CANADIAN REAL PROPERTY: THEORY AND COMMERCIAL PRACTICE

S. Michael Brooks, Ph.D.

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1 Glossary

Absorption:

Measures the net change in occupied space in a particular land use category (e.g. office) from one period to the next. Typically, it is phrased as a "net" number, such that negative absorption (i.e., decreases in space rented in various submarkets and over smaller time periods) is deducted from positive absorption (i.e., increases in space rented in various submarkets over smaller periods of time) to result in a "net" absorption number.

Absorption Rate:

The net absorption figure divided by the total occupied space in that geographic area in that land use type at the start of the period, expressed as a percentage. A positive absorption rate signifies tenant in-migration and/or tenant growth. A negative absorption rate signifies out-migration and/or tenant shrinkage.

Additional Rent:

A term used to define components of rent over and above what is commonly called "net" rent. It includes items for which the landlord invoices the tenant in addition to the net rent. This charge typically recovers the tenant's proportionate share of building costs such as realty taxes, operating costs, and utilities (if not metered separately).

Building Class:

A qualitative and subjective rating of Class 'A', 'B', or 'C' space. The class ratings reflect an evaluation of the age, location, design, size, building maintenance, building systems, amenities, access, and telecommunications services available. It is important to understand that the gradings are both relative and subjective. They are also subject to change with time or after substantial improvements. Generally speaking, however, the following statements can be made:

> **Class A buildings** are considered to be above average in most or all of the rating criteria outlined above
>
> **Class B buildings** may score very well in some of the criteria, but are only adequate in others
>
> **Class C buildings** may offer average benefits according to some of the criteria, but are below average or completely lack other elements

Capitalization Rate or Cap Rate:

Income producing property may be valued based on "capitalizing" the net income that is generated by the property, after all expenses and taxes are paid. A net income figure may be "capitalized" at a rate of between 6% to 12% or higher. The capitalization rate refers to the percent return that a buyer wishes to realize on its invested money. To acquire a premium property in a premium location, a buyer may accept a much lower rate of return on its investment

(say to 8%) than a buyer who is choosing a risky income producing property in an area that might be subject to change (in which case the buyer may look for a 12% or greater return on its money). The rate of return on a buyer's money (you and I might think of it as similar to the annual return we make on our bank savings or mutual funds) is similar in concept to the capitalization rate. The capitalization rate is merely the same interest rate or return measure applied to the actual income that is being generated to get to the investment amount required to reflect that percentage return.

By way of example, if an apartment building is generating $100,000 of net income a year and market data shows that investors in apartment buildings generally want an 8% return on their money, then the vendor of an apartment wanting to sell that building at the accepted market price would "capitalize" $100,000 net income by the 8% capitalization rate to determine a selling price of $1,250,000 ($100,000/0.08 = $1,250,000). In other words, a purchaser paying $1,250,000 and receiving $100,000 of net income a year is getting an 8% return on its investment

Common Gross Effective Rent:

The following definition is a standard term developed by the Canadian Institute of Public and Private Real Estate Companies ("REALpac") and the Appraisal Institute of Canada ("AIC"). Refer to www.realpac.ca > Standards > Terminology Standards. When referencing a REALpac/AIC standard term, users are requested to reference the alphanumeric identification number following each definition.

Common Gross Effective Rent is calculated by combining the Common Net Effective Rent with the building's quoted realty taxes and operating costs, but excludes direct billed or separately metered tenant hydro consumption (REALpac/AIC-CGER-1.01-2001).

Common Net Effective Rent:

The following definition is a standard term developed by the Canadian Institute of Public and Private Real Estate Companies ("REALpac") and the Appraisal Institute of Canada ("AIC"). Refer to www.realpac.ca > Standards > Terminology Standards. When referencing a REALpac/AIC standard term, users are requested to reference the alphanumeric identification number following each definition.

Common Net Effective Rent is the true Rent related to a certain lease transaction, based on the present value using the common discount rate, of all Rent receivable by a landlord over the initial fixed term, less the present value of all tenant inducements, free rent periods and commissions payable, with such remainder present value then amortized over the fixed initial lease term (REALpac/AIC-CNER-1.01-2001).

Minimum Rent:

The following definition is a standard term developed by the Canadian Institute of Public and Private Real Estate Companies ("REALpac") and the Appraisal Institute of Canada ("AIC"). Refer to www.realpac.ca > Standards > Terminology Standards. When referencing a REALpac/AIC standard term, users are requested to reference the alphanumeric identification number following each definition.

Net Rent is Rent, excluding a tenant's share of real estate taxes, operating costs, and other costs directly related to the tenants' occupancy of the space (REALpac/AIC-NR-1.01-2001).

Net Rent:

The following definition is a standard term developed by the Canadian Institute of Public and Private Real Estate Companies ("REALpac") and the Appraisal Institute of Canada ("AIC"). Refer to www.realpac.ca > Standards > Terminology Standards. When referencing a REALpac/AIC standard term, users are requested to reference the alphanumeric identification number following each definition.

Net Rent is Rent, excluding a tenant's share of real estate taxes, operating costs, and other costs directly related to the tenants' occupancy of the space (REALpac/AIC-NR-1.01-2001).

Net Effective Rent (NER):

For a definition of Net Effective Rent, refer to the definition of Common Net Effective Rent.

Rentable Area:

The tenant’s Usable Area (refer to definition below) plus an adjustment (or "gross-up") for a proportionate share of common areas, elevator lobbies and washrooms on the floor. The Building Owners and Managers Association ("BOMA") sets specific standards for measurement of office, industrial and retail space in BOMA's 1990 or 1996 standard ANS Z65.1, but these are not always observed by all landlords.

Sublet Space:

Space made available to users by existing tenants. The term available is the original term of the existing lease (then called the "head lease") less one day (called the "reversion"). The space available is all or any part of the tenant's space. Upon creation of the sublet, the original tenant is called the sub-landlord and the new sublet tenant is called the sub-tenant.

Term Space:

Space made available to users by landlords, but only with a maximum lease term. The landlord cannot make a longer commitment possibly because another tenant in the building may have an option to expand into the space at some date in the future.

Usable Area:

The Building Owners and Managers Association ("BOMA") sets specific standards for measurement of office, industrial and retail space in BOMA's 1990 or 1996 standard ANS Z65.1, but these are not always observed by all landlords.

Vacancy Rate:

The amount of vacant space divided by the total inventory, expressed as a percentage. A regional vacancy rate of 8 to 10% is considered by some to represent equilibrium, where the bargaining power of both landlords and tenants are equal.

Vacant Space:

The total amount of office space currently vacant. This statistic does not include space which is being marketed and not yet available. It does, however, include space which has been leased but not yet occupied. These definitions prevent double-counting of vacancy and absorption.

2 Canadian property rights

2.1 Introduction

Canada takes much of its cultural and legal history from the United Kingdom. Indeed, property rights, land registry systems and even local government structure is modeled on British and common law traditions. While property rights are not specifically protected under the Charter of Rights and Freedoms in Canada as they are in, say, the United States, they are indirectly protected in various other ways. All levels of government in Canada have powers of expropriation, but use those powers sparingly. Expropriation in public interest is used where the public benefits evident outweighs the hardship to those dispossessed. Legal skirmishes occasionally arise in Canada, where a politically motivated legislative activity is perceived to infringe on property rights. These sporadic events do not impact the day to day workings of the Canadian property markets, but occasionally impact specialty assets and unique situations.

