

BLAKES

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OVERVIEW



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The days when closing a real estate transaction meant lengthy meetings in lawyers' boardrooms are rapidly becoming a thing of the past.

During the last major development "boom" when I was negotiating joint venture agreements in connection with the construction and financing of BCE Place and other office developments in downtown Toronto, lawyers and their clients would generally meet in large boardrooms for the purpose of settling outstanding issues and documents – having first faxed and re-faxed mark-ups of the documents during the earlier stages of negotiation – and closing the transaction as a group. Now, draft closing documents and black-lined redrafts are circulated by e-mail and executed pages of the final versions are often provided on closing by means of PDF attachment. And where, previously, clerks from the various law firms involved in the transaction would personally attend at the applicable Land Registry Office and line up – sometimes for hours on end – in order to register real property documents against title prior to the close of business, now such documents may be registered electronically by the click of a computer button back at the law firm.

Along with technological advances has come another change, no less dramatic. Previously, the players in Canadian real estate transactions were almost invariably domestic. Now, they are international. Many foreign investors and lenders – from Europe, the Middle East, Australia and Asia – view Canada as a stable, long-term investment destination and, consequently, are often participants in important Canadian real estate transactions. Indeed, CB Richard Ellis Ltd. recently reported that the value of foreign commercial investments in Canada in the first six months of 2006 was almost twice that for the first six months of 2005. It would be no exaggeration to say that the internationalization of real estate has taken Canada by storm.

As real estate lawyers, we accommodate the challenges posed by different time zones when the parties are located on different continents just as, in the past, we addressed the issues when the parties were gathered in the same boardroom.

Despite all these changes, the fundamentals of a successful real estate transaction remain the same: strong personal business relations between the parties; tenants with solid covenants; and developers who are able to produce quality buildings on schedule and on budget. Essential, as well, are experienced real estate counsel who can find creative solutions to the problems which invariably arise during the course of a transaction and get the deal closed.

This bulletin contains articles by members of our legal team who would be pleased to discuss their topics or answer any questions which you may have.

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JOINT VENTURES –DIFFERENT VEHICLES

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One of the first decisions that needs to be made when two or more persons join together to develop a property is which joint venture vehicle should be used? Co-ownership and partnership (general or limited) are the most popular choices. Alternatives such as a trust may also make sense in some circumstances. Each offers different advantages and disadvantages. Income tax and liability issues often dominate.

CORPORATION

Why not a corporation? This is the simplest, though least popular option. Here, the corporation itself is the owner of the real property. The joint venture participants hold their interest as shareholders of the corporation. The corporation, rather than shareholders, owns the real property and carries on the business. The biggest advantage is that the corporations have limited liability. In addition, corporations are relatively straightforward, given that they are governed by a statute which sets out rules on everything from organizing to dissolving it.

However, the disadvantages usually rule out a corporation. There can be taxation at the corporate level and again at the shareholder level on essentially the same profits. Losses and profits as between the corporation and the shareholder respectively cannot be offset against one another. Similarly, capital cost allowances (depreciation) is taken at the corporate level and cannot offset income of the shareholder. Unless a tax-free rollover is available and used, tax may be triggered on the contribution from a shareholder of the real property to the corporation. Lastly, the shareholders agreement will usually need to be entered into anyway, similar to a co-ownership or partnership agreement.

CO-OWNERSHIP

A very popular joint venture vehicle is co-ownership. Although each co-owner (or co-tenant) may have a different percentage interest, each is entitled to an undivided interest in the whole. There are many advantages to using co-ownership, including that each co-owner receives its own share of the profits and losses and decides its own capital cost allowances and can sell, mortgage or otherwise separately deal with its interest (such to restrictions as agreed to among the co-owners).

There are special rules under the *Income Tax Act* for determining the amount of write-off available to a "principal business corporation" (a PBC). A PBC essentially is a corporation whose principal business is the leasing, rental, sale (or the development for leasing, rental or sale) of real property owned by the corporation. These advantageous rules apply to

a co-owner that is a PBC, but would apply only to real estate held in partnership if all the partners are PBCs. This is likely not the case where other partners are, for example, a bank or a life insurance company.

PARTNERSHIP

A partnership is not a separate legal entity, but is a relationship that exists between the parties who carry on business in common with a view to profit. Unlike a co-tenancy, the partners' interest is not held directly, but rather through the partnership. Partners share in the profits, losses and net proceeds on dissolution. If all of the partners are residents of Canada for purposes of the *Income Tax Act* (Canada), certain rollovers are available on the transfer of property to a partnership. This is an advantage over co-ownership where the contributing co-owner has to sell its interest and the receiving co-owner must buy it. The exposure of a partner to liability can be minimized by using a limited partnership rather than a general partnership, i.e., the liability of a limited partner is limited to the extent of its investment in the partnership. However, a limited partner must not take part in the affairs of the business. If it does, it risks losing its limited liability.

