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"NEGOTIATING A "NET NET" LEASE FROM THE TENANT'S PERSPECTIVE"

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NEGOTIATING A "NET NET" LEASE FROM THE TENANT'S PERSPECTIVE

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The following is a sample checklist of items to be considered from a tenant's perspective in negotiating a "net net" offer to lease or lease.

The checklist is not exhaustive in any way, but does touch on most of the critical elements.

BUSINESS/FINANCIAL TERMS

Commencement Date - what triggers payment of rent? if the C.D., is it clearly ascertainable

Term - if possession is delayed through no fault of the tenant, is there a rent abatement? damages? a cancellation right?

Fixturing Period/Rent Free Period - duration - what triggers its commencement? Is any amount of rent (or are any other charges) payable during this period?

Premises - beyond how they are identified, consider area measurement if rent is a function of area. Has the area been certified? By whom? How is the area to be determined? BOMA standard (an acronym for Builders, Owners and Managers Association) is recognized by ANSI (American National Standards Institute) and is widely recognized and used in the office sector. Can usually work for industrial but there is another standard, SIOR (Society of Industrial and Office Realtors) which is not ANSI-recognized and only allows, does not require, gross-up for

common areas. BOMA and SIOR are collaborating on a new method for measuring industrial space, which they have submitted to ANSI but is not yet available. BOMA is probably inappropriate for retail space - other methods are more commonly used for retail. The main financial issue in measurement of retail space is as to the treatment of a recessed storefront area. In office deals, the lease may reflect the gross-up (e.g. BOMA method) from Useable to Rentable Area as a percentage - does it fairly correspond to the common areas on the floor? The "gross-up" includes in the calculation of the area of the Premises a portion of certain only common areas (e.g. corridors, washrooms but not elevator shafts). The tenant pays Basic Rent (and Additional Rent) on the "grossed-up" rentable area of the Premises. BOMA 1980 (a.k.a. BOMA 1989, 1990, 1991) is less financially onerous than BOMA 1996 but some landlords claim to be setting the Basic Rental rate on a "revenue neutral" basis (how to verify?). Consider capping the area and therefore the rent (more important in the context of "yet to be built" space).

Minimum Rent - annual amount? based on an amount per square foot? Frequency of payment (monthly, annually?). Modify the expression, "without deduction, abatement or set-off" by "except as expressly set out in this Lease".

Percentage Rent - verify rate; tied to Minimum Rent or a false breakpoint? Frequency (monthly, quarterly, semi-annually or annually?)

- Payable on a cumulative basis?
- Payable at the end of the first month in which the annual breakpoint is achieved and thereafter monthly?

See issues relating to the definition of "Gross Revenue", below.

Additional Rent - what is the approximate rate per square foot as at the commencement (including operating costs, realty taxes, business taxes, utilities and advertising)? Can the estimate be re-cast as a representation and warranty, or can it be a capped figure subject to annual escalations in the cap as a function of CPI or some agreed percentage rate (e.g. 3%-5%) - or the lesser of the agreed percentage rate and the actual rate? See comments below regarding Operating Costs and Taxes.

Landlord's Work, Tenant's Work, Inducements/Fixturing Allowances - who performs the work; who pays and when; plan approvals.

PERCENTAGE RENT/DEFINITION OF GROSS REVENUE

Many landlords will agree to exclude the following from the definition of Gross Revenue:

- interest, finance or carrying charges charged by the tenant above its selling price;
- sales of the tenant's fixtures or equipment;
- charges for repairs, alterations, or delivery;
- the amount of any retail tax imposed by any federal, provincial, municipal or other governmental authority directly on sales;
- all refunds or allowances made on merchandise claimed to be defective or unsatisfactory or for any other reason returned to the tenant;
- transfers of any merchandise to any of the tenant's other locations;
- sales of gift or merchandise certificates, provided that the sales price of merchandise paid for by means of such certificates are included in Gross Revenue; and

- allowances and discounts to the tenant's customers, employees or the trade.

