BLAKES BULLETIN ON
Real Estate Leasing

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LENDER NON-DISTURBANCE AGREEMENTS – PITFALLS AND TRAPS

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The interplay between leases and mortgages is well settled at common law. Thus, a tenant whose lease has priority over a mortgage is bound by the lease if the mortgagee (lender) enters into possession. At the same time, the mortgagee in possession must honour the lease and cannot oust the tenant. However, a tenant under a lease that is subordinate to a mortgage is not bound by its lease if the mortgagee enters into possession and, accordingly, the tenant may vacate the premises rather than recognize the mortgagee as its landlord. Correspondingly, where the lease is subordinate to the mortgage, the mortgagee is not bound to the lease and may remove the tenant.

Non-disturbance agreements (NDAs) serve to alter the above-described common law. Although there are several reasons why a tenant and mortgagee would want to terminate the lease if the mortgagee goes into possession, tenants and mortgagees usually prefer to play it safe and obtain the protections afforded by an NDA. While entering into an NDA should be a win-win proposition for both tenants and mortgagees, care must be taken to ensure they are carefully negotiated, as a tenant or lender that fails to get it right could find itself in a precarious position. Some of the more significant issues to consider when negotiating NDAs are set out below.

Two Types of NDAs

Generally speaking, there are two types of NDAs. Under the first type, mortgagees simply agree that should they go into possession, they will not disturb the tenant's use and enjoyment of the premises (in other words, they will not evict or oust the tenant). Under the second type, mortgagees go one step further and *also* covenant to be bound by the terms and conditions of the lease while in possession. The second type is much more advantageous for tenants as it serves to create privity of contract between the tenant and the mortgagee in respect of the lease. Where the tenant is unable to obtain privity of contract, the tenant will only have the protection of enforcing the provisions in the lease that "run with the land." Of course, before agreeing that it will be bound by the lease, a mortgagee must ensure the lease does not contain any provisions that may be problematic for it should it enter into possession.

The Equities/State of Accounts

Many NDAs stipulate that the mortgagee will not be bound by the equities or state of accounts that exist between the landlord and tenant. Specifically, many NDAs state that the mortgagee is not to be bound by any pre-payments of rent, security deposits or other sums that may be payable by the landlord to the tenant (such as year-end adjustments). Also, tenants are often required

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COMMERCIAL LEASING AND ONTARIO'S LIMITATIONS REGIME

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When changes were made to the limitations laws in Ontario in 2002, the legal community debated extensively about when and how the new limitations would apply to commencing an action in respect of existing and future disputes. Parts II and III of the former *Limitations Act* were repealed and replaced with the *Limitations Act, 2002*.

Part I was renamed the *Real Property Limitations Act* (RPLA) and continued in its existing form. The new *Limitations Act* was designed to simplify the application of limitation periods by providing, subject to some exceptions, a basic limitation period of two years based on a principle of discoverability and an ultimate limitation period of 15 years.

Lawyers dealing with leasing real property were unsure of how potential litigious issues arising from leases and limitations would play out in the courts. A lease has a dual legal nature: it is a contract but at the same time it deals with rights to real property. So do disputes regarding leases fall under the contractual limitation periods in the new *Limitations Act*?

The answer is surprisingly straightforward. The limitation periods set out in the new *Limitations Act* do not apply to proceedings to which the RPLA applies. Thus, the limitation on several types of actions related to real property are governed strictly by the RPLA, which sets out limitation periods ranging from six to 60 years. The actions governed by the RPLA relating to commercial leases are primarily actions to recover arrears of rent or interest. Therefore if a dispute relates to arrears of rent, a party has six years from the sum becoming due, or six years following written acknowledgment by the party owing the sum, to bring an action.

Generally speaking, actions arising out of commercial leases that are not covered by the RPLA will be governed by the limitation periods in the new *Limitations Act*. Accordingly, any breach of covenant or breach of a clause in a commercial lease that does not pertain to payments that can be classified as arrears of rent will be subject to the basic two-year limitation period under the new *Limitations Act*. Some likely examples are situations of improper tenant assignments or sublettings, a landlord improperly withholding consent to assign or sublet, failure to obtain insurance though contractually obliged to do so, and failure to operate despite a continuous operating covenant.