A significant disadvantage of a partnership, compared to a co-ownership, is that income and loss are calculated at the partnership level with the result that discretionary deductions in computing income (such as capital cost allowances) must be taken at the partnership level and must be agreed to by the partners.

OTHER OPTIONS

There are other alternatives for joint venture vehicles, such as a trust. This has been popularized by the use of real estate investment trusts. Other factors that will also have an impact in determining the best vehicle to use – such as whether the investor is a non-resident or a specialized entity such as a life insurance company, in which case special rules and considerations apply – particularly from a tax point of view.

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ALTERNATIVE AND MEZZANINE FINANCING

GREG UMBACH

For a variety of reasons, developers of large projects may not be able to obtain their desired level of financing for a development.

Typically, institutional lenders will not go above 60-70% loan to value ratio for real estate developments. Mezzanine lenders will assist the developer in raising the loan to value ratio to between 70% and 90% and higher by (i) the mezzanine lender will provide financing in a "junior debt" position and receive a fixed income yield in a typical 8% to 12% range under a debt instrument like a mortgage or debenture; or (ii) relying on participating debt or preferred equity which combines a fixed income component and a participation or exit fee.

Security in the project varies depending on the nature of the deal between the mezzanine lender and the developer but there are some common elements.

DEBT MEZZANINE FINANCING

Such financing may involve any of the following:

Second Mortgage or Debenture. This allows a lender the most secure form of collateral and permits a mezzanine lender to foreclose on the project in a default. This security requires the consent of the senior lender and an interlender agreement or subordination agreement to set out the relationship between the mezzanine lender and the senior lender.

Assignment of Interest of Developer. This allows the mezzanine lender to take the developer's interest in the project in the event of a default. Essentially, the mezzanine lender is becoming an equity owner and will assume the obligations owed to the senior lender on a takeover of the project.

Cash Flow Note/Soft Second Mortgage. This provides that the mezzanine lender receives an assignment of cash flow from the project in exchange for mezzanine loan proceeds and a percentage of the proceeds from a sale of the project or lease income. No security is registered and, therefore, an intercreditor agreement with the senior lender is not necessary.

EQUITY/JOINT VENTURES

Equity/joint ventures involve the following:

Partnership Agreement/Joint Venture Agreement. The advantage to the mezzanine lender is that it obtains control over many major decisions especially surrounding cost increases or cost over-runs. The advantage for the developer is that it will be required to contribute much less cash to the project (sometimes as little as 5%). An additional advantage for

the developer is that it has the benefit of a partner who may be able to help if the project falters.

Security Agreement. Generally, the equity mezzanine lender will secure its loan with security in most cases over the lands involved in the project. In some cases, the mezzanine lender will take alternative security such as a pledge of shares, warrants for the issue of shares or personal property security.

INTERCREDITOR AGREEMENT

The intercreditor agreement is the essential link between the senior lender and the mezzanine lender's rights in a default situation. The intercreditor agreement sets out the system of communication between the senior lender, the developer and the mezzanine lender. An intercreditor agreement typically deals with the following issues:

Priority of Security Between Senior and Mezzanine Lenders.

Often the mezzanine lender will want to tie the senior lender to a fixed debt and interest amount and prefer that the senior lender not be able to re-advance any principal amounts or make changes to the financial structure of the senior loan.

Notification of Defaults under the Senior Lender's Security.

This notification may include a "standstill" period during which the mezzanine lender either cannot enforce its security or may also be prohibited from collecting any amounts from the developer. For this reason, the mezzanine lender will often maintain an interest reserve to allow for continuing payments of interest even during a standstill. The standstill period usually commences on a notice of default and ends when the senior lender is brought current or commences foreclosure.

A Right to Cure Defaults under the Senior Lender's Security.

This allows the mezzanine lender to take over the project and complete the development to realize its profits.

The Right to Enforce its Own Security.

This right usually occurs either after a specified period of time or once the senior lender has started enforcement. The definition of enforcement is critical since a senior lender will want the mezzanine lender to refrain from enforcement as long as possible, while a mezzanine lender will want enforcement to be confirmed to be "real" enforcement such as foreclosure or appointment of a receiver over the project.

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OWNERS AND THE “STANDARD” CONSTRUCTION CONTRACT

DAVIS FOTH AND GARTH ANDERSON

In developing an office building or complex, an owner will necessarily enter into a construction contract, often based on the standard form Canadian Construction Documents Committee CCDC 2-1994 Stipulated Price Contract (the Contract). When negotiating the Contract with the builder, a prudent owner should review the provisions with legal counsel and consider the amendments and other measures discussed below.

