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SYSTEM TWO
RENT AND RENT RECOVERY

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LEXPERT

Fundamentals of Commercial Leasing

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System Two:

Rent and Rent Recoveries

INTRODUCTION

To understand the fundamentals of the commercial lease it is useful to divide the lease into five fundamental systems. This paper looks at System Two: Rent and Rent Recoveries. Overall, we have designed this program for landlords, tenants, property managers and leasing consultants as well as lawyers. With this in mind, we have taken a practical everyday approach to Rent and Rent Recoveries and we will try to avoid the finer esoteric points which have little practical impact.

We have divided our analysis of the fundamentals of system two into two parts. Part I, will examine how rent and rent recoveries are dealt with in a typical commercial lease. Part II will provide an overview of disputes which arise over in the area of rent and rent recoveries.

When dealing with rent, the unwary will often focus on the minium rent or basic rent and ask the usual question "how much per foot?". In a commercial lease this is only the tip of the iceberg. Attached to this paper is a standard form shopping centre lease. We have underlined the numerous provisions in this standard form of lease which have an impact on the tenant's obligation to pay rent. Take a moment to flip through the lease, the amount of underlining is instructive.

When considering the question of rent, in addition to how much per square foot, you must consider:

- What is the definition of Rent?
- How is the area of the premises calculated?
- How is additional rent calculated?
- Does the lease provide for percentage rent and how is it calculated (generally retail leases only)?
- What is included in operating costs and how is tenant's share calculated?
- Add 7% for GST.

This leads us to Part II , what happens when there is a dispute over the rent. While the most common rent dispute is simply a collection matter, there are nevertheless genuine issues relating to how the rent is to be calculated, particularly operating costs and other items of additional rent.

In Part II we will examine how equitable principles such as estoppel and waiver may prevent a party from enforcing its strict legal rights under a lease when it differs from the established practice of the landlord and the tenant. We will review the "Interpretation Tools" used by the courts to resolve disputes about the meaning of the words and phrases used in a lease, such as "net lease" or various operating costs? And, finally how can we use mediation, arbitration and court proceedings to assist in resolving disputes.

PART I:

RENT AND RENT RECOVERIES - THE LEASE

Rent, What is it?

Rent is the payment which the tenant is bound by the contract to make to the landlord for the use of the land[1].

Sounds simple enough. However if you take a moment to peruse the attached standard form shopping centre lease you will find numerous paragraphs which have an impact on the payment of rent.

A commercial lease will typically define rent very broadly. This has a number of implications for the tenant, in addition to the primary concern of how much the tenant must pay each month. Most importantly, the failure to pay rent is an event of default which gives rise to the landlord's most powerful remedies, namely the right of distrain against the tenant's goods and the right to re-enter and terminate the lease.

In a typical commercial lease "Rent" will be defined along the following lines:

Rent: includes Minimum Rent, Percentage Rent and Additional Rent.

Minimum Rent: (or Basic Rent), is defined as an annual amount, generally based on the area of the premises, which is paid monthly.

Percentage Rent: is calculated as a percentage of gross sales in excess of annual minimum rent, or in excess of a stated dollar figure. The definition of "sales" is typically very wide. For example, "sales"

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[1] *C.H. Bailey v. Memorial Enterprises*, [1974] 1 All E.R. 1003 at 1007 (C.A.).

might be defined in the lease as "the total of the selling or retail price of goods sold or leased and services performed in or from the premises whether the sales or rentals are made or services performed on the premises or elsewhere".

Additional Rent: will include operating costs and any other amounts payable by the tenant under the lease, except Minimum Rent and Percentage Rent, whether or not such amounts are designated as Additional Rent.

MINIMUM RENT

The majority of all commercial leases (retail, office and industrial) entered into nowadays are "net leases". Occasionally, parties will agree to enter into a "gross lease" (generally for a larger tenant with a certain degree of bargaining power), where a tenant pays a fixed amount of rent and the landlord absorbs the cost of operating, maintaining, repairing etc. the Building with the corresponding risk that a big fat zero or a bracketed figure may appear at the landlord's bottom line. More often though, if the lease is not a "net lease", it will be a hybrid of the "net" and "gross" concepts often referred to in the industry as a "semi-gross" lease.

In a net lease, the tenant pays a fixed amount of "net" rent as well as a contribution to, or if it occupies the whole of a building, all of, the costs of maintaining, operating, repairing etc. the Building and any common areas.

This net rent is sometimes called Basic Rent, Minimum Rent, Net Rent, Annual Rent, and any other number of different terms. The terminology is not important - the fact that it is a minimum figure, as opposed to a maximum figure, is what's important.

In a "semi-gross" lease the tenant will still pay a fixed amount of basic rent while the tenant's contribution to realty taxes and/or the costs of maintaining, operating, repairing etc. the Building and

any common areas may be fixed or subject to a cap with or without an escalation factor during the term of the lease.

The Basic/Net Rent may be expressed as a flat amount or an amount based on the area of the leased premises. Typically it is calculated on the basis of an annual rate, payable in equal monthly instalments in advance on the 1st day of each month.

In these times when inducements are often an integral component of a deal, it is common for the parties to refer to not only the "Net" or "Basic" rent, but also to the "Net Effective" Rent. The Net Effective Rent is a term that reflects the fact that usually, when a landlord incurs a cost (in the way of an inducement) in order to obtain the tenancy agreement, it factors that cost into the Net Rent. In this way, if the fair market rent payable for certain office space is $5.00 per square foot of Rentable Area per annum, this rate might "grow" to $6, $7, $8 or whatever the correct rate would be that would effectively allow the landlord to recover, in the form of rent, the cost of its inducement over a certain period (usually the initial Term). As a result, the parties may agree in the example given that the Tenant will pay $8 per square foot of Rentable Area per annum as Basic Rent throughout the initial Term, all the while knowing that the "net effective rent rate" being agreed upon is $5. To further illustrate the issue, the parties may have agreed to an option to renew, the terms of which might be that the Basic Rent rate payable during the renewal period will increase, to a rate to be determined by the parties with reference to the then-prevailing fair market rental rates for similar premises, "but in any event not less than $5" (thereby implicitly acknowledging that the net effective rate they started out with was $5, and the $8 rate was merely the rate arrived at by factoring in the cost of the inducement).

Calculating Area - Useable, Basic Rentable, Rentable Areas

Where rent is expressed to be a function of area, the parties will have to spend some time considering how the area is to be measured. Ordinarily the landlord estimates the square footage of the premises

subject to the area being certified at a later date. The tenant should ensure that the certified measurement is being provided by an independent, professionally qualified architect or surveyor.

Landlords and their land surveyors or architects suggest many ways in which rentable space in a building might be measured. Some leases set out comprehensive definitions to be referred to for ascertaining the relevant areas (of the leased premises and the total of all leasable premises in the project for purposes of establishing the denominator of any proportionate share fraction used for calculating the tenant's additional rent obligation). Some leases do not set out any definitions and refer instead to certain industry standards, such as the BOMA Standard Method for Measuring Floor Area in Office Buildings, as the basis for measuring area.

The concepts typically found in net office and industrial leases with respect to the measurement of area are generically referred to as "useable" area and "rentable" area. These may be variously referred to as Net Rentable Area and Rentable Area, Useable Area and Gross Useable Area, Leaseable Area and Gross Leasable Area, Rentable Area and Weighted Rentable Area, or any number of other terms. Leases that provide their own definitions of these concepts should be read carefully to ensure that the concepts are correctly addressed and that the correct defined terms are referred to in the appropriate places throughout the lease.

What is the concept?

