



RealEstateBrief

April 2006

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Leases of a freestanding retail building within a development (commonly known as out-parcel or pad site leases) are becoming more and more common. This is especially true for retailers such as banks, restaurants and big box stores. In our first article Bill Rowlands reviews some of the special issues that arise in such leases. Our second article deals with the final phase-in of the Ontario Brownfields legislation. There is now new protection for environmental liability and new clean-up standards that will be of particular interest to those involved in the purchase, sale and lease of real estate. The article by Bruce McKenna and Erin Tully reviews these items.

We also include two entries from the blog of Lang Michener's Real Estate Group, lawoftheland.blogs.com. John Payne reviews physical and legal occupancy under commercial leases and Bill Rowlands looks at requirements for a binding agreement to lease.

Retail Out-Parcel Leases

Introduction

More and more retail developments are including freestanding retail buildings that are leased to one or more retail tenants. This is commonly known as an out-parcel or pad site. Tenants of pad sites include restaurants, banks and big box users. The shopping centre containing the pad site may be a retail strip centre, a neighbourhood or regional centre with an interior mall or a power centre or other collection of freestanding buildings. Typically a pad site is attractive to tenants due to the increased visibility, easier access and the opportunity for the premises to meet that Tenant's specific branding and other requirements (such as standard colours, signage and even building design). Further, the use of a pad site provides some flexibility for increased rights not typically found with in-line stores, such as drive-thru facilities, exclusive parking areas and outside patios.

The lease document used for a pad tenancy will need to recognize and deal with the unique features of the pad tenancy. Of course, any other issues generally relevant for a retail lease will be equally relevant in a pad site lease and some will have greater relevance in a pad situation. This article will identify and discuss a number of the special issues (in both of these categories) that arise in a lease of a pad site.

Access

One driving factor for a Tenant to negotiate for a pad lease is to get the benefits of better access for its customers. As most Landlord forms of leases will allow the Landlord to make changes to the common areas (including the access) as it sees fit, this benefit will require special protection by the Tenant.

Some Tenants will bargain for specific easements or rights in favour of the pad premises. These easements would be shown on a site plan attached to the document and run for the duration of the term and any renewal or extension. In these situations a Landlord may want to negotiate at least a right of relocation for the specific easements.

If specific easements are not granted, then the Tenant will at least look for some general covenants from the Landlord that the access will not be materially adversely changed (or not so changed without the consent of the Tenant). To state the obvious, a drive-thru only works where vehicles can

drive to it. The Landlord needs to balance the granting of any such rights against the desire to be able to control future redevelopment and other changes to the shopping centre.

When negotiating access rights, the Tenant needs to determine whether all of the access to its premises is in fact through the shopping centre or whether there are abutting developments where the Landlord has negotiated reciprocal rights. It is not uncommon to see some major retailers purchase their property from the developer of the remainder of the shopping centre, with the two parties then entering into a reciprocal operating agreement. This reciprocal operating agreement will grant rights of access and parking between the two sites.

A Tenant on a pad site on the shopping centre side will want to ensure that its rights under the lease include the ability to exercise the rights granted to the Landlord under the reciprocal operating agreement from the abutting owner. For example, a key access point may be across the abutting owner's property and the pad site Tenant will want to ensure that it and its customers can use that access. This may be critical enough for the Tenant to require an initial condition as to it being satisfied with the terms of the reciprocal operating agreement. Alternatively, the Tenant may rely on a covenant from the Landlord that such an agreement is in place.

Visibility and Signage

Just as access needs to be protected, the Tenant will want to protect the enhanced visibility a pad site provides. The granting of a specific no-build zone, identified on a schedule, provides certainty for both parties. A general covenant by the Landlord not to effect any changes that might materially affect the visibility is less specific and leaves open the possibility of a future debate. In both cases the Landlord will, to some degree, be limited in respect of future redevelopment and other changes to the shopping centre.

The visibility bargained for may include some signage situated at a location remote from the premises. This may be shared pylon signage or perhaps some directional signage.

As for signage on the building, if the Tenant is anticipating the right to have signage on all four sides, the Landlord's

typical signage provision of allowing and requiring only store-front signage would obviously be deficient. Similarly, if the Tenant has standard national signage, it will not want to simply agree to be subject to the Landlord's signage criteria for the shopping centre.

Use of Outside Areas

A pad lease gives flexibility for a Tenant to negotiate for the use of certain outside areas such as a drive-thru facility, a patio area and/or exclusive parking. These types of rights need to be considered up front, both to negotiate for the right in the agreement to lease and also to determine if there are zoning and/or site plan issues to be dealt with.

