

This short article outlines some of the issues that arise when a buyer is requested to accept a head lease with respect to such unleased space.

NATURE OF RELATIONSHIP

The problem with a lease is that it was developed to govern the relationship between an owner of a property and the user of a property. Where the seller, as tenant, has no interest in occupying the property but only has an interest in reducing its exposure to pay the rent and other costs as a tenant under the head lease, the concept of a lease does not fit the situation appropriately.

BANKRUPTCY

If a tenant goes bankrupt, the trustee in bankruptcy has the option to terminate (disclaim) the lease, thereby extinguishing all obligations of the tenant thereunder. It would seem clear that any trustee in bankruptcy would quickly disclaim or terminate any head lease as all it creates are responsibilities to the bankrupt tenant without giving it any benefits, which in a 'real lease' would normally be the occupation of the premises for the business of the tenant.

LANDLORD REMEDIES

The normal remedies a landlord has if the tenant does not fulfill its obligations are termination, suing on the covenant, or distraint. As the tenant under the head lease has no improvements, inventory or other assets in the premises, there is nothing to distrain against. The landlord wants the tenant under the head lease to continue to pay and, other than terminating, the only way it can practically enforce that is through bringing an action on the covenant each month to receive the rent owed.

VACANCY AGREEMENT

To deal with the problems inherent in the lease relationship, the practice has arisen whereby an agreement (which is not a lease) is entered into pursuant to which the seller agrees to pay to the buyer amounts that are equivalent to rent while the lease-up process by the buyer or seller continues. If these payments are also due in monthly increments, there is still the same issue of having to sue each time that a payment is missed. However, provisions can be added to call for an acceleration of the total of all payments should the amounts not be paid when due and, accordingly, make them all due and payable on default. As with a lease, the issue of the strength of the covenant of the vendor party which enters into the payment agreement still needs to be considered. Sometimes, the covenant can be buttressed by a holdback or other security such as a letter of credit.

LEASE-UP PROCESS

The question of whether the seller or the buyer will be principally in charge of leasing the vacant space is dealt with in the head lease or the vacancy agreement. Under a head lease, it is usual for the tenant/seller to continue to be responsible for the vacant space and then sublease the space to actual users. The trouble with this arrangement is that the seller only has an incentive to lease-up the space so that its obligations under the head lease are mitigated. Accordingly, it has no real interest in the long-term viability of the tenant, the tenant mix, or other issues that are of interest to most normal landlords. Usually minimum leasing guidelines are agreed to such as the minimum length of the term (often five years), that the covenant and use are acceptable to the buyer and that there are no unusual provisions in the lease, such as termination or downsizing rights.

Of course, from the buyer's perspective, it would like to control the leasing and, hence, the concept of the head lease whereby the seller may sublease is not its preferred course. Rather, the buyer would like to enter directly into leases with the tenants of the unleased space and this can also be achieved by having the head lease partially surrendered with respect to the newly leased areas. Issues that arise include at what point the seller/tenant under the head lease is relieved from its obligations. Does that occur when the new lease is

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signed up or, alternatively, when the new tenant is in possession or when the tenant is paying rent? Also, is the seller/tenant under the head lease still responsible should a new tenant of the unleased space default?

LEASING COSTS

It is important to understand the competing interests of the seller and the buyer in structuring leasing costs. In theory, only the seller or the party bearing the costs of leasing the unleased space has an interest in keeping them low. The buyer wishes to maximize the base rent. However, the net effective rent payable by the tenant is made up of the base rent less the cost of achieving the base rent including leasing commissions, tenant inducements (such as prior lease takeover costs, landlord's work and contributions to tenants' work) as well as free rent or reduced rent periods. Since the cost of leasing and the base rent together determine the net effective rent, it is important to ensure that guidelines on these leasing costs appropriately reflect the form of lease (presumably fully net), the types of leasing costs and by whom they will be payable.

