



RealEstateBrief

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In this issue, Bruce McKenna provides an overview of a typical sale leaseback transaction. Bruce describes the structure of such a transaction as well as commenting on a number of common issues. In our other article Celia Hitch comments on the situation where the lease of one tenant in a retail development allows a particular use that the landlord has previously promised another tenant that it will have the exclusive right to carry on that use.

Sale Leaseback Transactions: An Overview



**Bruce
McKenna**

The Typical Sale-Leaseback Transaction

Companies that carry on an operating business, whether it is manufacturing, retailing, or some other operation that is not in the business of investing in real estate, can often help maximize the use of their assets with a sale-leaseback transaction. An owner will sell its real property to investors and retain the benefits of its location through a tenancy, usually a long term lease with terms of 10 to 20 years.

A typical example would be a company, which I will call Xco, which has over the years acquired a number of locations across Canada where it manufactures its products. It has acquired these sites over time and either constructed or retrofitted buildings to make them suitable for its manufacturing purposes. These locations were acquired to meet the needs of its operating business and to be close to its customers in locations where it can obtain the raw materials and skilled workers for its manufacturing process. Xco acquired these locations using a mixture of the profits from the business (shareholders' equity) and loans to the company. Being in those locations helped the successful business grow and Xco is now a strong company with assets, a strong business and good support from its customers. However, Xco is not a professional real property investor or land developer. Its expertise is in manufacturing, sales and client service and there may be a number of reasons why it wishes to consider a sale-leaseback transaction as a way to free up debt and equity capital for the use of Xco or to provide to its shareholders.

Some of the possible benefits of a sale-leaseback transaction, where Xco sells its real properties and leases them back for 10 to 20 years, are as follows:

1. Xco frees up equity either to distribute to shareholders or to use by the corporation in a more effective, advantageous way than to hold real estate.

2. Xco ensures the continued use of those crucial sites for its operating business for the foreseeable future.
3. Xco makes strong profits in its core business-manufacturing, sales and services and can obtain greater returns than it can from the ownership of real estate.
4. Xco can eliminate debt and/or free up its ability to take on other debt to assist with the financing of its operational business. For example, Xco can use its borrowing capacity to acquire new manufacturing equipment as opposed to holding real estate.
5. Xco can focus its personnel on its core business. For example, Xco's plant supervisors can now deal with manufacturing, sales and service and not focus as extensively on property administration issues.
6. Xco can take advantage of existing market conditions by carrying out the sale and leaseback transaction at a time when market conditions are favourable.
7. Xco can take advantage of purchasers that have real estate expertise to handle future property issues. Xco can, for example, negotiate expansion rights in its lease and set out terms where its purchaser, a professional real estate manager, would be responsible for carrying out that expansion and charging back the cost in a reasonable rental to Xco.
8. In addition, depending on the corporation, there may well be material tax or accounting advantages of the restructure. For example, Xco under an operational lease will be entitled to deduct its rental as an ongoing operating expense. As an owner of a building, Xco was limited to taking capital cost allowance at low rates prescribed by law. In addition, Xco can shift the burden of capital tax to its purchaser (perhaps a tax-free entity).

Following a sale-leaseback transaction, Xco can focus its personnel on its core business. For example, Xco's plant supervisors can now deal with manufacturing, sales and service and not focus as extensively on property administration issues.

Other Similar Transactions

What is described above is a typical sale and leaseback transaction but each transaction will have its own individual characteristics. Other Vendors/Tenants in sale and leaseback transactions may have different goals. For example, Xco may decide to consolidate its five locations into a single location serving all of Canada with a goal of freeing up capital and taking advantage of the existing market conditions. It could carry out a sale and leaseback transaction with much shorter leases with a goal of continuing to provide the operating company with the use of the real estate assets only until the longer term organizational goal was realized. With that variation, the negotiation on the sale side and lease side is much closer to a traditional property sale and short term lease negotiation. While that kind of transaction is also technically a sale-leaseback transaction, it is for different goals and does not fit as closely with the typical structure this memorandum deals with.