The cost associated with these areas also needs to be dealt with. Typically, minimum rent is not charged for such areas and the square footage is not included when determining the Tenant's proportionate share of additional rent. However, the Tenant will have some specific maintenance and repair obligations. For example, notwithstanding that the patio may not be part of the premises, the Tenant will likely have the full obligation to operate, maintain and repair the patio area.

On the other hand, a provision that the Tenant is responsible for maintenance may not make as much sense for a drive-thru facility. The landscaping

and snow removal contractor for the shopping centre will likely do the drive-thru areas (as opposed to the Tenant hiring a contractor just for the drive-thru area). The question is, then, will the Tenant pay the cost attributed to the drive-thru or will it simply fall into the overall operating costs?

Operating Costs

The operating costs provisions in a pad site lease are often different than in an in-line lease. The pad Tenant will want to be treated differently and, in particular, may want to limit operating costs to exterior common area costs for the following reasons:

1. where there is an interior mall, the pad site Tenant argues it gets no benefit from this and should not have to contribute to the cost; and

When negotiating access rights, the Tenant needs to determine whether all of the access to its premises is in fact through the shopping centre or whether there are abutting developments where the Landlord has negotiated reciprocal rights.

2. the pad site Tenant operates its own building and does not want to see all building costs pooled with an obligation to pay its proportionate share of such building costs. The pad premises may be relatively new compared to the remainder of the shopping centre and a Tenant may feel it is therefore unfairly disadvantaged if all building repair costs are pooled and paid as operating costs. For example, the pad site Tenant will not want the costs of roof repairs on the 20 year old main building to be included in the operating costs paid by it.

Landlords may resist having two separate methods of calculating operating costs, as it will create more work. Even when the Landlord does agree to creating two separate methods, it is not as simple as limiting operating costs to exterior costs. The Landlord will need to capture certain costs that might not be defined as exterior costs. These would include insurance costs for the shopping centre (including building insurance, which is likely to be pooled in any event) and its management costs or administrative fee.

If the various building costs are not pooled across the shopping centre and operating costs are limited to exterior common areas, then those building costs relating specifically to the pad site premises need to be dealt with. This would include items such as HVAC costs and roof repair costs to the pad site building.

End of Term

Although the issues may not be unique, issues arising at the end of the term may have more importance in a pad site situation. These include the following:

1. in negotiating any renewal rights, the Landlord should consider whether it should seek a longer notice period than it requires for in-line tenants. Given the unique features of a pad site lease, the Landlord may require a longer lease-up time. The usual six or nine months may not be enough;

2. the allocation of a restoration obligation to the Tenant is a matter of dollars and cents in any lease negotiation. It may be seen as a more expensive issue in a pad site lease, where the restoration may be more extensive due to the specific branding of the building and due to the fact that the building may have been built for a specific purpose. For example, will the Tenant have the obligation to remove the drive-thru facilities?

3. the existence of this branding will also result in the Tenant seeking a right to do such work as required to remove such branding. For example, the colours on certain parts of the building may be identifiable with the Tenant and such Tenant will want to change those colours. Some indicia of the branding may even form parts of the building itself and the Tenant will want to ensure that it can remove these items.

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Conclusion

A pad lease is of course a retail lease, so all of the other usual retail lease issues will also be relevant. In fact, because a pad Tenant is typically one of the stronger retail tenants, it is more than likely that these issues will be subject to greater negotiation than normal. These may include the Tenant seeking provisions such as an expanded and evolving use provision and an exclusivity right.

Ed.: *This is an edited version of a paper presented by Bill for the Law Society of Upper Canada at the Six Minute Commercial Real Estate Lawyer on February 15, 2006.*



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Records of Site Condition

Background Information

In 2001, the *Brownfields Statute Law Amendment Act* was implemented to encourage the remediation and redevelopment of brownfield properties. Brownfields are abandoned, idled or under-used industrial and commercial facilities where expansion or redevelopment is complicated by real or perceived environmental contamination. The legislation clarifies environmental liability and attempts to address barriers to redevelopment.

In December 2002, amendments came into force that provided limited statutory liability protection for municipalities, secured creditors, and others who undertake certain actions at brownfield properties.

On March 9, 2004, the Soil, Ground Water and Sediment Standards for use under Part XV.1 of the *Environmental Protection Act* (the “Standards”) were released. The Standards set out the prescribed contaminants and the applicable site condition standards for Records of Site Condition (an “RSC”).

