

# Blakes Bulletin

## Real Estate

### Cross-Border Leasing Issues: Negotiating Hot Spots

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#### INTRODUCTION

Recent events are ensuring that the Canadian marketplace is looking very attractive to many foreign companies, most drawn by the relative stability of the Canadian market. Indeed, for many American companies (particularly retailers), Canada can present a logical "next step" in their business trajectory since many Canadians are already familiar with their brands, combined with the recent increase in the value of the Canadian currency and a relatively buoyant retail sector. However, many American companies looking to make the move into the Canadian market are often surprised by the profound differences in the leasing landscape; these differences are at many times so surprising they can cause a breakdown in negotiations, as parties on both sides accuse the other of being unreasonable. Don't be caught unaware — before moving into the Canadian marketplace and investing time and money in your lease, be alert to the following top "hot spots."

#### 1. TURNING THE TABLES: THE BARGAINING POWER OF THE PARTIES

Real estate holdings in the U.S. are more diversified than in Canada. Tenants have an enormous number of locations and landlords to choose from, all across the country. This creates a competitive market where landlords compete for the best tenants and are often willing to provide significant concessions in order to get them. In contrast, the vast majority (approximately 90%) of the Canadian population is concentrated within 160 km (100 miles) of the Canadian-U.S. border and even further concentrated within that strip into "mega-metropolises." Geographically speaking, Canada simply has fewer prime locations to lease, and this is compounded by the fact that ownership of the prime real estate is concentrated in a handful of major developers, many of whom are backed by pension funds. The result is that tenants are competing for the attention of landlords, rather than the other way around, and when

they do succeed in grabbing that attention, they find they have decreased bargaining power. Be aware that Canadian leases start out landlord-friendly, and much lease negotiation time will be spent trying to push the lease into middle territory, which Canadian landlords are less amenable to doing than their American counterparts. Also be aware that, given the imbalance in bargaining power, some Canadian landlords may require a tenant to first lease in a less desirable location before it will give space to that same tenant in a prime location.

#### 2. ABSENCE OF A LEGISLATIVE FRAMEWORK

Perhaps somewhat perversely, given the seeming absence of competition in the Canadian leasing market, the commercial landlord-tenant relationship in Canada is governed more by contract than by legislation. Although there are some exceptions — such as legislation pertaining to real property and sales taxes and the exercise of certain landlord default remedies on bankruptcy of the tenant — for the most part, parties are left to themselves to determine their relationship. Furthermore, even though many provinces and territories have legislation regarding commercial leases, that legislation can almost always be contracted out of by the parties. The result is that almost everything, for better or worse, is up for grabs and governed by what is "customary" leasing practice in Canada.

#### 3. LEASE DOCUMENTATION: ONLY START WHAT YOU INTEND TO FINISH

The standard practice in the U.S. is to execute a non-binding letter of intent, proceed to lease negotiations and sign up the lease before the tenant takes possession. If negotiations fall apart at the lease stage, the parties walk away with no hard feelings (or only a few). In contrast, the Canadian practice induces profound culture shock to Americans: letters of intent or offers to lease are almost always binding, and unless stated otherwise, the tenant is entitled to occupy on the basis of the binding agreement (even without a signed lease).

Possession without execution often results from aggressive expansion plans in the Canadian markets and, ironically, is often a by-product of the relative imbalance in the bargaining position of the parties since

CONT'D ON PAGE 2

CONT'D FROM PAGE 1

lease negotiations — particularly retail leases or major leases of large amounts of space — are almost always protracted. Further, the terms of the offer should be carefully parsed, since there is often very little leeway to negotiate agreed-to terms once at the lease negotiation stage. Since the offers are binding, it goes without saying that the parties need to be careful in crafting their terms since there are few ways out (without a carefully crafted condition) once signed up.

#### **4. COMMON "CENTS": COMMON AREA MAINTENANCE CHARGES**

In Canada, landlords typically rely upon a sweeping "net lease" clause to pass along almost all costs to tenants. Consequently, common area maintenance (CAM) clauses are often highly negotiated to exclude and deduct all manner of costs from the default starting position. However, following point 3 above, success will often depend on whether or not the binding offer forecloses any negotiations that will affect the "financial position" of the landlord. Also be aware that proportionate shares of CAM costs in Canada are often determined by proportion of leasable, rather than leased, area, meaning that Canadian tenants are not prejudiced by high vacancy rates (although many leases, particularly non-retail leases, will include gross-up provisions for costs that do not vary with occupancy rates). On the other hand, it is not uncommon, particularly in Canadian retail leases, for the square footage of major or anchor tenants to be excluded from the proportionate share calculations — meaning that smaller tenants are often picking up a larger proportion of the tab; this is to some degree justifiable if the major or anchor tenant is responsible for repairing or replacing the building and servicing components of its space. Finally, unlike in the U.S., fixed CAM deals are highly unusual in Canada — most landlords are unwilling to even agree to limiting the percentage increase year over year. Landlords can occasionally be pressed to cap CAM costs over which they have control, but this is also unusual.

