THE LATEST WORD ON THE LAW AFFECTING CONTROVERSIAL RENT RECOVERIES

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The majority of commercial leases are stated to be "net" leases. Whether the lease provides that it is a "net", "net/net lease", "absolutely net" or a "completely net and carefree" lease, the general intent on the part of the Landlord is that except as expressly set out in the lease, the Landlord is not responsible for any costs relating to the Premises while the Tenant is responsible for all such costs. The typical "net lease" provides that the Tenant will pay all, or its share of the Landlords costs and expenses incurred in connection with the maintenance, ownership, operation, repairing, replacing and administration of the project. While the net lease provisions, including the definition of "Operating Costs" or "Common Expenses", are most often drafted in a general and non-exhaustive manner, the typical commercial net lease goes on to provide a somewhat detailed and comprehensive list of charges which are recoverable by the Landlord under the lease, while at the same time stating that the listed items are not all-inclusive (e.g......including, but not limited to the following:) and do not in any way limit the generality of the net lease clauses or the landlord's right to recover any other costs incurred in connection with the maintenance, ownership, operation, repairing, replacing and administration of the project.

To emphasize the intent to make the net lease provisions as non-exhaustive as possible, and to allow the recovery of the widest range of costs, a lease is often stated to be a "net/net", "absolutely net" or "completely net and carefree". However, such a statement of intent will not, by itself, allow the Landlord to recover every single cost and expense incurred by the Landlord in relation to the maintenance, ownership, operation, repairing, replacing and administration of the project. Over the last approximately twenty years, the courts have imposed restrictive guidelines. Certain costs and expenses are not recoverable by the Landlord even in the face of general express statements that the lease

is "net net", or, even "triple net", unless the lease contains express language permitting the Landlord to recover them. This paper will focus on the interpretation of "net" lease clauses and the current status of the law relating to controversial rent recoveries .

A. ADMINISTRATION AND MANAGEMENT FEES

One area where the courts have provided guiding principle concerns administration fees and management fees. The typical commercial net lease will include, as part of its operating costs definition, a statement that requires the tenant to pay 15% of the total of the operating costs listed in the definition (although it is often stated not to apply to taxes charged under operating costs). In the case of office leases, and some retail leases, the administration fee is often expressed as a percentage (usually 3% or 4%) of the gross rentals received from the project. The landlord's explanation for these charges is that they represent a fee covering the head office costs and expenses of providing administration services for the project. A landlord may also retain a management firm and consultants to carry out the services required to operate and maintain the project and may seek to charge the tenants the management and consulting fees as operating costs. The landlord might also seek to recover both an administration fee and the management fees paid by it.

The current general principles concerning recoveries of administration and management fees can be summarized as follows:

(i) The fact that a lease is a "net lease" will not, by itself, allow the recovery of a percentage fee for administration, but if the lease requires the tenant to pay a share of operating costs, fees paid to a management company to operate the project are recoverable. [1]

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[1] 789247 Ontario Inc. v. 215 Piccadilly Properties Inc. (1991), 20 R.P.R. (2nd) 294, (Gen. Div.) Affirmed [1992], O.J. No. 214 (C.A.) (Granger J.); Dylex Ltd. v. Premium Properties Ltd., Ontario Court of Justice (Gen. Div.) [1996] O.J. No.2165, appeal dismissed [1998] O.J. No.

(ii) If a net lease expressly allows the recovery of management fees, the landlord , if it performs the management services itself, is entitled to charge a reasonable fee for those services, which may be a percentage fee, and the fee will apparently be recoverable even if the services are internal management services[2] but not if the lease requires that all operating costs be substantiated by paid invoices[3].

(iii) If a net lease states that the landlord may recover its costs of maintaining (i.e. operating or managing) a project and in addition, may recover a fee (often expressed as a percentage of operating costs) the landlord is entitled to hire a property manager to perform the maintenance, operation, or management, and still recover the percentage fee. [4]

(iv) If a net lease makes express provision for recovery of both management fees paid to third parties for management of the project, and a percentage fee as a cost of overhead, they will both be recoverable and no duplication of costs recovery will be found to exist.[5]

(v) If a lease is a net lease but makes no express provision for recovery of operating costs for the project (as opposed to operating costs for the leased premises or as opposed to taxes, insurance and maintenance costs for just the common areas) and

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1748 (Ont. C.A.); Faema Co. (Canada) v. Hammerson Mississauga Inc. (1991), O.J. No. 627 (Gen. Div.)

[2] Hardwick & Hardwick Meats Ltd. v. 471477 Ontario Ltd. [1991] O.J. No. 2057 (Gen. Div.).

[3] Dylex Ltd. v. Premium Properties Ltd., Ontario Court of Justice (Gen. Div.) [1996] O.J. No.2165, appeal dismissed [1998] O.J. No. 1748 (Ont. C.A.)

[4] 789247 Ontario Inc. v. 215 Piccadilly Properties Inc. (1991), 20 R.P.R. (2nd) 294, (Gen. Div.) Affirmed [1992], O.J. No. 214 (C.A.) (Granger J.);

[5] Han v. 9938 Investments Inc., British Columbia Court of Appeal January 13, 1995

makes no express provision for a percentage fee on operating costs or otherwise, then no management fee paid to a third party for managing or operating the project will be recoverable, and no percentage fee will be recoverable[6]

"INTERNAL MANAGEMENT COSTS"

One aspect of the courts' treatment of administration fees which should be discussed concerns the concept of internal management fees. The fact that a lease is stated to be a net lease, or a net/net lease will not, by itself , allow the recovery of "internal management fees or management's rental insurance to protect its own interest under the lease because such have nothing to do with the maintenance and operation of the premises".[7] Internal management fees are fees for the performance of duties that would normally be done by a landlord for its own interest. For instance, the collecting of rent, the banking of rent, the keeping of accounts in respect of rent paid and not paid and the keeping of accounts in respect of such matters as realty taxes, insurance charges, common area maintenance charges, the hiring of contractors or workmen to perform common area repairs or maintenance, are all duties that the landlord is expected to perform.[8]

In the case of *Lik Cue Co. Ltd. v. John Ingle and John Ingle and Associates*, an offer to lease only was signed; no lease was signed. The offer to lease provided;

"The rent herein. . . is a net, net rental... and the Lessee agrees to pay ...its

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[6]R. Denninger Ltd. v. Metro International General Partner Inc. (1992) 8 O.R. (3d) 720 General Division; Carbrig holdings Ltd. v. Olympia Tile International Inc. April 29, 1992 Ont. Court of Justice General Division

[7]Lik Cue Co. Ltd. v. John Ingle and John Ingle and Associates, Supreme Ct Of Ont. Sept. 22,23 .24. 1980 unreported

[8]R. Denninger Ltd. v. Metro International General Partner Inc. (1992) 8 O.R. (3d) 720 General Division;

> proportionate share of the realty taxes, hydro, heat, water, insurance and maintenance related to the space."

The defendant, landlord, argued that the offer was not a binding agreement to lease because the use of the term net rental without setting out the details of what was included in the rent made the agreement void for uncertainty. The defendant's lawyer cited a passage from an early edition of Williams and Rhodes to the effect that the terms net or net/net were not terms of art and considerable disagreement might be had.