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Limitations, and Capex, and Taxes! Oh, my!

LAUREN TEMPLE

Recent cases decided by the Ontario Superior Court should cause parties to take a closer look at long-used "typical" commercial lease provisions.

OF LIMITATIONS AND RECONCILIATIONS

Consider the typical net lease: the tenant, throughout the term, pays the landlord a minimum rent every month, together with an amount that has been estimated in advance for common area maintenance costs and real property taxes. The parties agree that they will adjust the estimated amounts within a certain period of time after the actual amounts become known. So just how long can the landlord take to reconcile the estimates and the actuals before it is barred from doing so? The answer might surprise both tenants and landlords.

In a recent case in front of the Ontario Superior Court of Justice, *Ayerswood Development Corporation v. Western Proresp Inc.*, the court considered this very issue. In front of the court was a lease that contained the following language:

> "Wherever under this lease the Tenant is to pay its proportionate share, the amount thereof may be estimated by the Landlord for such period as the Landlord may from time to time determine, and the Tenant covenants and agrees to pay unto the Landlord the amounts so determined in monthly installments, in advance, during such period and with other rental payments provided for in this lease. As soon as practicable after the end of such period, the Landlord shall advise the Tenant of the actual amounts for such period and, if necessary, an adjustment shall be made between the parties."

The parties had entered into a lease in May 2001, for an initial term of five years. Throughout the term, the tenant paid minimum rent as set forth in the lease and the estimated amounts for common area maintenance charges and taxes, as provided by the landlord. After the lease had expired, the tenant remained in the premises while the parties attempted to negotiate a lease, and during that time, the tenant continued to pay minimum rent and estimated charges as it had done during the term. The tenant annually requested the actual amounts owing for common area maintenance charges and taxes, but was not provided with a reconciliation statement until after the lease had expired and the parties had failed to come to terms on the renewal, in December 2007. When the tenant received the bill for the reconciled amounts, the tenant denied its liability, asserting that the landlord was barred by the *Real Property Limitations Act* (Ontario) and the provisions of the lease, given that the landlord had not reconciled the amounts "as soon as practicable" after the end of each period.

In a surprise twist, however, the court found in favour of the landlord, and dismissed these arguments. First, the court noted that the lease did not define the "period" over which the amounts at issue could be estimated. If the parties had intended to define the period, they would have done so, in the court's opinion. The court found that the landlord had selected a period ending in December 2007, and had billed the tenant accordingly. The inference, of course, was that it was open to the landlord to do so, given the open-ended wording in the lease. Second, the court noted that section 17(1) of the *Real Property Limitations Act* (Ontario) provided that arrears must be claimed within six years after they became due. Rather than becoming due after they were accrued – which may have been the intuitive answer – the court found that the amounts did not become due *until they were billed*, namely in December 2007.

The *Ayerswood* case highlights the need for tenants, in particular, to pay even greater attention to the additional rent and reconciliation provisions in their leases. While flexibility is important, the landlord in *Ayerswood* was certainly aided by loose drafting. A prudent tenant will insist on annual reconciliations of additional rent amounts, and will ensure that the lease clearly outlines the consequences to the landlord for failing to deliver reconciliations within that time-frame.

CAPEX: WHAT DOES THAT MEAN, EXACTLY?

Landlords and tenants often think they are on the same page when discussing treatment of capital expenditures. The general consensus is that these expenses are so large that they should not be charged fully in the year in which they are incurred, but rather excluded altogether or amortized over the life of the asset in question. But what exactly *is* a capital expenditure? Parties often discover to their surprise that they have different definitions of this "commonly understood" term.

