Commercial leases

Agreements between landlords and businesses are becoming increasingly complex as retail and other business needs evolve

By Marg. Bruineman

A fluctuating and evolving commercial real estate market that has seen high vacancy rates in some areas and changing needs across the country is resulting in more detailed and complex leases. And while many prefer the predictability of long-term leases, both the length of the lease and the terms they contain are undergoing greater scrutiny.

The certainty of continuous cash flow for a fixed period through a long-term lease is increasingly important to the landlord as leases largely determine both how the building is financed as well as its overall market value. Long-term leases also bring cost predictability and stability for many tenants seeking to establish their businesses with an eye to selling in the future.

But in an uncertain world, flexibility is key, says Natalka Falcomer, who sees the retail sector as the most vulnerable. Her Toronto-based Groundworks Realty Services law firm represents mostly tenants whom she says are often looking at leases differently. And she sees traditional retailers, who are taking the hit from online sales, search for alternative ways of doing business.

"The nature of retail leases will be changing," says Falcomer, who often recommends her clients seek shorter terms when locking into a lease. "What we're seeing for the first time is a real flip in the power between the landlord and the retail tenant.

"The big factor is that when a lot of these tenants sign long-term leases, it isn't taking into effect the Internet and how people buy, which affects revenue, which reflects how much the landlord makes as well as how much the store makes."

In retail, a percentage of the sales is usually paid to landlords in addition to the rent. Landlords have been struggling to come up with ways to capture some of the online sales as store sales drop. Some stores, acknowledging the trend for online sales, are using retail locations as "experience" centres where there is more of a focus on displaying and demonstrating products to encourage online sales, following Apple's model. In reaction to increased online sales, some retailers are looking to reduce the amount of physical store space they rent.

In the uncertainty and ever-changing retail world, Falcomer suggests the retail tenant seek co-tenancy agreements that allow them to lower their rent or get out of the lease if another particular tenant, such as the anchor store in a mall, disappears. She also tries to include a go-dark provision so that the tenant is

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not bound by a lease if another tenant continues to pay rent but is essentially no longer in operation.

Certainly, Target's abrupt departure from the Canadian market two years ago was a lesson for retail landlords and lawyers drafting leases. Toronto insolvency lawyer David Ullmann says guarantees from Target Canada's parent company in the United States made a huge difference for the landlords who managed to secure that as terms in the lease.

Another important aspect was the clauses wrapped around the leasehold improvements and who ultimately owned them upon termination of the lease. With the recent demise of Grafton and Company, HMV, Danier Leather, Aeropostale, PJ's Pets and Goodwill in Canada, Ullmann, a partner at Blaney McMurtry LLP, believes retail will continue to see changes. "We're still very much in the midst of this restructuring of the entire retail sector," he says.

Avison Young's 2017 North America, U.K. and Germany forecast makes a similar observation, pointing to disruptive technologies and rising consumer debt as threats to retail. But it calls the increase in physical stores by online retailers — such as Amazon's line-free grocery store and Google's shop within some Best Buy stores — a surprise, offering an unexpected upside for landlords of retail space.

In the office market, the study outlines uneven demand and new supply bringing Canada's vacancy up to 12.5 per cent, with Calgary posting the highest at 22 per cent. And the overall industry vacancy rate hovered at 3.1 per cent.

Avison Young reported record investment in office properties in Vancouver, which had a vacancy rate of 10.6 per cent in 2016. Even with new buildings coming on stream, commercial real estate leasing remains active, says Michael Leroux, a commercial real estate lawyer with Richards Buell Sutton LLP in Vancouver, pointing at Amazon and Microsoft, which have set up shop in the western Canadian city.

He sees continued value in long-term leases for the tenants who invest in their businesses as well as tailoring the space to their needs and installing their own fixtures. Additional investment tying tenants to the rented premises include branding and corporate registration.

But the security of space also becomes important when it comes time to sell that business. A longer-term lease with options to renew provides a sense of stability for ongoing operations for the purchaser who may consider the lease as a focal point of the transaction.