INDEMNITIES AND LIMITATION OF LIABILITY

The indemnity by the builder contained in section GC 12.1 of the Contract is limited to claims which are for personal injury or property damage caused by builder negligence and made in writing within the relevant limitation period. There is no recourse against the builder for consequential damages (i.e., loss of profits) under the indemnity, and the indemnity does not apply to third party claims that arise from a breach of contract by the builder. There is also a dollar cap on the indemnity of CAD 2,000,000. As well, section GC 12.2.1 of the Contract precludes the owner from suing the builder for anything other than (i) third-party indemnity claims, warranty claims, or claims which arise from improper responses to the discovery of toxic or hazardous substances at the work site or the introduction of such substances by the builder; (ii) claims which relate to substantial defects or deficiencies in the work; and (iii) claims which have been made in writing prior to final payment.

It is to be noted, as well, that the warranty period set out in the Contract is one year from the date of substantial performance, and not from the date of final payment. These provisions in the Contract constitute a significant limitation on the normal contractual and common law remedies available to a contracting party, and may not be necessary or appropriate in all situations. An example of a specific amendment to the Contract which would be useful for the owner is the expansion of the builder's indemnity to cover damages caused by the registration of liens on title, as well as the cost of clearing such liens from title.

FINANCIAL DISCLOSURE

Section GC 5.1 of the Contract requires the owner to provide, on an ongoing basis, reasonable evidence that financial arrangements have been made to fulfill the owner's obligations, and also requires the owner to notify the builder in writing of any material change to such financial arrangements. An owner should seek to delete this clause from the Contract.

INSURANCE

The insurance provisions should be reviewed by a professional insurance broker to determine if the insurance that the parties covenant to obtain is available and adequate. Each construction project has its own risk profile and the insurance requirements need to be determined on an individual basis. Depending on the circumstances, certain risks are more probable than others – such as delivery delays for long lead-time items, and third party claims in the event of delay in start-up.

OCCUPATIONAL HEALTH AND SAFETY

The Contract does not expressly reference the builder's obligation to comply with occupational health and safety legislation. Under the *Occupational Health and Safety Act* (Alberta) (the Act), a builder may become a “prime contractor” only by express agreement with the owner. If no such agreement is entered into, the owner is deemed to be the prime contractor and has the duties of a prime contractor under the Act. To ensure that these duties become the responsibility of the builder, the owner should insert a provision in the Contract to the effect that “the Contractor shall be solely responsible for all site safety and shall perform and fulfill all functions and duties of, and is hereby designated as, the “prime contractor” for purposes of all occupational health and safety legislation applicable to the Place of the Work.”

BONDING

Section GC 11.2 of the Contract stipulates that the builder will deliver a prescribed form of bond when a bond is required under the Contract. An owner should ensure that the stipulated form of the bond is adequate to cover all anticipated risks. An owner should also consider whether lenders will want to be added as dual obligees under the bond.

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ISSUES AFFECTING INVESTMENTS BY PENSION FUNDS IN DEVELOPMENT PROJECTS

CHRIS HUBAND

Canadian pension funds and their subsidiary pension realty corporations are frequently subject to limitations on the nature of the activities and investments they are permitted to make. Development projects, in particular, sometimes give rise to issues regarding a pension fund's ability to participate.

PENSION REALTY CORPORATIONS

When Canadian pension funds acquire real estate, they usually do so through subsidiary corporations described in paragraph 149(1)(o.2) of the *Income Tax Act* (Canada) (the Act). These pension realty corporations offer their shareholder pension funds the protection of limited liability, which is an important consideration in the case of large or risky real estate projects. Provided that such corporations are owned, and limit their activities and investments, in compliance with paragraph 149(1)(o.2) of the Act, the corporations will be exempt from tax under Part I of the Act in the same manner as their pension fund shareholders.

TYPES OF PENSION REALTY CORPORATIONS

Pension realty corporations fall into two categories. Corporations described in subparagraph 149(1)(o.2)(i) of the *Income Tax Act* must have been incorporated prior to November 17, 1978 solely in connection with, or for the administration of, a registered pension plan. The Act requires that the shares of these pre-November 1978 corporations be owned by one or more pension funds or similar entities, but otherwise imposes no restrictions on the activities or investments capable of being pursued by such corporations. The other far more common type of pension realty corporation is described in subparagraph 149(1)(o.2)(ii) of the Act. In addition to being owned solely by one or more pension funds or other similar entities, these corporations must limit their activities and investments strictly in accordance with subparagraph 149(1)(o.2)(ii) of the Act. Failure to comply with the statutory limitations will result in the corporation losing its tax-exempt status – obviously a highly undesirable result.