Another approach is to use a sale-leaseback transaction more as a financing technique, much more akin to a build-to-suit arrangement. In this situation, Xco has a site that it would like to develop, it arranges for a contractor/developer to buy the land from Xco, develop and construct the manufacturing facility and lease it back over a long term lease that will provide the developer/contractor with sufficient funds to pay off its financing and to obtain a reasonable profit from the construction of the building. In those circumstances, the lease is much more of a capital nature, not an operating nature and at the end of the term the tenant usually has the right to purchase on a nominal or reduced cost basis. Again, while technically a sale and leaseback, this financing is more a financing technique and is not the subject of this paper.

Process

There are a variety of possible purchasers in a sale and leaseback transaction. Obviously one significant group is institu-

tional investors, like pension funds, which do not face the same tax ramifications of holding income producing investments in real property that the operational owner faces. In addition, companies whose principal business is real estate may have the ability to offset the gains and incomes made on the site with losses on other real estate properties. Both groups have reasons to pay an enhanced value for the properties. One key factor in the traditional sale and leaseback transaction is the security that the investor gets from the long term lease and from the strength of the covenant of the Vendor. Clearly, a property that is sold with a strong tenant and a long term covenant to pay a fair rental is much more valuable to an investor than a vacant building in the same market.

The process to carry out a sale and leaseback transaction requires expert assistance in both marketing and legal structure. There needs to be offering material put together to describe the property, to describe the strength of covenant of the Vendor and the Vendor's business, and to set out the basic lease terms required. There are a number of brokerage firms that are experienced in putting together such packages and in identifying in the market the potential investors to approach. It is important that the Vendor also have appropriate legal assistance to structure the sales contract and lease in terms that help maximize the sales opportunity and protect the Vendor's interests. As you will see in the discussion that follows, Lang Michener LLP often finds that the challenge is to strike a balance between the goal of the broker to have the most marketable product that it can and the goal of the Vendor to ensure that it has adequate protection for its business interests in the future. That balance is a fundamental aspect in the key long term document in the sale and leaseback transaction – the lease.

A typical sale-leaseback transaction involves the preparation of an offering memorandum of some kind, to which we contribute the purchase agreement and a package of essential lease terms. The broker will identify prospective purchasers

and approach them to market the sale and leaseback proposal. Bids will be collected and, when the successful bidder is identified, it will be necessary for the broker and the lawyer to negotiate the final provisions of the agreement of purchase and sale in a prompt and efficient manner. Sometimes at this stage the lease is also negotiated. If it is not, it is negotiated and settled in a conditional period very shortly thereafter. The lease document is so fundamental to the nature and strength of the transaction that it is part of the inherent structure of the deal.

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Lease Terms

It is important that the essential lease terms be established and clearly identified before the information memorandum is sent out. It is an interesting process and when I recall the discussions that I have had with clients at this stage, I often smile because it often felt that Lang Michener LLP was negotiating against itself on many of the terms. Since it is part of the marketing package, the goal in drafting the lease terms is to be as fair and neutral as reasonably possible. A lease that is overly tenant friendly could be seen by prospective purchasers as unreasonable and could affect the marketability of the property. So the constant focus on the general provisions of the lease is to be fair to both

the Landlord and Tenant. The following is a brief commentary on a number of provisions in the typical sale and leaseback lease and a brief discussion as to how those provisions need to be dealt with in the sale transaction itself.

Rent

Rent is clearly a key component. The Vendor/Tenant wishes to maintain its right to use the real estate asset at a fair and reasonable price and the Purchaser/Landlord will look at the rate of return that it expects to receive when it sets the purchase price paid. This pushes the rent to be a fair market rental and often marginally above anticipated rates to ensure

that the purchase price is maximized. It is often possible for the Vendor/Tenant to achieve greater than usual certainty regarding increases in rent and renewal rents, as this gives the Purchaser/Landlord a more certain rate of return. This is often appreciated by institutional investors or lenders.

