
**SMALL BUSINESS ENTERPRISE CENTRE
BUSINESS & THE LAW SERIES**

Orangeville – October 22, 2008

Negotiating a Lease: The Essentials

By Nancy E. Claridge, B.A., M.A., LL.B.

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A. OVERVIEW OF TOPICS COVERED

- The Difference Between Offers to Lease and Letters of Intent
- Landlord and Tenant Due Diligence Issues
- Exclusive Use Clauses
- Transfers/Assignments
- Insurance Considerations
- Damage and Destruction

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- Additional Rent Clauses and Operating Costs Caps
- Guarantees/Indemnities
- Quiet Enjoyment
- Defaults and Remedies
- Lease Protections in Anticipation of Changes in the Marketplace
- Green Leases

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B. INTRODUCTION

- Commercial tenancies are very different from residential tenancies, specifically in relation to the applicable legislation
- Whereas in residential tenancies, the legislation will override the contract (the lease), in commercial tenancies, the contract will override the legislation
- Assumption that the commercial tenant is more sophisticated than a residential tenant

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THE DIFFERENCE BETWEEN OFFERS TO LEASE AND LETTERS OF INTENT

- A letter of intent is generally a strong expression of interest between the landlord and tenant, but it usually does not form a binding tenancy agreement between the parties
 - Intends to create a “moral” obligation
- An offer to lease is generally a binding agreement between the landlord and tenant that sets out the minimum terms for the lease

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- Neither the name given to the document nor the description of its effect is determinative
- The legal effect of the document will depend on the language used by the parties
 - i.e. a letter of intent will be a binding tenancy agreement if
 - it sets out the minimum requirements for a lease
 - it does not state in unequivocal terms that it is non-binding until a subsequent event occurs

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- **Important to have legal counsel review letter of intent to ensure it will not be interpreted as a binding agreement**
- **Reaching an agreement on a letter of intent can be a practical approach to attempting to create a tenancy**
 - **If the parties are unable to agree on the business terms, there is little point in incurring the expense of trying to draft a lease or offer to lease**
- **A binding letter of intent or offer to lease may be the operative lease document in the absence of a formal lease**

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DUE DILIGENCE ISSUES

- **Ownership of Property – The tenant should ensure the landlord is the registered owner of the property or has the right to grant a lease**
- **Legal Status – The tenant should ensure the landlord has the legal capacity to contract, i.e. if it is a corporation in good standing**
- **Zoning – The tenant should ensure that any offer or lease is subject to the tenant being satisfied that the zoning permits the tenant’s contemplated use**

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- **Occupancy Permit – The tenant should require an occupancy permit before being able to occupy the premises**
- **Status of other Tenants – What is the status of an important or anchor tenant?**
- **Financing – Ensuring the tenant has appropriate financing for fixturing**
- **Read the Lease – Do not wait until there is a problem to read the terms of the lease**

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EXCLUSIVE USE AND USE CLAUSES

- Every lease contains a permitted use clause
 - This limits the activities the tenant may undertake in the leased premises and as such should be carefully reviewed
 - Businesses change over time and some flexibility in the use clause should be contemplated
 - Limits on incidental/ancillary uses

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- An exclusive use clause is only relevant to multi-tenant buildings, i.e. a mall
- Such a clause is very important to a tenant to protect its customer base
 - Prevents a competitor from opening a store in the building or from other tenants selling the same type of products
- However, landlords will resist a broadly worded exclusive use clause
- Difficult to draft in the era of “one-stop shopping” stores, i.e. Walmart

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TRANSFERS/ASSIGNMENTS

- Tenants should carefully review any transfer/assignment provisions in lease
 - May be triggered by change in control of tenant corporation
 - Original tenant is often still liable under the lease after assignment
 - Need to determine if landlord can “reasonably” or “unreasonably” withhold consent to an assignment

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INSURANCE CONSIDERATIONS

- Insurance, damage and destruction, indemnity clauses are complex areas with significant consequences
- Main issue to consider is who will carry the risk of a loss and who will carry the insurance for such risk
- Tenant should review insurance requirements with insurance broker to ensure the necessary insurance is available and affordable

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- Ensure deductibles are manageable
- Landlords will generally seek a waiver of liability even in the event of “gross negligence” or “wilful misconduct” on the part of the Landlord or its agents
 - Tenants should seek to carve out such waivers of liability

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DAMAGE AND DESTRUCTION

- Lease should be reviewed to determine if a right exists to terminate in case of substantial damage to the premises or development
 - Is this solely a right of the landlord?
 - What are the tenant’s obligations concerning rent?
 - What are the landlord’s and tenant’s repair obligations?

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ADDITIONAL RENT CLAUSES AND OPERATING COSTS CAPS

- Additional rent clauses, i.e. operating costs, proportionate share calculations and realty tax allocations, are simply business terms
- They should not be reinvented in the lease, but should reflect the business deal captured in the offer to lease
- Operating costs should be without duplication
- Tenant should be wary of fees that are the responsibility of the landlord

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- Administration/management fees charged by the landlord
 - Are they reasonable?
 - Do they relate to services actually provided?
- Capital costs should be amortized over the useful life of the items repaired or replaced
- Operating costs should only include expenses related to the leased premises
- Tenants should insist on ability to review landlord's records concerning operating costs

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- Landlord should provide regular accounting concerning operating costs
- Landlords are likely to resist an operating cost cap, i.e. a cap on the increase in chargeable operating costs during the term of the lease
 - Operating costs caps assist tenant in budgeting
 - May result in a decrease in service levels