PERMITTED ACTIVITIES

Development projects pose special challenges for subparagraph 149(1)(o.2)(ii) corporations because the development of real property does not necessarily fall squarely within the permitted activities of “acquiring, holding, maintaining, improving, leasing or managing capital property that is real property” contemplated by the Act.

CAPITAL PROPERTY

In the first place, the property in question must be “capital property”. Generally speaking, this means that the property must be acquired with a view to holding it for long-term investment purposes. Certain development projects, such as residential condominiums intended for sale to investors or occupants, obviously do not fall into this category.

DEVELOPMENT ACTIVITIES

The permitted activity of “improving” real property enumerated in subparagraph 149(1)(o.2)(ii) of the Act seems to encompass most development activities. However, the Canada Revenue Agency at one time thought differently and determined in 1991 and 1992 technical interpretations that a “passive role” was required, which did not permit the development of real property. This position was revised in subsequent technical interpretations so that activities “undertaken to increase the return on investment on capital property” are acceptable. Development activities are permissible provided that they are associated with the earning of “passive investment income” on capital property – as opposed to development activities undertaken “with the intent to improve and develop for sale at a profit”, which are not permitted.

REGULATORY LIMITS

Subparagraph 149(1)(o.2)(ii) corporations are also required to make no investments other than in real property or an interest therein or investments that a pension plan is permitted to make under the *Pension Benefits Standards Act, 1985* (Canada) or a similar law of a province. This brings into consideration various qualitative and quantitative limits imposed under pension regulatory legislation. Perhaps the most important of these is that the proposed investment must comply with the written statement of investment policies and procedures of the shareholder pension fund and/or the pension realty corporation. The written statement of investment policies and procedures may restrict development activities in general or especially large or risky development projects in particular.

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INDUCING THE MAJOR TENANTS WHEN DEVELOPING A MAJOR OFFICE BUILDING

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INTRODUCTION

The developer/landlord has purchased, or has an option to purchase, the lands for an intended office building and, subject to necessary site plan approvals, wishes to proceed with construction. However, no developer will proceed without significant pre-leasing commitments from one or more tenants with sound financial covenants who will occupy, in the aggregate, a significant portion of the rentable area of the building. Assuming such tenant(s) can be found, how does the developer/landlord induce it to enter into a long-term unconditional commitment? In other words, what provisions are found in these major tenant leases which would not normally be found in a normal office tenant lease?

THE BUILDING

The location, size and quality of the building and the amenities within and around the building are of utmost importance to a tenant. Tenant design and specification input to permit its special requirements which would not otherwise be available in existing buildings is a very important inducement.

RENT

Annual basic rent is important but the total rent package (basic rent, additional rent and utilities) is even more important. A new building should be less costly to operate so, in return for the higher rent per square foot normally associated with a new building, lower additional rent per square foot may be offered. Some landlords will consider capping the amount of additional rent or certain segments of it with formulas for escalation over the ensuing years. Some tenants will insist on more detailed reporting and may ultimately require the landlord to keep certain records which are subject to audit by the tenant or its accountants.

PRIOR LEASES

A key exposure for any tenant is whether or not, when it commences its occupancy, it will continue to have obligations under an existing lease in respect of space it is vacating. Alternatively, a tenant's existing lease may expire prior to completion of the building. The landlord must deal with these concerns as a tenant will not want to be paying rent in two locations or, alternatively, risk having no space for the operation of its business. As well, a tenant will not want to move

into a partially-constructed building which adversely affects the operation of its business.

SIGNAGE

There are many types of signage and signage rights which may benefit a tenant. Building naming rights and top of building signage exposure are the most important to a tenant as well as podium signage, interior building signage exposure and building directional signage. Exclusivity with respect to any or all of these signage rights can also be important. In connection with discussions pertaining to signage, some tenants may seek to exclude business competitors from occupying the building or some portions of it.

ADDITIONAL SPACE

If a tenant is committed to a building for a lengthy period of time, it will seek reasonably flexible expansion rights which the landlord may combine with expansion obligations. These space rights/obligations are normally expressed by way of rights of first refusal, rights of first offer, early expansion space and additional expansion space. A landlord must be very careful not to inhibit the ongoing leasing program for the building by granting extremely flexible expansion rights to its major tenant(s).

EARLY TERMINATION RIGHTS

To address potentially adverse changes to its business circumstances, a tenant will also seek limited or extensive rights of early termination. These will be met with great resistance by the developer/landlord as it will inhibit its financing of the building.

TRANSFERS

The tenant may well seek assurances that, during the construction of the building and for some period of time thereafter, the developer/landlord with whom it is negotiating will not assign to a third party without tenant approval. Similarly, the landlord will also be concerned with the identity of the tenant and its financial condition and will seek to control the ability of the tenant to transfer its rights, particularly when the tenant has building naming and top of building signage rights.