Note that the provisions of the RPLA do not address issues of overpayment of rent. Presumably then, a tenant making a claim for recovery of overpayment of rent is subject to the two-year rule under the *Limitations Act*. Tenants would be prudent to bring any action, where necessary, to recover overpayment of rent within two years from the time where a reasonable person in the circumstances first ought to have known of the claim in accordance with the discoverability principle.

Whether parties can contract in a commercial lease to change limitation periods also depends on which act applies. Under the initial draft of the new *Limitations Act*, parties could not contract out of the limitations. The subsequent uproar by the business community led to the enactment of several exceptions to this general principle; now, in business agreements such as commercial leases, the parties can vary, suspend or extend the limitations (the ultimate limitation period may only be varied if the claim has been discovered). However, under the RPLA, there is no explicit prohibition or allowance on varying its statutory limitations, and any right to bring an action is extinguished upon the expiry of the period set out in the RPLA. Thus, it would seem the parties cannot suspend or extend these limitations, but could likely vary them by contract to reduce the applicable limitations period.

Landlords and tenants should remain diligent in the surveillance of the operation of a commercial lease so that enforcement of rights or disputes over breaches can be handled efficiently and to ensure the opportunity to utilize the courts is not lost. When it comes to recovering arrears of a rent payment, a party has six years from the date the payment became due to involve the courts for resolution. Where the issue is overpayment, a party may be restricted to bringing an action within two years. Parties are also limited to two years to seek the assistance of the courts with respect to breach of other terms under a lease. Where the applicable limitation is the two-year period provided in the new *Limitations Act*, parties may vary, suspend or extend the period in the lease agreement.

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HOW TO AVOID LITTLE-NOTICED TRAPS IN SUBLEASING

LAUREN TEMPLE

Subleases are far from being a new concept in leasing, but recent cases have highlighted the subtle differences of a sublease from a standard commercial lease. Sublandlords and subtenants should keep these thoughts in mind as they navigate the potential traps of sublease negotiations.

The Term

Perhaps the most commonly understood difference between an assignment and a sublease is that a sublease is a conveyance of less than everything the sublandlord has under the head lease. Typically this takes the form of reserving the last day of the term to the sublandlord.

However, it is unfortunately still the case that sublandlords and subtenants will often forget to reserve that last day, which may significantly complicate matters at a later time.

In *Goldman v. 682980 Ontario Ltd.*, for example, the Ontario Court of Appeal considered whether or not the failure to reserve the last day turned a sublease of a portion of leased premises into an assignment. An option to purchase a shopping centre was at stake; the head landlord argued that the failure to reserve the last day of the term meant the "sublandlord" had assigned away its right to exercise that option. Although the facts of the case ultimately could not support a finding that there was an intent for the option to flow through to the "subtenant," the Court re-emphasized that the sublease became an assignment by operation of law due to the failure to reserve the last day of the term.

Even though all ended well for the "sublandlord," the expense of litigation could have been avoided. This case emphasizes the danger in not reserving the last day of the term and further demonstrates that all parties have a vested interest in double-checking recitals and the length of the term.

Quiet Enjoyment

In the recent case of *581834 Alberta Ltd. v. Alberta Gaming and Liquor Commission*, the Alberta Court of Appeal considered a sublease that provided that the subtenant would have quiet enjoyment of the subleased premises without hindrance or molestation by the sublandlord or any person claiming "by, through or under the sublandlord." The head lease required the head landlord to use reasonable efforts to have its mortgagees execute a non-disturbance agreement, if requested. However, a non-disturbance agreement was never requested, and the head landlord subsequently defaulted on its mortgage and its mortgagee arranged for foreclosure.