The Judge pointed out that the edition was outdated. He cited with approval, the following often quoted passage from the *Re Kosmor Construction Inc. v. Rusonik*[9], (which although obiter dictum (ie, a statement of a judge"s opinion concerning a legal principle that is not necessary for the decision and therefore not binding.):

> "The inclusion in the offer to lease of the expression"net-net" makes it quite clear, in my judgement, that the landlord in calculating actual maintenance and utility costs, is entitled to include charges for all maintenance and utility costs; that is, that the determination of what is included in the category of maintenance and utility costs is to be arrived at by deciding any doubtful matter in favour of the landlord. Thus if the tenant were to claim a refund on the ground that the actual charges were not as high as the landlord represented them to be because they included matters that should not properly be included in maintenance and utility costs, I would expect the construction of maintenance and utility costs to be as broad as possible."

He then stated:

> "A net/net lease can be clear and concise and if there is a dispute between the parties then the preference is in favour of the landlord. There is nothing to say that persons dealing with small areas of rental space cannot agree to a net/net lease

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[9]Re Kosmor Construction Inc. v. Rusonik 22 O.R. (2d) 814, January 24, 1979

and incorporate such in a few paragraphs or a few pages. The term is well understood and can be enforced. While it may be unnecessary for me to say so, I am of the opinion that net/net includes all administrative expenses of the landlord applicable to the maintenance and operation of the premises as such but that it would not include such items as internal management fees, or management's rental insurance to protect its own interest under the lease because such have nothing to do with the maintenance and operation of the premises."[10] Note this statement quoted above is also obiter dictum (meaning a statement of a judge"s opinion concerning a legal principle that is not necessary for the decision and therefore not binding.).

In the leading case of *R. Denninger Ltd. v. Metro International General Partner* an agreement to lease was signed in 1976. Clauses 10 and 11 were as follows:

> "(10) The lease shall be absolutely net to the lessor so that the rent hereunder and thereunder payable shall be absolutely net save and except that the lessor shall be responsible to complete the demised premises and pay thereafter during the Term only structural, wall and roof repairs (excluding windows and doors) . . .
>
> (11) The lessee agrees to remit to the lessor (or its Agent) as rent within 15 days of invoicing, the lessee's share of realty taxes, insurance charges, common area maintenance charges and all other charges which may properly be assessed to the lessee in accordance with the intent expressed in Clause (10) above. . . . all fuel, hydro, water, interior maintenance and cleaning charges and rates, and all other operating expenses related to the demised premises shall be arranged by and be the sole responsibility of the lessee."

Metro purchased the property from its previous owner on April 30, 1986. (The agreement to lease was dated May 9, 1976). Metro hired Lehndorff as a property manager in 1988. Previously, the owners of the property made no claim for a management mark up.

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[10]Lik Cue Co. Ltd. v. John Ingle and John Ingle and Associates, Supreme Ct Of Ont. Sept. 22,23 .24. 1980 unreported

The landlord took the position that a management fee is recoverable under clauses (10) and (11). They argued as well that an auditor's report of rechargeable operating expenses together with a separate calculation sheet applicable to the tenant's tenancy entitled them to recover a management fee.

The management agreement with Lehndorff required it, as manager, to take responsibility for "renting the premises; hiring and supervising the labour and employees necessary for the maintenance of the premises; collecting the rent; refunding the last month's rent at the expiration of a lease; insuring the premises; purchasing supplies; paying the bills for the utilities, taxes, advertising costs, wages, mortgage payments, insurance premiums and repairs and alterations; and setting up and operating a management office on site at no cost to the agent. The agent undertakes to render monthly statements and to remit to the owner the net amount collected after deducting all disbursements and expenditures incurred by the agent in the exercise of the duties conferred upon and pursuant to the agreement."

The agreement also provided for the agent to receive a leasing commission, a supervisory fee for rehabilitation and construction, and a fee for insurance claims supervision in addition to the management fee.

The rechargeable operating expenses statements indicated that certain of the charges arising under the property management contract were sought to be passed on to the tenant in a proportionate share. It was explained that this was the yearly fee charged by Lehndorff to manage the property.

Concerning the issue of whether the word "absolutely net" allowed the landlord to charge for the management fee that it paid to the property management contract, the judge

referred to the numerous cases on point[11]

The "Lik Cue Case" was taken as supporting the position of the tenant on this issue. The judge referred to the quotation by Steele J. in the Lik Cue Case in which Steele adopted the reasoning of Southey J. from the Kosmor Construction case concerning the meaning of "net lease".

White J. stated:

> "Applying this reasoning to the case before him, Steele J. stated
>
> > "While it may be unnecessary for me to say so, I am of the opinion that net/net includes all administrative expenses of the Landlord applicable to the maintenance and operation of the premises as such but that it would not include such items as internal management fees or management rental insurance to protect its own interest under the lease because such have nothing to do with the maintenance and operation of the premises."
>
> It would seem, therefore, that if the fee can be characterized as a cost of internal management, the lessor cannot pass that cost onto the tenant under a net lease."

He then referred to Clauses (10) and (11) and concluded that they mean that any operating expenses relating to the demised premises were to be paid by the lessee. He noted that neither the original owner or the landlord, when the agreement to lease was entered into, addressed the issue of a management fee. Moreover, for several years no attempt was made to levy on the tenant a management fee under the aegis of clauses (10) and (11).

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[11]Dalfen's Ltd. v. Bay Roberts Shopping Centre Ltd. ; Hardwick & Hardwick Meats Ltd. ; 789247 Ontario Inc. v. 215 Piccadilly Properties Inc. ; Faema Company (Canada) Ltd. ; Lik Cue Co. Ltd. v. John Ingle

The standard lease form specifically allowed for management fees plus an administration fee of 15% but, that standard lease had never been signed by the tenant. The judge then stated:

> "Steele J.'s application of the reasoning of Southey J. indicates that internal management fees are not an administrative expense of the landlord applicable to the maintenance and operating of the premises and, therefore, not an expense chargeable to the tenant in a net net lease.
>
> In the case at bar, the lessor has already passed on the costs of general administrative expenses (salaries and benefits) building and equipment maintenance, general maintenance (in 1988) and "other in 1989 and 1990. The management fee is in addition to these costs. While this fee is an actual cost of the landlord in that it pays that fee to Lehndorff pursuant to a property management contract, the previous landlord apparently carried out these duties as internal management responsibilities and did not pass the cost of performing them on to Denninger. It is unreasonable, in my opinion, that by entering into a property management contract with another party, a landlord can incur a management fee as an actual cost and pass it on to a tenant who continues to occupy the same premises under the same agreement to lease as before the execution of the property management contract.
>
> I am therefore of the opinion that the following common area expenses in a proportionate share can be passed on by the landlord to the tenant under clause (10) of the agreement to lease: building maintenance and repairs, equipment maintenance and repairs, cleaning, snow removal, security, utilities, general maintenance expenses, insurance, realty taxes, garbage removal, water and sewage and the like but that fees generated under the management contract between Metro and Lehndorff are not recoverable by the landlord."