Briefly, the landlord wishes to recover rent on as much space as possible, even if it is not physically capable of use by the tenant, and even if it is not space that is actually leased to the tenant. For instance, some landlords measure to the outside face of outside walls. In those cases the tenant is paying rent on the area of the wall itself, which may add a few feet to the area of the premises. But more than the area of exterior walls, and penetrations into the premises (such as columns, for instance), is sought to be included. Where a tenant occupies space that opens out to a corridor, which is shared by other tenants on the floor of the office building, or in the wing of the industrial complex,

the landlord will want to recover rent on the corridor space, the theory being that if it had leased out the entire floor or the entire wing to one tenant, that tenant would have paid rent on the whole area without any deduction for the common corridor. Similarly the area of any common washroom on the office floor, or in the industrial wing, would have been included in the area of a single occupant of the entire floor or wing. Therefore, the landlord wishes to ensure maximum rent recovery where the floor or wing is multi-tenanted. Hence the concept of "useable" and "rentable".

The lease will generally distinguish between "Useable Area" and "Rentable Area" which set out how the square footage of the premises is to be calculated as well as identifying the boundaries of the premises. Basically, the "Useable Area" is the area of the space itself, using whatever definition for the boundaries of that space that the lease contemplates. In office leases it is not uncommon to pay rent on "Rentable Area" which is the area that is used for calculating all rent obligations, and it is obtained by taking the useable area and multiplying it by a fraction, or applying a pre-agreed gross-up rate, which is intended to arrive at a figure that reflects the tenant's share of the shared areas on its floor or wing, as the case may be. In the retail sector, you will occasionally encounter the concept of "Rentable Area" to account for service areas and caretaking facilities serving the shopping centre.

On average, Rentable Area is 10% to 15% higher than the Useable Area and in some cases it can be as high as 20%.

Method of Measurement

In the office sector, the lease commitment will ordinarily provide that the Useable Area of the premises is to be calculated using the BOMA standard method of measurement.[2]

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[2] Published by the Building Owners and Managers Association International as an American National Standard ("ANSI"), the latest BOMA standard is ANSI/BOMA Z65.1-1996 and represents a change from the previous (1980) standard. The revised standard allows landlords 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, etc. Since Canadian landlords have not yet, for the most part, started to revise measurements in this way, tenants should clarify how their space will be measured.

The latest BOMA standard is one that was approved on June 7, 1996 by the American National Standards Institute, Inc. The revised standard represents a major change from the previous (1980) standard.

The Introduction to the Standard states on page (v) that:

> The need for ... a changed approach was first identified within BOMA International in 1992. While surveys showed that the *Standard* was the most commonly used method of measurement for office buildings, they also documented that it was not being universally applied on a floor-by-floor basis. Buildings constructed during the 1980s tended to incorporate design elements intended to benefit building occupants generally, rather than on a floor-by-floor basis (for example, spacious entrance lobbies with concierge desks, health clubs, daycare facilities, conference centers, etc.). In view of this trend, BOMA's marketplace information indicated a widespread need to fairly account for these building-wide amenities.

Essentially, the revised Standard permits landlords to recover rent on not only the common areas of multi-tenanted floors of office buildings, but also on building common areas that provide services to building tenants. Examples of these common areas include lobbies, atrium spaces, concierge areas, security desks, conference rooms, lounges, vending areas, food service facilities, health or fitness centres, daycare facilities, locker or shower facilities, mail rooms, fire control rooms, fully enclosed courtyards outside the exterior walls and building core and service areas such as fully enclosed mechanical or equipment rooms. Excluded are parking spaces, portions of loading docks outside the building line, and major vertical penetrations (such as elevator banks).

The Standard contemplates that the landlord will measure the individual space's Useable Area, then gross that up by a factor reflecting the shared common areas on the floor, which grossed-up figure is referred to as the Basic Rentable Area. The Basic Rentable Area is, in turn, grossed-up by a factor

reflecting the shared building common areas, resulting in the Rentable Area which is the basis for calculating rent.

The good news for tenants is that it appears that Canadian landlords have not yet, for the most part, started to measure space on the basis of the new standard. Many landlords with mature portfolios believe that the conversion would be impractical and are not planning to adjust their measurements as their inventory of space rolls over. They may wish to reconsider this, considering the potential revenue being passed over. With respect to any newly constructed space, one would expect that landlords will want to use the new approach, of course depending on whether the market will allow it.

For tenants, the message clearly is to be very careful to clarify which BOMA standard it is that they are agreeing to be guided by, if a BOMA standard is to be used for measurement purposes.

In the retail sector, the landlord often defines how it will measure the premises in the absence of an established standard; i.e. landlords prefer to measure in a manner which increases the rentable area by measuring to the outside face of a bearing wall and including columns, common stairwells and recessed areas whereas tenants prefer to exclude these items.

Insofar as vertical boundaries of the premises are concerned, the landlord's preference would be to have the premises extended from the top of the structural floor slab to the underside of the roof deck, including all appurtenances thereto; and the tenant would prefer that such boundaries be less encompassing, if possible.

The definition of the leased premises directly impacts upon maintenance and repair obligations in the lease. Depending upon how the boundaries of the premises are defined, the tenant may find itself liable for maintaining, repairing or replacing such items as broken glass, cracks in load bearing walls, plumbing/mechanical and electrical systems, the roof membrane, and in an extreme case, an outdoor

oil storage tank that formed part of the heating system exclusively serving the premises. [*SEP Holdings Ltd. v. Metropolitan Stores of Canada Ltd.* 10 C.E.L.R. (NS) 104].

ADDITIONAL RENT - OPERATING COSTS

In a commercial net lease there should always be a clause that states that the landlord is not responsible for any costs relating to the premises and the tenant is responsible for all of those costs. The lease should also include comprehensive terms providing for the recovery by the landlord, in the form of additional rent (i.e. rent over and above the net/basic rent), all of the landlord's costs of operating, managing, maintaining, repairing, administering, owning etc. the building or project in which the premises are situated.

A lease will often include a broad-sweeping statement providing that the lease is intended to be completely net or "carefree" to the landlord and that the landlord will not be responsible for any costs or expenses related to the premises, all of which will be paid for by the tenant. By this broad language the landlord will try to pass through costs not particularized in the lease or perhaps not even contemplated at the time of the lease. The net lease clause is intended to lead to the conclusion that, given any question as to whether an item is properly chargeable to a tenant, the question is to be answered in the landlord's favour.[3] Note, however, recent cases, that have held that the fact that a lease is stated to be "net" or "net/net" will not, of itself, allow the recovery from tenants of certain items such as administration fees or capital taxes unless expressly provided for in the document, as it has been held that these types of costs have nothing to do with the maintenance and operation of premises or a development.[4] Landlords and tenants should be aware that there is an ever-increasing

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[3] See Re Kosmor Construction Inc. v. Rusonik (1979), 22 O.R. (2d) 814 (Ont. H.C.); also Hardwick & Hardwick Meats Ltd. v. 471447 Ontario Ltd. [1991] O.J. No. 2057 (Ont. Ct. Gen. Div.) for an interpretation of "carefree".

[4] See 789247 Ontario Inc. v. 215 Piccadilly Properties Inc. [1991] O.J. No. 855, overturned on appeal, Ont. C.A. File No. C11893; Faema Co. (Canada) v. Hammerson Mississauga Inc. [1991] O.J. No. 627 (Ont. Ct. Gen. Div.); Carbrig Holdings Ltd. v. Olympia Tile International Inc. [1992] O.J. No. 884 (Ont. Ct. Gen. Div.), R. Denninger Ltd. v. Metro International General Partner Canada Inc. [1992] 8. O.R. (3d) 720 (Ont. Ct. Gen. Div.); KPMG Peat Marwick Thorne and Johnson & Higgins Ltd. v. SPE Operations Ltd. (1995) D.T.C. 5269; Dylex Ltd. v. Premium Properties Ltd.,

number of cases emanating from the courts where general net lease language has been successfully attacked by tenants. Landlords should review their standard forms of documents with these cases in mind and consider whether it might be appropriate at this time to re-draft the important additional rent clauses in order to make them as all-encompassing as possible.

