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**"PRACTICAL GUIDE TO DRAFTING AN EFFECTING
COMMERCIAL LEASE: UTILIZING AND PROTECTING
YOUR COMMERCIAL PROPERTY
– TYPES OF COMMERCIAL LEASES –"**

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**Practical Guide to Drafting an Effecting Commercial Lease:
Utilizing and Protecting Your Commercial Property
– Types of Commercial Leases –**

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This paper describes the broad categories of commercial lease. By way of introduction, it is important to know what constitutes a lease and to be able to distinguish a lease from a license.

THE DISTINCTION BETWEEN A LEASE AND A LICENSE AGREEMENT

The Nature of Leases

A lease of real property is a contract between one party, the landlord, and another, the tenant, under which the landlord grants to the tenant the right of exclusive use of identified property for a determinate period of time in consideration for which the tenant agrees to pay rent to the landlord. The term can be virtually any length of time so long as it is determinate. The key element of the lease is that the contract creates an interest in property which enables the tenant to claim and defend a right of exclusive possession against third parties. The tenant's right to treat intruders as trespassers and to evict them is not dependent on cooperation from, or any action on the part of, the landlord but is a

right enforceable directly by the tenant in the property. When a landlord and tenant relationship is created (i.e., when a lease exists), a number of important rights flow from the relationship. The tenant, as a tenant, holds what is referred to as a leasehold estate. In other words, it has an estate or interest in the leased property and, accordingly, is entitled to rights and benefits such as those described below.

A Right of Subleasing and Assignment

Unless the lease contains an express provision restricting or prohibiting the tenant from doing so, the tenant is entitled to assign its lease to third parties. In other words, it can sell and transfer its leasehold estate or lease. The tenant can also itself become a landlord by leasing (subleasing) either the entire portion of the property that it leases, or portions of it, so long as the term of the sublease is shorter than the term of the lease. (If the tenant fails to reserve the last day of the term then, instead of a sublease, the tenant is held to have assigned its leasehold estate.)

Application of Applicable Legislation

Landlord and tenant legislation will apply where a lease is entered into and that legislation will, in some cases, simply confirm common law rights or modify or create additional rights. Accordingly, for example, if the tenant enters into a sublease and then subsequently surrenders its lease to the landlord, the sublease becomes the direct tenant of the landlord under the terms of the sublease even if the landlord did not know of the existence of the sublease. (Section 17 of the Ontario *Commercial Tenancies Act*, and Section 5 of the New Brunswick *Landlord and Tenant Act* expressly provide for this.

Nova Scotia does not have a Landlord and Tenant Act, and we could not find any other statute dealing with this in Nova Scotia. However, the same result may apply based on common law principles. See *Chater v. Elia* (1998), 16 RPR (3d) 187 (N.S.C.A.)

Running of Covenants

When a lease is assigned, the assignee obtains the benefit of the lease and can enforce its rights as tenant directly against the landlord except for certain rights which are said "not to run with the land". For example, an option to purchase or a right of first refusal that is contained in a lease document has been held not to be enforceable by an assignee of the lease unless the landlord has expressly agreed in the lease that the assignee would be entitled to the benefit of those rights, or the landlord otherwise confirms in writing or agrees with the assignee to be bound by those rights.

Conversely, when a landlord sells the property that is subject to the lease, the purchaser obtains the benefit of the lease and can enforce it directly against the tenant, and the tenant can enforce its rights as tenant against the transferee of the landlord's interest (except for certain covenants that are said not to run with the land). For example, an obligation to pay a construction allowance or tenant inducement, an obligation to repay a security deposit, or an obligation to readjust in respect of overpayments of rent have all been held not to run with the land and not to be enforceable against a subsequent landlord, unless the subsequent landlord expressly agrees with the tenant to be bound by those obligations.

Frustration of Contract

In contract law, when circumstances occur beyond the control of the parties with the result that the contract cannot be performed, the parties may be released from their obligations under the contract based on the principle of frustration of contract. In the situation of a landlord and tenant, the principle of frustration of contract virtually never occurs because, regardless of what happens to the property, from a physical perspective the leasehold estate continues to be vested in the tenant, and the landlord and tenant relationship continues.