The effect of foreclosure was that the head lease and sublease were extinguished. The subtenant consequently brought an action against the sublandlord for breach of the covenant for quiet enjoyment, claiming that the head landlord's mortgagee claimed "through" the sublandlord. The Court of Appeal rejected this argument and held that the covenant was qualified and did not protect the subtenant from eviction by paramount title – i.e., the head landlord and its mortgagees.

Prudent subtenants will want to carefully examine their covenant for quiet enjoyment and ensure that it is unqualified. Further, and it should go without saying, non-disturbance agreements should be requested if such a right is provided.

Flow-Throughs

Most subleases provide that the terms of the head lease will be performed by the subtenant, with respect to the subleased premises, as if it were the head tenant under the head lease. However, in many cases, an absolute flow-through is not appropriate. Parties should consider the implications of the flow-through in many areas of the sublease, including rent, maintenance and repair, restoration obligations, time to cure defaults, and use.

The latter issue was considered in the British Columbia Court of Appeal decision in *Canacemal Investments Inc. v. Regions Group of Companies Trading Ltd.* The head lease provided that the premises would be used for "general office purposes."

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GREEN BUILDINGS AND GREEN LEASES: WHAT'S IN IT FOR ME?

LARRY WINTON

The past several decades have seen a major push towards environmentally friendly products, increased conservation of resources, and ensuring viable sustainability for future generations. Although progress has been slow, the "green" movement is becoming more prevalent in the commercial and industrial building and leasing sector of the economy.

Developers are now erecting "green buildings," employers are actively seeking environmentally friendly spaces from which to operate under "green leases" and employees are choosing to work for companies that value social responsibility.

A green building is one that is designed and operated using environmentally sound principles of promoting the efficient use of resources and minimizing the negative effects to the natural environment. Green building can lead to reduced operating costs by increasing productivity and using less energy, water and other natural resources, improved public and occupant health due to increased indoor air quality, and reduced environmental impacts. Green buildings are often built to satisfy a number of requirements in the Leadership in Energy and Environmental Design (LEED) certification system, originally developed by the United States Green Building Council and now under licence in Canada by the Canada Green Building Council. The LEED rating system is also being used in the United Kingdom, Australia and India. Alternatively, green buildings may have the BOMA Go Green or Go Green Plus designation, which are particularly useful for greening existing buildings.

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 the ongoing use and operation of the building minimizes the impact on the environment. A green lease incorporates provisions that provide incentives to the landlord and the tenant to reduce energy consumption through efficient energy management practices, to increase the rate of recycling, and to use environmentally friendly materials when installing tenant improvements. Provisions contained in a green lease may also include: (i) setting targets and benchmarks for environmental performance by both landlord and tenant, together with remedies such as increased or decreased rent when those benchmarks have not been met by the respective parties; (ii) instituting rules and regulations regarding energy use, indoor air quality, materials used in the building and the leased premises, and recycling; and (iii) dispute resolution mechanisms to effectively govern disputes between landlord and tenant with respect to the targets and benchmarks.

The leasing of space in green buildings to tenants under green leases is on the rise. The question that landlords, tenants and even property managers are asking is "why do I care about utilizing green buildings and green leases – what's in it for me?" The answer is simple: increased cost savings over the long term coupled with decreased negative environmental impacts and wasting of resources.

From a land owner and landlord's perspective, green leasing helps to maximize the long-term return on investment obtained from a particular building. Although the upfront costs involved in constructing a green building are currently estimated to be approximately 5% higher than the costs involved in constructing a conventional building, the maintenance costs and expenses for green buildings are considerably lower. Additionally, research suggests that tenants may be willing to pay a slightly higher basic rent for space in a green building and that green buildings often attract a significant premium when being sold. Further, various government incentives, such as those found in the Canadian C-2000 program, exist to help make green building and green leasing more attractive from a financial perspective.

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GREEN BUILDING DESIGNATIONS FOR GREENHORNS: LEED VS. BOMA GO GREEN

JENNIFER WILLIAMS

It seems these days that everyone is going green. The real estate sector is no different, with industry players rapidly familiarizing themselves with terms such as “green leases” or “greening a building.”