What are the tenant's reporting requirements? monthly statements? certified or audited annual statements? Many landlords are prepared to forego annual audited statements, representing a potential savings to the tenant in the order of $3-5K per store.

TAXES

Definition of realty taxes - consider excluding capital tax, corporations tax, all taxes on income of landlord, business transfer tax, all penalties and interest relating to late payments by landlord. (Repeat this exception in the Operating Costs definition. See below.) Provincial capital tax is declining and may be phased out. Some non-institutional landlords will agree that capital tax is not recoverable.

Realty Tax Apportionment - for a multi-tenanted property, what is the basis on which the tenant pays realty taxes relating to the Premises: (i) a separate assessment (or equivalent in terms of assessment information provided by the assessing authority); or (ii) proportionate share of realty taxes levied against the Project (i.e. based on area). Many landlords will agree to (i) even though separate assessments per se are no longer available. If the fair market assessment value of the Premises is greater - per square foot - than other tenants in the project, proportionate share is the preferred method. The corollary is that if the fair market assessment value of the Premises is lower - per square foot - (e.g. big box amongst in-line stores, grocery store, dept. store) then (i) is preferable. Be careful not to state "based on separate assessments" only if the intention is to rely on equivalent information. *Zellers Inc. v. Orlando Corp.*, 2002, 62 O.R. (3d) 220 (S.C.J., affirmed by C.A.).

Gross up (e.g. to 90-100% occupancy) is designed to ensure vacancy credit passes to landlord. Most landlords will agree not to profit from grossing-up, i.e. recover more than 100% of actual taxes. Sample wording is:

> ", provided that in so doing the landlord shall make reasonable efforts to achieve an equitable distribution of Taxes among those tenants whose Rentable Premises comprise the property to which substantially all of the assessed value (from which Taxes are calculated) is attributed, the intent of this provision being that the tenants of the actual space on which Taxes are levied should pay such taxes, and not that the landlord should profit from this calculation. For greater certainty, this provision will not be construed as permitting the landlord to recover more than one hundred percent (100%) of the Taxes, nor will it permit the landlord to recover the cost of Taxes on vacant space from the tenants of Rentable Premises."

Apportionment wording is typically negotiated in the context of realty taxes as they are currently understood and administered. Not much, if any, consideration is given to the possibility of non-assessment based taxes being introduced by taxing authorities in the future. This is a real possibility, as cash-strapped municipalities consider alternative means of generating revenue. Consider the possibility that garbage removal services will be converted into a separate user-fee programme, particularly where large commercial buildings/shopping centres are concerned. Quebec and British Columbia have been facing the possible imposition of parking taxes for the past couple of years and if they proceed, other provinces and their cities are likely to follow suit.

Most leases provide for a broad definition of realty taxes, i.e. these taxes will be picked up/recovered. Consider tightening the definition so that only the known taxes are recoverable. (NB: Sophisticated landlords will not agree.) As to the method of apportionment, assessment-based wording will likely not work (as we are talking about non-assessment-based taxes), and proportionate share may not be fair relative to, for example, garbage generation.

OPERATING COSTS

Review the definition of Operating Costs closely. Most clauses specify that Operating Costs "include but are not limited to" the costs set out in the definition. Amend the definition so that it lists "without duplication and without profit to the landlord" those costs that comprise Operating Costs.

"Net net" to the landlord means that the tenants of the Project shoulder the entire burden of the costs of operating the Project. In order to limit the burden of these costs, the tenant should negotiate the deduction of some or all of the following from the Operating Cost "pot":

- the amount of proceeds of insurance recovered or recoverable by the landlord in connection with Operating Costs;
- any recoveries received by the landlord from other tenants in the Project (other than recoveries of Operating Costs from tenants under the usual net lease clauses) or other persons;
- any recoveries derived from charges, if any, made for use of the parking facilities of the Project;

- net proceeds received by the landlord from warranty claims in respect of the original construction of the Project.