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Leases for commercial real estate are becoming more detailed and complex. These clauses are appearing more frequently in long-term leases:

- Security from the tenant's parent company;
- Multiple options to renew;
- Co-tenancy and go-dark arrangements;
- Assignment, to allow the purchaser of the business to assume the lease;
- Relocation and demolition clauses;
- Death and disability clauses.

"If you don't have a decent term of lease plus a significant number of renewals . . . that business is not sellable unless someone is just buying the stock and the name," says Leroux.

While long-term leases are desirable for landlords, they also want flexibility to respond to changing markets and demands. Many leases, particularly in Vancouver and Toronto, now contain relocation or demolition clauses requiring tenants to move with six months or a year's notice. Leroux has had success pushing that clause out of the initial term into the renewal periods, providing more stability for the tenant.

"It makes it hard to sell a business in that context because the buyer is never going to know if it buys the business how long the business is going to be there," says Leroux. "Those clauses may never be used, but who's to know."

Key for tenants thinking about selling their business in the future is the assignment clause, allowing them to assign their lease to the purchaser of their business. But landlords seeking to maximize profits and exert some control over who occupies their building are making them more complex, says Cameron Bryant, a Toronto-based lawyer and lease negotiator with Cirrus Consulting Group, which finds space for medical tenants, including doctors and dentists.

Landlords want to see the financials of the new tenant, personal background information and details about their professional history. And they want the ability to withhold their consent. But within the assignment clause some landlords also seek "considerations" above and beyond the rent. The idea is that the landlord doesn't want the original tenant to profit from assigning the premises. But the considerations inclusion leaves tenants asking if it means they have to give a cut of their practice to the landlord. Bryant finds that ambiguous and says he tries to carve out sale proceeds from the definition of excess consideration in the lease to make it clear that any profit tenants make from their business does not go to the landlord.

"Almost every lease will have something there which governs transfer of the lease," says Bryant, whose clients eventually do want to sell their business or practice. "We definitely want to lay down the rules for that."

Death and disability clauses have also become important to medical professionals. They will lay out what happens following the unexpected death or disability of the tenant holder. Often, that will allow their family members to get out of the lease if they have no success in finding another professional to take over the practice and assigning the lease to a new owner after six months.

With so many different pressures on both landlords and tenants, Michael Kennedy, a commercial lawyer with Patterson Law in Halifax, says leases have become much more detailed and complex than they were even a decade ago. And, he adds, they can be incredibly flexible to adapt to changing needs.

The tenant, responding to ever-changing market conditions, may search for the right to terminate or downsize through the lease. On the other side of the spectrum, they may want the option to lease adjacent premises or have first purchasing rights if the landlord chooses to sell the building.

But not only is the landlord's income derived from the lease, it also determines the value of the building. Kennedy points out that older leases look much different from today's lease partly because the value of the building is no longer determined by its bricks and mortar. "Today, very little attention is paid to how much it cost to build it; it's more the leasing revenue that's associated with it that affects the value. So leases have become the financing tool."

A tenant who remains for a longer term allows the landlord to forecast revenues out longer and lower turnover means less administration and less wear and tear to the premises, adds Garth Anderson, a partner with Blakes Cassels & Graydon LLP in Calgary. But the long-term leases, as they reach their end, start showing their age.

Anderson has seen ground leases with no mention of the environment or environmental concerns, providing no direction in the event of contamination. Also, how the square footage of a building is measured using standards set by the Building Owners and Managers Association has changed, so the same space may not contain the same square footage as it did a decade ago.

The lease, with all its flexibility, serves a number of different objectives, and it's likely to become even more complex in the future, says Kennedy.

"How you deal with that real estate and how the landlord deals with that real estate can be altered in the terms of the lease so that each party gets the rights that they want," he says. "I think we're going to see more and different types of leasing arrangements."

And that, he concludes, likely means more work for lawyers. CL