2.2 Property rights and freedom

Many philosophers and authors over the past 200 years have identified individual property rights as a necessary incident of freedom. These authors include John Stuart Mill, John Locke, Rousseau, and others. Democratic ideas reappeared in Europe on a significant scale in the 17th Century. This was because barbarian invasions and the fall of Rome in the 5th Century led to a European society more concerned with security than individual freedoms and democratic institutions. This gave rise to a different kind of social contract; feudalism and manorialism. In these social contracts, individuals worked for a higher lord or baron in return for security from aggression. In addition, political attitudes during this period of time were affected by the Christian church. Gradually, the "Divine Right" claimed by medieval Kings gave way to the defacto reliance by those Kings on Barons and Lords for practical advice given in a open meeting environment. Attendees at these meetings over time wanted more than simply advisory powers, and membership was accordingly enlarged so that all representative groups had attendees at the meetings, including the knights (i.e. army) and the burgher (i.e. merchant) classes. This was the forerunner of the modern legislature.

John Locke argued that a political sovereign is enabled by a social contract in which individuals give up complete freedom in return for the provision of certain services (including security) by a governmental entity. This governmental entity is charged with the obligation to protect the natural rights of life, liberty, and property in return for individual recognition of this authority. These thoughts were reflected in the US Declaration of Independence in 1776. The same ideas caused the French Revolution in 1789, although France did not achieve real democracy until approximately 1870. On a similar scale, democracy evolved in England from 1832 to 1884. Most other modern democracies evolved in the 20th Century.

John Locke further argued that property rights were the natural extension of an individual's right to hold whatever they produced by their own initiative. The "fruits of the earth" belonged to those who were willing to use their labour to produce them. At the time of Locke's writing in the late 17th century, England, like much of Europe, was still in a predominantly agrarian state of production and evolution. In 1690, England had just emerged from a fifty year period marked by civil wars, the rise of a merchant class and the economic transformation the upheaval had brought. Property rights would evolve in the following centuries as the feudal system continued to wane.

Perhaps the most famous of the classical economists, Adam Smith, did not discuss the issue of property rights at great length in his major work The Wealth of Nations (1776) which described the principles for the operation of a free market economic system. Smith's view of property and property rights was incidental to his advocacy of improving industrial capabilities and manufacturing capacity. For Smith, property and property rights were still tainted by the remnants of a feudal era where the remaining "feudal elite" of the 18th century were acting detrimentally to the growth of the English economy as a whole. They did so by not using their property for value added purposes such as manufacturing. In essence, Smith's economic writing favoured replacing the ownership of property only to encourage the use of that property for developing and enhancing the emerging industrial society. It could provide the manufacturing base which England would need to achieve economic prosperity and shift away from its agrarian economy.

Subsequent writers such as David Ricardo would further advocate the use of property as a means to an end of economic growth, prosperity and global power. In a real sense, the modern value of property, deriving from the ability to add value to the land itself with buildings and structures serving multiple uses, stemmed from the early contributions of Smith, Ricardo and the other classical economists. They took Locke's view of property rights to their next logical step.

2.3 Property rights in modern economics

There is a considerable body of literature, particularly since the early 1990's given the decline of Soviet Russia, and the market led reforms in China and elsewhere in the world, which discusses property rights in an economic context as a reason for the success of a given nation. From Garrett Hardin's classic article on "The Tragedy of the Commons", economists around the world now see that individuals who have residual rights in property try to perpetuate and enhance the value of the property for themselves, their heirs or those they may sell the property rights to. This "enlightened self-interest" ensures careful management of the asset.

Even in primitive societies, degrees of private ownership in personal property existed. Private ownership of real property appears to have evolved much later, once nomadic tribes settled down in permanent agricultural communities. Aristotle saw that common ownership of agricultural land made no sense. There was an incentive for labourers to be lazy, since their share of the output was the same in any event. Conversely, there was no incentive for any particular labourer to work any harder since there was no extra output for them or their family as a result thereof. Even today in many African and Asian countries, land is considered the property of a tribe or clan.

In the middle ages, absolute ownership of land was unusual, given the prevalence of the feudalist system, in which land was held subject to obligations to a superior lord. After the discovery of North America, the availability of land that could be privately owned put European feudal societies at a competitive disadvantage. Competition for labourers and production may have hastened the demise of feudal land ownership.

It is not surprising that during history, ownership of land has been considered the greatest source of wealth. However, with the industrial revolution, other forms of property, including stocks and bonds, became more and more significant as sources of wealth. In communist countries, the means of production (i.e. property) were owned by the state for the benefit of the people as a whole. However, in communist countries, individuals were permitted to own personal articles such as furniture and clothing and in some cases, small farms and dwellings could be privately owned.

During the technological revolution of the 1980's and 1990's, property rights in non-tangible forms of property, including computer software, creative works such as music and entertainment, and in corporate names, trademarks and Internet domain names became very important. These new assets have enabled an extension of law of private property, but with the same principles applying.

2.4 Property rights in Canadian history

Canadians take their law from British common law, which has developed over a period of 1,000 years. This common law emerged from the feudal system imposed after the Norman conquest. The right to sell land privately in England goes back to at least 1290 A.D. by the statute Quia Emptores. The right to pass real property by will was permitted in 1540 under the Statute of Wills. These acts limited the divine right of Kings and imposed a uniform system of feudalism and a uniform system of local manorial courts. In England, judicial decisions made by the kings' courts were recorded and legal doctrines began to emerge. This was judge-made law. While statutes continued to be enacted by Kings, and later by parliament and legislatures, even these statutes were interpreted according to common law rules, including stare decisis (following the reasoning of a matter that has been decided) and placing the rule of law over the rule of man.

The Statute of Frauds was enacted in 1677 to require all transactions regarding land to be in writing. This was a statutory codification of the need for some stronger evidence that a person owned land, other than recollections of a verbal promise made. Land needed to be treated differently than chattels where the possessor is normally the owner, because values of lands are much higher and the risks and rewards for fraud are accordingly greater. Indeed, British courts called property "real" if an action to restore it could be made to its rightful owner; everything else could be compensated for in damages (i.e. loss of personal property). It is interesting to note that leasehold interests were historically held to be personal property although more recently they have grown to be associated with an estate in land and therefore real property. Since land is immoveable, it will never be dealt with on the same footing as the sale of goods. Land provides economic independence and that is a significant element of freedom.

Despite the rise in private property rights, land was and is never held absolutely. Land is always held "of the Crown", subject to government regulation, or pursuant to a tenurial incident. This is held to mean, given the John Locke concept of "social contract", and the Max Weber perspective of government as the sole owner of the power of compulsion, that land is always subject to the sovereign right of governments. In Canada generally, the first grant of land tenure is from the Crown; the "Crown Patent". Many Crown Patents reserve mines and minerals or timber rights to the Crown. In most cases, there are no other feudal incidents remaining, although provincial acts still revert land to the Crown in the case of, for example, a dissolution of a corporate owner of land.