A major tenant lease which addresses all key issues will likely exceed 100 pages and will deal with issues summarized above as well as many other matters.



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BUILDINGS LOCATED AT THE INTERSECTION OF REAL AND INTELLECTUAL PROPERTY

GARY DANIEL

With the myriad of issues to consider in connection with developing a major office building, could there possibly be intellectual property issues? The short answer is a resounding “yes”. While intellectual property issues may not be a major factor in all development projects, such issues will often arise in the context of a major office building, hotel, sports facility, or other distinctive venue.

COPYRIGHT

While patent issues may relate to building materials and processes, for those involved in the development of a major building or complex, the intellectual property issues primarily arise in connection with copyright and trade-marks.

Copyright subsists in original works which are tangible expressions of ideas. Since 1988, the *Copyright Act* (Canada) (the Act) provides that copyright subsists in an “architectural work”, defined as “any building or structure or any model thereof”. Prior to 1988, copyright subsisted only in an “architectural work of art”, which more narrowly protected only the artistic character or design and not the building itself.

Each architectural work will have one or more “authors” who may be different from the owners of the copyright in the building. The precise facts will determine who is author of the architectural work and who is the developer or the owner of copyright in a building. It is clearly best for an owner of a building to obtain an assignment of all applicable copyrights from architects, designers and others who may have a copyright interest.

In addition to the copyright in the building, the building’s blueprints and drawings for construction may also be subject to copyright. In cases where, for example, the architect or designer or other owner of copyright in blueprints or drawings is replaced before completion of the project, the unauthorized use or modification of those blueprints and drawings may constitute copyright infringement unless the proper rights are obtained.

MORAL RIGHTS

Even if copyrights in the building and plans are properly assigned, a building’s designer or architect may have additional rights. Well-known architects are often retained to design “landmark” buildings – sometimes after a lengthy and public

design competition – and the success of such projects may substantially affect the reputation of its designer. Authors of copyright works also enjoy what are known (somewhat misleadingly) as “moral rights” under the Act. Moral rights (a literal translation of the French “droit morale”) are personal rights that belong to the author, as distinct from the economic right of copyright. Significantly, while copyright in the design of a building may be assigned to the owner, moral rights may not be. Moral rights may only be waived. This issue is of particular relevance when it comes time to modify the architect’s original design or, potentially, when the building is to be demolished or rebuilt. Moral rights last as long as the copyright. Generally, that term extends 50 years beyond the life of the author. Thus, if a landmark building is designed today by a relatively young designer or architect, their moral rights in respect to the building (if not waived) may last upwards of 100 years, and may impact the ability of the owner to remodel or demolish the building.

Because architectural works are generally located in public spaces, the exclusive right to reproduce such works is more limited than is the case for other types of copyright works. The Act permits anyone to make a reproduction of an architectural work in a photograph, painting, drawing, engraving or audio-visual recording, provided that the reproduction is not in the nature of an architectural drawing or plan. As a result, a building may be freely photographed or filmed. However, without the permission of the copyright owner, the building may not be copied in order to create a plan either for the purpose of repairing or renovating the building or, indeed, of duplicating the building elsewhere.

To counterbalance the rights of owners of copyright, the Act specifically provides that, once construction of a building or other structure has started, the owner of the copyright is not entitled to obtain an injunction in respect of the construction of that building or to require the destruction of the building. Certain other remedies that are otherwise available to copyright owners and certain criminal copyright provisions also do not apply in the case of such a building or other structure.

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QUÉBEC REAL ESTATE OWNERS BECOME GUARANTORS OF CONTRACTORS' OBLIGATIONS

YANNICK BEAUDOIN

INTRODUCTION

On October 6, 2005, the Supreme Court of Canada rendered its decision in *DIMS Construction (Trustee of) v. Attorney General of Québec (DIMS)*. Though this decision did not receive much publicity in the construction and real estate financing fields, it has definite implications for real estate owners in Québec and thus, for real estate lenders. As a result of this decision, any real estate owner who suspects that one of its contractors is in financial difficulty should pay any of that contractor's unpaid dues to the Commission de la santé et sécurité du travail (the Québec Workers Compensation Commission) and the Commission de la construction du Québec (the Québec Construction Commission) (QCC) as soon as possible and prior to the contractor's bankruptcy, if it wants to be able to set-off those payments against amounts owed to the bankrupt contractor's estate.

In effect, Section 316 of the *Québec Industrial Accidents Act* authorizes the Québec Workers Compensation Commission to require an employer governed by the *Québec Industrial Accidents Act* to pay to it dues and assessments owing by a contractor retained by the employer. Pursuant to this section, an employer who has paid the amount owing may also withhold the amount paid out of the sums that it owes the contractor.