Definition of Operating Costs

The definition of operating costs will often refer to all costs for the maintenance, operation, repair, replacement, management and administration of the development. In reviewing the definition of operating costs you should consider issues such as; does it include costs paid by the Landlord or by others on behalf of the Landlord, are the costs in respect of the entire lands and the development on it and not just the common areas, are the costs allocated to the lands and development where appropriate. For example, a portion of the landlord's blanket insurance premiums must be allocated to each of the landlord's developments; are the costs calculated as if the development was 100% occupied by tenants. Is the Landlord entitled to gross-up Operating Costs that vary with the level of occupancy so that tenants pay their fair share. When the cost is grossed up to reflect full occupancy, the tenant pays its appropriate share.

Landlords will generally resist changes to the operating cost definition. Landlords argue that changes impact on their financial return, restrict their flexibility in operating and managing the development and create an administrative burden as customized statements of operating costs are needed for different tenants resulting in additional costs passed on to all tenants.

Operating Cost Inclusions and Exclusions

The list of items which the landlord will seek to include in operating costs and which a tenant will wish to exclude is lengthy. The list of inclusions on the part of the Landlord has become more lengthy and detailed due to the ever increasing number of cases where tenants have been successful in

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Ontario Court of Justice (Gen. Div.) Judgment June 7, 1996.

attacking the landlord's rights to recover certain costs and expenses by virtue of the fact the there was no express language in the lease that permitted the landlord to charge and recover certain costs from the tenant. For a more in-depth discussion on recoveries, please refer to the paper on "Controversial Rent Recoveries" enclosed with the seminar materials.

Inclusions

- Landlord's insurance costs which may include premiums, brokers' fees, costs of defending claims and paying claims within the "deductible range" and all costs of obtaining and maintaining insurance,
- common area cleaning, window cleaning, snow removal, waste collection and disposal, recycling programs, landscaping, etc. Premises janitorial services generally applies only to office (not retail);
- utilities and telecommunications facilities serving common areas;
- security services including policing, supervision and traffic control, life safety systems;
- management office expenses including rent for the management office whether actual or imputed, all equipment and supplies used in the office and salaries and benefits paid to staff and other costs of employing staff. Pro-rating of employee expenses may be included to cover personnel at head office who perform property management functions or staff at a regional management office which manages more than 1 location;

  rental equipment, signs, building supplies, materials and tools;
- audit, accounting, legal and other professional and consulting fees and disbursements;
- maintenance, operation, repairs and replacements to the development and equipment serving it (including any repair or replacement which is a capital cost);
- depreciation or amortization of capital costs for repair and replacement as described above, if not fully charged in the year incurred;
- interest on undepreciated or unamortized repair and replacement costs, usually at the interest rate defined in the lease. The landlord pays the full cost initially and recovers through depreciation over time so it claims interest;

- HVAC costs - In shopping centres this will usually only include HVAC costs for common areas. Premises HVAC will be dealt with and charged elsewhere in the lease. In office buildings, HVAC costs will include premises and common area HVAC;
- capital taxes, including Large Corporation Tax. The justification for passing on this tax stems from the landlord's arguments that (1) the acquisition of the development involves the borrowing and investing of capital and capital tax is payable regardless of its income stream; and (2) if the tenant was to acquire its premises rather than leasing them, it would be required to borrow and invest capital and therefore pay capital tax;
- in office buildings, costs of operating the parking garage are often included, especially if the garage is exclusively for the benefit of the tenants. If the garage is open to the public it is less common to include these costs in operating costs. In shopping centres, the cost of maintaining and operating the parking lot is included in operating costs;
- in retail leases, an administration fee usually 15% of all other operating costs is included. In office leases, a management fee usually between 2% - 4% of all Rents is included.[5]

Exclusions and Deductions

The tenant, depending on its negotiating strength may try to have the following excluded from operating costs and not be included as Additional Rent:

- costs attributable to areas excluded from the denominator of the proportionate share definition;
- professional fees (including legals) for negotiating, enforcing or interpreting leases;
- interior mall space expenses passed onto non-mall tenants;
- costs, including utilities, incurred for the benefit only of a particular tenant of the development;

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[5] There are cases which have held that unless a lease provides for it, a tenant is not obliged to pay any administration fees, or management fees or both to the landlord. See for example: R. Denninger Ltd. v. Metro International General Partner Inc. (1992) 8 O.R. (3rd) 720 (Ont. Ct. Gen. Div.); Lik Cue Co. Ltd. v. John Ingle and John Ingle and Associates, Supreme Court of Ontario, Sept. 22, 23 and 24, 1980 unreported; Faema Co. (Canada) v. Hammerson Mississauga Inc. (1991) O.J. No. 627 (Gen. Div.).

- costs of structural repairs or replacements;
- costs of repair or replacement of any item required to be covered by landlord's insurance under the lease;
- capital costs of any nature, including without limitation capital expenditures to improve or increase the value of any portion of the development;
- costs that are required to be depreciated under generally accepted accounting principles and any other depreciation or amortization expense;
- credit for rentals obtained by landlord for use of common areas;
- marketing or advertising costs for the development;
- any off-site salaries and expenses including executive or managerial salaries, consulting fees, fees paid to architects, engineers, attorneys or other professionals, market study fees;
- any general overhead costs including any rent or other costs attributable to a management office, and any other administrative, management or supervisory fees or expenses and any off-site salaries;
- initial paving, initial striping or initial landscaping costs;
- costs of sculptures, paintings or other artwork in the common areas;
- penalties incurred because the Landlord fails to pay taxes or any other obligations on time, fees and interest charges, principal payments or other payments of any kind related to the landlord's acquisition, financing or refinancing of the development or any portion of it, rental or other payments under any ground lease and money the landlord must pay if it defaults under a lease or other agreement;
- the cost of containing, removing or otherwise testing for or remediating any contamination of the land or other portions of the development or other environmental liability, home or branch office expenses;
- administration fees;
- costs resulting from any sale or transfer of the development or any interest therein by the landlord;

- expenses resulting from defective construction or other work, including the use of defective or inferior materials, or the negligence of or other improper performance or non-performance of the landlord;
- any cost of work which is to be performed at the expense of the landlord under any other provision of the lease;
- any excessive amount the landlord pays a contractor or vendor because of a special relationship;
- costs of any repairs and damages in respect of which the landlord is entitled to reimbursement pursuant to contractors' or manufacturers' warranties;
- costs relating to repairs and damages to the systems bringing utilities to the premises;
- work or improvements to the premises or the development carried out as a result of governmental requirements as to fire or earthquake protection, structural upgrading or other governmental requirements not resulting from the tenant's default under this lease;
- capital taxes, income taxes, corporate taxes, excise taxes, profit taxes or other taxes personal to the landlord;
- any single expense of which tenant's proportionate share exceeds two thousand five hundred dollars ($2,500.00) and which has not been approved in advance by the tenant, or any other unjustifiable or unreasonable cost;
- leasing commissions, brokerage fees, legal fees, tenant's inducements, improvement allowances and all other costs and expenses incurred by the Landlord to lease other premises in the development;
- improvements, modernizations, additions or alterations to the development, leasing costs and expenses for redecorating and renovating space for new tenants;
- amounts directly chargeable to other tenants or vacant space of the development for services, costs or expenses solely attributable to or payable by those other tenants or vacant space.

Allocation of Operating Costs:

Grossing Up Operating Costs

In office and industrial developments, where a building is only partially occupied, it is common to find a clause in the lease that allows the landlord to "gross up common expenses" to the amount that the landlord estimates would have been incurred if the building were fully occupied.

Naturally, tenants usually have severe reactions to these clauses.

However, depending on the common expense to be "grossed-up", this arrangement is in fact not at all unfair. It is not a case of the landlord passing on the cost of vacancy to the tenants in the building. It is a matter of trying to match costs with users, so that the fact there is a vacancy does not cause the landlord, as a result of the shortfall, to subsidize the costs actually generated by the occupants of the building.