The tenant should also negotiate the exclusion of some or all of the following from the definition of Operating Costs:

- any costs and expenses incurred as a result of faulty construction or design, improper materials or workmanship or structural defects or weaknesses in respect of the Premises or the Project;
- any costs of maintenance, repairs or replacements to the structural portions or elements, including, without limitation, the outside walls and structural roof deck, of the Premises and the Project;
- any capital costs (in accordance with generally accepted accounting principles);
- any costs incurred as a result of the existence or removal of contaminants and hazardous substances from the Project other than as a result of any act or omission of the tenant or those for whom it is in law responsible;
- any income taxes, corporation taxes, business taxes, capital taxes, value-added taxes or taxes payable on rent or the rental of space, or other taxes personal to the landlord, or penalties relating to the late payment by the landlord of any taxes;
- any ground rentals, and any principal, interest or other carrying charges or mortgage payments or other financing in respect of the Project;
- costs arising from or occasioned by the acts, omissions, default or negligence of any person other than the tenant;

- costs relating to the leasing of space or premises in the Project including leasing commissions and advertising costs;
- all fines, suits, claims, demands, actions, costs, charges and expenses of any kind for which the landlord is or may become liable by reason of any breach, violation or non-performance by the landlord or those for whom the landlord is in law responsible of any covenants, contained in the Lease or by reason of any negligent act or omission to act on the part of the landlord or those for whom it is in law responsible (although the landlord will be correct to insist that this be treated consistently with the risk allocation provisions – see below);
- the amount of any sales tax, goods and services tax, value added tax or any similar tax ("GST") paid or payable by the landlord on the purchase of goods and services included in Operating Costs which may be available to and claimed by the landlord as a credit in determining the landlord's net tax liability or refund on account of GST by only to the extent the GST is included in Operating Costs;
- any costs incurred in enforcing or remedying the obligations of other tenants of the Project;
- all costs which are expressly set out in the Lease as the obligation of the landlord;
- any costs of performing the landlord's work in connection with the original construction of the Project;
- any costs incurred by the landlord in renovating or upgrading the common areas and facilities;
- the cost of repairing other tenants' premises in the Project;

- any costs associated with surplus lands retained by the landlord for the purposes of future development;
- any costs of administration, auditing, insurance and reporting associated with the landlord's mortgages and/or ground leases;
- any consultants' costs, including legal fees, except as may be expressly set out in the Lease as being the responsibility of the tenant;
- costs of shared common elements which arise from or should be apportioned to other components in a mixed-use project;
- any costs of repairs for which third parties are responsible pursuant to reciprocal easement agreements;
- any costs of accounting and bookkeeping associated with tenant billing inquiries;
- administrative or management costs and expenses in excess of fifteen percent (15%) of Operating Costs.

In a retail context, the tenant under a net lease typically pays its Proportionate Share of the Operating Costs of the Project. The term "Proportionate Share" should be scrutinized to ensure that the tenant is not paying too high a share (i.e. the denominator should be as large as possible - "rentable" vs. "rented" space in Project). Examine closely all exclusions of space from the denominator. The current trend is towards 10,000 - 15,000 square foot exceptions for anchor tenants! Some lease forms continue to state that the denominator will exclude the area of all tenants whose contributions to shared costs are "limited, reduced or non-existent", i.e. the tenant subsidizes every other sweetheart deal done by the landlord. The latest trend is for tenants to accept the so-called anchors excluded from the denominator at the time of entering into the lease,

but to attempt to limit the landlord's ability to convert small tenants into anchors (from a denominator standpoint). Sample wording:

(a) "Proportionate Share" means the fraction, the numerator of which is the Gross Leasable Area of the Leased Premises and the denominator of which is the Gross Leasable Area of all Leasable Premises within the Shopping Centre including the Leased Premises but excluding (i)….; (ii) ….; (iii) individual Leasable Premises having a Gross Leasable Area in excess of 15,000 square feet ("Major Tenant Premises") provided, however the denominator shall not be reduced, more than once during the Term of this Lease, as a result of the landlord converting existing commercial retail unit premises (excluding the Excluded Areas) to a new Major Tenant Premises; …

- or alternatively, the following amendment to the definition of "Major Tenant Premises":

(b) "Major Tenant Premises" means any single premises in the Project (excluding Free Standing Premises) which have an area in excess of 15,000 square feet of space, provided that if any combination of premises existing as of the Commencement Date is consolidated to create Major Tenant Premises, it shall not qualify as Major Tenant Premises.

In an office context, the concept of "grossing-up" comes into play in connection with Operating Costs. In order to deal with those situations where an office building is only partially occupied, the lease will usually provide for a gross-up of Operating Costs above actual costs, to the amount that the landlord estimates would be incurred if the Project were fully occupied. For example, if

the tenant were the only tenant in an otherwise substantially vacant office building such that the only janitorial services needed for the building (other than in respect of the common areas) were those for the tenant's Premises, it would be unfair for the tenant to pay only a proportionate share of the janitorial services. The grossing-up of the janitorial services to an amount that would equal the total for a fully occupied building (to which the tenant's Proportionate Share is subsequently applied) is a mathematical means of bringing about a fair result.

Clarify whether any administration fee (the fee imposed by the landlord to cover head office costs of providing administrative services for the Project) is to be calculated on realty taxes, insurance premiums, depreciation, interest or the administration fee itself. In a retail setting the administration fee is most commonly in the range of 15% of Operating Costs. In an office context, the fee typically amounts to 3% - 5% of the gross rentals from the Project. Common parlance is to distinguish these two types of fees by the terms "administration fee" and "management fee". The terminology is not important - what is important is what the tenant pays. Often there is an administration fee at the end of a list of charges, but buried within the list of charges is wording that is broad enough to pick up a management fee too. The tenant should ensure that it is not "double-billed" for both an administrative fee and the fees charged to the landlord by a property management company. The courts will allow both to be recovered if it the lease so stipulates.

The landlord should provide the tenant with an annual statement setting out (i) all Operating Costs for the Project that year and (ii) the tenant's Proportionate Share of the Operating Costs. The statement should be audited or at least certified and given to the tenant within a reasonable

time (i.e., 60 - 120 days) after end of the fiscal year. Consider whether tenant has sufficient bargaining clout to negotiate a right to examine landlord's books and records in order to confirm that all Operating Costs are proper and accurate and when that right lapses.

Other costs to be analysed: Utilities consumed in Premises - how is consumption to be measured, what costs will be included (e.g. professional consultants/engineers and/or administration fees); HVAC costs - operating charges, facilities charges (e.g. depreciation), administration/management fees; Promotion and/or Advertising Fund contributions (in a retail setting), merchants' association dues; Plan Approval/Tenant Coordination Fees, Hoarding Charges.

REPAIR RESPONSIBILITIES

There is a current trend amongst tenants to attempt to reduce their exposure to capital expenditures, i.e. HVAC replacement, structural repairs, roof and parking replacements. Big box tenants, drug stores and grocery retailers - and some pad-restaurant tenants will agree only to perform ordinary day-to-day repairs, excepting reasonable wear and tear, but no replacements or major repairs. The expression "capital repairs" is used but it is not helpful as its meaning is not clear. Monetary thresholds are sometimes negotiated (e.g. any items over a certain amount). Some tenants will agree to pay after an "equivalent-to-useful-life" period has lapsed, e.g. 15 years - and thereafter on an amortized basis only.