Determination of Tenancies

There are a number of specific principles relating to how a lease can be terminated. Notice requirements are specified in landlord and tenant legislation or are provided for by the common law for various types of tenancies (such as monthly, yearly, or fixed term tenancies) and certain jurisdictions make specific provision for relief to be granted to tenants seeking to remedy their defaults.

The Right to Distrain

Commercial landlords have the right to distrain against the goods of a tenant on the premises where the tenant fails to pay rent when due. This right which permits the landlord, subject to following certain restrictions and satisfying certain requirements, to seize the goods of the tenant on the property and sell them in order to obtain payment of its rent.

The Nature of Licenses

A license is a simple contract under which the owner of property, the licensor, grants to another party, the licensee, permission to occupy or use the property. The licensee does not have any interest in the property. It merely has the right to occupy or use it. The licensee has no rights as against third parties to enforce exclusive possession and must depend upon the licensor to protect it from invasion or trespass by third parties. The license is not enforceable against transferees of the licensor's interest in the property unless the transferee, in each case, expressly agrees to be bound by the license. The licensee has no right to transfer its privilege to occupy or use the property to third parties unless the licensor expressly grants to it that privilege. The licensor has no right to distrain against the assets or property of the licensee situated on the licensed property.

The licensee also does not have the right to sublicense or to grant permission to third parties to occupy or use the property while the licensee's rights of use and occupancy continue in force vis-à-vis the licensor.

It is sometimes difficult to distinguish a license and a lease. Generally speaking, if a party has a right of exclusive possession in connection with an item of property and the language of the document is in the form of a grant of exclusive possession or the word "lease" is used, and the parties are described as "landlord" and "tenant", the arrangement will be considered a lease. However, even where the parties are described as licensor and licensee, or in some other way, if the essence of the contract between them is that one of the parties grants to the other a right of exclusive possession of property for a stated

period of time in consideration for the payment of money, the contract will likely be considered a lease.

From a practical point of view, perhaps the most significant aspect of the distinction is that the tenant can, by registering notice of its lease, establish priority and protect its leasehold interest against subsequent transferees from the landlord as well as mortgagees and other encumbrance holders.

CATEGORIES OF COMMERCIAL LEASE BASED ON RENTAL STRUCTURE

Commercial leases are often categorized according to their rental structures. The basic categories are as follows:

Net Lease

Under a net lease the rent payable to the landlord is paid on a net basis with the intention that the cost and expenses associated with the leased premises such as repair, real property taxes, maintenance, insurance, utilities, etc. are paid by the tenant to the landlord as additional rent over and above a basic rent that is fixed for the term of the lease or is stipulated for identified years of the term. The advantage of this lease from a landlord's point of view is that, in theory, it provides the landlord a fixed return and protects the landlord from the variable costs associated with operating and owning the leased premises. It takes much of the risk out of ownership of the property. Some of the difficulties associated with net leases arise from the fact that there is often disagreement concerning what kinds of costs should be additional rent items. Tenants generally wish to exclude costs of a capital nature, interest, costs of administration, taxes personal to the

landlord (capital tax), costs that result from the landlord's negligence, and many other costs. Negotiating the list of exclusions can be time consuming and expensive. The situation is aggravated where the leased premises are part of a multi-occupant building or complex and is further aggravated when the complex is a mixed use complex which combines retail, office and other uses.

Disputes during the course of the lease regarding improperly included costs frequently occur and these may involve expensive audits and litigation. The arrangement also entails the preparation of detailed statements of costs which often are required to be audited.

Gross Lease

At the opposite end of the spectrum are gross leases under which the tenant pays a stipulated rent and is not responsible for the costs of operating, maintaining or repairing the leased premises. This arrangement is inherently risky from a landlord's point of view but, in certain cases, it can actually be beneficial if the landlord succeeds in building into the rental rate enough of a cushion to protect it against the costs associated with ownership of the leased premises and their operation over the term of the lease.