In principle, all land is owned by somebody, including roads. But the rights that each individual land owner has need to be held in a balance with the collective aspirations of the community; i.e. the public interest. For example, freedom of speech is constrained in the public interest.

Property rights have often been regarded as a bundle of specific and individual rights. This concept has its origins in Roman law, but applies today. The following are the six rights of ownership in the "bundle of rights" in Canada:

* Right of Possession
* Right to Exclude Others
* Right of Disposition
* Right of Using
* Right of Enjoying the Fruits and Profits of Land (including wild animals while on the property)
* Right of Destroying or Injuring Property

The qualifications that apply to private rights of ownership are all in the public interest and include health, safety, morals, general welfare, market failure broadly defined, the interest of neighbours, and the interests of the community. The following are examples:

2.5 Constraints on property rights

Property Right	**Constraint in the Public Interest**
Right of Possession	Crown Patent reservations (possession of mines, minerals or hunting rights in others)
	Family Law Acts (matrimonial home rights)
	Expropriations Acts (ability of government to take)
	Rights of Way; Easements (not exclusive possession)
	Assessment Acts (have to pay property tax to keep possession)
	Fraudulent conveyances (can't convey away to avoid debts)
Right to Exclude Others	*Fire Marshalls and Fire Code Acts* (fire warden's access)
	Building Code Act (building inspector's access)
	Occupational Health and Safety Acts ("OHSA")(labour inspector's access)
	Criminal Code (search and seizure laws-police access with or without warrant)
	Easements and Rights of Way (right of limited access to others)
Right of Disposition	*Family Law Act* (may need spouses consent)
	Registry Act (must observe conveyancing formalities)
	Land Titles Act (must observe conveyancing formalities)
Right of Using	*Environmental Protection Act* (can't pollute)

	Planning Act (limits land uses)
	Nuisance (can't create noxious odors or noises)
	Assessment Act (must pay property tax to keep on using)
Right of Enjoying the Fruits and Profits of Land (including wild animals)	*Assessment Act* (must pay property tax to keep on using)
	Construction Lien Act (liable for debts to workers who improve the land)
	Execution Act (judgment creditors can look to the land for payment)
Right of Destroying or Injuring Property	*Environmental Protection Act*, (limits ability to pollute ones own land)
	Occupational Health and Safety (OHSA) (limits ands controls health risks on lands)

Pursuant to the *Constitution Act* (Canada) 1982, the primary legislative enactments constraining private property rights are within provincial jurisdiction. These might include Acts empowering local municipalities to govern, Acts empowering local municipalities to determine permitted land uses within their municipal boundaries, Acts establishing the process for registering documents of ownership, Acts establishing the nature of the rights of commercial and residential tenancies, Acts providing for a process of expropriation by the local or provincial governments, Acts establishing the process for determining how local property taxation occurs, and Acts providing for the rights of spouses to a matrimonial home or family farm.

2.6 Constitutional protection for property rights in Canada

Canada still has links to the British Parliament by virtue of its Constitution. Canada did not have a "Boston Tea Party", and has never unilaterally declared itself a republic (unlike the United States). Canada negotiated for self government, resulting in the *British North America Act*, 1867, an Act of the British Parliament ("BNA Act"). In 1982, revisions were made to the BNA Act, and it was retitled the *Constitution Act*, 1982.

Property rights were not specifically entrenched in the Canadian Charter of Rights and Freedoms upon its repatriation from the British government in 1982. This fact needs to be contrasted with international trends, such as is reflected in the Universal Declaration of Human Rights, the European Convention for the Protection of Human Rights, the Inter-American Convention on Human Rights, the US Bill of Rights, and Quebec's Charter of Human Rights and Freedoms, all of which protect real property.

2.7 An international comparison

Canada	**U.S.**
No express constitutional protection in Canadian Charter of Rights and Freedoms	5th Amendment, American Bill of Rights - no taking without just compensation -

	denial of rights to use all of one's property will constitute "taking"
Right to affect use in the public interest (as long as not for a public purpose)	Right to affect use in the public interest - if affect 75 to 87.5% of usability = compensation
Availability of private rights: trespass, nuisance, negligence	14th Amendment - no - state shall "deprive anyone of property without due process of law"
Rights viz. municipal bodies: 1. ultra vires; 2. procedural protection 3. substantive protection; 4. power to regulate vs. prohibit; 5. bias; 6. discrimination; 7. under inclusiveness; 8. unreasonable bylaws.	

Why did Canada miss the opportunity to entrench property rights in the Canadian Charter of Rights and Freedoms in 1982? Property rights protections did exist in initial drafts of the Charter. There are several reasons why it was removed from subsequent drafts of the Charter. There was at the time socialist (NDP) party opposition to it since it may have prevented nationalization efforts. Several provinces, including Saskatchewan and Prince Edward Island wanted to control non-resident ownership of property. Women's groups were concerned about the impact of enfranchised property rights on the division of assets upon divorce and rights to the matrimonial home.

At the present time, it is generally agreed that Section 7 of the Charter, the "right to life, liberty and security of the person" does not apply to economic rights, such as property rights. Is the omission critical? Generally not. Private property owners have private rights as against others, such as in trespass, nuisance or negligence. As against municipal bodies, there are certain procedural protections that owners have, including the doctrines of ultra vires, procedural protection, substantive protection, the doctrine that the "power to regulate does not include a power to prohibit", bias, prohibitory effect, discrimination, under inclusiveness, unreasonable by-laws, and disguised expropriation. As against provincial and federal bodies, however, the protections diminish.

If nothing else, the cancellation of the Pearson privatization initiative in 1996 demonstrates that property rights even in a free market economy are by no means absolute and without impediment. Under certain international treaties for economic cooperation and trade, such as NAFTA, provisions have been drafted in which offer some measure of property rights protection for the foreign partner doing business in the country that chooses to expropriate or repudiate contracts. It is ironic that while Canada does not expressly protect property rights in its Constitution for its own nationals, it has signed treaties which extend such protection to foreign concerns. It is also regrettable that foreign nationals have, in some circumstances, higher property rights than Canadians.

2.8 Review questions

1. Are property rights protected in the Canadian Constitution?
2. What are the remedies in Canada for a party who believes that their property rights have been taken away?

2.9 Annotated bibliography

Atwood, Evan and Michael Trebilcock, "Public Accountability in an Age of Contracting Out," July 1996, Vol. 27 *Canadian Business Law Journal 1*.

> This article looks at the Pearson Deal, outlines the events leading up to the current situation, and places the situation within the context of what it means for the government's plans to contract out more and more of its services in an era of government downsizing and budgetary cutbacks.

Becker, Lawrence C. *Property Rights: Philosophic Foundations*. London: Routledge & Kegan Paul Ltd., 1977

> In this book Becker examines a number of property rights arguments such as the first occupant argument, the labour theory proposition, the utility theory and the political liberty argument. He lays out what each theory argues and then explores the soundness of the argument. In laying out each theory he explores the arguments of the proponents of the theory as well as those who oppose the argument. In the end he offers his own justification of property rights and he examines some of the problems associated with property rights such as how far can property rights go before they should be constrained.

Broom, J.H. *Rousseau: A Study of His Thought*. London: Edward Arnold (Publishers) Ltd., 1963.