This shift toward green building practices has been driven greatly by benefits that are a direct result of implementing a green approach. But how, exactly, is a building designated as “green”?

LEED

The Leadership in Energy and Environmental Design (LEED) 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. Through its use as a design guideline and third-party certification tool, LEED aims to improve occupant well-being, environmental performance and economic returns of buildings using innovative practices, standards and technologies.

Originating in the U.S. and active in Canada, green building council members representing every sector of the building industry develop and continue to refine the LEED system. Commercial buildings as defined by standard building codes are eligible for certification under the following categories: new construction, retail, existing buildings, schools, commercial interiors, and core and shell rating systems.

The rating system consists of an explicit set of environmental performance criteria, organized into six categories: (1) sustainable sites; (2) water efficiency; (3) energy and atmosphere; (4) materials and resources; (5) indoor environmental quality; and (6) innovation in design process. Projects earn one or more points towards certification by meeting or exceeding each credit’s technical requirements. All prerequisites must be achieved for certification. Points add up to a final score that relates to one of four possible levels of certification: LEED Certified, Silver, Gold and Platinum.

The fundamental reduction and relative environmental impact in addition to all the economic and occupant benefits go a long way for making a case for a LEED-certified building. However, some have criticized the LEED rating system as being insufficiently sensitive to local environmental conditions, since its rating system does not sufficiently take into account local environmental conditions. Another criticism is that LEED certification costs require money that could be used to make the building in question even more sustainable.

BOMA Go Green

By contrast to the LEED methodology, which primarily aims to capture new construction and development, the BOMA Go Green Environmental Certification program is a volunteer program designed solely for existing and occupied buildings. This program is industry driven, administratively simple and inexpensive. It is offered by BOMA Canada as a service to all member and non-member commercial building owners. Rather than setting specified quantifiable levels of environmental standards as with LEED, the program focuses on the development of environmental management plans, programs and policies for existing buildings. The process helps owners assess how a building is performing and includes suggestions for reduction of energy consumption and operating costs, as well as improving waste management.

BOMA Go Green is intended to recognize those buildings where environmental best practices had been implemented into the operations, including the following components: identification of a “best practices” benchmark for professionally managed buildings; recognizing buildings that meet or exceed the requirements inherent in the benchmark with a “Go Green” designation; and assisting buildings that cannot meet the requirements.

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LANDLORD WAIVERS

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Occasionally a tenant will present a landlord with an agreement entitled "landlord waiver" or "landlord's waiver and consent," requesting execution by the landlord, often on an urgent basis.

A landlord waiver is usually delivered to a landlord for execution in the context of a loan transaction by a tenant. As part of the financing, the tenant may be required to grant security over both its real and personal property in favour of its lender.

The granting of a leasehold mortgage (i.e., the registration of a mortgage in respect of the tenant's leasehold interest in the real property) will typically require the landlord's consent, which may or may not be unreasonably withheld, depending on the terms of the lease.

Where the tenant has significant personal property assets, such as valuable equipment, machinery, parts, supplies, raw materials, work in process and finished goods inventory, the lender will also require that a security interest in respect of those assets be granted. The security agreement entered into by the tenant will give the lender a security interest in the present and future assets and personal property of the tenant located in or on the real property leased by the tenant from the landlord. Not surprisingly, the security agreement will provide the lender with a variety of rights and remedies vis-a-vis the personal property collateral in the event of default by the tenant under the loan, including an ability to seize and sell the collateral, either by the lender itself or through a receiver or another agent or representative.

Competing with the leasehold lender's claim to the tenant's personal property in the event of default under the financing will be the landlord's rights in respect of the same personal property if the tenant defaults under the lease. These landlord rights, claims or liens in respect of the collateral, whether arising pursuant to the lease, at common law or by statute, may trump the leasehold lender's claim to the collateral, even if the latter's security interest is registered under the applicable personal property security legislation.