Semi-Gross Lease

The semi-gross lease represents a kind of compromise. Under this arrangement the tenant pays a basic rent and, in addition, pays certain categories of cost such as, for example:

- (a) realty tax increases over a base year's tax amount;

- (b) a stipulated amount in respect of operating costs for a base year and increases in subsequent years based on cost of living increases or some other factor;
- (c) operating costs stipulated for a base year, and for subsequent years, fixed percentage increases in those operating costs, or a capped increase; or
- (d) a stipulated amount for operating costs in respect of a base year and increases subject to a cap in subsequent years but with "carve outs" for uncontrollable costs such as snow removal, insurance premium rates or utility rates.

Percentage Rent Lease

Under a percentage lease, in addition to a basic rent or a minimum rent and additional rent or in addition to a gross rent, the tenant pays to the landlord a rent calculated as a percentage of revenue generated from its business on the leased premises. Usually the percentage rent is a percentage of gross revenue in excess of a threshold amount.

Ground Lease

A ground lease is a lease under which the basic rent reflects the rental value of the land as opposed to improvements on the land. Under the ground lease, the tenant is usually required to, or permitted to, construct improvements on the land at its cost, and the rent payable by the tenant does not reflect the value of those improvements. Since the ground lease is usually entered into on the basis that the tenant will invest substantial amounts in constructing a building or other improvement on the land, the term of the ground lease tends to be for a longer period of time than other kinds of leases. This enables the tenant to recover its investment in the improvements.

CATEGORIES OF LEASE BASED ON TYPE OF LEASED PREMISES

Commercial leases of real property are also categorized based on the type of building or premises involved. Regardless of the type of building or premises, the lease might be net, gross, semi-gross; might be a percentage lease; and might be a ground lease.

Retail Lease

The retail lease, obviously, is used for retail space. The retail space may be part of a mixed use project, a shopping centre or a standalone building. And the lease form will be different in each of those situations. Examples of various types of retail leases are as follows:

Regional Mall (CRU) Form – The form of lease used by commercial retail units (stores) in enclosed malls will usually be a net lease with provisions for payment of percentage rent and will typically contain: (i) a covenant on the part of the tenant to operate, (ii) restrictions as to the type of use that the tenant can operate in the premises, and (iii) requirements related to advertising and obligations to contribute to a promotion fund or in some cases to join a merchants' association.

Anchor Store Lease – In a regional mall or a strip centre, a department store or food supermarket which serves as a draw to the centre would be accorded special rights and privileges associated with anchor tenants. This might include various degrees of control over the merchandise mix of the centre, particularly within the vicinity of the anchor store, restrictions on alterations of the shopping centre that would impede the visibility, vista, accessibility or disruption of the parking field

serving the anchor store, and numerous other rights consistent with the importance and status of the anchor tenant within the centre.

Big Box Store Lease – Retail centres that do not involve a major enclosed mall and are occupied by several large, separately located, typically freestanding stores are often referred to as big box centres. The kinds of leases that are entered into with so-called "big box" tenants in a big box centre will seldom contain percentage rent clauses, obligations to contribute to promotion funds or advertising clauses, and will usually include exclusive use restrictions prohibiting competitors of the big box tenant from operating within the centre. These leases will usually, also, contain restrictions on alterations to the centre that would interfere with access, visibility or parking fields serving the store, and would normally, also, include restrictions on changes to access, or other alterations that would adversely affect pedestrian or traffic patterns. "Big Box" leases also typically contain provisions ("Go Dark clauses") allowing the tenant to cease operating, and may also contain clauses ("Co-Occupancy clauses") that abate rent in whole or in part, or even to terminate if occupancy levels in the centre fall below a stipulated threshold.