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In the case of *RioCan Holdings Inc. v. Metro Ontario Real Estate Limited*, the Ontario Superior Court considered whether a large-scale parking lot repaving project was recoverable by a landlord. RioCan, the landlord, resurfaced the pavement of the parking lot at its shopping centre in order to correct some cracking and distress created by general wear and tear. Although it maintained it was under no obligation to do so, RioCan then amortized those costs over 20 years and charged Metro its proportionate share of those costs. Metro paid its proportionate share for a few years without complaint, but then had an apparent change of heart, and alleged that the costs were capital expenditures for which it should not be liable. The lease itself allowed recoverability of paving repairs, except for those "expenditures which by accepted accounting practice" were of a "capital nature." Although the parties agreed that capital expenses should be excluded, it turned out that they had very different ideas about what, in fact, constituted a capital expense, in no small part because they had differing ideas of which accounting practices should govern the determination.

For its part, Metro argued that the lease should be governed exclusively by generally accepted accounting principles (GAAP). Under GAAP, an item would be considered capital if it "enhanced the service potential" or was a betterment of the asset; for example, where the associated operating costs are lowered, or the life or useful life of the asset is extended. In this light, Metro argued that that by so substantially repairing the parking lot, RioCan had extended the useful life of the asset and the expenditure should thus be considered capital in nature.

RioCan, in contrast, argued that while "accepted accounting practices" might include GAAP, they could also include tax accounting practices that were not inconsistent with GAAP. Under tax accounting principles, RioCan argued that one of the key factors considered by the Canada Revenue Agency in determining whether an expense was capital in nature was whether it served to restore an asset to its original condition or to materially improve the asset beyond its original condition. The former would be considered a repair, while the latter would be considered a capital expense. In RioCan's view, the rehabilitation simply restored the parking lot to its close-to-new condition. Further, RioCan argued that, under tax accounting practices, a capital expense should be one that brought a future economic benefit to the asset owner. RioCan insisted that it was not profiting from the parking lot or benefiting from any increased shopping centre revenues as a result of the parking lot repair. Finally, although RioCan agreed that GAAP looked primarily to extension of the life of the asset, RioCan insisted that Metro was looking at the wrong asset – the relevant asset to RioCan's accounting was the shopping centre as a whole, and the parking lot rehabilitation did nothing to extend its life.

The court agreed with RioCan that the failure of the lease to specifically bind the parties to GAAP meant that GAAP was not determinative, although it could be instructive. However, the court rejected RioCan's argument that the relevant asset was the shopping centre, holding instead that the relevant asset was the parking lot. RioCan's internal accounting practices, which treated the relevant asset as the shopping centre and amortized the cost of the repair to reduce overall chargebacks, were irrelevant in the court's view. The dispute was about the parking lot, and the rehabilitation undoubtedly extended the life of the parking lot. Furthermore, the indirect economic benefits to RioCan – in the form of lower operating costs, attracting new tenants, retaining old tenants, and complying with the landlord's lease obligations – were sufficient to establish an economic benefit to the landlord such that the expense could be considered of a capital nature even under tax accounting practices. It was not necessary to directly link revenue to expense to prove a capital expenditure. On the facts before it, whether one used GAAP or tax accounting practices as the determining method, the court found that the parking lot repairs were of a capital nature and not recoverable by the landlord.

This case underlines the necessity of ensuring common understanding in drafting and interpreting leases, particularly where a lease excludes recoverability or requires amortization of capital expenditures. The best way for parties to accomplish this is to properly define terms and discuss intent before the lease is signed; ideally, the lease will explain what is meant by a capital expenditure and provide examples. Alternatively, parties may wish to consider a monetary threshold for expensing repairs fully in the year in which such expenses are incurred. For example, the parties may

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decide that any expenditure over C$200,000 must be amortized over the useful life of such item or a specified term, such as 10 years. Finally, parties should take care to identify the appropriate accounting standards that will govern any such determination in advance – whether GAAP, International Financial Reporting Standards or tax accounting standards – and understand the resulting treatment of capital and other expenditures thereunder.