Voluntary Records of Site Condition

On October 1, 2004, amendments came into effect which provide new protection for environmental liability and new clean-up standards. These amendments are found in *Records of Site Condition* (Regulation 153/04) (the “Regulation”).

These amendments allow for protection from environmental clean-up orders for owners if an RSC is filed in the Environmental Site Registry. These amendments allow an owner or occupier to *voluntarily* file an RSC if they want protection from statutory liability.

Mandatory Records of Site Condition

On October 1, 2005, the final brownfields amendments came into effect. These new amendments require filing of an RSC if there is a change in the proposed use of the property from a less sensitive use category to a more sensitive use category. For example, if the property is being changed from “commercial use” to “residential use,” it is now *mandatory* to file an RSC. A change in the zoning of the property under municipal by-laws does not require an RSC.

It is also mandatory to file an RSC if a person intends to construct a building, if the building will be used in connection with a change in the use of the property. Municipalities will not issue building permits in these circumstances until an RSC has been filed.

What is a Record of Site Condition?

RSCs provide owners with immunity in respect of administrative orders that might be issued with respect to a property. The criteria that have to be met in order to file an RSC are found in the Regulation. There are a number of exceptions to the immunity provided, including:

- it applies only to administrative orders under sections 7, 8, 12, 17, 18, 97, 157 and 157.1 of the *Environmental Protection Act*;
- it does not apply to emergencies or off-site migration;
- it is not retroactive; it applies only to the person who filed the RSC or a subsequent owner of the property; and
- if a past owner wants to benefit from the statutory protection of an RSC, the agreement of purchase and sale must contain a specific covenant requiring the purchaser to file an RSC.

On October 1, 2005, the final brownfields amendments came into effect. These new amendments require filing of an RSC if there is a change in the proposed use of the property from a less sensitive use category.

Whether RSCs, with these exceptions, will be found to be effective in limiting liability has yet to be determined.

At a minimum, a Phase I Environmental Site Assessment (“ESA”) is required for an RSC. The Phase I ESA must be performed by a “qualified person” as defined in the Regulation. The standard for a Phase I ESA in Canada that is most frequently referred to in retaining environmental consultants is the Canadian Standards Association Standard Z768-01, *Phase I Environmental Site Assessment*.

Phase I ESAs typically cost in the range of \$2,000 to \$6,000, and can be completed in a matter of days. A Phase I ESA is intended to identify potential sources of environmental impairment both on- and off-site. A Phase I ESA includes:

1. **Record Review:** including historical records detailing previous land use, governmental reports and information regarding surrounding sites.

2. **Site Visit:** the qualified person will visit the site, looking for things that might potentially cause problems (e.g. an abandoned underground storage tank).
3. **Interviews:** the qualified person will interview site personnel, neighbours, former employees, government officials, etc., to obtain information about the site.
4. **Report:** the qualified person will compile the information and make suggestions regarding further steps.

After completing a Phase I ESA, a Phase II ESA may be necessary. The purpose of a Phase II ESA is to confirm whether or not potential sources of environmental impairment identified during the Phase I ESA exist on- or off-site. A Phase II ESA involves quantitative sampling and analytical techniques. The standard for a Phase II ESA in Canada that is sometimes referred to in retaining environmental consultants is the Canadian Standards Association Standard Z769-00, *Phase II Environmental Site Assessment*.

The cost of a Phase II ESA varies depending on the methods used, size of the site, number, type and identity of suspected contaminants, and what is being tested (i.e. air, surface water, groundwater, soil, soil vapour, etc.). Phase II ESAs can take substantially longer and cost significantly more than a Phase I ESA.

In the event that a Phase II ESA confirms the presence of contamination at a site, as set out in the Standards, remediation or risk assessment (which may still result in remediation) will be required before an RSC can be filed.

The owner or occupier may remediate the property to meet the Standards. Once a property meets the Standards, an RSC can be filed.

In some cases, it may not be cost-effective to meet the Standards. The Regulation allows owners to develop site-specific standards through the preparation of a “risk assessment.” This method permits the development of alternate standards to address contamination. This can result in no clean-up activities or reduced clean-up activities at the site. Once the risk assessment criteria have been met, the RSC may be filed. A risk assessment can take approximately a year to complete.

If the MOE accepts the risk assessment, the MOE may issue a Certificate of Property Use (“CPU”). This is a discretionary power under the Regulation. A CPU may require the owner or occupier to take certain risk management actions, refrain from certain activities on the site, or post financial assurance. If the CPU requires the owner to refrain from certain activities on the site, the owner must provide a copy of the requirement to the occupants of the site.