Referring again to the matter of the correct interpretation of Clauses (10) and (11) of the agreement to lease the judge concluded that the tenant should not be responsible under the concept implied in the words "absolutely net" for the payment and performance of duties that would normally be done by a landlord in its own interest. For instance, the collecting of rent, the banking of rent, the keeping of accounts in respect of rent paid and rent not paid and the keeping of accounts in respect of such matters as realty taxes, insurance charges, common area maintenance charges, etc. are all functions that would normally be done by a landlord. Further, matters such as the hiring of contractors or workmen to perform common area repairs or maintenance are duties which the landlord is expected to perform. The judge concluded:

> "The fact that Metro delegated its ordinary landlord's duties to an agent does not vary the quality of those duties. Those duties are essentially landlord's duties. Charges for the performance of landlord's duties should not be passed onto a tenant whether the words seeking to create a net lease are the words "absolutely net", "net net" or "net" or any other words of similar implication. If the landlord would have the tenant pay for some agent to perform the ordinary duties of a landlord then it is the responsibility of the landlord to insert a term to that effect into the agreement to lease."

The judge held that the management fees were not properly passed on to the tenants and that an accounting would need to be made to determine what the actual costs of the landlord without provision for any payment of the commissions, mark ups or administrative charges charged by Lehndorff for Metro for performing the functions that Metro, as landlord would normally perform for itself would need to be conducted.

B. CAPITAL COSTS, AMORTIZATION AND DEPRECIATION

A second area where court guidance has been obtained concerns capital costs. The definition of "Operating Costs" in most commercial leases specifically includes capital costs, although tenants however, generally take the position that they should not be responsible for them. Landlords will usually succeed in including capital costs but there is often considerable debate concerning which capital costs will be included and how those costs are to be passed on to the tenants. The debate relates to whether capital costs will be fully charged in the year the cost was incurred, whether the cost will be depreciated or amortized, whether interest on the undepreciated or unamortized portion of the cost will be added into Operating Costs, and what method of depreciation or amortization will be used.

Before discussing the controversy, it will be useful to explain briefly the concepts of "Capital Costs", "Depreciation" and "Amortization" in the context of commercial leases.

Capital Costs

In accordance with generally accepted accounting principles, "Capital assets, comprising property, plant and equipment and intangible properties, are identifiable assets that meet all of the following criteria:

(a) Are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance or repair of other capital assets;
(b) have been acquired, constructed or developed with the intention of being used on a continuing basis; and
(c) are not intended for sale in the ordinary course of business.[12]"

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[12] CICA Handbook, The Canadian Institute of Chartered Accountants.

In the context of Operating Costs definitions in commercial leases, a capital cost is an amount expended to acquire or replace, to add to, or to do a major repair of the equipment, buildings or improvements forming part of a project. Examples of capital expenditures in the context of a commercial lease include, the installation of a new heating system[13], the cost of replacing the majority of a roof[14], the costs of paving, lighting and striping a parking lot that had been previously unpaved and unlit.[15]

The distinction between capital costs and current expenditures is important as a lease expressed to be a "net lease" will not, in itself, allow for recovery of capital repairs or replacements[16]. In *789247 Ontario Inc. v. 215 Piccadilly Properties Inc.* the lease contained the following definition of operating costs:

> "Operating Costs means the total amount paid or payable whether by the Landlord or others on behalf of the Landlord for complete maintenance of the Premises and all improvements thereon, such as are in keeping with maintaining a first-class standard for the building complex, which operating costs shall include the following:
>
> (a) the cost of providing electricity not otherwise chargeable to tenants;
>
> (b) fire insurance costs;
>
> (c) casualty, liability and other insurance cost;
>
> (d) other utility costs not otherwise chargeable to the tenants;

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[13]*Tom Jones and Sons Ltd. v. Obodynski*, 1993 O.J. No. 1135 (Ontario Court of Justice (Gen. Div.), Kozak J., May 12, 1993)

[14]*Alderman Holdings Inc. v. McCutcheon Business Forms Ltd.*, [1997] O.J. No. 4386 (Ontario Court of Justice (Gen. Div.), Belleghem J., October 23, 1997)

[15]*9247 Ontario Inc. (c.o.b. Waldo's of London) v. Piccadilly Property Inc.*, [1991] O.J. No. 855 (Ontario Supreme Court - High Court of Justice, Granger J., May 2, 1991) reversed O.J No. 1214 (Ontario Court of Appeal, Robins, Tanopolsky and Weiler JJ.A., **June 16, 1992)**

[16]789247 Ontario Inc. v. 215 Piccadilly Properties Inc. (1991), 20 R.P.R. (2nd) 294, (Gen. Div.) Affirmed [1992], O.J. No. 214 (C.A.) (Granger J.);

(e) an administrative fee of 10% of such maintenance costs;

(f) all other expenses paid or payable by the Landlord in connection with the operation of the Premises including property taxes not otherwise payable by the Tenants.

The trial judge concluded based on the wording of this clause that the cost of paving the parking lot which was unpaved at the time the leases were signed, despite being a capital cost was recoverable along with the cost of erecting, illuminated signs, posts, striping the parking lot, and the business taxes paid by the parking lot operator to which the parking lot was leased. However, on appeal, the Court of Appeal reversed the trial judge with respect to the recovery of capital costs and held that paved parking lot improvements had nothing to do with maintenance and therefore were not recoverable.

Where the lease does not expressly permit the recovery of capital costs, the Landlord will prefer to classify expenditures as current expenditures and not capital expenditures so that the expenses can be recovered from tenants under the definition of Operating Costs. In addition, most commercial leases that permit the recovery of capital costs provide that capital costs are not to be fully charged in the year expended but rather depreciated or amortized over the life of the item in question together with interest on the unamortized or undepreciated portion of the expense.

The underlying principle as to the distinction between capital expenditures and current expenses in the context of repairs, maintenance and alterations, can be simply stated as follows:

"An expenditure in one fiscal period that enhances, substantially improves, enlarges or prolongs the life of an asset beyond that period, is a capital outlay. In contrast, an expenditure that merely maintains an asset or restores it to its original condition

is a deductible current expense."[17]

"The characterization of expenditures is a factual determination in the context of broadly defined legal principles."[18]

It has been said that while there is no single one test that can be applied to all circumstances, "there are however, three broad criteria that offer a useful starting point in determining whether an expenditure is on account of capital or revenue:

1. The character of the advantage or enduring benefit sought, and how permanent the benefit (the more enduring the benefit the more likely that the expenditure is on account of capital);

2. Recurrence and frequency of the expenditure (the more frequent the expenditure the less enduring the benefit);

3. Identification of the payment as surrogatum for expenditures that would be on account of capital or revenue (a substitute for a capital expenditure is more likely a capital expenditure."[19]

Amortization and Depreciation

When a capital cost is incurred, in effect, a quantity of usefulness over a period of years equal to the life of the asset is acquired. Since the life of the asset is limited (everything wears out sooner or later), this quantity of usefulness is also limited and will, in effect, be

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[17]Fundamentals of Canadian Income Tax, 5th Ed., Vern Krishna, CGA Tax Research Centre (University of Ottawa), Carswell Thomson Professional Publishing, at p.362

[18]Ibid at P.364

[19]Ibid at P.364

used up by the end of the asset's useful life.