DANGERS OF "LEFT-OVER" TAX LANGUAGE IN LEASES

It is not uncommon for standard commercial leases to allow for determination of a tenant's share of realty taxes with reference to separate assessments, notwithstanding that separate assessments have not been available in Ontario since 1998. However, the recently decided case of *Terrace Manor Limited v. Sobeys Capital Incorporated* underscores the need for landlords to look more closely at their standard form leases.

The facts of the case in front of the Ontario Superior Court were relatively simple. The lease provided, as many still do, that if separate tax assessments for the leased premises were not made available, the parties would use reasonable efforts to have them made available, and failing that, to obtain "sufficient official information" to determine what such separate assessments would have been if they had been made. If a separate assessment was not available, the tenant would be responsible for its "share" of taxes in respect of the leased premises. The tenant's share would be determined by the landlord reasonably and equitably, having regard to the generally accepted method of assessment and applicable elements utilized by the lawful assessment authority in arriving at the assessment of similar developments, if known. The tenant would not be required to pay more than its proportionate share of such taxes. The landlord had charged the tenant on a proportionate share basis from 1998 to 2003, when the tenant disputed the allocation, whereupon the landlord began to charge the tenant on an assessed-value basis until 2009. In 2009, the landlord then renewed its attempts to obtain recovery on a proportionate share basis.

Both parties acknowledged that separate assessments were no longer available. However, Sobeys asserted that sufficient "official information" – namely the Municipal Property Assessment Corporation's (MPAC) working papers – existed in order to permit the parties to proceed on this basis. The court held that MPAC's working papers and valuation records were official and sufficient to permit the parties to determine what the separate assessment would be, had it been made, because such papers contained "all of the information necessary to work out how the current value was calculated for each of the units". Moreover, the court noted that it was untenable for the landlord to now argue that this method was unreliable when it had charged the tenant for half a decade on this basis. Although the lease stated that the tenant would not pay more than its proportionate share, this was the ceiling on their recovery, and the landlord could not simply assume that proportionate share recovery was the default, particularly when the lease required its allocation to be made with regard to "the generally accepted method of assessment". As such, the court agreed with Sobeys that its share should be determined on an assessed value, rather than on a proportionate share basis.

The court's decision in the *Terrace Manor* case might seem difficult to reconcile with its previous rulings regarding MPAC's working papers (see, e.g., *Indigo Books & Music Inc. v. Manufacturers Life Insurance Company,* and *Sophisticated Investments Ltd. v. Trouncy Inc.* among others). In particular, the court had ruled in such cases that MPAC's working papers were not reliable, and did not create a separate "assessed value" of the premises. In some respects, then, Terrace Manor could be forgiven if it had assumed the court would find that such papers could not be relied upon. Importantly, however, the language in Terrace Manor's lease did not appear to give the landlord any discretion in considering whether the working papers were *reliable* enough to determine a separate assessment – rather, the lease provided that, if *sufficient*, the parties were to use such papers to determine what the separate assessment would have been, had it been made. Further, even if separate assessments were not available, the lease provided that the landlord's determination should be made with reference to assessment methods. These distinctions seemed to make all the difference to the court.

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Like the other cases referred to in this article, the *Terrace Manor* case stresses the need to pay careful attention to the wording in the lease, rather than assuming that the parties will simply proceed in accordance with commercial norms. Courts will work hard to give effect to the intent of the parties, *whatever it might be*. While many landlords and tenants are "stuck" with leases that pre-date the elimination of separate assessments, both parties would do well to closely examine the wording of their lease to ensure that recovery of taxes is proceeding in the manner that the parties intended when they first struck the bargain contained in the lease. Landlords should also be careful not to compound any recovery problems by carrying over language from prior standard forms of leases into new leases. If the landlord's intent is to charge back taxes on a proportionate share basis, then it should say so; and if taxes on some portion of the development are to be excluded prior to the application of the proportionate share, the manner of determining the taxes attributable to such excluded portion should be clearly identified in the lease. Needless cluttering of the lease with left-over language from days when separate assessments were available can have dangerous consequences for landlords.

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