For instance, if the tenant were the only occupant of the building, it would be unfair (to some extent) to require the tenant to pay only its proportionate share (based on area) of utilities consumed by the building, since there would be no other occupants using electricity, water, gas or whatever and the only utility costs would be those generated by the tenant (leaving aside any common area utility consumption). Similarly, any janitorial services provided to the tenant would be priced to the landlord to correspond with the actual space being served, and if the tenant were to pay only its proportionate share of those costs then the landlord would effectively be absorbing some of the tenant's janitorial costs.

There are a couple of ways to get around this result, mathematically. One way is to adjust the denominator of the proportionate share fraction to ensure that the actual users of the services are included and vacant space is not. Another way is to gross-up the costs so that when the proportionate share fraction (unadjusted for vacancies) is applied to the grossed-up amount, full recovery is

achieved. A combination of these mathematical approaches may in fact be necessary to truly match costs to users.

Some landlords will agree to write in some language that expresses the intent of the provision (which is very difficult to capture without watering down the provision), again in order to give the tenant a quasi-assurance that the landlord does not have the right to pass on the cost of vacancy.

Some common expenses are inappropriate for grossing-up, such as insurance, and to some extent, the cost of personnel carrying out administrative or property management functions.

Proportionate Share Fraction

Additional rent charges, particularly operating costs and taxes are generally apportioned to the tenant by the lease through a proportionate share calculation.

In the office sector, the proportionate share fraction has as its numerator, rentable area of the premises, and as its denominator, rentable area of the building. The 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 full floor, no gross-up factor is applied. Applying the gross-up factor ensures that the total area on multi-tenant floors is equal to 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 of office premises.

In the retail sector (and mainly in larger shopping centres as opposed to strip malls) one often finds the proportionate share fraction has, as its numerator, the Weighted Gross Leaseable Area ("GLA") of the premises and as its denominator, the Weighted GLA of the Shopping Centre. Landlords commonly use a "weighting formula" to distinguish among different types of space in a

centre. The typical retail unit will have a weighting of 1.00. A higher weighting is often given to food court premises as they are small in area and generate higher common area costs. These tenants can generate significant sales in a smaller area than they would have needed to rent if the food court was not available. A lower weighting is often given to stores with no interior mall access or frontage to reflect the more difficult method of generating sales.

Exclusions from the "Weighted GLA" of the Shopping Centre

Typical exclusions from the denominator of the proportionate share fraction are: kiosks, storage space, free standing buildings, theatres, office space, recreational/sports/health facilities, day care facilities, mezzanines, government/community/charitable organization space, and anchor tenants. These areas are excluded because tenants in these categories of space often do not pay their full proportionate share of operating costs, and a shortfall would result to the landlord if these areas were included. For example, kiosks are excluded because they are often temporary in nature and often pay a flat fee per day or week without any contribution to operating costs. Any contributions, however, made to operating costs by these categories of tenants are deducted from total operating costs.

The tenant should review the list of exclusions from the definition of "Rentable Area of the Shopping Centre". The typical list has expanded through the last few years and the landlord should be required to justify each of the proposed excluded areas. Most importantly, any contributions to Operating Costs made by the excluded tenants must be deducted from the total operating costs of which the tenant is paying its proportionate share, since it has recently been held that if the lease is properly drafted, a landlord may recover more than 100% of its actual operating costs.[6] In addition, any costs relating to the maintenance and repair of the excluded tenants (e.g. the cost of maintaining the roof and exterior surfaces of a freestanding building) may not be included in operating costs.

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

Multi-Use Complexes

Where a single complex is a combination of retail shopping area and office floors, the landlord will often set up separate Operating Cost centres for the 2 components and the tenants will pay their proportionate share of the Operating Costs for the component they reside in. However, some costs are inevitably shared between the 2 components and the landlord should allocate costs between them, acting reasonably and equitably. In very large retail complexes 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.

When a shopping centre or building is linked to another complex, the landlord also needs the ability to allocate costs which are common or shared. For example there may be a shared walkway or shared parking facilities. If the buildings are managed in common, there will also be shared management costs.

The tenant must ensure that any allocations between the various portions of a multi-use complex are made on a reasonable and equitable basis. The tenant of a particular portion of the complex must ensure that, if the Landlord has allocated certain costs to that portion of the complex, the tenants of such portion are in fact getting a benefit from the expenditure of the particular cost. Also, it is sometimes necessary to calculate interior (enclosed mall) expenses differently from exterior (parking lot) expenses. Not all tenants benefit from an enclosed mall and not all who do benefit, benefit in the same way. If a tenant is free-standing it should try not to pay any interior Operating Costs.

Caps

A tenant with leverage may be able to negotiate a "cap" on its proportionate share of operating costs or the landlord may be willing to "cap" the increases in operating costs by either a specified percentage increase (e.g. 3% to 5%) or by the Consumer Price Index ("CPI"). Once a cap is agreed upon, a further issue arises; is it to be incremental or cumulative; that is, can the expenses cut off by the cap in one year be recouped in another year when the increase in that year is below the cap. Some

landlords will resist the cap on subsequent year increases. One compromise that has become popular, is to ensure that the cap does not apply to "uncontrollable expenses", examples of which are insurance premiums and snow removal expenses. Caps are administratively wonderful for tenants as there is no need to monitor any operating cost inclusions nor is there any necessity for auditing costs.

Monthly Estimates and Revisions

The lease will provide for the landlord to make a reasonable estimation of operating costs to be paid monthly based on annual Operating Cost estimates, to ensure cash flow. The landlord will also want a right to revise the estimated payments from time to time, if required. Landlords will insist that they are not bound to the estimates arguing that an estimate represents an approximation of costs only and not any sort of "guarantee" of costs.

Reporting Requirements

Landlords should be required to produce a fairly detailed annual statement of operating costs soon after the end of a year to avoid the possibility of any challenges. If possible, an audited statement of operating costs from an independent auditor goes far to prevent the trouble and/or expense of having the landlord's books and records inspected or audited by tenants.

Audit Requests

Landlords will resist providing tenants with rights to audit as they are disruptive and time consuming. Imagine a large shopping centre with over 100 individual tenants all seeking to audit the landlord's records and the disruption that such audits would cause the landlord! Landlords view audits as an unwarranted intrusion by "hired gun" auditors intent on finding fault and errors where none exist. The responses to request for audit provisions in leases range from outright refusal (obviously from the stronger landlords with good negotiating positions) to granting audit rights upon certain conditions. If a landlord is going to grant the tenant a right to audit its records for Operating Cost, then it should insure that the right is exercised within a limited time frame after the landlord has provided 1st year end statement and also provide that the audit must be conducted by a licensed and

qualified accountant in the province where the premises are located and not be conducted on a contingency fee basis (this should limit frivolous audits).

PERCENTAGE RENT

Percentage rent is typically expressed as either:

a) the greater of minium rent or a fixed percentage of gross sales - referred to as the natural break point, or

b) a percentage of gross sales once they reach a certain level - referred to as the fixed break point

In recessionary economic times a landlord will sometimes agree to a tenant paying rent on a straight percentage rent basis, however, landlords try to avoid this if at all possible.

Gross Revenue Definitions

A landlord will typically attempt to make Landlord's standard definition of gross revenue as inclusive as possible, see paragraph 1.01, of the attached standard form lease. Landlords will seek to include all sales from the premises including orders that are placed elsewhere and filled from the premises similarly, if an order is placed at the premises but filled elsewhere the landlord will seek to have that included as well.

An emerging issue in the calculation of gross revenues is internet sales and when they are to be included in the gross revenues of a particular location.

The tenant will seek to have certain items excluded from the calculation of gross sales including sales taxes and returns.