The Canadian Institute of Chartered Accountants ("CICA") defines amortization as "the writing off, in a rational and systematic manner over an appropriate number of accounting periods, of a balance in an account"[20]. It is also defined as "the charge to income which recognizes that life is finite and that the cost less salvage value or residual value of a capital asset is allocated to periods of service provided by the asset"[21]. In accordance with CICA, amortization may also be termed depreciation. In effect "depreciation is another form of amortization, applied to tangible fixed assets"[22].

The effect of amortizing or depreciating capital costs is to spread out the capital costs over the asset's expected useful life. Interest is also charged on the unamortized or undepreciated balance of the capital costs so as to reimburse the landlord for the cost of the funds which it has expended and made available to the tenants. Many tenants will insist that any administration or management fee charged under the lease not apply to the interest charged on the unamortized or undepreciated balance of the capital costs, a request that although may seem reasonable is practically a problem for a landlord as the landlord's books will not likely break down the interest component of the amortized or depreciated costs making it extremely difficult for the landlord to comply with the exception granted to the tenant.

The most common method of amortizing capital costs in a commercial lease is by a "straight line" method which reflects a constant charge included in operating costs determined over the asset's relatively useful life. The alternative approach is a "variable" or "accelerated" method which can lead to higher charges during the earlier years of an

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[20]See *Terminology for Accountants*, 4th ed., The Canadian Institute of Chartered Accountants, 1993, p.11.

[21]CICA Handbook, The Canadian Institute of Chartered Accountants, Par. 3060.33

[22]See footnote 21 above

asset's life, the method least preferred by tenants.

The Controversy

Landlord's Position

Landlord's generally believe that certain capital costs such as (a) the original cost of heating, ventilating and air conditioning machinery or energy conservation systems, (b) the cost of capital improvements which would result in operating costs savings or will provide greater comfort and convenience to tenants and customers of the project, (c) maintenance, cleaning and operating equipment, master utility meters and all other facilities, improvements, fixtures and installations that are part of the common areas and facilities, and (d) renovations of the common areas and facilities, should be included in a lump sum where they do not result in excessive increases year over year, or in the form of depreciation, as operating costs of which the tenants pay their proportionate shares as additional rent under the lease. Landlord's also maintain that the cost of major repairs and the capital costs of replacements in respect of the project (including, for example, the cost of replacing a roof or repaving a parking lot) should be included in operating costs either as a direct charge for the full cost in the year the expenditure is made, or in the form of depreciation or amortization. The Landlord's position is that because these systems and equipment require periodic replacement, and to avoid the entire cost being charged fully in the year in which it is incurred, depreciation or amortization of this type of expenditure should be charged as an operating cost.

In addition to the amortized or depreciated amount, interest is also charged to the tenants on the undepreciated or unamortized portion of such costs. The purpose of the interest charges are to reimburse the landlord for the cost of funds which it has expended and made available to the tenants.

Tenant's Position

Tenant's on the other hand, take the position that the basic rent which they pay for their premises in the project is supposed to cover the costs of acquiring and constructing the project as well as the cost of major repairs and the replacement of major components of the project. They view the basic rent as a amount paid in consideration of obtaining use of not only the premises that they occupy but a fully completed, properly constructed building together with common facilities in good condition and repair, free of defects. They believe that if the landlord charges to them the cost of doing major repairs to the building, replacing major components of it, or the cost of providing operating equipment such as HVAC units, the landlord is passing on to the tenants capital expenditures which should be included in the basic rent. Their view is that only expenditures that are expense items are properly included in operating costs. Notionally, the basic rent covers the depreciation expense in connection with the capital cost of the project (together with interest, a reasonable profit on the original capital costs and amortization of the cost of the land on which the project is located). Accordingly, any attempt to pass on to the tenants capital costs is regarded as charging a kind of double rent.

<u>Comments on Tenant's Position</u>

In theory, the tenant's position seems reasonable. However, the following observations should be noted:

1. The life expectancies of heating, ventilating and air conditioning equipment, security systems, and operating equipment are much shorter than the life expectancies of "bricks and mortar" of the building and therefore the cost of these items is best treated separately from the "bricks and mortar" and the land cost that the basic rent covers. For that reason, some form of depreciation or amortization on HVAC units and other operating equipment is usually charged as an operating cost and interest on the undepreciated balance of the cost of the equipment is also included as an operating cost. (The theory for charging interest is that the landlord, when it purchases the equipment, pays for it in full and, it is in a sense, making available to

the tenants in the shopping centre, funds in a kind of notional loan for the acquisition of the equipment. On this theory, the rate of interest that the landlord charges on the undepreciated balance is not the actual cost at which the landlord borrows funds, but rather the rate of interest that funds would be loaned for the purpose of acquiring such items to a typical borrower. The landlord regards itself as a kind of bank or lender in this situation and charges a rate which is usually equal to at least two percent (2%) over "Prime").

2. The Equipment and other improvements might just as readily be leased by the landlord for the project instead of being purchased. In that case the equipment rentals would be included as operating costs. (They would be expenses and not capital expenditures.) Rental payments under equipment leases include both depreciation and interest components at market rates. (In fact, landlords will sometimes dispose of operating equipment owned by them, and replace it with rented equipment where their leases of space do not contain operating cost definitions that enable them to pass on the capital costs of operating equipment in the form of depreciation, and to charge interest on the undepreciated balance of the capital costs.)

3. The tenants position ignores the commercial reality of leasing. It assumes that landlords, when they are negotiating basic rent, will take into consideration the cost of anticipated major repairs and replacements and will pass the anticipated costs on to tenants in the form of basic rent. That is simply not feasible. Even if the landlord could accurately predict the capital expenditures that would be required over the term of the lease, it would seldom succeed in getting the tenant to agree to a higher rent as the result of the need to make those capital expenditures. The reality is that the tenant takes the project on an "as is" basis and that the contingency of major repairs or other capital expenditures has the effect of depressing the basic rent that the tenant would otherwise pay. It should be noted too, that the tenant is usually in a better position than the landlord to take the risk

of these contingencies in that the landlord's only source of income is the rent it collects. If it does not have rental income to pay these costs it must go bankrupt. Tenants on the other hand generate their revenue through sales, and in the operation of their businesses in the premises.

Basic rents are governed more by what the market will bear than by an analysis of capital costs and projected capital costs for a project. Basic rents reflect a net leasing concept under which capital costs are in fact passed onto tenants. A developer that seeks to increase rents in connection with the project in order to cover the cost of major capital repairs or improvements will find that it is competing against other projects where rents are structured on the basis that the cost of these items will be passed on to tenants as operating costs. it will find therefore that it is unable to attract tenants unless it reduces the basic rent to a competitive level. If it does so without including in its lease the right to recover from tenants the cost of major capital repairs or other capital expenditures it will eventually go bankrupt.

It is primarily due to the considerations noted above that it is increasingly accepted that capital costs will not be excluded from operating costs simply by virtue of the fact that they are capital and not expense items. However, having passed that hurdle, there are still a number of related issues to address.

Sub-Issues

The following are a number of comments concerning sub-issues in the "capital costs expense" controversy.