To deal with these competing interests, the lender will request that the landlord review and execute an agreement through which the landlord will, among other things, waive and release in favour of the lender all present and future rights, claims and liens that the landlord may have in respect of the collateral (hence the term "landlord waiver"). The landlord will also frequently be asked to acknowledge the existence of the lender's prior rights in respect of the collateral and, if necessary, consent to the granting by the tenant of the security interest in the collateral.

The landlord waiver establishes a direct contractual link between the landlord and the tenant's lender. Accordingly, in addition to securing the landlord's waiver and consent, the lender may take advantage of the opportunity to request that the landlord confirm the lease is in good standing and there are no existing defaults.

In addition to these basic (and usual) provisions, many other elements of the landlord waiver will be the subject of negotiation between the landlord and the tenant's lender, if applicable, including:

(a) at what point in time the lender, by virtue of its enforcement of its rights and remedies under its security, should be recognized as the tenant under the lease and become liable to carry out the tenant's obligations under the lease;

(b) to what extent the lender shall be provided with notice of, and an opportunity to cure, a default by the tenant under the lease, if such default would entitle the landlord to terminate the lease;

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(c) whether the lender or its agent will be entitled to conduct an auction or sale from the leased premises to dispose of the collateral (this will be particularly important to a landlord in the retail setting, where liquidation sales may reflect poorly on the property in which the premises are located);

(d) the length of time during which the lender and its agents and representatives may occupy and remain on the leased premises (including after expiration or termination of the lease), to permit the collateral to be removed and disposed of, and whether the lender should be required to pay rent during its occupation (including any rent in arrears for the period preceding the lender's occupation) and, if so, how much rent should be payable; and

(e) the extent to which the lender will be responsible for repair at its expense of any physical damage to the leased premises caused by the removal of the collateral from the premises.

Some of these matters may be more appropriately dealt with in a subordination, non-disturbance and attornment agreement, although there is some overlap between this type of agreement and a landlord's waiver document. Whatever the length and complexity of these agreements, a careful review should be undertaken in all circumstances, whether being reviewed from the landlord's perspective or the lender's perspective, to ensure an appropriate balance is struck between the landlord's and the lender's respective interests.

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LAUREN TEMPLE

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The sublandlord then subleased a portion of the premises to a language instruction company and provided that the offices could be used for language instruction. The sublandlord and the subtenant did not obtain the consent of the head landlord to this use and, ultimately, the Court found that "language instruction" did not fit within the meaning of "general office purposes." The terms of the head lease prevailed, and the sublandlord was found to be in default.

Two principles are highlighted here. First, a strict flow-through is not appropriate in many instances (as was the case here) and deviations should be addressed in the sublease. Second, and the corollary to this, is that the sublandlord cannot grant to the subtenant more than what it has. Both parties would be wise to ensure the head landlord's consent is obtained to deviations when there is any doubt as to this matter.

Although both sublandlords and subtenants often take the point of view that subleases are "easy" negotiations given that the terms have already ultimately been decided by way of the head lease, subleases also leave the parties in a more tenuous position than a traditional lease. Parties should consider this and act to protect their interests accordingly, whether this is by way of improving the covenant for quiet enjoyment, drafting the sublease to adequately address required deviations, obtaining head landlord consents or ensuring that non-disturbance agreements are obtained.

GREEN BUILDINGS AND GREEN LEASES: WHAT'S IN IT FOR ME?

LARRY WINTON

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From the perspective of a tenant, green leases help increase profitability through materially reduced additional rent flowing from the increased efficiency of building systems and management practices. Of course, these cost savings will only be experienced in long-term leases since the basic rent charged under green leases in green buildings may be higher than rent charged in conventional buildings. In addition to the financial benefits that can be gained from operating under a green lease, the positive public relations effects of being associated with the green movement may be important. Also, the ability to attract and retain talented employees that are looking to work in a healthy and physically superior environment may be increased.