> Broom closely examines many of themes of Rousseau*s arguments. The book is divided into sections, each analyzing a theme found in Rousseau*s writings. The book brings together many of the arguments that Rousseau makes on each topic throughout his works. Some of the topics which are included are Rousseau*s indictment of civilization, Rousseau*s historical hypothesis, Rousseau*s politics of regeneration and his views on education and morality. The book also provides a chronological outline of Rousseau*s life and his works. This is useful in understanding how Rousseau*s arguments developed over the years.

Burbaker, Elizabeth, *Property Rights in the Defense of Nature,* Earthscan Publications, Toronto, 1993: www.environmentprobe.org/environprobe/pridon/index

Carter, Alan. *The Philosophical Foundations of Property Rights*. Hertfordshire: Harvester Wheatsheaf, 1989

> Carter covers a number of topics as to the origin of many things such as labour and liberty. He discusses the views of many philosophers on topics such as utility, efficiency, first occupation, moral development and human nature. Carter examines these issues and what different philosophers wrote on these issues.

The Canadian Radio-Television and Telecommunications Commission (CRTC)

The CRTC, Canadian Radio Television and Telecommunications has a website which also deals with the properties required for radio and televisions communications. The submissions bearing on access to multi-tenant buildings ("MDU") will be of particular concern to proponents of property rights.

Conference Board of Canada

Some links to presentations made in the field of Real Property have been listed on this site in the past. This website has hot-links to various different presentations that they have made at various conferences.

Daniels, Ronald and Michael Trebilcock, "Private Provision of Public Infrastructure: An Organizational Analysis of the Next Privatization Frontier," (1996) 46 *University of Toronto Law Journal*, 375.

This article follows the experience of public-private sector developments from the Pearson Deal to the development of Highway 407 to the fixed link between PEI and New Brunswick. The article focuses on the problems and possibilities which governments face for securing private sector contracts to perform these "infrastructure" projects. The article has the purpose of showing that the failure of past government contracts lead to the development of a large public sector in Canada.

Federal Department of Justice

The official website for the Federal Government's Department of Justice. This again is a law based connection for all those interested in real property and includes some information on expropriation. Federal government departments and agencies in general can be found at:

Hogg, Peter W., *Liability of the Crown*. 2d ed. Toronto: Carswell, 1989.

This book was written by one of the most well known constitutional law scholar in Canada. As such, it traces the constitutional and common law principles which concern the liability of the crown in Canada. The book goes step by step through the aspects of Crown liability both for contract repudiation, and actions of the Crown's agents. This particular book is in its second edition, however, the original first edition written some twenty years earlier dealt exclusively with Australia and New Zealand. This edition is expanded to include Canada.

Hume, David. *Moral and Political Philosophy*. Edited by Henry D. Aiken. New York: Hafner Publishing Company, 1948.

This book contains many of Hume*s most important writings. The book contains Hume's writings on the Treatise of Human Nature which includes writings on the passions, morals, justice and injustice and of other virtues and vices. The book also contains an Enquiry Concerning the Principles of Morals and other essays written by Hume. It also includes an introduction into Hume*s works by the editor.

Keohane, N.O., "Rousseau on Life, Liberty and Property." *In Theories of Property: Aristotle to the Present*, pp. 203-217. Edited by Anthony Parel and Thomas Flanagan. Waterloo: Wilfrid Laurier University Press, 1979.

> This article examines Rousseau*s writing on life, liberty and property. It looks to all of Rousseau*s work for his theory on these topics. The article answers two specific questions. The first question is: How do free men become slaves? This essentially discusses Rousseau*s view of how civil society developed. The second question is: How do slaves become free? This essentially examines Rousseau*s view of how people can enjoy freedom in civil society. Thus, this article essentially focuses on Rousseau*s views of property and freedom.

Law Reform Commission of Canada, Expropriation, Working Paper 9, Ottawa: Information Canada, 1975.

> This text on the law and compensatory provisions for expropriation seems to still hold merit despite the fact that it is now nearly 22 years old. The aspects on reform to the law of expropriation to make it more equitable and less discretionary is surveyed.

Locke, John, *Two Treatises Of Government*. ed. Peter Laslett. New York: Cambridge University Press, 1963.

> The original text of John Locke.

MacAdam, James, "Rousseau: The Moral Dimensions of Property." *In Theories of Property: Aristotle to the resent*, pp. 181-202. Edited by Anthony Parel and Thomas Flanagan. Waterloo: Wilfrid Laurier University Press, 1979.

> This article examines the arguments made by Rousseau on property and property rights. It examines how Rousseau*s arguments on property rights developed throughout his writings. It incorporates all of Rousseau*s works and looks at Rousseau*s theory of property and property rights. It also examines any contradictions made in Rousseau*s writings and offers reasons for these contradictions. The article also looks at Rousseau*s* theories on property, law and freedom and how these theories interrelate with each other in Rousseau*s writings.

Monahan, Patrick J. "Is the Pearson Airport Legislation Unconstitutional?: The Rule of Law as a Limit on Contract Repudiation by Government," (1993), 33 *Osgoode Hall Law Journal* 411.

> This paper appears to be one of the first which discusses the constitutional aspects of the Pearson Airport Deal and the legality of what happened.. It is critical of the government in the sense that the government is placing itself above the law by denying recourse to litigation and capping its own liability.

Munzer, Stephen R. *A Theory of Property*. Cambridge: Cambridge University Press, 1990.

> This book provides a theory of property. It begins with providing readers with an understanding of property, property rights and personal rights. Munzer discusses many issues related to property such as the idea of property and conceptions of property. The book also covers a number of other issues such as property and moral character, utility

and efficiency, justice and equity, conflict and resolution as well as such things as business corporations.

O'Byrne, Shannon Kathleen, "Public Power and Private Obligation: an analysis of the government contract," May 1992, *Dalhousie Law Journal*, Vol. 14, 485.

This article focuses on the liberal theory of the state and how that theory relates to the rise in government contracts with the private sector for the delivery of goods and services. It concentrates on the inequality of bargaining power between the individuals and the state and the resulting problems that arise from this.

Rosenfled, William "Privatization and Development Arrangements" *in Doing Business with Government*, Toronto: Department of Education, The Law Society of Upper Canada, Osgoode Hall, 1986.

This is an article in a series which was put together by consultants and legal practitioners for a panel discussion in the mid-1980s on making contracts with the Government. This particular paper dealt with some of the opportunities with privatization offered for private sector contractors and the requirements which the government might have for accepting bids.

Rousseau, Jean-Jacques. *The Basic Political Writings*. Translated and Edited by Donald A.Cress. USA: Hackett Publishing Company, 1987.

This book contains Rousseau*s Discourse on the Sciences and the Arts, Discourse on the Origin of Inequality, Discourse on Political Economy and On the Social Contract. It contains many of Rousseau*s most important writings and includes an introduction by the editor.

Schlatter, Richard. *Private Property: The History of an Idea*. New Jersey: Rutgers University Press, 1951.

In this book Schlatter examines the idea of private property throughout history. He begins by examining the Greek era and their idea of private property. He then examines the Roman era*s idea of private property and ends with the nineteenth century. Throughout each era he refers to the most prominent philosophers and presents their views on private property and property rights. He also compares the philosophers of each time period with each other to gain a better understanding of how their views differed from each other and to gain a better understanding of the arguments that each philosopher presented.