Section 54 of the *Québec Labour Relations Act* contains a similar set-off right and effect as the one found under the *Québec Industrial Accidents Act* but based on the principle of joint and several liability between the employer and contractor. The *Québec Labour Relations Act* allows the QCC to claim from an employer any arrears due to the QCC from a contractor employed by that employer by way of a claim against any unpaid wages owed by the employer to the contractor. The effect of the *Québec Industrial Accidents Act* and the *Québec Labour Relations Act* is to make an employer an involuntary legal surety or guarantor of the obligations owed by a contractor.

THE SUPREME COURT OF CANADA DECISION

In coming to its decision, the Supreme Court of Canada reviewed the elements of legal and equitable set-off. The Court confirmed that legal set-off was available to a real estate

owner/employer to set-off amounts paid by it to governmental agencies against amounts that would have otherwise been payable by the real estate owner/employer to the bankrupt contractor's estate only if payments to those governmental agencies were made prior to the date of bankruptcy.

Furthermore, the Court decided that equitable set-off, a common law principle which was widely accepted in the common law provinces and which had slowly gained acceptance in Québec, was no longer available in Québec. As a result, the right of set-off contained in the two statutes at issue could not be enforced by a real estate owner/employer to set-off post bankruptcy obligations against a trustee-in-bankruptcy.

The Supreme Court of Canada found that except for amounts paid by any of the real estate owners/employers prior to DIMS' bankruptcy, no other amounts could be set-off against amounts owing to the Trustee. It came to this conclusion, not on the basis that section 316 of the *Québec Industrial Accidents Act* or section 54 of the *Québec Construction Labour Relations Act* subverted the priorities for distribution set out under the *Bankruptcy and Insolvency Act (Canada)* but by applying strictly the rules of legal set-off and by finding that equitable set-off no longer applied in Québec. For a more detailed summary of this decision, see *The Supreme Court Rules – The End of Equitable Set-off in Québec*, Blakes Bulletin on Restructuring & Insolvency, November 2005.

The Supreme Court held that the Québec Workers Compensation Commission and the QCC were not prohibited from demanding payment from a real estate owner/employer even after a contractor's bankruptcy. Based on the right of legal set-off, the Court found that the real estate owners/employers who had not paid any amounts to the Québec Workers Compensation Commission and/or the QCC prior to DIMS' bankruptcy would have to pay the unpaid assessments of DIMS and also pay DIMS' Trustee all the monies owed to DIMS, free of any set-off for monies paid to the Québec Workers Compensation Commission or the QCC after bankruptcy. With respect to the real estate owners/employers that paid the QCC prior to DIMS' bankruptcy, they were permitted to set-off the amounts paid against amounts owing to DIMS' estate for pre-bankruptcy services provided.

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LAND TRANSFER TAX IN ONTARIO – Potential Hidden Liability in Construction Contracts and the Audit Process

JOHN HUTMACHER

Most registered and unregistered conveyances of interests in commercial real property in Ontario are subject to the payment by the transferee of a land transfer tax, which is calculated on the “value of the consideration” paid for the interest transferred.

This tax is payable at the following graduated rates: (i) 0.5% on the first CAD 55,000; (ii) 1% on the portion of the value from CAD 55,000 to CAD 250,000; and (iii) 1.5% on the portion of the value in excess of CAD 250,000.

The *Land Transfer Tax Act* (Ontario) (the Act) contains a definition of the “value of the consideration”. Usually, the “value of the consideration” reflects the gross purchase price agreed to between the vendor and the purchaser of the property. However, the definition contained in the Act is rather more expansive and includes “the value of any liabilities assumed by the transferee and the value of any benefits conferred by the transferee on any person as part of the arrangement relating to the conveyance”. As the following summary in *Assaly v. Minister of Revenue (Ontario)* demonstrates, purchasers wishing concurrently to acquire lands and enter into an agreement for construction contract must carefully structure their transactions to avoid potentially significant unintended land transfer tax consequences.

THE ASSALY CASE

The *Assaly* case involved a sale of vacant land from a builder to a developer. As a condition of the agreement of purchase and sale, the parties also entered into a separate construction agreement under which the vendor/builder was to construct improvements upon the vacant land in exchange for additional consideration. Registration of the actual conveyance of legal title to the lands did not occur until construction was completed. The issue for the Ontario High Court of Justice was whether land transfer tax was payable solely on the purchase price for the vacant lands, or whether it was also payable on the consideration paid to the vendor/builder under the construction agreement. The Court decided that, in the circumstances, there was a strong connection between the agreement of purchase and sale and the construction contract and that the construction contract constituted part of the “arrangement relating to the conveyance”. As a result, the Court found that land transfer tax was payable not only on the value of the vacant land but also on the amount of the consideration paid under the construction contract. The decision of the Ontario High Court of Justice was subsequently affirmed by the Ontario Court of Appeal.