(i) Forced Depreciation or Amortization

Tenants would prefer that, when a capital expenditure is made which is to be included in operating costs, (a) the cost be depreciated, (b) the useful life of the asset for the purpose of depreciation be as lengthy as possible, and (c) that a straight line method

of depreciation or units of production method (depending on the nature of the asset) and not an accelerated method (declining balance or sum-of-the-years-digits) be used. They are concerned that the landlord may elect to pass on the full amount of a capital cost in one year instead of depreciating or amortizing it. This would be particularly burdensome to a tenant who is faced with this cost in the last years of the term of its lease and is therefore not in a position to benefit from the cost of the capital expenditure. A similar concern arises where the landlord elects, instead of amortizing or depreciating at a uniform rate, to use an accelerated method of depreciation or amortization in respect of a capital cost incurred in the later years of the tenant's term.

A separate concern is that the landlord may not use a generally accepted accounting method of depreciation or amortization but may, instead elect to adjust the amounts of depreciation or amortization it charges in respect of capital expenditures on a year-by-year basis, having regard to the level of other operating costs from year to year, with the objective of evening out the overall operating costs from year to year, with the objective of evening out the overall operating costs from year to year. Landlords, however, believe that they need to maintain flexibility, and will insist upon being able to decide (a) whether or not to depreciate or amortize instead of charging the costs in full in the year they are incurred, (b) whether to use a straight line method or another method, and (c) whether or not to follow generally accepted accounting practices, in accordance with prudent management practice.

(ii) <u>Renovations</u>

When capital improvements to the project are necessitated as the result of expansions, renovations or modifications to parts of the project other than the premises, the tenant will object to being required to pay those costs, particularly where the tenant feels that it is getting no direct benefit from such improvements. For example, when it is necessary to install sprinklers and fire retardant features in a project simply because another tenant with expansion rights (perhaps a department store) applies for a building

permit and a condition of the permit is the installation of sprinklers in the balance of the building or the addition of extra fireproofing or safety standard improvements, the tenant feels the landlord should be responsible. Similarly, a tenant that is presented with a bill for its share of operating costs which include the cost of constructing new fountains, upgraded floors in the mall areas, and other capital improvements, may feel that they are not proper amounts to include in operating costs. The tenant may feel that these upgrades do not provide direct benefits to the tenant and the tenant might not be persuaded that by increasing the attractiveness of the project generally, the market value of all rentable space in the project increases. The tenant's right to assign or sublet its lease is usually severally restricted in major projects, so that it is difficult for the tenant to realize on any increase in the value of its space. If the tenant wishes to stay in the project at the end of the term under a new lease, it will have to pay an increased rent that reflects the value of these improvements although the tenant may, in fact, have paid its share of the costs of putting the new improvements in place.

A compromise might be for all capital costs relating to new improvements to be excluded except those that reduce operating costs such as, for example, energy-saving equipment, security systems that reduce vandalism or allow security staff reductions, or new floor surfaces that reduce maintenance costs.

While the underlying principles are easy to state it is the difficulty in applying the principles that leads to countless landlord and tenant disputes.

C. CAPITAL TAXES

1. What is a "Capital Tax"?

To understand the controversy surrounding capital taxes in the commercial lease context, it is necessary to first understand what capital taxes are, and how they are calculated by the taxing authorities.

Provincial Capital Tax

Capital tax is imposed by certain provinces (currently Ontario, Quebec, British Colombia, Saskatchewan and Manitoba) on corporations that have a permanent establishment in the province. The concept behind the tax is that not only should revenue earned in the province be taxed, but since the company owns facilities and resources in the province, it should also pay tax on the capital it employs in the province. The rates vary from province to province with the current rate in Ontario being 0.3%.

The basis for determining taxable paid-up capital differs in certain aspects from province to province but generally, the taxable paid-up capital of a corporation will include:

- its paid-up capital stock (which is the value of all the shares of the company, whether preferred, common or other, as depicted on the balance sheet of the company);
- earned surplus, capital and other surpluses;
- most reserves;
- amounts advanced or loaned to the company by its shareholders, by any person related to a shareholder, by any other corporation, or by the government;
- all of the company's indebtedness that is secured on any of its assets; and
- indebtedness represented by bankers' acceptances.

  (Investment allowances are provided for to avoid a duplication of taxation between corporations in situations such as where one corporation invests in the shares of, or makes a loan to another corporation, with the result that the financial statements of both corporations reflect the same capital.)

Computation of the tax is based on the financial statement of the corporation and the tax is payable regardless of whether the corporation earns income or not. It is a kind of annual tax on the money that a corporation has invested whether the corporation has earned, borrowed or otherwise acquired the money. Capital tax is not levied on a particular project

or property and no appraisal or valuation of any particular property or project is made in computing it.

When a corporation has permanent establishments in more than one province, since the tax is not based on physical assets situated in the province, but is collected in each province based on the balance sheet of the corporation, duplication in taxation would occur if there were not some kind of allocation formula. Accordingly, corporations can reduce the amount of capital tax payable to a particular province by an amount based on the taxable paid-up capital employed in the permanent establishments outside the province. The formula for allocating the taxable paid-up capital is the same as the one used in apportioning income for income tax purposes. It reflects (a) aggregate salaries and wages paid by the corporation to employees in the permanent establishments in Canada, outside the province, compared to salaries and wages paid by the corporation in all Canadian jurisdictions, and (b) gross revenue reasonable attributable to the corporation's permanent establishments in Canada, outside the province, compared to total gross revenue of the corporation in all jurisdictions in Canada. In Quebec, the formula is different from the formula for the other taxing provinces, but the general net effect is similar. In Quebec, having regard to salaries, wages and gross revenue, you determine what proportion of a corporation's total taxable paid-up capital related to Quebec and you allocate into Quebec, whereas the formula for the other provinces requires an allocation out of the province in each case with the residual balance being taxed in the province.

Since the basis of determining taxable paid-up capital varies somewhat from province to province, a separate calculation has to be made for each taxing province in which the corporation has a permanent establishment.

Federal Large Corporations Tax

The Federal Government imposes a special "Large Corporations Tax" (under Part I.3 of the Income Tax Act (Canada)) on corporations whose taxable capital employed in Canada

at the end of a taxation year exceeds ten million ($10,000,000.00) dollars. The tax is currently levied at 0.225% on such excess amounts and is calculated in a manner similar to provincial capital taxes as discussed above. The ten million ($10,000,000.00) dollar capital deduction is allocated among related corporations. Accordingly, if the landlord corporation were to have related corporations with taxable capital employed in Canada, the net effect would be to increase the amount of Large Corporations Tax payable by the landlord because it would not get the full use of the initial $10,000,000.00 deduction.

2. The Controversy

Landlord's justify the charging of capital tax to tenants on the basis that the development and construction, or the acquisition of a project necessitates the borrowing and investing of capital. They point out that by calculating the landlord's development costs or its project acquisition cost, the amount of capital tax that the project actually attracts, on an annual basis, can readily be determined or at least estimated. The landlord maintains that, simply by virtue of the fact that it has developed or acquired a project, it has been required to acquire and invest capital and is required to pay annual capital tax on it whether the project is profitable or not. In this sense, capital tax is similar to a real property tax and unlike an income tax. Landlords also point out that if a tenant were to construct or purchase its premises instead of leasing them from the landlord, the tenant itself would be required to acquire and invest capital and would therefore attract capital tax. Based on these considerations, landlords will seek to include among operating costs a share of capital taxes that the landlord considers to be attributable to the project. Alternatively, some landlords will expand the definition of real property taxes (which are passed on to tenants) so that "real property taxes" are considered to include capital taxes.