Simmons, A. John, *The Lockean Theory Of Rights*. New Jersey: Princeton University Press, 1992.

This is quite a useful source of discussion on different arguments by Locke with respect to various rights. Sections are divided according to general topics of rights and chapters are broken down into more specialized areas of rights. This made it easy to pinpoint the area that I was studying, and I was able to read the most useful chapters only. It makes reference to Locke*s original work with book, section, and chapter being provided, which facilitates checking the original. As well, footnotes rather than endnotes are provided which also facilitates checking sources and cross-referencing.

Todd, Eric, *The Law of Expropriation and Compensation in Canada*, 2nd ed., Toronto: Carswell, 1992

> This book follows up on the concepts of expropriation as they have developed since Confederation and relates them to the push for property right entrenchment in the Constitution. It deals at length with the possible options open to those persons who have been expropriated.

2.10 Non-annotated bibliography

Augustine, Philip W., "Protection of the Right to Property under the Canadian Charter of Rights and Freedoms", 18 *Ottawa Law Review* 55 (1986).

Alchian, A. A. "Some Economics of Property Rights". *Il Politico*. 1965; 30: 816.

Alvaro, A., "Why Property Rights Were Excluded from the Canadian Charter of Rights and Freedoms", (1991) 24 *Can. J Pol Sc* 309-329.

Barber, William J., *A History of Economic Thought*, Penguin Books, New York, 1991.

Bauman, R.W., "Living in a Material World: Property Rights in the Charter" (1982) 3 *Constitutional Forum* 49-54.

De Alessi, Louis. "The Economics of Property Rights: A Review of the Evidence". *Research in Law and Economics.* 1980; Vol 2: 1-47.

Discussion: Property Rights and Liberty. (1988) 1 *Can J of Jurisprudence* 217-235.

Doumani, Robert G., Glenn, Jane Matthews, "Property Planning and the Charter", Vol. 34.

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Friedman, Milton, "Capitalism and Freedom", University of Chicago Press, Chicago, 1982.

Hanke, Steve H., "Dancing on a Volcano", *Forbes*, Jan. 2, 1995, p.293.

Johansen, David, "Property Rights and the Constitution", Ottawa: Library of Parliament, Research Branch, 1992, 14p. "October 1991", Issued also in French, (Background paper; BP-268E).

Mill, John Stewart, "On Liberty", 1859.

Mill, John Stewart, "Principles of Political Economy", 1848.

Mossman, M.J., "Toward 'New Property' and 'New Scholarship': An Assessment of Canadian Property Scholarship", (1985) *23 Osgoode Hall L J* 633-652.

Nedelsky, Jennifer, "Private Property and the Formation of the American Constitution, Toronto: Osgoode Hall Law School of York University, 1985, p.59.

Osterhoff, A.H., Rayner, W.B.. Vivian, P.E., *Restrictions on the Property Right in Ontario*, Canadian Real Estate Association, 1974.

Shumiatcher, M.C., "Property and the Canadian Charter of Rights and Freedoms", (1988) 1 Can J of Jurisprudence 189-208.

"The Politics", Aristotle, Book II, Section v.

"The Pattern of Development", Halsbury's Laws of England (1991), p. 3.

Weaver, Ronald L., Solov, Mark D., "Travels on the Long & Winding Road to Property Rights Protection", *Development Magazine*, Fall 1994, pp. 16, 18 & 40.

3 Theory

3.1 Introduction: Role of and explanation of theories relevant in real estate

Experienced real estate practitioners may not think that there are any theories which can inform real estate practice or inform any frameworks for structuring real estate transactions. Indeed, nothing could be farther from the truth. The current theoretical field is very rich in materials and theoretical approaches. Recently, portfolio theory has made its way into the mainstream in institutional decision making. But there are many other robust bodies of theory that practitioners can have regard to help them sort through issues in dealing with real property. They include:

* Property Rights (economics)
* Game Theory (economics)
* Principle-Agent Literature (economics)
* Public Choice Theory (political science - economics)
* Decision Theories (i.e.. Lindblom Incrementalism, rational comprehensive, social learning, social mobilization, transactive, etc.)
* Location Theories and theories of regional comparative advantage (e.g. Weber, Losch, Christaller, Hotelling, Ricardo, Porter)
* Transaction cost literature; the theory of the finn (economics)
* Competitive Market Theory (economics)
* Theory of Non-Market Failure
* Market Failure: Free Rider and Negative Externality Problems
* Chaos Theory

The following is a brief introduction to a few of these fields.

3.2 Property rights (the economic theory) in real estate

Given the non-transferability of ownership claims in the public sector, bureaucrats have no particular, personal stake in the longevity of the asset (Hardin, 1993; DeAlessi, 1980). According to DeAlessi, public firms tend to fail to price properly, favour voters, have higher operating costs, and use more capital intensive production techniques. The evidence that this is so is not simply based on satellite photographs of grazing lands in Africa, as in the Harden article; rather the failure of a former Soviet Union and Eastern Europe, the rapid decline of Cuba, and the economic comparisons available between North and South Korea shows clearly the success of capitalist mixed economies, which enable private property ownership, over communistic ones. Indeed, property rights are often used or recommended by economists as possible solutions to the free rider and negative externality problem. Providing property rights in elephants in Africa are causing an increase in elephant populations. Property rights cannot be provided in some cases such as for air, but property rights in, say, the right to emissions from factory smoke stacks have been used in the US. Regulation and contractual arrangements may also control free riders and negative externalities, but may be little use if transaction costs to establish, distribute, and monitor them are high. It is interesting to note that through the economic literature on property

rights that some economists can envisage a positive theory of public enterprise and, through it, a normative concept of good government (Vickers and Yarrow, 1988 at page 1).

3.2.1 Theory of the firm: Transaction costs

The theory of the firm literature, also known as transaction costs literature, focuses on decisions by economic units to either make a product itself or buy it from outside sources. There are situations in which it is better to source products from outside rather than tool up to make it internally, unless the good or service is critical or strategic, co-ordination costs would be too high, or outside supply is limited and exposes the firm to shortages of supply. In a real estate firm, this has employment implications. Does a firm hire an in-house lawyer or use outside counsel? Should a Pension Fund do its own property management or use a third party? In the business literature, this topic is dealt with under the heading of core businesses vs. peripheral businesses; fixed overhead vs variable overhead, and others. See the Coase article for more information.

3.2.2 Principal agent literature

Principal-agent literature analyzes incentives and information in organizations (notionally, "agents" of shareholders), asking what is the best compensation, incentive, and environment for the principal to lay down for the agent to incent desired outcomes. Principal Agent literature suggests that the profit motive of private sector firms translates within the firm to efficiency-seeking and profit-seeking incentives. These in turn ensure that the internal structure of the firm maximizes efficiency and profit. There is no concern about the relative importance of other objectives. Government agencies, on the other hand, have many purposes, including social welfare, maximizing votes, minimizing the potential for political embarrassment, and the incentives to the agent (i.e.. bureaucrats) are often mixed. Often, labour and capital redundancy are a design standard. Performance bonuses are rare in the public sector public bureaucrats have little incentive to minimize costs or increase the value of the "service", since the asset is not transferable.