Pad Lease – A pad lease is a lease in which the landlord agrees to provide a pad to the tenant which is serviced with utilities and parking and is suitable for construction of the tenant's store (often a restaurant) and the tenant agrees under the pad lease to construct a store and lease it from the landlord. In some cases, the landlord agrees to reimburse the tenant the cost of construction and those costs

are reflected in the rent recovery as part of the basic rent. Typically, a pad lease will also include exclusive use restrictions, restrictions on the tenant's use of the premises and protections in relation to parking, vista and other changes within the centre that might adversely affect the business of tenant. Percentage rent may or may not be provided for. It is also rare for a pad lease to contain an obligation for the tenant to contribute to a promotion fund or advertising fund or to join a merchants' association or similar association relating to the promotion of the centre. Pad leases may also include "go dark" clauses and "co-occupancy" clauses.

Strip Centre Lease – A strip centre would typically contain one or more rows of space leased to smaller stores, a lease of premises to at least an anchor store (often a food supermarket), and freestanding buildings such as restaurants. The typical lease of a store that is situated within one of these rows of buildings would usually not contain provisions pertaining to a merchants' association, promotion funds or similar obligations, but would, in most instances, be similar to the lease of a commercial retail unit in a regional mall.

Each of these types of leases might be affected by circumstances such as whether they are within a mixed use complex, whether they are in a downtown location served by public transit (for example, the Eaton Centre in Toronto), or elsewhere.

Office Lease

A good example of an office lease is the REALpac standard office lease, a copy of which can be obtained by Googling "realpac national standard green office lease" and clicking on "National Standard Green Office Lease for Single Building".

One of the biggest concerns to landlords and tenants regarding the leases of office space is the need for flexibility in expanding, reducing or relocating within the building. The landlords will often need to assemble space within a building to attract a large tenant and may need to move smaller tenants from one space to another and, accordingly, relocation clauses become very important.

Tenants will also often need flexibility to expand and, accordingly, rights of first refusal or rights of first offer in relation to space within the building, particularly contiguous to the leased premises, are a common feature.

Another aspect of office leases that is frequently overlooked at the offer to lease stage relates to the need for the tenant to have access to a rooftop antenna, special telecommunication lines, and backup generator facilities. A well negotiated office lease will generally address these concerns and may have attached to it a form of generator license agreement, a rooftop license agreement for antenna, provisions dealing with access to risers and communication spaces for data and special phone lines, and will also normally include provisions relating to storage areas and parking rights in the parking facilities of the building.

In office leases, another major concern involves the obligation to restore the leased premises at the end of the term. The cost of returning a portion of a building to so-called "base building condition" can be substantial. Typically, new tenants leasing space in a building prefer to have the space delivered to them unencumbered by the fixtures and improvements of the previous tenant. This concern would apply in retail situations as well but, as a matter of practice, it appears that the negotiations in connection with commercial leases tend to focus on the restoration issue in the context of office leases more often and to a larger degree than where retail space is concerned. Perhaps it is due to the fact that often, a retail store will not involve extensive removal and realignment of interior partition walls. The store tends to be an open space. Expensive demolition pertaining to offices, and realignment of electrical and mechanical systems and lighting patterns do not need to occur to the same extent as when office space is being prepared.

Industrial Space Leases

Leases of industrial space are generally entered into for warehousing, distribution, manufacturing, and similar purposes. The lease may involve a single building and its adjacent parking and landscaping, or it could involve a space within a building containing multiple smaller industrial users. It might also include a building within a complex of buildings that share common roadways, parking, facilities and other amenities.

Perhaps the most distinguishing feature of industrial leases is the focus on environmental concerns and the need to address the use of substances that may be restricted under

environmental legislation. Environmental audits, inspections, and express provisions dealing with remediation are very important in industrial leases.

Provisions dealing with restoration of the building at the end of the term are also particularly important because there will sometimes be customized alterations of the building to enable the installation of cranes, specialized racking facilities, loading facilities and other amenities. Deposits for restoration can be particularly important in industrial lease transactions.

Conclusion

The comments set out above in this paper are intended as a basic primer. A much more detailed, comprehensive paper (actually a book) would be needed to adequately address all of the issues associated with the various types of commercial leases. However, it is anticipated that this paper can serve as a kind of introduction to, or background for, the detailed materials that will be dealt with in this workshop.

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