Business Issues

It is important that the lawyer take some time and care with the Vendor/Tenant to understand and appreciate its business needs so that the lease can protect the essential elements of the business. The following are some of the provisions we have included to meet the needs of specific business operations:

1. **Alterations** – Special rights to make alterations or additions to the premises to deal with the specific nature of the business operation or possible future changes to the business operation.
2. **Expansion Rights** – One of the advantages of obtaining the real estate expertise of the Purchaser/Landlord is that the terms and conditions of the expansion options can be negotiated and put into place as part of the sales package.
3. **Signage** – As these are single purpose properties and will continue to reflect the nature and character of the business, signage rights are often expanded.
4. **Extension and Renewal Rights** – So long as the rate of return is specified or the Purchaser/Landlord has reasonable protection in accordance with the terms, the Vendor/Tenant often wants to ensure that the special purpose building can continue to be used by the Vendor/Tenant.
5. **Removal and Restoration Obligations at end of Term** – Care needs to be taken. Consult with the Broker to structure the transaction so that the Vendor/Tenant gets to remove the equipment and other essential property that

It really makes sense to do an initial environmental audit of the property before any sale. It is inevitable in these days that a Purchaser will require the same and a clean audit will both facilitate the sale transaction and provide an accurate baseline for the environmental provisions in the lease.

- it requires for its operational business and the Purchaser/Landlord obtains a facility in which it can convert to uses for other tenants in a cost-effective way. Again, while its important to protect the Vendor’s interest, it is also important to have a structure that would seem fair and reasonable to a prospective Purchaser.
6. **Assignment and Subletting** – As the transaction is usually part of a restructuring and the leaseback will run for a substantial period of time, it will need to accommodate potential changes to the business of the Vendor/Tenant, such as the use of parts of its premises by third party service providers and the proposed or potential future restructuring of the Vendor/Tenant and its business.
 7. **Waiver of Distraint** – Since this is an operating business with significant assets all distraint rights should be limited.
 8. **Destruction** – The Vendor/Tenant needs to advise his lawyer clearly as to the business and operational needs in the event of damage or destruction to the property. While those must be tempered with the Purchaser/Landlord’s rights and its ability to obtain financing, the Vendor/Tenant needs to ensure that it can carry on its business operation in the premises or elsewhere.

Environmental

A key issue effecting both the lease and the sale is the environmental condition of the properties. It really makes sense to do an initial environmental audit of the property before any sale. It is inevitable in these days that a Purchaser will require the same and a clean audit will both facilitate the sale transaction and provide an accurate baseline for the environmental provisions in the lease. As far as responsibility for environmental conditions after closing, both the Purchaser/Landlord and the Vendor/Tenant should take the property and the premises, respectively, in an “as is” condition, both in

respect of a physical condition and environmental matters. However, both parties need to covenant how they will be responsible for environmental matters just like they need to covenant how they will be responsible for repairs and maintenance during the term of the lease. The allocation of responsibilities needs to be fairly determined depending upon the extent of the Purchaser/Landlord's activities and involvement with the site. The baseline environmental audit and arrangements for a termination audit are excellent ways to be able to allocate responsibility.

Repair and Maintenance

The responsibility for repair and maintenance can vary according to the structure of the deal that the Vendor/Tenant wants. At one end of the spectrum the Vendor/Tenant can maintain effective control of the property, paying taxes and doing ongoing maintenance and repairs with the Purchaser/Landlord only being responsible for major structural or capital repairs. At the other end of the spectrum, the Vendor/Tenant wishing to limit its involvement in real property management may choose to allocate more of those responsibilities to the Purchaser/Landlord. The circumstances need to be adjusted to the needs of the particular Vendor/Tenant with the Broker's advice as to the market implication of such elements.

Financing

Obviously for the sale and leaseback to be marketable to as many prospective purchasers as possible, the lease needs to provide sufficient flexibility for the Purchaser/Landlord to

obtain financing and set out the manner in which the security of the Vendor/Tenant's interest is protected in the event that the Purchaser/Landlord defaults. There must be appropriate subordination non-disturbance, and attornment language to allow flexibility to the Purchaser/Landlord and yet protect the Vendor/Tenant is important.

Obviously for the sale and leaseback to be marketable to as many prospective purchasers as possible, the lease needs to provide sufficient flexibility for the Purchaser/Landlord to obtain financing and set out the manner in which the security of the Vendor/Tenant's interest is protected in the event that the Purchaser/Landlord defaults.