3.2.3 Public choice theory

Buchanan's Nobel Prize-winning in public choice theory offers another theoretical insight. Public choice theory applies assumptions about self-interested behaviour in the marketplace to governments; to bureaucrats, to special interest groups and to politicians. Interest group-government interaction is likely to produce, according to public choice theory, economically irrational decisions (Linowes at 234). These start from stated government policy and compare skewed results or implementations. Examples include the use of environmental legislation to curb competition (Shaw, 1993 at p. 152). Public choice has libertarian roots, but is broad in its applicability and explanatory, although not particularly predictive. It shows the loose control provided to governments through the ballot box, and the dynamic of decision making within it (Shaw, 1993: see also Sproule-Jones, 1983: Hartley and Parker, 1991).

3.2.4 Game theory

Game Theory originates with the famous mathematician Von Neumann, the father of the computer. The classic game theory example is that of the prisoner's dilemma Two prisoners who have been arrested on suspicion of committing a crime are interrogated in separate rooms. If either one confesses before the other, there is the possibility of that prisoner obtaining more

lenient treatment at the hands of the Crown. On the other hand, if neither confesses, then perhaps both would be free of the charges. What should the strategy of any individual prisoner be? Game theory has grown in acceptance in business since it involves the study of rational behaviour in situations involving interdependence. Game theory deals with competition, cooperation, oligopoly, risk, and uncertainty which individuals and companies involved in real property face every day. The awarding in 1994 of a nobel prize in economics for game theory research signified that game theory has come out of the closet and into the business mainstream. Game theory is credited with yielding many multiples of additional proceeds for the US Federal Communications Commission in auctioning off wave lengths of the radio spectrum. In real estate, game theory can be applied to auctions, for example, to maximize the proceeds of disposing of real estate assets. Game theory lets potential bidders express their own preferences for different aggregations of assets and the point of game theory is that it may be more efficient, and more profitable, to let buyers determine which aggregations of properties are most viable to them rather than sellers.

Game Theory has been considered in connection with the sale of real estate portfolios. The choices to sell off properties one at a time, as a group, or in groups could dramatically impact the total value achieved.

3.2.5 Decision theory

There are decision theories in most disciplines including business, economics, social science as well as urban and regional planning. Many of these decision theories share common lineage although they are given different titles in different disciplines. Charles Linblom's classic "muddling through" decision theory has been labeled incrementalism in several disciplines. Rational comprehensive, synoptic planning, is the command and control scenario most often followed by planners and by businesses in arranging their affairs. Other decision theories have been articulated, including social learning (in which the participation by individuals in the decision process causes a cultural shift), social mobilization (like a social learning decision model, but in which a particular actor plays a role to catalyze the group), and transactive planning (where there is a transaction involved of mutual betterment in the decision making process), amongst others. Implicitly, a social learning strategy is adopted for a strategic business plan in a company where management tries to ensure the participation of labour in the development of the plan and, accordingly, co-opt their support for the plan ultimately determined. The same is true to some extent of management efforts to inform employees as to the determination of a company's profitability and their accounting standards in the "open books" model of management. In these situations, there is a social learning effect whereby employees, as they become better informed, become better at cooperating with others in the company since they understand the overall goal much more explicitly than in the past.

3.2.6 Non-market failure theory

The emergence of the non-market failure literature suggests government ought to have efficiency dimensions to its actions that apply regardless of the policy course sought. Wolf argues that aspects of non-market failure includes the dispersed majority-interested minority problem, the high time-discount of political actors (similar to Marsh's "political short-termism), the political find-a-problem, legislate-a-solution ethic, group enfranchisement, reduced tolerance of market shortcomings, the decoupling of benefits and burdens, and internalities of government. These are thought to provide a way for policy analysts to see how government efforts to compensate for market failures may themselves fail in predictable ways.

> "a common element in the property rights and public choice literature is that, in the absence of the profit motive, ...government departments will tend to pursue goals such as budget maximization, risk aversion, over-manning and non-optimal pricing, employment and investment"
>
> (Hartley and Parker, at p. 15)

3.2.7 Location theory: Porter, Ricardo

A competitive "diamond" is introduced in Porter's 1990 publication. The Competitive Advantage of Nations, ("Nations") and refined in its applicability to Canada in Porter's 1991 Canada-specific study entitled "Canada at the Crossroads: The Reality of a New Competitive Environment" ("Crossroads"). Porter purports to offer a new method of analysis for the reasons for the competitive success of some nations and the relative failure of others. At stake in the competitiveness debate is whether a nation is able to achieve a high and rising standard of living for its people or not. Competitive nations can and do achieve a high and rising standard of living, and uncompetitive nations do not, according to Porter. The critical elements of the Diamond as modified in Crossroads are reviewed.

Porter has in Nations supposed new determinants of competitive advantage between nations. Porter contends that there are four key elements supporting national advantage in any particular industry sector.

1. Factor conditions
2. Related and supporting industries
3. Demand conditions.
4. Firm strategy, structure, and rivalry.

These four elements were graphically arranged like bases in a baseball diamond and called the competitive "diamond" by Porter in Nations. Also mentioned as relevant factors, although not part of the Diamond (perhaps the competitive "hexagon" isn't a catchy enough name), is government and the role of chance.

Porter focuses on macroeconomic and industry specific research to generate his determinants of competitive success. Porter claims both that his theory has predictive capability and that it can be applied at the individual firm as well as the national level. What is not clear from the book is how the various levels of government who might be otherwise involved in policy initiatives, and individual businesses, do this, since there are so many determinants and the relative importance of any one factor, industry sector to industry sector, would vary.

A detailed review of the four headings discloses a larger list of matters bearing consideration;

1. Factor conditions:

- factor endowment in:
  - human resources
  - physical resources

        - knowledge resources
        - capital resources
        - infrastructure
    - distinctions between basic factors and advanced factors
    - distinctions between generalized factors and specialized factors
    - the need to continually upgrade factor conditions
    - advantage can grow out of disadvantage in some factors

2. Related and supporting industries:

    - competitive advantage in supplier industries
    - exchange of innovation and supplier induced upgrading
    - competitive advantage in related industries "pull-through" demand (a customer's competitiveness increases demand for a supplier's products or services)

3. Demand conditions:

    - both quantity and quality of home demand
    - segment structure; range of segments,
    - number of independent buyers
    - rate of growth in demand
    - distribution channels representing demand
    - cultural "passions" creating sophisticated demand
    - saturation point

4. Firm strategy, structure, and rivalry:

    - strategy and structure of domestic firms
    - management practices, firm cultures
    - orientation of firms toward competing globally
    - company goals
    - individual goals, attitude towards wealth, risk
    - national prestige, traditions
    - strong domestic rivalry; new business formation

Chance items are those outside the control of firms and, usually, government, and they include pure inventions, breakthroughs in basic technologies, major shifts in foreign market demand, and external political developments.

According to Porter, these "chance" events create "discontinuities", a term coined by Drucker, that can shift competitive advantage. Government is also listed as a relevant determinant since it is seen as able to improve or detract from national advantage through its laws, standards, policies, and its taxation and investment initiatives. As shown above, there are interrelationships between listed factors, and between the listed factors and government and chance respectively.