The MOE can order an owner to tell a prospective purchaser about the CPU. If the owner fails to do so, the transaction is voidable by the purchaser (s. 197, *Environmental Protection Act*). The MOE may order the CPU to be filed on title. If the CPU is filed on title, it is considered deemed notice to the prospective purchaser.

Since October 2005, the chief building officer must refuse to issue building permits that are prohibited by a CPU. The Regulation provides that notice of the CPU must be provided to certain municipal officials whenever a CPU is issued by the MOE.

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Brownfields Environmental Site Registry

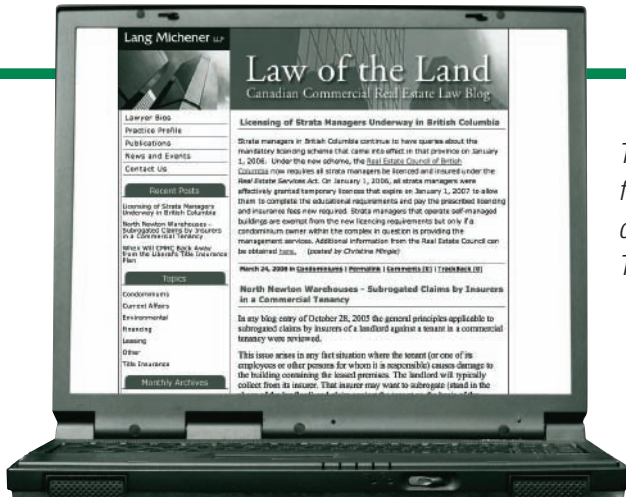
The Brownfields Environmental Site Registry should be a standard search in any property transaction. The Registry can be accessed free of charge, on-line, at www.ene.gov.on.ca/environet/BESR/index.htm.

Summary

In dealing with real estate, it is important to keep in mind that RSCs may be filed to assist in protecting an owner or occupier from administrative orders in respect of contaminants present as of the certification date, and that RSCs must be filed if there is a proposed change in property use to a more sensitive use.



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The Real Estate Group of Lang Michener LLP maintains a blog (short for “website logs”) to share news and views on legal issues relating to commercial real estate. Our blog can be found at lawoftheland.blogs.com. The following are two entries from the blog.

Physical and Legal Occupancy Under Commercial Leases

Can a Tenant vacate a premises and still be in “occupancy”? According to the Ontario Superior Court of Justice, the answer seems to be yes.

In *Nortel Networks Ltd. v. Kanata Research Park Corp.* (2005), 73 O.R.(3d) 594, Nortel leased space from Kanata. The lease gave Nortel the right to cancel the lease upon the payment of certain liquidated damages. The right of cancellation began with the words, “Provided the Tenant or a subsidiary is in occupancy of the Leased Premises and is not in default of the Lease beyond any cure period in the Lease...” Shortly after the Lease was entered into, Nortel began to cut jobs and consolidate office space. By the time Nortel notified Kanata that it was exercising its cancellation right, there were no employees remaining in the leased premises (Nortel had the right to vacate the leased premises provided it continued to pay rent and meet its other financial obligations).

The day after it received Nortel’s notice, Kanata replied that Nortel had not validly exercised its right of cancellation, since it was not in occupation. In its application, Nortel argued that there was no reason to import the concept of physical occupancy into the term “in occupancy.” In Nortel’s view, legal occupancy was sufficient, and Nortel had been in legal occupancy since the execution of the lease.

The Court reviewed the definition of “occupancy,” “occupant” and related terms in various legal dictionaries, and con-

cluded that the ordinary definition of occupancy includes both physical occupation and legal occupation. Unless the lease specifically restricted the definition of occupancy to one or the other meaning (which it did not), legal occupancy was sufficient to satisfy the precondition for the right of cancellation. Furthermore, the Court noted that there was no evidence to

indicate that it made any difference to Kanata whether or not Nortel was in actual physical occupation of the premises at the time of the cancellation. It would be interesting to see whether a Court would reach the same conclusion in a fact situation where the lack of physical occupancy by the tenant resulted in a loss to the landlord.

Landlords frequently make occupancy of the premises a precondition of various tenant rights, including rights of renewal, rights of cancellation, rights of first refusal and the like. Landlords’ counsel should be careful in drafting such preconditions if the intention is that actual physical occupancy by the tenant is required.