Auditing of Gross Revenues

Many retail leases provide that the tenant's statement of gross revenue delivered to the landlord at the end of each lease year be audited by an independent auditor. Despite the requirement for audited statements, the landlord should ensure that the lease provides the landlord with the right to audit the tenant's records of gross revenue. An astute tenant will try and negotiate a limitation on the landlord's right by providing that it must be conducted within a fixed period of time from the date the tenant provides its statement of gross revenue to the landlord for the applicable lease year failing which the landlord's audit right will be lost with respect to that particular lease year. Most retail commercial leases with percentage rent provisions require the tenant to maintain its records at the premises or its head office for at least three years and also specifies the type of device upon which gross sales are to be recorded.

GST AND COMMERCIAL LEASES[7]

GST is payable on all rent under leases of commercial property As such, it is important to keep in mind that most commercial Leases provide that all amounts payable under the Lease are payable as rent.

A landlord of commercial property (unless qualifying as a small supplier, by receiving lease payments of less than $30,000 annually) must, under section 240(1) of the *Excise Tax Act*[8] register, collect and remit GST. Under section 169(1) the landlord can claim input tax credits on purchases used in leasing operations involving commercial property.

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[7] For a more in-depth discussion of this topic see J.E. Dennis Daoust with Dennis A. Wyslobicky *"GST and Commercial Leases"* Canadian Bar Association (Ontario), GST Bible for Real Estate Transactions: Practice, Precedents, and Developments, June 8, 1998, a copy can be ordered through our web site. www.dvbb.com.

[8] The Goods and Services Tax, is levied under Part IX of the *Excise Tax Act*, R.S.C. 1985, c. E-15.

Tenants that are GST registrants, can claim input credits for rent paid for commercial property but to the extent they use the premises for making non taxable supplies, the input credit is available only on the part of the rental payment that relates to taxable supplies.

The question arises whether by amending or drafting a lease so that certain amounts payable under the lease (for example, recoveries of real property taxes) are not payable as rent, the tenant could avoid the obligation to pay GST in respect of them. This is particularly significant in situations where the landlord pays real property taxes on the property (which, when paid to the municipality, are not subject to GST) and then obtains reimbursement from the tenants of those amounts as additional rent. The additional rent reimbursements of real property taxes, do attract GST and accordingly, in effect, a transaction (the payment of real property taxes) which was never intended to have any GST implications attracts GST. The same comment applies to insurance premiums paid by a landlord in respect of insurance for a project where those premiums are reimbursed through contributions by the tenants to operating costs. Insurance premiums do not attract GST. It would be very useful to draft lease clauses so that certain amounts are not payable as rent, if doing so allowed GST to be avoided. Banks and other financial institutions, medical and dental clinics and other tenants who are not entitled to input tax credits would be particularly interested in this issue. Unfortunately GST is payable on "the value of the consideration for the supply" (Section 165 (1)) and "supply" means ". . . the provision of property . . . in any manner, including. . . . licence, rental, lease. . ." (Section 123(1)). Any amount that is payable by a tenant in consideration for the use of the space will be subject to GST whether it is called rent or not. It would appear therefore that wherever an amount could be said to be paid by the tenant in order to obtain or preserve the privilege of occupying space it will be treated as consideration for a taxable supply of real property in respect of which GST must be paid.

There is no real benefit to drafting leases so as to describe amounts payable under the lease as being payable other than as rent. Moreover, there is a definite disadvantage to doing so having regard to the landlord's right to distrain for arrears of rent. As between the landlord and the tenant it is possible

to agree that the landlord will have all of the same rights in respect of the nonpayment of amounts under the lease that the landlord would have if the amounts were payable as rent. However, if the amounts are not in fact payable as rent the landlord's right to distrain, as it relates to third party creditors of the tenant or a trustee in bankruptcy would be jeopardized. For example, the landlord's right to distrain for arrears of rent would have priority over a chattel mortgagee's claim under its chattel mortgage in respect of the goods of the tenant on the premises when the tenant is in arrears but if the amounts payable by the tenant are not payable as rent, then as between the landlord and the chattel mortgagee it is questionable whether its priority would continue to exist under the *Personal Property Security Act*. Similarly, when a tenant becomes bankrupt the landlord obtains a right to obtain a payment of arrears of rent in preference to other creditors to the extent of three months arrears where there are goods on the premises available for distraint equal to the amount of the arrears. If the amounts owed by the tenant are not payable as rent it is questionable whether the landlord's right to a preferred payment ahead of the unsecured creditors of the tenant's estate would continue.

Operating Costs and GST Paid by Landlord

Should landlords include in operating costs chargeable to tenants, the GST which they pay on their purchases of services and supplies in connection with the operation of the project? As the landlord obtains an input tax credit in respect of the GST which it pays on these purchases, GST does not truly represent an expense and there is a good argument that it is not properly included as an operating cost.

Prepayment and Security Deposits

The general rule is that a deposit, whether refundable or not, given in respect of a taxable supply will not be treated as consideration paid for the supply unless and until the supplier applies the deposit as consideration for the supply.

If a tenant pays a deposit to the landlord, no GST is payable at the time of payment of the deposit. Rather it only becomes payable when the deposit is applied toward the purpose for which it was held.

If a tenant paid in advance, as a deposit, the first two months rent under a lease, the GST would be payable by the tenant only when and to the extent the deposit was applied toward that rent. This situation should be distinguished from situations where Section 182 applies such as where the landlord holds a security deposit and, as the result of a breach of the lease, the deposit is forfeited. In this situation the landlord is considered to have collected the GST and the tenant is considered to have paid it with the result of the amount of the deposit available to the landlord is actually reduced by the GST which is deemed to have been collected by it. It would be wise for landlords to increase the amounts to be paid as security deposits by 7%.

Tenant Inducements

Where a landlord pays a construction allowance or an inducement payment to a tenant in consideration of the tenant's entering into a lease, the amount of the inducement will be subject to GST. Accordingly, the tenant will be required to collect and the landlord will be required to pay as GST, 7% of the amount of the inducement.

PART II

DISPUTES OVER RENT AND RENT RECOVERIES

USING ESTOPPEL AND OTHER EQUITABLE PRINCIPLES TO RESIST A CLAIM

Equitable Estoppel

Equitable estoppel, like most other equitable principles, is rooted in fairness and is closely related to waiver[9]. Equitable estoppel arises when the parties, in our case the landlord and the tenant, have dealt with each other on one basis and it would be unfair for one of the parties to now change the established basis for dealing with each other and begin to insist on the strict application of the lease. It is not uncommon for one of the parties, well after the tenancy has started, to read the lease closely and discover that the parties have not been conducting themselves in accordance with the terms of the lease. What then?

The doctrine of equitable estoppel has its origins in an old English case known as *Hughes* v. *Metropolitan R.R. Co.*[10] In that case the landlord gave notice to the tenant to make certain repairs within six months. Following the notice the parties entered into negotiations for several months which ultimately failed. The tenant then proceeded to make the required repairs but was unable to do so within the original six-month period stipulated by the landlord's notice. The landlord moved to forfeit the lease six months after the first notice. It was the tenant's position that the six month period for repairs ran from the date on which the negotiations broke off. The court agreed with the tenant:

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9 For a discussion of waiver see - Eric Gillespie's paper in these materials, "Dealing With Defaults";

10 (1877), 2 App. Cas. 439

> "... it is the first principle upon which all Courts of Equity proceed, that if the parties have entered into definite and distinct terms involving certain legal results -- certain legal penalties or legal forfeiture -- afterwards by their own act or with their own consent enter upon a course of negotiation which has the effect of leading one of the parties to suppose that the strict rights arising under the contract will not be enforced, or will be kept in suspense, or held in abeyance, the person who otherwise might have enforced those rights will not be allowed to enforce them where it would have been inequitable having regard to the dealings which have thus taken place between the parties."[11]

The essential factors giving rise to an equitable estoppel are set out in the often quoted case of *Greenwood v. Martins Bank Ltd.*[12] and are as follows:

(1) A representation or conduct amounting to a representation intended to induce a course of conduct on the part of the person to whom the representation was made.