While stating that he agrees with classical notions of Ricardian comparative advantage, Porter believes that it doesn't go far enough in explaining why some nations have prospered and others have declined. Porter's diamond is suggested as a new model for determining national comparative advantage. Porter thus expands on the classic Adam Smith factors of production formula (labour, capital) by breaking down capital into its many component parts, and by looking at the dynamics of these and other factors in a competitive society. David Ricardo's classic refinement of the theories of comparative advantage looks at the role of finite resources between two countries and suggests that a country will focus on the production of goods in which its relative advantage is highest and opportunity costs are the lowest Both Smith and Ricardo, however, assumed finite resources and the immobility of resources between countries, two assumptions that are challengeable today and that Porter's model accounts for. The former assumption ignores the role of innovation and product and material substitutability. Resource exploitation, at least in the sense of commodity (lumber, raw materials) exportation is not according to Porter the recipe for permanent competitive success and a high sustainable standard of living. The latter assumption (immobility of resources) while perhaps true in Smith's and Ricardo's time seems now unduly rigid. Certainly financial capital is mobile among advanced nations, limited only by the risk tolerance of the international investor. Management level human capital is also mobile, both temporarily by air travel and permanently by virtue of immigration, although the world's labour is by no means mobile.

Both Smith and Ricardo seemed to ignore the demand side of production (a factor now included by Porter), and the role of the individual firm in taking advantage of factor endowments or in succeeding despite comparative disadvantages. Smith's and Ricardo's recipe for success was very mechanical, and ignored the qualitative aspects of human capital. The Diamond is very broad and modern, and factor endowment is only one aspect of the competitive success formula.

3.3 Economic location theory - Introduction

Location was originally a factor in Ricardian comparative advantage. Comparative advantage can be generalized as suggesting, as between countries with factor endowments supporting certain products, which products should be produced in which countries. Similarly, economic geography does two types of things; firstly, by examining cost components primarily in raw materials, transportation and labour for a specific industry, it permits the determination by deductive reasoning of the ideal location based on those factors alone. Thus, for generalized uses, optimum cost minimizing location can be deduced. Secondly, by examining the existing location of uses, the type of use likely to locate in a given location can be suggested by inductive reasoning. Thus, for generalized locations, users valuing that location the highest at any point in time can be generally inferred. These analytical tools may be helpful in the global context in determining lowest cost locations for certain uses, and in determining highest and best use for given locations.

A review of the current state of locational geography reminds one of the current state of macro-economics in general. In macroeconomics, many schools of thought or intellectual current exist; the Keynesians, the new Keynesians, the classicals, the new classicals, supply-siders and so on. In economic geography, many streams of thought also exist, although they are not necessarily contradictory. While there are probably four main s, there are many other models of spatial interaction that have been proposed and refined since the 1950's. There are models based on the applicability of gravitational models, statistical (probabilistic) approaches, commercial location models based on utility theory, models of spatial public economics (which looks at the effect of governmental intervention), and spatial econometrics using the principle of "allotopy" (which compares economic actions in a given space to actions in another). The analysis of precise spaces

has given way to the analysis of fuzzy (i.e. unclear borders) spaces. Authors have approached the analysis of locational economic activity from the firm point of view, from the consumers point of view, and from the exchanges between the two point of view.

There does not seem to be a single unifying theory of general spatial equilibrium that one can apply to today's economy accurately. On the other hand, and like much of macroeconomics, there are fundamental s that form the basis for most current. Most start with some assumptions designed to minimize initial variation. Some apply to durable goods sectors only. The root of these theories, however, are from four German locational theorists; von Thunen (1826), Weber (1909), Christaller (1933 and 1966), and Losch (1940).

In this summary, the group is profiled, focusing particularly on the contributions of Alfred Weber. Weber is an interesting candidate for review, to the extent his bridged economics with locational planning, and resulted in a model that helped to explain reality. There is much in the current world spatial arrangement that is Weberian, particularly durable goods manufacturing where raw and final material shipping costs are significant. However, Weber's contributions cannot be considered in isolation. Weber was part of that group of four German planners/economists who were engaged in spatial research during the late l9th and early 20th century. Accordingly, the following is a brief profile of each of the four Germans.

3.3.1 Von Thunen and agricultural location theory

It is generally felt that economic geography (also known as "spatial economics") originated in the l9th century, primarily with the of Johann-Heinrich von Thunen in 1826. Von Thunen differed from the English classical economists of his time (Adam Smith, David Ricardo) to the extent he felt that factors of production (labour, capital) failed to adequately reflect his observed reality on the concept of land rent. Adam Smith was aware of the role of transportation cost in determining production location and the value of products, but Ricardo's on comparative advantage between nations seemed to von Thunen to ignore the spatial factor (transportation costs) altogether.

Von Thunen was a farmer in northern Germany, and noticed the effect of the local town's growth on agricultural production and crop rotation in his area Farmers began to grow what was valued the highest and changed their crop rotation habits. Von Thunen observed the exchange economy that grew between the town (buyers of agricultural goods) and the country (sellers of agricultural goods) and the creation from that process of the concept of land rent, what someone would pay to farm land in a given area Von Thunen postulated an even plain, and a town in the centre. He suggests an even price in the urban centre for each type of agricultural good (commodity). Von Thunen observed that the type and weight of the produce (where transportation in his time was based on the horse and cart) and the distance to the urban centre from a local farm (excluding consideration of variations in land fertility) determined the land rent for that farm. This resulted in a theory that land rent decreased as distance from the urban centre increased in concentric rings. In each ring, typical crops were suggested. For example, market gardens and dairy herds were kept in the first concentric ring, since vegetables and milk were difficult to transport and there was no refrigeration. Accordingly, they were more scarce and they had a higher value in the urban centre. Also, the proximity of the first concentric ring to the town meant that fertilizer could be purchased easily in the town and used in the first concentric zone to improve yield. Accordingly, the relationship between price and land rent was established by von Thunen in what was called a "marginal price theory". Von Thunen was also aware of the effects of rivers on skewing the concentric rings (water transport may be cheaper), taxes on reducing rents, and fertility on production and therefore land rent.

Von Thunen's model was an equilibrium model, explaining the default spatial arrangement. Von Thunen's agricultural models are still accurate, and his theory helps explain urban locations. Many modern authors have since taken up refinements of the von Thunen model.

3.3.2 Alfred Weber and industrial location theory

The German transportation economist W. Launhardt was responsible for seeing in von Thunen's agricultural location theory some principles applicable to the industrial revolution. Launhardt suggested in 1882 that individual manufacturing firm locational decisions would be made on the basis of transportation costs relative to the location of raw materials and consumer markets. Again considering the weight of the cargo and the distance to be traveled, Launhardt was able to deduce optimum locations for any firm. This was to foreshadow the industrial location theories of Alfred Weber.

Weber developed his minimum transport cost theory in 1909. He based his locational theory on minimum transport cost but expanded Launhardt's approach by introducing variables (labour cost, agglomerating factors and deglomerating factors) in an economic closed system and applied it to a variety of industries. Weber assumed as given (and static) the location of raw materials and of consumption of the output, the immobility and unlimited supply of labour at fixed wages and transportability of raw materials. Weber is also dealing with durable goods. Unlike von Thunen, Weber is concerned with the locational preferences of the individual firm, rather than an equilibrium model of general location of manufacturing activities.

