Commercial Leasing:
pitfalls and pratfalls

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**Introduction**

For many entrepreneurs, both new ones and old ones alike, the space from which they operate their businesses is essential in determining their current and future success. One of the primary reasons for this is that the cost of the space which they occupy will form a substantial part of their overhead costs and will have a direct impact on their bottom lines.

While leasing space is not as permanent a commitment to a particular space as purchasing is, it is still a major commitment and will normally bind a business to a property for a substantial period of time. As a result, caution must be taken when entering into a lease arrangement.

The purpose of this paper and this presentation is to bring to your attention some of the pitfalls that I often see entrepreneurs, both new and old, fall into when leasing space. I will begin by discussing the various methods by which a lease is negotiated and entered into. A person’s liabilities with respect to a space can, and often do, arise long before even an actual draft lease is tabled for discussion. Special caution needs to be taken at the earliest stages of negotiations, when term sheets, letters of intent and offers to lease are exchanged or executed. Entering into a binding offer to lease where it is agreed that the tenant will sign the landlord’s standard form of lease, more often than not, makes the actual execution of the lease as tabled by the landlord, a fait accompli, and additional negotiations will not be possible.

Next, I will briefly discuss net leases and the various forms of rent which are normally included in a lease, namely, minimum, percentage and additional rent. This will be followed by a more in depth discussion of additional rent and the definition of operating costs which is the main component of additional rent. Depending on how “operating costs” are defined in the lease, additional rent can become a profit center for a landlord and make an otherwise profitable business become a blackhole for a tenant.

**Letters of Intent, Offers to Lease and Leases**

Letters of Intent and Offers to Lease are the two types of documents that are most often used in lease negotiations. The differences between Letters of Intent and Offers to Lease are often not clearly understood but great care must be taken when either are drafted and executed as they may bind the parties to a lease relationship even if a lease is never formally executed.

A Letter of Intent is normally a non-binding document and is executed by the landlord and a tenant, generally in the early stages of negotiations. Care must be taken in drafting such
a letter, however, as depending on the wording used, the potential exists for a court to find that it is in fact a binding agreement.

The purpose of a letter of intent should be to set out the major financial and business terms of the lease for later inclusion in the offer to lease and/or the lease itself. Normally, a letter of intent would set out what space will be leased, how much the minimum rent will be, whether percentage rent will also be payable, how long the term will be and whether there will be a right of renewal.

A letter of intent can also include binding provisions between the parties. In order to be enforceable, these provisions and the letter itself must be carefully drafted. The most common binding provision found in letters of intent is that the parties agree to negotiate in good faith. This usually means that the parties agree that they will not, except under certain limited conditions, consider offers from third parties.

An offer to lease, often referred to as an agreement to lease, is meant to bind the parties. It will contain the financial and business terms found in a letter of intent but in far greater detail. It will likely also set out some of the other major terms of the lease such as what will constitute an act of default and it may contain various covenants and warranties given by one party to the other.

It is at this stage that the four corners of the lease relationship are established in a binding fashion and, therefore, care should be taken to ensure that any significant issues are not only addressed in the agreement to lease, but also addressed in significant detail so that there are no arguments later on as to the meaning of various terms.

Offers to lease also normally contain a provision which states that following execution of the offer, the tenant agrees to execute the landlord’s standard form of lease by a certain date. An example of such a clause is included in Appendix A. If after reviewing the landlord’s standard form of lease following the signing of an offer to lease, the tenant is not satisfied with some of the terms or definitions in the lease, such as the definition for operating costs, the tenant does not have a choice and must, except in rare circumstances, execute the lease as tabled. A tenant can of course still request certain revisions to the lease once a binding offer to lease has been executed, but most landlords will refuse to even consider them, particularly revisions to the financial terms of a lease. At this point, the landlord will simply point to the above-noted binding provision.