(2) An act or omission resulting from the representation, whether actual or by conduct, by the person to whom the representation was made; and

(3) Detriment to such person as a consequence of the act or omission.[13]

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11 Ibid at 448

12 [1993]A.C. 51

13 Ibid at 57

Detrimental Reliance

The third factor holds the key to equitable estoppel and is often referred to as the need for "Detrimental Reliance". This occurs where one of the parties has relied on the words or conduct of another and changed their position to their detriment, then the other party will not be permitted to revert to their previous position. When reviewing cases involving equitable estoppel one will find that without detrimental reliance the claim is rarely successful. It is also worth noting that the mere fact that money has been paid does not in itself amount to a change in position or detrimental reliance[14].

Estoppel by Conduct and by Convention

Recent cases have identified different forms or types of estoppel which have evolved from the root concept of equitable estoppel and have applied them to landlord and tenant cases. A good example is the recent British Columbia case of *Canacemal Investment Inc.* v. *PCI Realty Corp.*[15] which identified two kinds of estoppel. In that case the landlord had incorrectly under billed a tenant for its proportionate share of taxes throughout the term of the lease. The tenant argued that since both parties were mistaken concerning the rentable area of the ground floor of the shopping centre (which impacted the calculation of the tenant's proportionate share of taxes) the landlord was estopped from requiring the tenant to pay more than what had been billed.

Estoppel by Convention

The first form of estoppel which the court discussed was estoppel by convention. The court stated the principle as follows: When parties have acted upon the agreed assumption that a given state of facts is accepted between them as true, then each will be estopped against the other from questioning the truth of the state of facts so assumed but only if the party claiming the benefit of the estoppel has relied on the assumption to its detriment. A considerable degree of formality, or

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14 *Hydro Electric Commission of Township of Nepean v. Ontario Hydro*, (1982), 132 D.L.R. (3d) 193 (Ont. S.C.).

15 [1999] B.C.J. No. 2029.

at least conscious dealing between the parties must exist in order to create a convention to replace the actual facts as the basis of the transaction. If a party has reason to know of the inaccuracy of the assumed facts, the doctrine is not available.

In this case, the parties did deal with each other on the agreed assumption that the proportionate share calculation was correct. However, there was no detrimental reliance. The tenant had not changed its position in any detrimental way as the result of the mutual assumption of an incorrect state of facts. Remember, the mere fact that money has been paid does not in itself amount to detrimental reliance.

Estoppel by Conduct

The court also held that there was no estoppel by conduct. After reviewing the three point test from the *Greenwood v. Martins Bank Ltd.* case, the court again found there had not been any detrimental reliance. Moreover, there was no representation to the tenant and there was no intentional alteration of legal relations. Where both parties act under a mistake as to one party's legal rights, courts will not give effect to estoppel by conduct. The mistake must amount to a representation intended to affect the legal relations between the parties. Note; what the court called estoppel by conduct is not very different from equitable estoppel.

Promissory Estoppel

Equitable estoppel is based on the principle that a person is precluded from retracting a statement upon which another has relied. Originally this was confined to statements of fact or representations by words or conduct of past or present facts that induced the other person to act or change their position in reliance on the representation. However representations or promises about future events were, originally, not considered capable of founding an estoppel. This changed after Lord

Denning's decision in *Central London Property Trust Ltd. v. High Trees House Ltd.* [16] Today "Promissory Estoppel" is well established.

Promissory estoppel arises where one party has by words or conduct made to the other a promise or assurance which was intended to affect the legal relations between them and to be acted on accordingly, then once the other party has taken him at his word and acted on it, the one who gave the promise or assurance can not afterwards be allowed to revert to the previous legal relations as if no such promise or assurance had been made by him. He must accept their legal relations subject to the qualification which he himself has so introduced, even though it is not supported in point of law by any consideration, but only by his word.[17] In the *Central London Property v. High Trees* case Lord Denning held, *obiter*, that a landlord, having promised to reduce rent payable under a lease was bound by his promise and could not subsequently demand the rent originally due.

In *Long v. Inter-Habitation Inc.*[18] the court applied the principle of promissory estoppel in a landlord and tenant matter involving the payment of operating costs. In that case the tenant had only paid base rent and not operating costs, as required by the lease, for a period of over 7 years. This came as a result of negotiations with the landlord relating to the landlord permitting another store in the plaza to sell baked goods in competition with the tenant. The landlord promised not to charge operating costs to compensate for the increased competition, however the lease was never amended. When the property was purchased, the course of conduct established between the previous tenant and the previous landlord was held to be binding on the new owner of the property even though the new owner knew nothing about the variation of the payments.

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16 [1947] I K.B. 130

17 *John Burrows Ltd. v. Subsurface Surveys Ltd.* [1968] S.C.R. 607 at 615

18 [1999] O.J. No. 3305

Mistake and Rectification

Another equitable principle which arises in landlord and tenant matters which may be used to resist a claim is the equitable principle of rectification of a mistake in the lease. In order to succeed on a claim for rectification one must convince the court that the parties had an agreement but they did not write it down correctly.

In *HF Clark Limited v. Thermidari Corp. Limited,*[19] Justice Brooks JA, in an often quoted passage, sets out the equitable principle of rectification as follows:

> "When may the court exercise jurisdiction to grant rectification? In order for a party to succeed on a plea of rectification it must satisfy the court that the parties, all of them, were in complete agreement to the terms of their contract but wrote them down incorrectly. It is not a question of the court asking to speculate on the parties intention, but rather to make an inquiry to determine whether the written agreement properly records the intention of the parties as clearly revealed in their prior agreement. The court will not write a contract for businessmen or others but rather through the exercise of its jurisdiction to grant rectification in appropriate circumstances, it will reproduce their contract in harmony with the intention clearly manifested by them, and so defeat claims or defences which would otherwise unfairly succeed to the end that business may be fairly and ethically done.[20]

In deciding this question, the court does not look at what the parties today think the provision means or what one of the parties intended it to mean. The court must decide what, if anything, the parties agreed to at the time the agreement was made. For example a situation where a claim for rectification may succeed is where the offer to lease differs from the lease ultimately signed by the

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19 [1973] 33 DLR 3d 13 (Ont. C.A.)

20 Ibid at 18.

parties. One of the parties could claim rectification of the lease so that it conformed with the offer and the offer would generally be good evidence of what the parties agreed to at the time.

The decision of the Ontario Court (General Division) (as it was then known) in *Strategeas v. Lloyd Parish Holdings Limited*[21] provides in interesting glimpse into the law of rectification. In this case the tenant purchased a restaurant business in 1981. The purchase agreement provided that the tenant would enter into a lease in the "usual form". The tenant signed a Dye and Durham lease form which was reviewed by his lawyer prior to signing. Dye and Durham's lease form grants the landlord a right to terminate the lease in the event the property is sold. In 1990, nine years after the lease was signed, the landlord found a buyer for its property and relying on the termination right in the lease gave notice of termination. The tenant applied to have the lease rectified.

The court found that the termination clause could not be considered a usual covenant. The clause was found to be completely contradictory to the granting of the lease as it gave the landlord the power to destroy the tenant's investment in the restaurant. The court went on to find that given the importance of the clause, the landlord's solicitor had an obligation to point out the clause to the tenant's solicitor and not just assume that the tenant was aware of the clause and had accepted it.

It is indeed unusual for a court to suggest that the landlord's solicitor ought to have drawn the tenant's solicitor's attention to the termination clause. What this demonstrates is that equity is about fairness and the courts will often stretch principles in order to ensure a fair result.

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21 (1991), 17 R.P.R. (2d) 293 (Ont. Ct. (Gen. Div.))