#### **5. CANADIAN TAXES DON'T END WITH REALTY TAXES**

It should come as no surprise to anyone familiar with commercial leases that realty taxes are payable by the tenant. However, be aware that, in Canada, tenants are also responsible for the payment of the federal goods and services taxes (GST) on all amounts owing under the lease. Although this 5% tax (or more, where

harmonized with provincial or territorial sales taxes) cannot be contracted out of, tenants should ensure that their landlords deduct from operating costs the amount of any GST input tax credits they would be entitled to; this will avoid the landlord receiving a tax "windfall." Second, many Canadian leases provide that tenants are responsible for paying the landlord's capital taxes, which are imposed by some provinces on the landlord's paid-up capital. Many landlords argue that this tax is akin to a real property tax because it is imposed by virtue of the landlord owning the real property. However, it is also personal to the landlord, being dependent on its own corporate structure and the amount of capital it owns. Therefore, such taxes are open to negotiation and exclusion, particularly at the offer stage. Finally, certain provinces may impose land transfer taxes on the registration of the lease or notice of lease, so you should be sure to ask your lawyer if any such taxes are payable.

#### **6. PRESERVING SECURITY OF TENURE: REGISTERING THE LEASE**

In many Canadian provinces, registration of the lease (or a notice of the lease) is necessary in order to protect the tenant's security of tenure, i.e., to protect it from subsequent purchasers and mortgagees. Without such registration, the lease could be vulnerable to attack by subsequent purchasers without notice of the lease, the result of which is that the purchaser without notice is not bound by the lease and the tenant may be ejected from the premises. This is of particular concern when it comes to lenders, who can take priority to the lease either by simply being on the scene prior to the lease coming into force *or* by the terms of the lease and, if they enforce their security in priority to the lease, have the option of extinguishing the tenant's interest.

In order to protect the security of their tenure, Canadian tenants will therefore both register a notice of the lease or the lease itself as soon as the lease is concluded and obtain a covenant from landlords to obtain a non-disturbance agreement from present and future lenders.

#### **7. SECURITY: DISTINGUISHING BETWEEN INDEMNITIES AND GUARANTEES**

Although often used interchangeably, in Canada, "indemnities" are distinctly different than "guarantees" and impose many more primary obligations. Be aware that a guarantee makes the guarantor a secondary obligor with a number of rights and defences that

CONT'D ON PAGE 3

CONT'D FROM PAGE 2

an indemnifier, as a primary obligor, does not have. Indemnities, as opposed to guarantees, are often required by Canadian landlords, particularly when dealing with a subsidiary or holding company. As a tenant, you should try to push for a guarantee or, better yet, post some form of security and avoid the guarantee or indemnity altogether.

### 8. LANDLORD "LIENS" AND THE RIGHT OF DISTRESS

In some U.S. jurisdictions, landlords have statutory liens on the tenant's personal property that may be levied by the landlord in the event of non-payment of rent. Similarly, in Canada, the landlord has the common-law right of distress, which operates outside of personal property security legislation and often in super-priority to the same. However, Canadian landlords do not need to file any petitions with the court, post bonds as security or otherwise provide notice to the tenant before exercising its right of distress. While Canadian landlords do have to follow certain rules in levying distress, these rules are much more limited in scope and application than the judicial processes required in some states in the U.S. Furthermore, Canadian leases distinguish the right of distress from landlord liens on the tenant's personal property granted as additional security. The former is automatic, while the latter requires a specific granting of security and is often perfected by registering the landlord's interest in the appropriate personal property security registry. Before agreeing to grant the landlord a "lien", be clear that this is a lien in addition to the landlord's distress right and could cause you to be off-side your credit arrangements.

### 9. LANDLORD DEFAULT AND TENANT TERMINATION RIGHTS

Perhaps one of the most surprising aspects of Canadian leasing law is that it is uncommon to find a lease that provides a tenant with many, if any, remedies on the landlord's default, and most landlords are not amenable to considering inclusion of any landlord default and tenant remedy provisions in the lease. Indeed, many Canadian leases expressly limit the rights of the tenant on landlord default to suing for damages or obtaining

an injunction. Although at Canadian common law the tenant continues to have the right to terminate the lease upon the "fundamental breach" of the lease by the landlord (absent agreement to the contrary), the threshold to prove "fundamental breach" is very high. The result is that if the tenant wants to have a termination right, whether on the landlord's default or otherwise, it is better off negotiating that right upfront at the offer-to-lease stage.

### 10. INSURANCE AND WAIVERS OF SUBROGATION

American leases often provide for total reciprocity for insurance provisions, including releases, waivers of subrogation and indemnities. It is often surprising to them, therefore, that this position is not a given under Canadian leases. While many anchor tenants are successful in achieving such mutuality, this is not the norm, and many smaller tenants have difficulty obtaining these concessions. To avoid uncertainty, prudent tenants would be wise to include the provision of waivers of subrogation (at the very least) in their offer documentation.

***A Note on the Province of Quebec.*** It is important to note that many of the issues described in this bulletin are treated differently in the province of Quebec. This is primarily because Quebec retains a civil system for issues of private law, whereas all other provinces and all territories within Canada follow the common-law legal tradition as is followed in most states in the U.S. The civil-law system in Quebec (like the civil-law system employed in part of the state of Louisiana) relies heavily on a written civil code that sets out standards of acceptable behaviour or conduct in private legal relationships.

This civil code includes numerous provisions governing the landlord-tenant relationship, but oftentimes, these provisions set out rules that are different or even contrary to the ones employed in the other provinces and territories. Should you require further information on leasing in Quebec, please contact [Daniel Ferreira](#) at 514-982-4089.

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