While green buildings and green leases are not currently the norm in commercial and industrial building and leasing in Canada, the instances of these buildings and leases continue to grow. As additional information and studies further show that the long-term benefits can outweigh the short term costs, it is anticipated that green building and green leasing will increase.

GREEN BUILDING DESIGNATIONS FOR GREENHORNS: LEED VS. BOMA GO GREEN

JENNIFER WILLIAMS

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The criteria for the BOMA Group Go Green program are listed as minimum requirements identified in five key environmental areas: (1) resource consumption; (2) waste reduction and recycling; (3) building materials; (4) interior environment; and (5) tenant awareness.

Without the express environmental performance criteria of the LEED methodology, BOMA Go Green involves a lower threshold to obtain designation. However, with the focus on planning rather than implementation and the absence of design guidelines for new construction and development, the effectiveness of this strategy to truly "green" a building in significant measurable results is somewhat limited. Notwithstanding this limitation, the program still carries significance in enhancing perceived value of a building and marketing a property to prospective occupants.

Complementary Rather Than Competing Application

Rather than operating as competing models, BOMA Go Green and LEED certification can be used in a complementary manner and in combination to develop strategies that help building managers meet new environmental standards. While the majority of available green building information relates to LEED certification for new construction and major renovations, existing-building owners who want to green their buildings to stay competitive in the leasing market can either use LEED certification for LEED-Existing Buildings or use the BOMA Go Green standard to meet the requirements for environmental best practices in the operation of their buildings.

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JOSEPH GRIGNANO

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to waive any rights of set-off, defences or claims that they may assert against the landlord. This is problematic for tenants as they may find they are required to pay a mortgagee amounts they have already paid to their landlord (or amounts they were not required to pay to their landlord). From a mortgagee's point of view, obtaining the foregoing concessions from tenants helps ensure it receives the cash flow it expected to receive and the mortgagee itself is not out-of-pocket.

Lease Amendments, Assignment and Sublets, Terminations and Surrender

One can easily appreciate that a mortgagee would have legitimate concerns in respect of alterations to the landlord-tenant relationship, which it is unaware of and had no input over. Accordingly, many mortgagees seek concessions to the effect the mortgagee will not be bound by any amendments to the lease made without its consent. This will often be expanded to include lease terminations and surrenders, assignments and sublets. However, from a tenant's point of view, consent provisions are problematic simply because they are almost always overlooked with the result that the tenant may lose the benefit of an amendment it had bargained for. In the surrender or termination scenario, it is conceivable that a tenant could find itself liable to a mortgagee long after the tenant has vacated the property with the belief its obligations had come to an end.

Collateral Lease Rights/Financial Obligations

Mortgagees often try to strip tenants of many of their collateral rights. Typical examples include stripping tenants of rights of first offer and refusal and options to purchase. Less typical examples include provisions where the landlord has covenanted to purchase a certain amount of goods or services from its tenant. This may not be fair to a tenant that has relied on these collateral rights as a material inducement to enter into the lease. At the same time, however, it is not unreasonable to permit a mortgagee to extricate itself from a particular lease obligation where it would be impossible for the mortgagee to perform the obligation (for example, where the landlord has agreed to grant an exclusive that extends to more than one property owned by the landlord but that is not subject to the mortgagee's security).

In other cases, mortgagees will try to eliminate potential financial obligations such as landlord's construction obligations and tenant allowances. While one can sympathize with a mortgagee's reluctance to pour more money into an already losing proposition, it is not reasonable to expect a tenant to forego these rights where the cost of the obligations has been incorporated into the minimum rent payable by the tenant.

Mortgage Proceeds

Mortgagees often insist that all insurance proceeds following an event of damage or destruction be used to pay down the debt rather than repair the property. This is problematic from a tenant's point of view as it may find itself in a situation where it is bound to continue to occupy its premises and to perform its obligations notwithstanding that the property is left in an untenantable or quasi-untenantable state. From a mortgagee's point of view, having to utilize insurance proceeds for repairs may not be the best option for the mortgagee as it relates to the recovery of its investment.

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