APPROPRIATE TOOLS OF INTERPRETATION

The Intention of the Parties

The starting point for interpreting a lease, or any contract for that matter, is to ascertain the true intention of the parties to the agreement. The intention of the parties is to be ascertained from the agreement, in our case the lease, which the parties signed. The signing of a lease is considered evidence that the parties intended the lease to be the exclusive record of their agreement, and the courts in interpreting the lease are respecting that intention. The courts will consider extrinsic evidence limited to establishing the commercial setting or factual matrix in which the lease was made. Evidence of the prior negotiations or what the parties subjectively intended when they signed the lease is irrelevant. If it were otherwise there would be little point in signing a lease for whenever there was a dispute either party could testify that they intended something totally different from what the lease provided thereby making the written document irrelevant.

In determining the intention of the parties and in order to understand the meaning of the words used the courts will accept extrinsic evidence of the "commercial setting" or the "factual matrix" in which the lease was made. This is not evidence of the parties' subjective intention, but is evidence designed to assist the court in understanding the meaning of the words used by the parties in the lease.

Parol Evidence Rule

The parol evidence rule is a rule against the use of parol evidence or extrinsic evidence to change the terms of a written agreement. The rule has a very long history dating back to the early English common law. In 1833 Denman C.J. stated the rule as follows:

> "By the general rules of the common law, if there be a contract which has been reduced into writing, verbal evidence is not allowed to be given of what passed between the parties, either before the instrument was made, or during the time that it was in a state of

preparation, so as to add to, or subtract from, or in any manner to vary or qualify the written contract"[22]

The rule works well and makes sense when applied to an agreement that has been the subject of negotiation between parties of equal strength. In that case it is fair to say that the parties have reduced their entire agreement to writing and intend to be bound by the agreement as written. However, the rule can be harsh and unfair when applied to the many pre-printed, standard form agreements which we routinely sign without reading carefully and without any opportunity to negotiate or modify the terms.

When considering a standard form agreement that a party is required to sign with little opportunity to negotiate then the courts will side step the parol evidence rule and consider extrinsic evidence in order to ascertain the true agreement between the parties which may not be reflected by the standard form agreement.

Contra Proferentem

The principle of "*contra proferentem*" [23] is often helpful to tenants when dealing with the interpretation of a lease which is in the landlord's standard form. The courts will construe a document more strictly against the party who drafted it. However this does not mean that the landlord's standard form lease will always be strictly construed against the landlord. There are certain preconditions which must exist before the *contra proferentem* rule is applied.

In order to engage the *contra proferentem* principle the lease must be in one of the parties' standard form, most commonly the landlord's, with no opportunity to modify. The rule will not generally

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22 *Goss v. Lord Nugent* (1833), 5 B. & Ad. 58, at pp. 64-65

23 Blacks Law Dictionary, sixth ed., defines contra proferentem as follows: "Against the party who proffers or puts forward a thing. As a rule of strict construction, "contra proferentem", requires that contact be construed against person preparing terms thereof."

apply to a negotiated lease between sophisticated parties of relatively equal bargaining power. Secondly, there must be an ambiguity or imprecise term or provision. Where the lease is clear then there is no need to resort to the *contra proferentem* rule as the clear words of the lease will govern. However, where there is an ambiguity such that a provision in the lease is capable of more than one equally reasonable interpretation, then the meaning less favourable to the author of the document (the landlord) and more favourable to the other party (the tenant) should be adopted.[24] One must always keep in mind that the two competing meanings must both be commercially reasonable. If one of them is unreasonable, or leads to an absurdity, then there is no contest.

Management and Administration Fees - the Piccadilly Case

The case of *789247 Ontario Inc. v. 215 Piccadilly Properties Inc.*[25] provides an instructive example of a judge applying the foregoing principles of interpretation to interpret the provisions in a lease relating to operating costs and the landlord's ability to recover a management fee and a 10% administration fee. For an excellent discussion of this area and a detailed review of the case law pertaining to court's interpretation of leases and the landlord's ability to recover administration and management fees, capital costs, capital tax and the allocation of expenses see the paper prepared by my colleagues, Kenneth Beallor and Dennis Daoust entitled *"Controversial Rent Recoveries - The Latest Word"* which is found in the material for the second day of this seminar.

In the Piccadilly case the court was asked to determine, among other things, the landlord's entitlement to charge a "management fee" in addition to an "administration fee".

The relevant parts of the lease read as follows:

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[24] *Hillis Oil & Sales Ltd. V. Wynns Canada Ltd.* (1986) 25 D.L.R. (4th) 649 (S.C.C.) at 657.

[25] (1991), 20 R.P.R. (2nd) 294, (Gen. Div.) Affirmed [1992], O.J. No. 214 (C.A.) (Granger J.)

"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;
(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.

Premises means the entire land and Premises described in Schedule "A" together with any other land or Premises which may be designated from time to time by the Landlord for use as an expansion of the Premises." (Schedule "A" is the description of the whole of the Premises at 215 Piccadilly Street. Schedule "B" is a description of the premises demised to each tenant.)

The lease was a "net" lease and provided as follows:

"It is the intention of the parties that except as otherwise herein provided the rent herein provided to be paid shall be net to the Landlord and clear of all taxes (excepting the Landlord's Income Taxes) costs and charges arising from or relating to the premises and that the Tenant shall pay all charges, impositions and expenses of every nature and kind relating to the Demised Premises and the Tenant hereby covenants with the Landlord accordingly, subject to the restrictions set out in paragraph 4.03."

Before dealing with the particular areas requiring interpretation, the court set out the general principles of interpretation which should be applied in this case.

> "The primary approach to the interpretation of any document is that the meaning to be put upon it is the plain, clear and obvious result of the words used, understood in their plain, ordinary and popular sense."[16]

The court went on to state:

> "The defendant submits as a further alternative that extrinsic evidence is properly admissible to resolve a latent ambiguity. In my view, that submission is unfounded because there is no latent ambiguity. That term is used to describe the situation which exists if there is uncertainty when an attempt is made to apply the words in the document to the subject matter. I have already indicated that I find no such problem here. In my view the words in their plain meaning apply aptly to the disputed areas. Any ambiguity if there is one, is as a result only of the extrinsic evidence that is not inherent in the document".

Finally the court stated:

> "The parties negotiated the terms of this Lease, and it is not for this court, or any court, to vary, alter or change the terms of the agreement. If the literal construction of the Lease would lead to a commercial absurdity, extrinsic evidence can be admitted or referred to, in order to avoid such a result."

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16 Ibid. being a quote from Anderson J. in *Doral Holdings Ltd. v. Steinberg Inc* (1987) 60 O.R. (2nd) 54, at 558.

With these principles stated, the court turned to resolving the various points of interpretation that were at issue. We will only consider those points in the decision which relate to the operating costs section of the lease.

Granger J. also held that the Landlord was entitled to charge both the management fee which it paid to its property manager for carrying out the maintenance of the building ($10,073.10) plus the 10% administrative fee. This, despite the fact that the previous landlord had handled the maintenance for itself and had not retained a management company to provide maintenance. The court observed, that although there may have been a change in the manner of managing the building to the financial detriment of the tenants, it is clear that the administrative fee of 10% is based upon the maintenance cost. The lease does not require the landlord to carry out the maintenance work. The Landlord is entitled to contract out the maintenance of the building and the administrative fee is 10% of the maintenance cost.

Note that the word "maintenance" in the definition of operating costs appears to be intended to cover more than such items as cleaning, and servicing of physical improvements. It clearly contemplated administrative duties such as arranging fire insurance, paying utilities and otherwise operating the project. It is significant too, that there was no suggestion by the court that a differentiation should be made between so called "internal management" costs or duties such as arranging for maintenance contractors or arranging for insurance or other management costs.

The court also concluded, based on the wording of the operating cost paragraph, 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. This part of the decision was overturned by the Court of Appeal. It held that the parking lot improvements had nothing to do with maintenance and therefore were not recoverable.