Lease Conclusion

In the end, the lease in a sale-leaseback transaction must be of a balanced nature and result in a marketable document that is reasonably neutral and fair to both the Vendor/Tenant and Purchaser/Landlord.

Conclusion

The traditional sale and leaseback may be an excellent way for a company to use real estate that is important to its operations for the foreseeable future, while allowing the company to free up debt and equity capital and achieve some of the various advantages listed earlier. In order to complete such a transaction there are significant marketing and legal issues to be dealt with and it is important for a company to obtain the right advisers so that the

transaction is carried out, the value is maximized and that the company's operational interests are adequately protected during the term of the lease. Lang Michener LLP has enjoyed having the opportunity to work on a number of these transactions and can bring significant expertise to the structuring and negotiation of these deals.

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Fixing the Unfixable: Conflicts Between Permitted Uses and Exclusivity Rights



Celia Hitch

Introduction

Earlier this year, I was asked to speak at the Law Society’s “Six Minute Commercial Leasing Lawyer” program. My assigned topic was “Exclusive and Use Clause Breaches.” In asking me to address this topic, the organizers assumed that I would be able to bring to the

podium the perspective of a former in-house lawyer who had experience in fixing the kind of problems that crop up when things do not work out quite as expected.

I had written a little bit about problems which arise from badly drafted exclusive clauses in the Fall 2006 *Real Estate Brief* (“Five Questionable Things You May See in a Lease”) but this is a different twist, since the core question was not how to make sure this does not happen to you but what to do once it does.

Who Owns This Problem?

Practically speaking, this is one of a landlord’s worst nightmares, as it almost always creates tension in the landlord and tenant relationship and can sometimes create tension between the affected tenants.

There are really two ways that a breach like this can happen: either a tenant can start selling things which are not permitted by its permitted use clause and thus violate another tenant’s exclusive rights covenant; or a landlord can permit a tenant to sell items or offer services which the landlord has already agreed it will not permit other tenants to sell or perform.

The first is a difficult situation for a landlord to navigate but at least a landlord can try to negotiate an agreement which will bring the tenant with the offending use into line. What makes this difficult is that the offending tenant may not care

whether or not it is causing its landlord to breach an exclusive rights covenant and may not be willing to co-operate.

The second is also difficult because it is most likely to arise because a landlord has inadvertently given one tenant a right which violates another tenant’s rights.

In either case, though, the answer to the question “who owns this problem?” is “the landlord.” In the first case, the land-

lord – and not the aggrieved tenant – is the party which has a binding agreement with the offending tenant. Usually only the landlord can enforce its rights under the contract and require the offending tenant to adhere to its permitted use clause (registration of its exclusivity right may give the tenant with such right an ability to seek an injunction directly but it will usually want the landlord to pursue the matter). In the second case, the landlord created the problem and cannot shirk it, whether or not it intended to create this problem.

What’s a Landlord to Do?

Good question. Often, a landlord does not want to annoy a tenant over use clause breaches which it considers to be minor in nature – especially if it is a successful retailer or a national retailer with whom the landlord has

multiple locations. On the other hand, the landlord also does not want to further annoy the tenant with the exclusive. This is particularly sensitive when the breaches are not major.

Consider this example: A landlord enters into a lease with a toy store and gives it the exclusive right to sell toys. That landlord then enters into a lease with a coffee vendor. The coffee vendor’s use clause says that it can sell coffee or tea by the cup or in bulk for consumption on or off the premises. As ancillary to such use, the coffee vendor can sell directly relat-

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ed products. No landlord would look at these two tenants' rights together and presumptively see a problem. What if the coffee tenant starts to sell mugs? Most would agree that they are ancillary to the use of selling coffee and tea so that is not a problem. What if the tenant starts to sell mugs and packages of coffee cello-wrapped together for Christmas time? Again, no perceived problem. What if the coffee vendor adds little stuffed Santas and reindeer in the cello-wrapped gift packages? Once again, most of us would agree that it is probably within the meaning of the ancillary use provision.

So far, there does not appear to be a problem. That is, until the manager of the toy store walks in to get a coffee and sees that there is a box of those stuffed Santa's and reindeer right beside the cash register and anyone can just come in, buy some of those and leave without buying a coffee. Suddenly, there is a violation of an exclusive rights clause that was likely unforeseeable at the time the lease was signed.