If a tenant refuses to sign the landlord’s standard form of lease as presented following the entering into of a binding offer to lease which includes a provision that states that the tenant agrees to execute the standard form, the tenant exposes itself to a possible lawsuit and damages being awarded in favour of the landlord. In addition, even if the standard form of lease is not executed, a lease relationship may still be found to exist by the courts and the tenant and the landlord will be bound by the terms as set out in the offer to lease.
In order for a lease relationship to be found to exist without an actual lease having been executed, five essential elements need to be established:

1) The Premises – they must be clearly defined and ascertainable;
2) The Parties – they must be correctly named, and they must be correct;
3) The Rent – all types of rent, minimum, percentage and additional must be clearly expressed;
4) The Term – the commencement and expiry dates must be both clear or readily ascertainable; and
5) All other material terms of the contract not incidental to the landlord and tenant relationship, including any covenants, conditions, exceptions or reservations.

If all five of these elements can be found to exist based on what is contained in the offer to lease, and in most cases they can be, a lease arrangement will be found to exist and the tenant will be bound to the terms as set out in the offer, whether or not an actual lease is executed by the parties.

What all of this means is that great care must be taken at every stage of the lease negotiation process. Waiting to see your lawyer or other advisors until after a binding offer to lease has been entered into, is an example of waiting too long. If this happens, your lawyer’s ability to protect your interests is greatly diminished and consists primarily of ensuring that the terms of the offer to lease are properly reflected in the lease and explaining to you what your exposure is, particularly in regards to additional rent. It will be very difficult, if not impossible, to negotiate various terms of the lease at this point, particularly the major terms of the lease and you will be bound by the definitions in the offer throughout the agreed to term.

With the assistance of your lawyer, steps can be taken to protect you during lease negotiations. In the case of letters of intent, ensure that the document states in very clear language that the document does not intend to bind the parties (an example of such wording is included in Appendix B). Please be aware however that even if the letter does contain such wording, depending on how the rest of the letter is worded, it can still be found to be a binding agreement and therefore the assistance of your lawyer is essential in preparing a properly drafted document.

For offers to lease which contain a provision similar to the one in Appendix A, a request to change that provision so that the tenant will have the right to make such changes to the lease that it may desire is rarely accepted by a landlord on the basis that it would swing the pendulum too far in favour of the tenant. A more middle of the road revision that I frequently suggest, and which is more often accepted by landlords states as follows:

“…the lease is to be negotiated subject to such amendments as shall be mutually agreed to between the Landlord and Tenant, and their respective solicitors, all acting reasonably and in good faith expeditiously to negotiate such amendments.” Some landlords prefer that the
term ‘reasonable non-financial amendments’ be used in place of ‘amendments’, however, caution should be taken in this regard since it is arguable that any amendment will impact a financial provision in the lease.

A final and more direct way of protecting yourself during lease negotiations is simply to forego the letters of intent and offers to lease and proceed directly to the lease itself. In certain circumstances, this may in fact be the only option available. It certainly has the potential to reduce some of the costs involved and, in some cases, it may actually expedite the process. This method is the preferred method of entering into lease arrangements in the United States of America but it has not yet been commonly adopted in Canada.

**Net leases, Rent, and Operating Costs**

The majority of commercial leases are net leases. If a lease states that it is a completely net lease to the landlord, this means, except as expressly stated otherwise in the lease, that the landlord is not responsible for any costs relating to the premises and the tenant is responsible for such costs. Sometimes people refer to leases as being net-net leases or triple net leases. In many ways these terms are terms of art and the actual terms of the lease need to be analyzed to determine what is and what is not payable by the tenant.

Under net leases one often finds two types of rent that are charged to the client, as well as possibly a third type. There is the basic, minimum rent which is the yearly rent payable by the tenant for the space that is normally expressed as the cost of the space per square foot. There is also percentage rent, which is not as commonly found in leases as it was in previous years, likely due to current market conditions and trends. Percentage rent normally charges the tenant a percentage of its annual revenues above a certain preset amount. This can be a potentially lucrative type of rent for a landlord, depending on the type of business being operated and its level of success. On the other hand, the downside of this type of rent for a landlord is it effectively results in the landlord obtaining a financial interest in the tenant’s business which can lead to some uncertainty for the landlord with respect to its financial bottom line.

The final type of rent that is found in a net lease along with minimum rent, is additional rent. Additional rent is what makes a net lease, net to the landlord. It is through additional rent that the landlord recoups its costs of operating the space, which include, among other things, repairs, cost of insurance, and taxes.