For an “ordinary” tenant (i.e. one without the type of bargaining strength as described in the preceding paragraph), try to exclude from the tenant's repair obligations relating to the Premises:

- reasonable wear and tear;
- damage by fire, lightning, tempest and other casualties required to be insured against by the landlord (although the landlord will be correct to insist that the resolution of this issue be consistent with the other risk allocation provisions – see below);
- structural repairs and repairs resulting from structural defects or weaknesses or improper materials or workmanship or faulty construction;
- repairs or maintenance that the landlord is obligated to effect;
- repairs or maintenance resulting from the negligence or wilful act or omission of the landlord (once again - the landlord will be correct to insist that the resolution of this issue be consistent with the other risk allocation provisions – see below).

Consider necessity of warranties being assigned to the benefit of the tenant, e.g. if landlord performs pre-Term work as an inducement or if tenant inherits the benefit of existing improvements but the lease assigns the responsibility for the repair and maintenance thereof to the tenant.

Seek a representation from the landlord to the effect that no hazardous substances have been manufactured, refined, stored, disposed of, produced or processed on or in any part of the Project or the Premises.

Landlord's repair obligation - add a covenant on the landlord's part to maintain the Project to a first-class standard and to effect all structural repairs (or those repairs that are specifically excluded from the tenant's obligation to repair as set out above).

Address the landlord's repair obligation on damage and destruction where the lease is not terminated. Many leases are vague in this respect. Repair responsibilities in these instances should line up with the insurance coverage. Consider stating at a minimum that the landlord must repair/restore the Premises to the degree of improvement of the Premises at the time possession was first delivered to the tenant.

INSURANCE & RISK ALLOCATION

Tenant's Insurance – verify that the tenant's policy coverage and limits meet lease requirements.

Landlord's Insurance - add a positive covenant that the landlord will insure the Project. Outline types, amounts: (i) all-risks (for the Project including all common elements and those components of the Premises that were included on delivery of possession to the tenant) to at least 90% of full replacement, (ii) boiler and machinery to the same limits as set out in (i), (iii) rental income insurance for at least 12 – 24 months, and (iv) commercial general liability of a minimum of $5Million or whatever greater level would typically be carried by prudent landlords of similar properties.

Reciprocal release, or limited release. The usual allocation of risk in a net lease completely releases the landlord. The landlord is also indemnified by the tenant with respect to any occurrences at the Premises. The tenant may seek reciprocity, or for the landlord to accept liability for negligence.

Waiver of subrogation - negate requirement if landlord accepts liability for negligence, or if there is a mutual release, follow through with a mutual requirement for waivers of subrogation.

MAKE-GOOD/RESTORATION

Most leases require the tenant to remove all of its trade fixtures and leasehold improvements from the Premises at the end of the Term. This can be a huge cost item. The tenant should attempt to delete the obligation to restore the Premises at end of Term or consider limiting the work to be undertaken (for example, make clear that the tenant is not required to remove partitioning walls, wall and floor coverings, internal stairways, HVAC systems). Many landlords will agree to indicate, as a condition of approving plans for improvements to be made to the Premises, whether they will require the removal of those improvements on expiry and that failure to so require at the time of approval is deemed permission to leave the improvements behind on expiry.

BUSINESS INTERRUPTION

What rent abates if the Premises are rendered "untenantable" (define this as meaning more than unusable – broaden it to include lack of reasonable access as the Premises may be relatively unscathed but inaccessible) as a result of damage/destruction? Both Minimum Rent and Additional Rent should abate (and if applicable, Percentage Rent).

If disruption occurs as a result of something other than an event of casualty (e.g. a power outage) the lease may not permit a rent abatement. Sophisticated landlords will not entertain such an abatement provision. If the lease contains a provision setting out the landlord's right to

redevelop the Project, modify/close common areas, cut off the supply of utilities, etc., it is appropriate to attempt to include a provision entitling the tenant to an abatement if as a result of the landlord's exercise of its rights, the tenant's business in the Premises is materially disrupted.