In rendering its decision, the Court mentioned that the result could have been avoided with “appropriate tax planning”.

Accordingly, steps should be taken, where appropriate, to segregate the purchase and sale transaction from the construction contract to avoid the unintended land transfer tax consequences which arose in the *Assaly* case.

THE LAND TRANSFER TAX AUDIT

Land transfer tax must be paid at the time of registration of a conveyance of land or, if an unregistered conveyance of land has occurred, within 30 days of the date of the unregistered conveyance. The Ontario Ministry of Finance (the Ministry) regularly audits transactions to confirm that the amount of land transfer tax paid was correctly determined. Two or three years may pass before a written request is received from the Ministry for additional information concerning the transaction that gave rise to the payment (or non-payment) of land transfer tax. However, the assessment or reassessment of tax resulting from an audit must be completed within four years from the day the tax became payable, unless the taxpayer has waived the time limit.

As an initial step in the audit process, the Ministry usually requests information that will assist it in confirming that the value of the consideration indicated in the land transfer tax affidavit accompanying the registered conveyance is correctly reflected and, accordingly, that the correct amount of land transfer tax was paid). Frequently, the Ministry requests copies of the agreement of purchase and sale (as well as any amendments and assignments) and the statement of adjustments. In addition, if there is any discrepancy between the vendor and purchaser shown in the agreement of purchase and sale and the parties appearing in the registered conveyance, the Ministry will also request details of any consideration that may have passed between such parties. The latter information is intended to bring to light any unregistered “flips” of real property in respect of which land transfer tax has not been paid. Initial Ministry requests for information are usually followed up with requests for more specific information, especially in connection with complicated transactions.

The Act requires that documents, records and accounts be kept for a period of seven years after the date on which the conveyance to which they relate is registered or the information to which they relate is given to the Minister, in order to facilitate the audit process.

Joint Ventures — Different Vehicles

CONT'D FROM PAGE 2

JOINT VENTURE AGREEMENT

Whatever the joint venture vehicle, a shareholder, co-ownership or partnership agreement should, and almost always is, entered into. While such agreements vary somewhat depending on the joint venture vehicle, they basically all try to answer similar questions, such as:

- Who makes the decisions?
- What are the major decisions and do they require unanimity?
- What if there is a deadlock or a dispute – how is it resolved? By buy/sell or arbitration?
- Who pays for expenditures?
- Who gets what portion of the revenues?
- What rights do owners have to sell or mortgage their interest (in the case of a corporation, the shares)?
- Do the others have a right (a *piggy-back*) or an obligation (a *drag along*) to sell out too?

SUMMARY

While different vehicles can get you to the same place, they do so with significantly different tax, liability and other consequences. Care should be taken in choosing the one that make the most sense for you.

Alternative and Mezzanine Financing

CONT'D FROM PAGE 3

EXIT STRATEGY

Repayment of the mezzanine loan may occur in several ways. One of the most typical scenarios is the orderly repayment of the mezzanine by the developer, either through the planned sale of the project or by the funds available through the developer's "take-out" or permanent financing to replace the senior lender and the mezzanine lender. Another exit is where the cash flow of the project is sufficient to service the debt on the senior lender but not sufficient to the pay portion of the mezzanine. In such a scenario, the developer and mezzanine lender will negotiate an outcome but often the mezzanine lender can take an interest in the project.

BANKRUPTCY

Profit participation loans can be structured in such a way as to avoid problems with the priorities between creditors in a bankruptcy. Section 139 of the *Bankruptcy and Insolvency Act* (Canada) may preclude an equity investor from claiming priority over the general class of creditors of the bankrupt. A claim that can be construed as a loan will not be postponed to other creditors in a bankruptcy situation in the same way. It is critical that any equity or profit participation type of arrangement be structured as a loan so that the mezzanine lender can argue for its priority over other creditors. Security that is taken in connection with the loan will be enforceable. Accordingly, it is recommended that every mezzanine loan require some limited security to enforce in the case of a bankruptcy.

Owners and the “Standard” Construction Contract

CONT'D FROM PAGE 4

PARALLEL LIABILITY

The Contract deals inadequately with parallel liability, i.e., liability that the parties may have under other contracts with one another. The owner should ensure that the Contract contains a provision to the effect that the only liability they will have to one another is what is set out in the Contract and that the Contract supersedes any prior negotiations or agreements – if such, indeed, is the intention of the parties.

In addition, it is desirable to ensure that the Contract may only be amended by the express written agreement of the parties or in accordance with the change order. These objectives could be achieved by substituting the following for Article A-2.2: “The Contract Documents constitute the entire agreement between the parties relating to the Work and may be amended only by written agreement between the parties, or as otherwise provided in the Contract Documents.”