The Court of Appeal, on the issue of the recoverability of the management fee and the 10% administration fee, stated:

> "Finally, the Tenant contends that the Judge also misconstrued the operating costs clause in so far as he permitted the Landlord to charge an administrative fee which included a management fee to an outside manager of the building. In this respect, it is sufficient to say, without setting forth the pertinent facts and the applicable lease provisions, that we agree with the judge and would not give effect to this contention".[27]

Words Crossed Out in the Lease

What use can a court make of words or even paragraphs in a lease that have been crossed out but are still legible. In the English case of *Inglis v. John Buttery & Co.*,[28] the House of Lords was unanimous in their conclusion that excised words could not ordinarily be referred to in construing an agreement:

> "With reference to the deleted words, it is of great importance to have it understood that there is no doubt on that point in the mind of any one of your Lordships. When those words were removed from the paper which had presented the full contract between the parties, they ceased to exist to all intents and purposes; and whether it was possible, as in point of fact it was, still to read them, in consequence of their simply having a line drawn through them, or whether they had been absolutely obliterated, appears to me not to make the smallest difference. The contract was complete after the deletion."[29]

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27 [1992] O.J. No. 214 (C.A.)

28 (1878), App. Cas. 552 (H.L.)

29 Ibid at 571

This position was accepted by the majority of Supreme Court of Canada in *Knight Sugar Co. v. Webster*[30]. However an exception to this rule has been carved out which is based on Chief Justice Anglin's dissent in that case. In his view the ruling in *Inglis* was too broadly stated:

> "While, no doubt, under ordinary circumstances, it is not proper to look at deleted words in an instrument as an aid to its construction...that rule, I venture to think, is sometimes too broadly stated and *does not apply where, as a result of the deletion, there is an ambiguity such as that now before us.*"[emphasis added]

Chief Justice Anglin's approach has been supported by several cases since and now appears to be a valid exception to the rule. For example, in *Louis Dreyfus & Cie. v. Parnaso Cia. Naviera S.A.*,[31] Diplock J. commented, in obiter, that "while I think that I must look first at the clause in its actual form without the deleted words, if I find the clause ambiguous, I think I am entitled to look at the deleted words to see if any assistance can be derived from them in solving the ambiguity".

Just last year, the Alberta Court of Appeal also seems to have acknowledged that a deletion may be used in order to clarify an ambiguity[32]:

> *" Where, as here, there is no ambiguity justifying the admission of extrinsic evidence in aid of interpretation,* it is not proper to refer to the deleted words in construing the meaning of the words actually used by the parties to express their agreement."[33][emphasis added]

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30 [1930] S.C.R. 518.

31 [1959] 1 Q.B. 498 (C.A.) at 513

32 *Paddon Huges Development Co. v. Pancontinental Oil Ltd. et al.* (1998), 223 A.R. 180.

33 Ibid at 520.

The foregoing is only an outline of some of the issues relating to the interpretation of a lease which is intended to give some practical guidance on the subject. A full examination of the area is beyond the scope of this paper.

MEDIATION, ARBITRATION AND COURT PROCEEDINGS

Mediation

Mediation is designed to be a non-binding, without pre-judice attempt to negotiate a resolution of a dispute with the assistance of a person trained and skilled in the art of dispute resolution. Non-binding, means a resolution cannot be imposed but must be agreed to by all participants. Without prejudice, means that a party is not bound by any positions taken or concessions made during the mediation process. All of this is intended to encourage the parties to negotiate freely and frankly without being concerned that their case may be weakened by participating in mediation.

Generally, where the two parties agree to mediate their dispute, there is a high likelihood that the case will be resolved during the mediation. Voluntarily agreeing to mediation, is always a significant step towards settlement.

Selecting the Mediator

Retired judges and senior practitioners offer themselves as mediators. Private mediators are paid by the hour and the rates charged generally reflect their experience and stature in the profession. While retired judges, senior practitioners and experienced mediators tend to charge an hourly rate that is in keeping with their experience, if they are able to resolve the dispute then it is certainly good value.

From a landlord-tenant perspective, mediation may be most useful where there is an ongoing tenancy and a genuine dispute has developed which needs to resolved without destroying the business relationship between the landlord and tenant.

Arbitration

Many leases include an arbitration clause. An arbitration clause can be a simple statement that any disputes under the lease will be resolved by arbitration in accordance with the *Commercial Arbitration Act*[34] (the "Act"). Or, it can be several paragraphs long detailing how the arbitrator or arbitrators will be selected, what issues may be arbitrated, who will pay the cost of the arbitration and other procedural matters. No matter the length of the provision, it is considered an arbitration agreement within the meaning of the Act.[35] It is also important to note that unless the parties specify otherwise, the arbitration will be governed by the Act.

Pros and Cons of Arbitration

Proceeding by way of arbitration can have the following advantages:

a. it may take less time as the parties are not subject to the scheduling difficulties experienced by the courts;

b. it may be less costly because the parties have the ability to streamline the process and set their own procedures;

c. the parties can agree on an arbitrator who has knowledge and expertise in the area of the dispute;

d. an arbitration can be private and the result of the arbitration does not create a binding judicial precedent which may affect the rights of third parties or be relied on by third parties;

e. an arbitrator's award only binds the parties to the arbitration;

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[34] R.S.B.C. 1996, Chapter 55.

[35] Ibid s. 1; see definition of "arbitration agreement".

f. preservation of valued relationships. This may in fact be the most important feature of arbitration. Where the parties, in particular a landlord and a tenant wish to preserve their business relationship but there has arisen a genuine dispute between them and they have not otherwise been able to resolve the issue then arbitration is probably the best route to resolve the dispute.

On the other hand, an arbitration can be as complex, drawn-out and expensive as any court proceeding. Although the Act seeks to limit court intervention, there are still numerous issues which can be the subject of a court application including:

a. the selection of the arbitrator;

b. the definition of the issues to be arbitrated; and

c. the determination as to whether the issues within the four corners of the arbitration agreement.

Once the arbitrator's award is made the right of appeal is limited to a question of law.[36] However, the arbitration agreement may provide for more extensive rights of appeal. A party may, in addition, apply to the court for an order setting aside the arbitrator's award if the award was improperly procured or if the arbitrator:

a. acted in a corrupt or fraudulent manner;

b. was biased;

c. exceeded the powers of the arbitrator; or

d. failed to observe the rules of natural justice.[37]

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[36] Ibid s. 31(1)

[37] Ibid s. 30 and definition of "arbitral error" under s. 1.

Finally, parties should keep in mind that the Act permits an arbitrator to may an interim award in connection with any matter on which the arbitrator may make a final award.[38] The Act also provides for the awarding of costs.[39]

Court Proceedings

When mediation and arbitration fail, then one can always turn to the courts. Even though one has engaged the court process it is always open to the parties to resolve their dispute through mediation, in fact it is encouraged.

Distress

The right of distress allows a landlord to seize, take into possession and ultimately sell, the goods of a tenant in order to recover unpaid rent. It is a self-help remedy which means that it is available to landlords without resorting to any judicial process. While the remedy of distress originated (and is still available) at common law, it has been preserved by statute in most jurisdictions. In British Columbia, for example, the *Rent Distress Act*[40], and certain provisions of the *Commercial Tenancies Act*, govern the levying of distress.

For a discussion on the right of distress, see System Five, Default and Cure included in these materials.

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38 Ibid s. 9

39 Ibid s. 10

40 R.S.B.C 1996, Chapter 403.

CONCLUSION

We hope that this paper has impressed upon the reader that it is insufficient to simply focus on the question "how much per foot?" Landlords and tenants must consider, inter alia, how the different types of rent payable under a lease are defined, how area is calculated and who is to pay for the costs and expenses associated with the premises and the project. While rent and rent recovery issues often depend on the bargaining strength of the parties, a thorough understanding of the issues will undoubtedly provide a party with a valuable advantage.

We also hope that this paper has provided the reader with an understanding of the equitable principals, interpretation tools and types of proceedings that are available in order to assist parties in resolving lease disputes. By knowing what is available, parties can resolve their disputes in a much more effective, expedient and cost-efficient manner.