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GUARANTEES AND INDEMNITEES

- A guarantee is an agreement to answer for the default of a principal debtor
 - Before there can be any liability, there must be both a principal debtor and a debt
- A guarantee must be in writing and signed by the guarantor: *Statute of Frauds*
- The mere statement that a party will guarantee the obligations of the tenant may not be sufficient to create an obligation

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- The disclaimer of a lease by an assignee tenant making a proposal under the *Bankruptcy and Insolvency Act* will not release the guarantor
- On the bankruptcy of the tenant, a guarantor remains liable to the landlord
- An indemnity is a primary direct obligation which is not conditional on the default of the principal debtor
 - Theoretically, a principal debtor is not required

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- In practical terms, it will be rare that a landlord will call on an indemnity before the tenant has defaulted
- The disclaimer of a lease by an assignee tenant making a proposal under the *Bankruptcy and Insolvency Act* will not release the indemnitor
 - Some leases may require the indemnitor to enter into a lease for the remaining term
- On the bankruptcy of the tenant, an indemnitor remains liable to the landlord
- May avoid liability if procedure not followed

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QUIET ENJOYMENT

- A covenant for quiet enjoyment of the leased premises protects the tenant’s occupation of the premises
- A lease will generally provide a covenant from the landlord for the tenant’s quiet enjoyment, but will be implied in the absence of the express covenant
- It is not a right to silence, it is a right to exclusive occupancy of the premises without interference by the landlord

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- However, such a covenant does not necessarily protect the tenant should a mortgagee take possession of the building
- Tenants may wish to include a provision requiring the landlord to use “best efforts” to obtain a Non-Disturbance Agreement from any current mortgagee, and to require any new mortgagee to enter into a Non-Disturbance Agreement
- Such an agreement can ensure the tenant remains in possession of the leased premises so long as it is not in default under the lease

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- Two important considerations in negotiating a Non-Disturbance Agreement
 - If the mortgagee exercises its rights under its security, what are the rights between the tenant and the mortgagee for claims against the landlord arising prior to the date of the take over?
 - On what terms will the lease be assumed by the mortgagee?

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DEFAULTS AND REMEDIES

- Even without challenging economic times, landlords and tenants may inevitably find themselves in default of the terms of the lease
- In negotiating the terms of the lease, the tenant should give consideration to the consequences of default
 - Not every default should result in the same consequences

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- Tenants should ensure that the lease provides adequate time periods to cure a default, together with the ability to extend the time period if necessary, i.e. if repairs to the premises will require additional time
- To avoid costly disputes in the future, it is important to have the lease specify what remedies are available for each default and how it will be exercised

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LEASE PROTECTIONS IN ANTICIPATION OF CHANGES IN THE MARKETPLACE

- Mid-term termination right
 - Usually involves a termination fee to compensate the landlord for early termination
 - Beneficial to the tenant because it enables the tenant to cut its losses and leave at a fixed cost

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- **Termination right for breach of covenants, i.e. exclusive use, maintenance and repair, relocation, etc.**
 - Gives the tenant greater power to insist on strict compliance with the terms of the lease
- **Right of First Refusal**
 - A tenant can benefit from the option to potentially pick up space from other defaulting tenants or to add space when needed without the need to carry the cost of paying for excess rental space

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- **Right to go dark**
 - Enables the tenant to either ride out a bad economic period, re-tool and re-launch, change the tenant’s use or seek a subtenant
 - Stops (or slows) the bleeding while rent is payable, by enabling the tenant to either reduce or eliminate its operating expenses, employee costs, etc.
 - Prevents competitors from leasing the space and potentially benefiting from the goodwill and/or established customer flow

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- **Co-tenancy Provisions**
 - The tenant ties its obligations to lease the space into the tenancy of other major or significant tenants that arguably bring customers into the building
 - Tenants can request a combination of rent abatements, go dark rights and/or termination rights in connection with co-tenancy provisions
 - Advantageous for a tenant going into a new shopping centre to ensure the Landlord meet a minimum number of leased units

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GREEN LEASES

- New trend is to have a “green lease” or to “green a building”
- Two designations for green buildings
 - **LEED: The Leadership in Energy and Environmental Design Green Building Rating System is a third-party certification program and internationally accepted benchmark for the design, construction and operation of high-performance green buildings**

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- **LEED aims to improve occupant well-being, environmental performance and economic returns of buildings using innovative practices, standards and technologies**
- **Uses an explicit set of environmental performance criteria**
- **Focus is on new construction and development**

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- **BOMA Go Green Environmental Certification program: a volunteer program designed solely for existing and occupied buildings**
- **Industry driven, administratively simple and inexpensive**
- **Program focuses on the development of environmental management plans, programs and policies for existing buildings, i.e. reduction of energy consumption and operating costs, improving waste management**

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- A green lease is a lease for space in either a green or conventional building that incorporates ecologically sustainable development principles that help to ensure ongoing use and operation of the building minimizes the impact on the environment
- Incentives to the landlord and the tenant to reduce energy consumption through efficient energy management practices, increase in recycling, and use of environmentally friendly materials when installing improvements

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- Increased cost savings over the long term and decreased negative environmental impacts and wasting of resources
- Green lease considerations
 - For new development, include a positive obligation for the landlord to construct a LEED or other type of green rated building
 - Include a positive obligation for landlord to maintain its LEED, BOMA GO Green or other green rating throughout term

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- Ensure both the landlord and the tenant are able to comply with the greening provisions
- Carefully consider how the landlord may recover the costs of greening from the tenant
 - Capital costs associated with greening initiatives should be recovered on an amortized basis
 - Consider limiting recoveries to the amount of any operating cost savings achieved
 - Annual caps on permitted greening expenditures may be appropriate

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