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Requirements for a Binding Agreement to Lease

The following statement from Williams & Rhodes, Canadian Law of Landlord and Tenant (6th ed) has been adopted by the Ontario Courts:

“To be valid an agreement for lease must show (1) the parties, (2) a description of the premises to be demised, (3) the commencement, and (4) the duration of the term, (5) the rent, if any, and (6) all the material terms of the contract not being matters incident to the relation of landlord and tenant including any covenants, exceptions and reservations.”

The first five requirements (parties, premises, commencement date, duration of term and rent) are invariable requirements. They are also, for the most part, fairly straight forward.

The sixth requirement is much more subjective. If there are matters material to one party that are mentioned to the other, they must be unconditionally accepted (or otherwise resolved) in order for there to be a concluded agreement. If such material terms have not been accepted or otherwise resolved, the matter will be seen as continuing to be in negotiations and not a concluded contract.

The recent case of *Blubarrie Hill Inc. v. 1645110 Ontario Ltd.* (2005) 36 R.P.R. (4th) 101 Ont. S.C., provides an example of what can be seen as material points where no agreement had been reached.

The *Blubarrie Hill* case involved a restaurant premises. The property where the premises was located was sold and the new owner of the property met with the restaurant owner prior to closing to discuss a new lease. The points agreed to included the commencement date, the duration of the term and the rent. Some paperwork was exchanged but the parties did not sign an agreement. The restaurant owner eventually brought an action for a determination whether or not the parties had agreed to a lease.

The restaurant owner’s claim that there was an agreement failed, as not all the material terms of the contract had been agreed to. The court held that the material terms upon which there was no agreement included whether or not there was an obligation to pay by postdated cheques, whether or not a personal guarantee was to be provided, what liability insurance coverage was required and the lack of a clear definition of available parking.

Other examples of the sixth requirement for a binding agreement can be seen from previous cases. The Ontario

Court of Appeal held in *Ossory Canada Inc. v. Wendy’s Restaurants of Canada* (1997), 36 O.R. (3d) 483, that the provision of a garbage enclosure and pylon signage rights were material to Wendy’s (as a fast food service operator) and that such importance had been communicated to the Landlord. Accordingly, there was no concluded contract in that case as agreement was not reached in those items.

In *Barque Investments Ltd. v. DKT Computer Learning Centre Inc.* (2001) AB QB 768, the court held that the rental rate in the overholding clause, the prohibition on change of use on sublease, the relocation right in favour of the Landlord, the Landlord’s right to terminate in lieu of granting consent to an assignment or sublease and a right

of early termination in favour of the Landlord were all substantial matters for which no agreement had been reached. Accordingly, again there was no concluded contract.

These cases show the importance of fully documenting any preliminary agreement regarding the lease of premises. The failure to deal with all material terms could result in the court finding that there is in fact no agreement reached.

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Upcoming Events

Current Issues in Commercial Leasing – Practical Tips for Landlords and Tenants

April 26, 2006

Lang Michener LLP, Main Boardroom
BCE Place, Suite 2500, 181 Bay Street, Toronto, Ontario

As part of Lang Michener's ongoing Five O'clock Lecture Series, we invite you to join members of our Real Estate Practice Group for a series of seven-minute primers on current commercial leasing issues such as:

- Tenant Restoration Obligations – How to avoid disputes at the end of a term
- Pad Site Leases – Special concerns and issues for landlords and tenants
- Landlord Security – How to protect yourself when a tenant goes bankrupt

This presentation will be of interest to anyone involved, either on behalf of a landlord or tenant, in the leasing or managing of commercial real estate.

Presenters

Tenant Repair & Restoration Obligations

Bronwyn Atkinson

Pad Site Leases

Bill Rowlands

Landlord Security & Tenant's Bankruptcy

John Payne

RealLeasing Conference

October 3, 2006

Presented by Real Property Association of Canada

Toronto, Ontario

Lang Michener is pleased to again be a sponsor of the RealLeasing Conference at the Metro Toronto Convention Centre on October 3, 2006. RealLeasing is a forum for owners, landlords, users and tenants to tap into strategies, current issues, practices and trends in Real Estate Leasing for office, industrial, and retail applications. This conference provides an opportunity for executives to analyze and enhance their leasing strategies and to gain greater insight into the challenges and issues that permeate the industry. For more information on the event, or to register, please visit the Real Estate Forum website at www.realestateforums.com.

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Brief offers general comments on legal developments of concern to business and individuals. The articles in *Brief* are not intended to provide legal opinions and readers should, therefore, seek professional legal advice on the particular issues which concern them. We would be pleased to elaborate on any article and discuss how it might apply to specific matters or cases.

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