Incidentally, this alternative method of recovering capital tax is often incorrectly executed. Lease forms that include capital taxes as part of the real property tax definition often do so by simply adding language to the affect that real property taxes will be deemed to include capital taxes. Unless capital taxes are also defined, and unless the method is expressly

stated for calculating those that are attributable to a particular project, it is almost impossible to say with certainty what the intention of the parties is. This is because capital tax is not imposed against any item of real property, nor is it calculated by any reference to any specific real estate asset. Any clause in a lease that is intended to impose capital tax as a charge or cost of the tenant should specify a method for calculating or deeming the tax attributable to the project, because the statute that imposes the tax does not do so.

Tenants argue that capital tax is not properly chargeable as an operating cost nor as a realty tax on the project because capital tax is based on the financial statement of the company and is not calculated on a project-by-project basis. They argue that it is in the nature of an income tax and therefor is not a proper inclusion even in a net lease. They are also aware that since the taxable paid-up capital of a company is based on its financial statement, it can be affected in a great variety of ways by decisions, adjustments, and changes made by the landlord in relation to its general corporate undertakings. There is, therefore, a major risk of unpredictable increases that have little or nothing to do with the operation of the project. In fact, a recent Ontario Court of Appeal decision sided with the tenants position in finding that the Ontario Capital Tax and Federal Large Corporations Tax were not taxes with respect to the leased land but rather they were taxes on the landlord's capital, and of a similar nature to estate, inheritance or income taxes.[23]

3. Landlords' Recovery - The Law

The current status of the law is that unless the obligation to pay for capital taxes is expressly included in the lease, the tenant will not be obligated to pay capital tax, as capital tax is considered to be personal to the Landlord and not an "operating cost" and would not

[23]Dylex Ltd. v. Premium Properties Ltd., Ontario Court of Justice (Gen. Div.) [1996] O.J. No.2165, appeal dismissed [1998] O.J. No. 1748 (Ont. C.A.).

be caught by the general net lease provisions.[24]

In *Dylex Ltd. v. Premium Properties Ltd.*, the Court adopted the reasoning of Mr. Justice Lane in *KPMG Peat Marwick Thorne and Johnson and Higgins Ltd. v. SPE Operations Ltd.* who held that a tax upon a landlord's capital is personal to the landlord and cannot be charged to a tenant failing an express provision in the lease permitting the recovery of such wealth taxes. Dylex's lease provided that Dylex would pay its proportionate share of realty taxes as well as "all other taxes...of any kind and nature whatsoever with respect to the said lands". The lease further provided that Dylex would not be responsible for the payment of any "estate, inheritance...or income taxes...or any taxes of a similar nature". The Court found that the Ontario Capital Tax and Federal Large Corporations Tax were not taxes with respect to the leased land but rather they were taxes on the landlord's capital, and of a similar nature to estate, inheritance or income taxes, for which the tenant was expressly excluded from paying for under the provisions of the lease.

The principles applicable to a landlord's right to recover wealth taxes, such as capital taxes, from a tenant are a further example of the Court's reluctance to imply that landlords can shift the burden onto tenants for those obligations which would normally be those of the landlord or which are not related to the leased premises or the project upon which the leased premises are located. Examples and clear language is needed in the lease or agreement for such a shift to occur.

D. ALLOCATION OF COSTS AND EXPENSES

If the lease is drafted to allow the landlord to do so, it may be able to recover more than

[24]KPMG Peat Marwick Thorne and Johnson & Higgins Ltd. v. SPE Operations Ltd. (1995) D.T.C. 5269; and Dylex Ltd. v. Premium Properties Ltd., Ontario Court of Justice (Gen. Div.) [1996] O.J. No.2165, appeal dismissed [1998] O.J. No. 1748 (Ont. C.A.).

100% of its actual operating costs[25] for a project. Operating costs can be a profit centre for the Landlord.

The typical method of allocating operating costs amongst tenants of the project is by way of "proportionate share", which is a fraction, the numerator of which is the rentable area of the premises and the denominator of which is the total rentable area of the project. However, there are several common variations.

(i) Retail: Landlord's of retail developments often use a "weighting formula" to distinguish between different types of space within the development. The numerator is defined as the "Weighted GLA of the Premises" while the denominator is expressed as "the Weighted GLA of the development".

The typical retail shopping centre premises will have a weighting of 1.00. A higher weighting is usually given to kiosk and food court premises as they are small in area and generate higher common area costs. These types of tenants can generate significant sales in a smaller area than they would have needed to rent if the mall or food court were not available. A lower weighting is often given to stores with no interior mall access or frontage to reflect the fact that they do not enjoy mall pedestrian traffic.

Most retail commercial leases exclude from the denominator the area occupied by tenants who do not contribute costs on the same basis as the majority of the tenants in the project (ie. pay their full proportionate share of operating costs). Kiosks are generally excluded as they are temporary in nature and often pay a flat fee towards operating costs. A shortfall would result if these rentable premises were not excluded. However, most of the leases provide (and if they do not tenant should ensure that the lease is so amended to provide) that any contributions to operating costs made by these

[25]Lou Vetesse Transport Inc. v. Cabano Transport Inc. (1996) 4 R.P.R. (3d) 227 (Ont. C.A.).

categories of excluded tenants, are deducted from Operating Costs.

Typical exclusions from the denominator of the proportionate share fraction are: (1) kiosks, (2) storage space, (3) free standing building, (4) theatres, (5) office space, (6) recreational/sports/health facilities. (7) day care facilities, (8) mezzanines, (9) government/community/charitable organizational space, (10) rentable premises with a GLA of over a defined threshold (usually 10,000 or 15,0000 square feet). These exclusions ultimately increase the tenant's proportionate share of operating costs and an efforts should be made by tenants to limit or reduce the exclusions.

(ii) Office: For office premises the numerator is expressed as the Rentable Area of the premises and the denominator is the Rentable Area of the office building.

Rentable Area of the Premises is generally defined as the Useable Area (the actual space used by the tenant) multiplied by a gross-up factor (often 10-15%) to give each tenant a share of the common areas on the floor. Where a tenant leases a whole floor, no gross-up factor is applied. Applying the gross-up factor ensures that the total area on a single tenant floor of the same size so no rent is lost. Rentable Area of the Building is equal to the total of the Rentable Areas of all Rentable Premises whether or not occupied, but should not include parking, storage or other miscellaneous use space. The BOMA standard is the common method of measurement for office premises.[26]

(iii) Multi-Use: Where a project is a combination of retail shopping and office

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[26]Published by the Building Owners and Managers Association International as an American National Standard ("ANSI"), the latest BOMA standards is ANSI/BOMA Z65.1-1996 and represents a change from the previous (1980) standard. The revised standard allows landlord's to recover rent on not only the common areas of multi-tenanted floors but also on building common areas that provide services to building tenants, such as lobbies, atrium spaces, concierge areas, lounges, loading docks etc.. Since Canadian landlords have not yet, for the most part, started to revise lease measurements this way, tenants should clarify how their space will be measured.

floors, the landlord will often set up separate operating cost centres for the 2 components and the tenants will pay their proportionate share of operating costs for the component they reside in. Some costs are inevitably shared between the 2 components and the landlord needs to be able to allocate costs between them. In very large retail centres, the landlord may set up separate cost centres for more than one defined retail area. For example, the food court may be treated separately or there may be different development phases or different ownerships involved. As well, where a one centre is linked to another complex, the landlord will require the ability to recover and allocate costs which are common or shared. For example there may be a shared parking lot or shared walkways. If the buildings are managed in common there would also be shared management costs,

(iv) Parking Facilities: Often ignored are parking garages or parking lots and the costs associated with maintaining, repairing and replacing and operating such parking facilities. Parking facilities are generally not treated as rentable premises within the project and are treated as part of the common areas. As such, all costs of operating and maintaining, the parking facilities would be included in operating costs.