The Legal Solution

The courts are pretty clear that, if there is an injury, damages are adequate compensation. If the landlord gives an exclusive rights covenant and there is a breach of it, then a court will likely look to assess what the tenant's damages are and assess damages which take into consideration that amount.

If the tenant can establish that it has lost \$10,000 a year since the breach occurred, then a court will give serious consideration to this amount.

More difficult is a breach which happens when the tenant is new and not fully established. Even in a case like that, the court has admitted evidence of what the tenant's projected profits were likely to be.

To avoid being found liable for damages, if the offending tenant refuses to co-operate a landlord may find itself in the unfortunate position of having to seek an injunction to stop the tenant from selling the offending product(s). Alternatively, it may have to consider commencing default proceedings and, if necessary, termination of the lease. In either case, litigation is likely and it is important to ensure that the

landlord's efforts are co-ordinated with its choice of litigator so that the case is as strong as possible when the court date comes around.

The Practical Solution

Although these types of court decisions are interesting to read, there really are not as many of them as one might expect.

I suspect that this is because a solution is often created and implemented before the parties make it to court. Realistically, if a court is likely to award damages anyway, there is no point in going to court, since the case should be capable of settling outside of court. The same applies to injunctive relief.

The hardest cases to assess, however, are the ones where there are no apparent damages. In the coffee vendor instance,

what are the real damages to the toy store? Likely, there are none. Here, some creativity may need to be brought to the table. Perhaps a sign location within the property, gratis for the duration of the breach; perhaps something else. In any event, a real and tangible recognition that there is a right and it has been violated is often what the tenant with no damages most desires.

Conclusion: Avoidance – and the Importance Thereof

In the end, situations like this can be avoided by ensuring that property staff in a retail environment are aware of the contents of the tenants' use clauses and trained to monitor regularly what the stores are selling. The best way to stop the incremental approach of adding new uses outside of a permitted use clause is at the beginning, not after several years of turning a blind eye. Even though it may feel awkward to property management staff to raise this with the offending tenant, in the end, even the offending tenant can rest assured that the landlord is taking seriously its obligations to each tenant to ensure that the others abide by their leases in order to ensure that the property runs as harmoniously as possible.

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News & Events

News

February 14, 2007 – Great Canadian Gaming Completes Debt Refinancing

On February 14, 2007, Great Canadian Gaming Corporation (TSX:GCD) completed a refinancing of its corporate indebtedness by establishing a C\$200 million revolving credit facility and a US\$170 million term loan. Great Canadian also issued US\$170 million senior subordinated notes for total aggregate proceeds of approximately C\$600 million.

Lang Michener acted for Great Canadian Gaming on this transaction. Led by **Desmond Balakrishnan** (General Counsel) and **John Morrison** (Banking), the team included **Leo Raffin** (Securities), **David Ross** (Banking), **Stacey Handley** (Real Estate), **Steve Mathiesen** (Corporate), **James Munro** (Securities), **James Bond** (Corporate), **Christine Mingie** (Regulatory), **Graham Matthews** (Banking), **Shanah Ali** (Real Estate), **Peter Botz** (Tax) and **Marnie Foster** (Corporate) of the Vancouver office; **Eric Friedman** (Corporate) and **William Rowlands** (Real Estate) of Toronto.

Lang Michener Lawyers Recognized in *The Canadian Legal Lexpert Directory 2007*

We are proud to announce that several Lang Michener lawyers have been recognized as leading practitioners in *The Canadian Legal Lexpert Directory 2007*. **William (Bill) Rowlands** and **Celia Hitch** from the Real Estate Group were recognized as leading commercial leasing lawyers.

Event

American Conference Institute's 2nd Annual National Forum on Negotiating Restaurant Leases

July 11–12, 2007

The Affinia Manhattan Hotel

New York, NY

This event will offer a practical discussion of real-world issues that arise in restaurant lease negotiation and offer winning and workable strategies to resolve these issues. **Celia Hitch** will be presenting “Making Sure It Runs Smoothly: Tackling Operations Issues.”

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