Is there a termination right if the Premises or the Project cannot be rebuilt within a certain time? At whose instance? Reciprocal or unilateral? If the landlord is the only party with a termination right, seek the landlord's covenant not to terminate the tenant's lease unless (i) a percentage of all other tenants are terminated, or (ii) landlord also terminates other designated tenants in a particular zone (these provisions guard against arbitrary terminations by the landlord).

ASSIGNMENT AND SUBLETTING

Assuming the Lease prohibits the tenant from assigning or subletting without the prior written consent of the landlord, clarify that landlord's consent may not be unreasonably withheld or unduly delayed. Provide that the landlord's consent is not required for some types of transfers. For example, to assign the Lease or sublet the Premises to: (i) a subsidiary, parent or affiliate corporation (so long as it remains an affiliate); (ii) a corporation formed as a result of a merger or amalgamation with another corporation; (iii) (in a retail setting) an acquirer of a substantial number of the tenant's other locations in a particular jurisdiction or an acquirer of a division of the tenant corporation, which includes the business operated on the Premises; and (iv) a franchisee approved by the tenant. The standard lease form will likely call for the imposition of a number of conditions in the landlord's consent, including the execution of the landlord's standard form documentation and the payment of the landlord's legal and/or administrative fees in connection with consenting. Most landlords will agree to cap these fees at a reasonable level

($1,000 for legal fees, $150 - $300 for admin fees). Some will waive fees for a no-consent transaction.

Delete the landlord's option, if any, to terminate the Lease rather than consenting to a transfer, as this right will give the landlord the upper hand in any negotiation of a buyout and it may deprive the tenant of the opportunity to earn a return on its capital investment in the Premises.

If the conditions of the landlord's consent include the right to increase Minimum Rent if there is a transfer, delete this. If the conditions include the right to scoop any uptake in the rent over the lease rate, delete this but be content to settle for a 50-50 sharing after netting the tenant's costs of re-letting.

RATE ON EXTENSION/RENEWAL OR EXERCISE OF ROFR/ROFO

If the lease contains an option to renew (the lease) or extend (the Term), or a right of first refusal or opportunity to lease other space in the Project, review carefully the issue of what rate of rent is payable on the exercise of the right. Recommended wording is along these lines (to be adapted for better use in the context of a ROFO (ROFR):

> "….at a rate to be agreed on between the parties without consideration for Leasehold improvements, based on the net effective rent then payable by renewing tenants unrelated to their landlords for comparable unimproved premises in comparable buildings in the vicinity of the Building. Net effective rent shall mean the net rent equivalent of the present value, using a discount factor of ten percent (10%) per annum, compounded

annually, not in advance, of the net rent receivable by landlords over a ten (10) year term for comparable premises in comparable buildings, less the present value of all landlord's costs of the deal including, without limitation, tenant inducements, free rent periods, commissions, moving costs, lease assumption costs, and landlord's work. Failing such agreement three (3) months prior to the expiry of the Term or the then current Extension Term, as the case may be, the net rent payable during the relevant Extension Term will be determined by arbitration pursuant to the *Arbitration Act, 1991 (Ontario)*."

OTHER FINANCIAL MATTERS

Review the terms of any indemnity or guarantee. Consider limiting it to a certain amount or a certain period of time, for example, the first two years of the Term.

Limit the amount of any Security Deposit.

Beware of any provision limiting the tenant's ability to obtain financing, e.g. a default definition that requires unencumbered goods equivalent to 12 months' rent to be situated on the Premises at all times, or a clause in the assignment provision allowing the landlord to unreasonably withhold consent wherever the tenant seeks to mortgage the lease or the leasehold improvements. It should appease the landlord to simply require that no such arrangements may be entered into without a 3-party comfort agreement (between the landlord, the tenant and the tenant's lender).

Ensure any relocation provision is structured to protect the tenant from: (1) costs of relocating and (2) material business disruption.