There are few issues where such parking facilities are for the general benefit and use of all the tenants of the project and their invitees. However, issues will arise where the landlord imposes fees for parking within all or parts of the parking areas upon the project, or leases out the parking areas to companies who will manage and operate the parking areas. From the tenants perspective, as these areas are in essence being leased out to the parking lot operators, the parking area should be treated as rentable premises and all costs associated with such parking areas should be excluded from Operating Costs. Similarly, if a landlord is charging for parking upon the project, while at the same time passing on to the tenants all the costs associated with operating and maintaining the parking facilities (which could include fees being paid to operators of the parking facilities), there is a windfall to the landlord if the parking area charges are not credited against Operating Costs. Tenants should insist that all receipts from the operation of the parking areas be set-off against Operating Costs which would reduce the Tenant's proportionate

share of such costs. Landlord's will often agree, provided that it is only "net recoveries" received from the operation of the parking areas that are set-off against Operating Costs, but only to the extent of the total costs of maintaining and operating such parking facilities.

Landlord's Right to Allocate Operating Costs:

Landlord's often require the right to depart from proportionate share and exercise their discretion in allocating costs and expenses as amongst the various tenants in the project as it sees fit or using some standard of reasonableness, equity or good faith. The general premise being that if one tenant is using a disproportionate share of a certain expensed item, or if one tenant is not receiving the full benefit of the services provided by the landlord to the other tenants, the landlord can allocate the expense amongst the various tenants in the project so that the sharing of the expense is either "reasonable", "equitable", "fair" or such other term as may be negotiated in the respective leases with the tenants of the project. The question that one has to address is what is the difference between the terms "reasonable", "equitable", "fair" and "good faith"? Do some of these terms instill a greater onus, or degree of responsibility, upon the landlord when the landlord is considering how to make the allocations.

According to Blacks Law dictionary, 4th ed.:

"Equitable": is defined as (a) just; conformable to the principles of justice and right; and (b) Just, fair and right, in consideration of the facts and circumstances of the individual case.

"Fair": is defined as "just; equitable; even-handed; equal, as between conflicting interests."

"Reasonable": is defined as (a) just, proper; ordinary or usual; fit and appropriate to the end in view; and (b) thinking, speaking or acting according to the

> dictates of reason; not immoderate or excessive, being synonymous with rational; honest; equitable; fair; suitable; moderate; tolerable."

On the face of the definitions the "reasonable" standard appears to be a lesser standard than both "fair" and "equitable" as it speaks to being rational and moderate, suitable and tolerable as well as being fit and appropriate without stressing the circumstances of an individual case or even handedness. On the other hand an "equitable" standard elevates the standard beyond just being appropriate to the end in view, or not excessive, but a higher standard requiring consideration of the circumstances in each individual case and more than just an even handed approach. To agree to act "reasonably and equitably" would imply that the Landlord would have to look at the circumstances of each individual case in determining how to allocate the costs and expenses as opposed to considering the whole situation outside the scope of the impact on each individual tenant and its circumstances.

As for distinctions between acting "reasonably" and acting "in good faith", Sutherland J. in *Cadillac Fairview Corp. v. Canstar Sports Inc.*[27] implied that acting "reasonably" involved a higher standard than acting "in good faith". The court did not consider it necessary to discuss what it means to act reasonably but it did comment on what constitutes good faith. Acting in good faith involves not acting in a "capricious or colorable or unfairly harsh way". The case seems to draw a definite distinction by accepting that a person might well act in good faith and yet, not reasonable. For a detailed discussion concerning this case and the principles of good faith, please refer to the paper prepared by Francine Baker-Sigal and Jeanne Banka on Good Faith and The Tort of Negligent Negotiation, later in this program.

<u>Gross Up as if Fully Leased:</u>

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[27]Cadillac Fairview Corp. v. Canstar Sports Inc. [1991] O.J. No. 1560 (Ontario Court of Justice - General Division).

Landlord's should be entitled to gross-up operating Costs that vary with the level of the occupancy of the project so that the tenants pay their fair share. For example, if the tenant was the only occupant of an office tower and it occupied 50% of the tower, it would be unfair if the tenant paid only 50% of the janitorial costs (which are all incurred in that tenant's premises). When the cost is grossed-up to reflect full occupancy, the tenant then pays its appropriate share. Fixed costs such as insurance premiums should not be grossed up since these types of costs are not specific to the occupancy of any specific tenant.

Realty Tax Allocations:

Realty taxes in the province of Ontario have always been a hot bed of issues. Due to the changes in the Municipal Act and the Assessment Act that became effective in 1998 in Ontario, allocations of realty taxes became even more contentious. In Ontario there is now only one assessment for the entire property. It is no longer possible to get a separate assessment for a tenant in a multi-occupant project. Landlords want to make sure that they reserve the right to allocate taxes amongst the various tenants so that there is no shortfall. Real property tax problems are addressed in greater detail in the paper which will be presented by Natalie Vukovich and Dennis Daoust.

E. STRUCTURAL REPAIRS

Most standard form commercial leases allow landlords to recover the costs of structural repairs to the shopping centre through operating costs. However, an increasing number of standard form leases provide (and tenants are often successful in negotiating) that tenants are not responsible for the costs of repairing "inherent structural defects and weaknesses" in and to the premises and the shopping centre. The issue becomes one of deciding if the work would be construed as a repair of an inherent structural defect or weakness (the cost of which is not generally recoverable) or it might instead be considered as a cost of maintaining and operating the shopping centre (which will be recoverable under most leases if it is not a repair of an inherent structural defect or weakness).

Dictionary definitions such as that found in the Oxford Dictionary indicate that something that is "inherent" is a permanent intrinsic characteristic. Where the term "inherent defect" has been considered by courts, in relation to structure, it is clear that if there is a flaw in the original design of the structure, it will be considered to be an inherent structural defect. An example of this situation is set out in the case of Ravenseft Properties Ltd. v. Davstone (Holdings) Ltd. [1979] 1 All E.R. 929). In that case (the "Ravenseft Case") a building was built in England with a reinforced concrete frame and stone claddings at a time when the need for expansion joints was not yet understood. The lack of expansion joints in the cladding created a problem which required modifications to the cladding when it began to pull away from the concrete frame. The court had little difficulty in accepting the fact that the building, and in particular the cladding, had an inherent defect which required repair. The modification of the cladding was regarded as a repair of an inherent structural defect That case was referred to with approval in the Ontario Court of Appeal decision York Condominium Corp. No. 59 v. York Condominium Corp. No. 87, 42 O.R. (2nd) 337 (the "Condominium Case").