Most of the additional rent charged to a tenant will be made up of what is often referred to in a lease as “Operating Costs”. “Operating Costs” are normally a defined term and its meaning must be reviewed carefully prior to a lease being signed or an offer to lease being entered into which requires a tenant to execute the landlord’s standard form of lease.

In most cases, requests for substantial changes to the definition of operating costs will be rejected by the landlord, particularly where a space is being leased in a shopping center, an
office building or some other facility where there are many other tenants. The reason for this approach being taken by landlords is that if there are say 30 tenants in an office building and every tenant had a different definition of operating costs in its lease, the management of the building by the landlord would become an administrative nightmare. The landlord would need to make 30 different calculations of rent as opposed to one calculation divided by 30.

Nevertheless, the definition of operating costs should not be ignored simply because changes to it are likely to be difficult to obtain. Firstly, when it comes to clauses in a lease or any other agreement, it never hurts to request a change. Secondly, a detailed review of the definition must be undertaken to ensure that all operating costs are fully understood. These type of costs can quickly get out of control and have the effect of doubling or even tripling the amount of rent that the tenant had expected to pay and result in the failure of an otherwise successful business. A detailed review will provide a tenant with the opportunity to perform a complete risk assessment which should lead to an informed decision as to whether or not it is wise to enter into a lease for a particular space.

In many net leases the definition of additional rent and/or operating costs allows a landlord to charge to a tenant all of the operating costs for the space, even those that are not specifically set out in the lease. Not only does such a clause contribute to the possibility of operating costs spiraling out of control, but also to the likelihood of hidden costs being charged to a tenant.

One way to try and deal with this potential problem is to request a revision to the additional rent provision that states that all of the costs set out in the definition of operating costs are meant to be exhaustive. Not surprisingly, many landlords balk at such an amendment. Another approach by the tenant that is more likely be more successful is listing various expenses that will be specifically excluded from the lease.

Another potential hidden cost to be aware of is the administrative fees that may be charged by the landlord under the definition of Operating Costs. An administration fee charged by the landlord is consistent with the theory of a net lease as the fee represents the costs incurred by the landlord in the operation and management of the leased space. An example is head office expenses. Normally the administration fee will be between 5 and 15% of the rent charged. Some landlords will retain outside consultants to either assist in the operation of their leasing enterprise or to take complete responsibility for it. Depending on how operating costs are defined in a lease, the costs of retaining this outside assistance may be chargeable back to the tenant with no abatement in the administration fee. What effectively happens in such an instance is that the tenant is charged double rent in regards to the operation of the building.

In order to deal with this issue, one of two amendments can be requested. First, the tenant can request that the administration fee be reduced in proportion to the cost of retaining
outside assistance. Second, the tenant can request that the cost of retaining outside assistance simply not be included in the cost of operating expenses.

There are several other ways in which hidden costs of a landlord may be charged to a tenant under the terms of a lease, whether intentionally or otherwise. In order to prevent this from happening, a tenant should insist on a clause being inserted in the lease to the effect that the tenant shall have the right to examine and perhaps even to audit the books and financial records of the landlord. Having an audit performed on a landlord’s books and records could result in some expense to a tenant, however, it represents a good method, and perhaps the only method, by which a tenant can have some leverage or control over the landlord after the offer to lease or lease has been executed.

**GST**

Finally, I would like mention GST and leases. Many tenants do not realize it, but GST is payable on all rents set out in the lease, even if the lease does not state that GST is payable on the rents. This is so unless the lease specifically states that GST is included in the rents, however, in order for such a provision to be effective, it must be carefully drafted and a lawyer should be consulted to ensure that the wording is correct.

**Conclusion**

Commercial leasing is a complicated endeavour with many pitfalls awaiting the unwary. Retaining the assistance of a qualified, experienced advisor, such as your lawyer, early in the lease negotiation process can help you avoid many of those pitfalls, which will allow you to focus not on where your business is but where it is going.

Readers should not apply information provided herein to their circumstances without seeking legal advice. This information is not intended to provide legal advice or opinion, as neither can be given without reference to the specific facts, events, and situations of individual circumstances. If you would like to consult with a business law lawyer, contact Geoffrey Cantello at (613) 231-8287.
BIBLIOGRAPHY