CONTRACT DISPUTES

In our experience, the bulk of construction contract disputes relate to the scope of work intended to be covered by the Contract. Care should thus be taken to describe the scope of work by identifying and attaching as schedules to the Contract copies of drawings and specifications which are as detailed possible. In larger projects, the risk of inconsistent obligations appearing in different contract documents may be significant. In order to address this risk, it would be prudent for the owner to supplement the paramountcy provision (section GC 1.1.9 of the Contract) by referencing specific documents which do not fall into one of the categories listed in that section.

Issues Affecting Investments by Pension Funds in Development Projects

CONT'D FROM PAGE 5

OTHER INVESTMENT STRUCTURES

Pension funds and pension realty corporations may also acquire real estate indirectly, in conjunction with other participants, through investments in partnerships or limited partnerships. Like corporations, limited partnerships offer limited liability protection, but do not allow limited partners to participate in the management and operation of the real property. Direct investments by pension funds in limited partnerships are subject to the qualitative and quantitative limits imposed by pension regulatory legislation, including the written statement of policies and procedures. Investments by pension realty corporations in limited partnerships are generally characterized as “investments” (as opposed to an “activity”) so long as the pension realty corporation is an inactive limited partner.

ALTERNATIVES

If development activities are prohibited by the written statement of policies and procedures of the pension fund or its pension realty corporation, it may nevertheless be possible for the pension realty corporation to participate in the project by obtaining an option to acquire the property or an interest therein once the development is complete. This may be coupled with a financing arrangement, the repayment of which is capable of being set-off against the option purchase price. Under this scenario, the mortgage financing arrangements and the option must comply with the qualitative and quantitative limits imposed by pension regulatory legislation, including the written statement of policies and procedures.

Buildings Located at the Intersection of Real and Intellectual Property

CONT'D FROM PAGE 7

TRADE-MARK

Trade-mark issues with respect to office buildings typically arise in the context of the name of the building, either where the name of the building or complex is derived from, or associated with, the major tenant – Commerce Court, Scotia Plaza, First Canadian Place or Royal Bank Plaza – or where the name of the building (typically, but not invariably, a residential condominium) is intended to be distinctive in order to promote a sense of exclusivity or luxury – the Renaissance Plaza, the Churchill or the Prince Arthur. In the latter case, conducting a simple trade-mark search for the purpose of determining the availability of a particular name would seem a prudent measure for a developer to undertake at the outset of the development, especially in view of the considerable amounts which will be expended in constructing and promoting the building.

In certain (albeit rare) instances, the outline of the building itself can become a landmark and potentially itself a trade-mark. This is particularly so with very tall towers (such as the CN Tower or the Empire State Building,) or sports venues (the stadium formerly known as Skydome). While, as noted above, the owner of a building's copyright cannot prevent the photographing or filming of the building, even for commercial purposes, the owner of the rights in the building may in certain circumstances wish to protect the image of the building as a trade-mark. This will prevent the unauthorized use of the likeness of the building (on t-shirts, posters and other souvenirs) by others for profit.

Québec Real Estate Owners Become Guarantors of Contractors' Obligations

CONT'D FROM PAGE 8

THE AFTERMATH

In light of the Supreme Court's conclusion in *DIMS*, the following principles are applicable to each of the real estate owners/employers in the Province of Québec:

- If a person paid any amount *before* the date of bankruptcy, he will be entitled to claim legal set-off against the Trustee up to the amount that he has paid.
- If a person paid any amount *after* the date of bankruptcy, he cannot claim legal set-off against the Trustee and the only recourse will be to file a proof of claim as an unsecured creditor.
- The relevant governmental authority has the right to demand payment from such real estate owner/employer even after the debtor's bankruptcy. In such a case, the real estate owner/employer could be required to pay the unpaid amounts to such governmental authority and pay all amounts which remain outstanding to the Trustee for the work performed by the general contractor, without any set-off of any kind.

QUÉBEC DISTINCTIVENESS

Similar legislative provisions are in force in other Canadian provinces to assist bodies enjoying powers akin to those of the Québec Workers Compensation Commission and the QCC to collect amounts they are owed.

It will be interesting to see how such legislation will be interpreted in light of the Supreme Court of Canada's decision in *DIMS* and whether *DIMS* will be distinguished in order to permit real estate owners/employers of contractors in other provinces to continue to assert a right of set-off in respect of any payments made by them to a body similar to the Québec Workers Compensation Commission or QCC after a contractor's bankruptcy. For the time being, however, there exists a fundamental distinction between Québec and the other provinces in respect of the existence of the right of equitable set-off.

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