It is important to note that in determining whether there was an inherent structural defect or weakness, it is not the date upon which the work was originally completed that is determinative, but rather the date the upon which the repair or replacement is required to be completed. It is the standards that exist at the time the repair or replacement is required that will be applied to determine whether there was a flaw in the original design of the structure. Simply put, there may have been nothing wrong with the original design of the structure at the time it was built but, if the structure would not comply with the standards that exist at the time the repairs are taking place, a court would find that there was an inherent structural defect or weakness in the structure the cost of which would then not be recoverable from tenants whose leases contained terms similar to those discussed above. To rectify this apparent inequity, the language in the lease should be clear that it is only inherent structural defects or weaknesses that did not comply with design criteria that existed at the time the structure was designed and built, that will not be recoverable from tenants under operating costs. The fact that the design does not comply with current

design criteria should not be a factor.

F. SUMMARY

(i) Landlord Considerations

The "net lease" clause should provide that the lease is intended to be completely "net" or "carefree" to the landlord and that the landlord is not responsible for any costs or expenses related to the premises or the project, except as expressly set out in the lease, all of which shall be paid for by the tenant. The goal should be to draw the clause as wide as possible to cover even those costs which were not contemplated at the time the lease was entered into and such that nay question as to whether an item in question is changeable to the tenant will be resolved in the landlord's favor. The effect of such a provision was best stated by Southey J. in *Re Kosmor Construction Inc. v. Rusonik*:

> "The inclusion in the offer to lease of the expression"net-net" makes it quite clear, in my judgement, that the landlord in calculating actual maintenance and utility costs, is entitled to include charges for all maintenance and utility costs; that is, that the determination of what is included in the category of maintenance and utility costs is to be arrived at by deciding any doubtful matter in favour of the landlord. Thus if the tenant were to claim a refund on the ground that the actual charges were not as high as the landlord represented them to be because they included matters that should not properly be included in maintenance and utility costs, I would expect the construction of maintenance and utility costs to be as broad as possible."

In light of the recent cases referred to above in this paper, the proposition set out in the *Kosmor* case has been somewhat diluted. Costs which have nothing to do with the operation or maintenance of a tenant's premises or the project will not be recoverable under the typical all encompassing "net lease" clause unless the lease expressly provides for their payment by the tenant.

The definition of "Operating Costs" in the lease should take into account the following:

- The preamble to the definition should contain broad language which makes it abundantly clear that the specifically listed items are not all inclusive (including, but not limited to the following:);
- The definition should refer to all costs for the maintenance, operation, repair, replacement, management and administration of the project;
- Include costs whether paid or payable in a year;
- Include costs paid by the landlord or other on behalf of the landlord;
- Include costs in respect of the entire lands and the project (not just the common areas). For example, insurance is maintained on the whole project not just the common areas. Try and use the term "Operating Costs" as opposed to "Common Area Costs" so that the tenant understands that the recharges are associated with more than just the common areas;
- Include costs allocated to the lands and the development where appropriate. For example, a portion of the landlord's blanket insurance premiums should be allocated to each of the landlord's projects;
- Remember that having a different definition for "Operating Costs" for each tenant of the project will require the property manager to create customized statements which will create an administrative burden and a resulting increase in costs;
- Include costs calculated as if the project was 100% occupied by tenants. Landlord's should be entitled ton gross-up operating Costs that vary with the level of the occupancy of the project so that the tenants pay their fair share. For example, if the tenant was the only occupant of an office tower and it occupied 50% of the tower, it would be unfair if the tenant paid only 50% of the janitorial costs (which are all incurred in that tenant's premises). When the cost is grossed-up to reflect full occupancy, the tenant then pays its appropriate share. Fixed costs such as insurance premiums should not be grossed up since these types of costs are not specific to the occupancy of any specific tenant.
- Costs and expenses which are otherwise not recoverable by the landlord from the

tenant as they have nothing to do with the actual maintenance and operation of a project (such as capital taxes, administration and management fees) should be specifically included within the definition of "Operating Costs".

(ii) Tenant Considerations

Tenants should attempt to make the landlords usual broad preamble in the definition of Operating Costs in the lease restrictive. They should insist that the landlord state in clear terms a list of costs and expenses which will be passed on and that the landlord expressly acknowledges that only items on the list will be recoverable. If the tenant fails to convince the landlord to accept the principle of an "all inclusive" approach to the definition of Operating Costs that restricts Operating Costs to a definitive list, the tenant should insist on incorporating into the lease, a detailed list of items which would be either excluded or deducted from Operating Costs, which costs should be payable by the landlord to the complete exoneration of the tenant. (See Appendix "A" attached for a suggested list of tenant's exclusions and/or deductions from operating Costs);

The lease should state that there cannot be any duplication in the costs charged to the tenant under the definition of Operating Costs;

The general definition of Operating Costs should clearly specify that the Landlord may only include costs and expenses that are directly related to the project and for the specific benefit of the tenants of it. Tenant's should also limit the general definition of Operating Costs to "Operating or maintenance costs and not allow "ownership costs in as ownership items can include the following:

> the original cost, depreciation or amortization of the project; ground rentals; costs associated with any mortgages, loans or refinancings respecting the project; expenses incurred for replacements under warranty; professional

fees (including legal and accounting fees) related to the ownership, construction or leasing of the project; costs of correcting defects in the construction of the development; salaries for individuals beyond the level of development manager; overhead expenses not related to the project.

If the lease provides for the grossing-up of Operating Costs to amounts that would be incurred if the development was fully occupied, tenants of partially occupied projects should examine each cost item to ensure that it is specific to the occupancy of the particular tenant and not to the project generally.

It is best to exclude the allocation of any costs by the landlord among its various properties. If the landlord insists, then the tenant must ensure that the allocation is made on a reasonable and equitable basis and in a manner consistent with allocations made generally in the industry. Ideally there should be a specific formula stated for the allocation.

CONCLUSION

A landlord, needs to ensure that the definition of Operating Costs in its lease contains express provisions permitting the landlord to recover costs such as management fees, administration fees, capital and other wealth taxes, and capital costs. It is clear from the current state of the law that a landlord is not able to rely solely on the fact that a lease is stated to be a "net", "net/net", "absolutely net" or "completely net and carefree" lease if it wishes to recover costs such as these. Tenants on the other hand should make every effort to alter the definition of operating costs so as to ensure that it does not become a profit centre for the landlord at the tenant's expense. It must be remembered that although items such as internal management costs, capital taxes and capital costs, are not recoverable, they can certainly be made recoverable by means of appropriate express wording. Also, Tenants can take comfort in the knowledge that courts will imply an obligation for landlords to act in good faith when making apportionments and allocations that are provided for in the lease but they need to be aware, that a landlord acting in good

faith in making an allocation or apportionment does not (it seems) have to act reasonably. The ultimate advice for both landlords and tenants is to take great care in drafting operating costs definitions.