Weber also deals with weight of transported goods and distance, but converts variables such as less than carload shipments either into weight or distance equivalents, and postulates only one form of transportation.

Weber starts with the "locational figure", the area bounded by the places of consumption and the source(s) of raw materials and energy. For example, if there were two sources of raw materials and one place of consumption, a triangle would be the "locational figure" from drawing straight lines between the three points. Weber suggests that the point of minimum transport cost is within this figure, with the precise point generally depending on the strength of the attraction of the raw material points and the consumption place. Weber recognized that a calculation of "ton-miles" within the locational figure depends on the extent to which the raw materials are "pure" or "weight losing" raw materials. An example of a pure raw material might be cane sugar, and nickel ore an example of a weight losing raw material Obviously, weight losing raw materials lose weight during the production process and thereby increase the locational pull of the source of the raw material in determining minimum transport cost. Conversely, pure raw materials closest to places of consumption (a good example is a gravel pit, provided the range and quality of the gravel is good) will tend to be used since the total transport cost would be lowest for users of those sites. Since the pure raw materials (located close to places of consumption) would tend to be exhausted over time, Weber suggests over the long term that for industries for which raw materials have weight losing characteristics, location near the source of the raw material becomes an even stronger pull. This is reinforced by process and technological improvements implementable over time at the raw material source.

After the point of minimum transport cost is located, Weber considers labour costs and the extent to which lower "real" (i.e. subjective productivity divided by the local wage rate) labour costs pull the locational decision off the optimum minimum transport cost point. In similar fashion to von Thunen's concentric rings, Weber drew circles around his point of minimum transport cost

("isodapanes") within which additional transport costs were equal. "Critical Isodapanes" were isodapanes in which the saving in labour cost was at least equal to the increased transport cost at the new location outside of the point of minimum transport cost. Out of these assumptions, Weber was able to mathematically construct for any finn the locational figure, the point of minimum transport cost, the isodapanes and critical isodapanes for that firm, as well as certain ratios such as labour cost to weight of transported good. Weber was able to generalize that low population density increased the average distance between locational figures and labour, and that the rate of transportation cost increase with distance determines the size of the isodapanes. Conversely, where transport costs are uniformly low and the rate of increase low with distance, labour cost exerts a much stronger pull on optimum firm location.

Weber also recognizes the role of land cost on his locational theories. Weber suggests the increase in land rent caused by the concentration of firms ("agglomeration") causes an opposite effect as land rent rises ("deglomeration"). Weber suggests there are cost savings in concentration (adaptability to market conditions, lowering of general costs) that can counterbalance increased land rent and that can be the subject of isodapanes. In this context, critical isodapanes regarding concentration exist where the rise in transportation cost is balanced by the lower cost due to concentration. These isodapanes can also be overlayed on the minimum transport cost point to determine whether overall cost savings are completely offset by increases in land rent or not.

Thus Weber believes locational patterns of industrial firms (the "locational pull") are based on these three principles; minimum transport cost, labour isodapanes, and effects of agglomeration. Weber's theories complemented von Thunen's, but Weber's locational theories didn't explain central places, and critical assumptions such as the unlimited availability of labour could skew results. Weber has been criticised for inadequately dealing with site rent, varying prices and demand, and variable factor proportions (the substitutability of capital for labour and vice versa in deciding locational choices) in production.

Weber, however, has been regarded as accurately articulating the reasons for location of certain types of industry:

- as a function of transport cost where it does not use weight losing raw materials;
- that are drawn to the sources of raw materials where it does use weight-losing raw materials; and
- causing a concentration of industries which have a high labour cost per weight.

In addition, the theory of locational pull has been characterized as a regional comparative advantage model, since it is partially determined on the basis of production costs within the region. However, Weber's model is a supply side model, and assumes static demand in either a single market or to a single distribution point to multiple markets. The model has also been criticised for inadequately considering site rent in the locational decision, or in contemplating that desirable sites will cost more as landholders recognize the value of their land.

More recent models have been constructed based on economic base or input-output models, but these have more to do with centrality than industrial location.

3.3.3 Central place theory

Optimum cost minimizing location could be determined for a given industrial use using Weber's approach. Optimum agricultural uses for a given rural location around a town could be determined using von Thunen's equilibrium-based model. Central place theory expanded the von Thunen approach to infer the locations typically arising for a wide variety of land uses in an urban setting.

Beginning with Burgess in 1929 and then with Hoyt in 1939, theories as to the nature of city spatial structure have been proposed and stochastically verified. The approach, largely emanating from the University of Chicago (the "Chicago School"), was equilibrium-based like von Thunen but looked at land uses in the city as opposed to agricultural uses around a town. Burgess' concentric ring theory of city development (and land uses within a city) was based on a study of the growth of Chicago, a city on a flat plain beside a lake. Burgess drew concentric rings around the central business district, and suggested areas for offices, working class people and industries. Hoyt's sector theory demonstrated that different sectors (particularly high income sectors) cut across Burgess' concentric zones in a manner similar to that proposed by Losch many years before. Hoyt is credited with developing the "ecological" approach to city development, by considering the change in uses over time; called "succession" and "invasion" by Hoyt, and the tendency toward "highest and best use". Harris and Ullman further refined Hoyt's approach by recognizing that several sub-nuclei existed (the "multiple nuclei theory") in addition to the central business district identified by Burgess, but also stated that due to diversification and multiple nuclei, particular land uses within a city could not be predicted.

New work based on the Burgess-Hoyt-Harris and Ullman has included social area analysis and factorial ecology to show clustering of certain social groups. Other research has included urban public facility location. The relevance of the later is in its verification that one cannot accurately infer the highest and best use for an urban location using any of these theories.

In 1933, Christaller published a landmark article describing the relationship between central places (cities and towns) and the hinterlands they served. In 1966, he devised new applications of this theory, called "Central Place Theory", to transportation problems, tourism, regions in Europe and even world trade. Central Place Theory has been combined with Losch's theory of regions as two foundation theories of central place hierarchies in capitalist societies.

Central Place Theory seeks to explain the reason for varying land uses between central places by focusing on their region-serving importance ("centrality") and the higher populations necessary to support rare services. Centrality in turn represents the extent to which surplus goods are sent out of the central place to the region of which it is a part. The opposite of a central place (one having a surplus of goods and services) was a deficit place (having to import goods and services from higher order central places), and auxiliary places were neither clearly central places nor deficit places. Christaller doesn't simply focus on a single central place-region situation, but also on systems of central places formed around system-forming central places.

Central Place theory gives us reasons for understanding the centrality and the growth of urban centres and why they are magnets of commerce. It is not simply a case of minimizing transport cost (although that occurs), but also of achieving economies not available to dispersed factors of production. Christaller was much more effective than other authors at explaining reasons for growth of central places, the development of "nested" central places, and centrality; producing goods and services it sells beyond its borders. These goods and services are referred to as basic,

while goods and services consumed in the central place were referred to as non-basic. The higher the value of basic activities conducted, the greater the growth and prosperity of the central place. The analogy to international comparative advantage at this point is clear.

While pure Central Place Theory has not gone uncriticised, the correlation between the theory and reality is obvious. Periodicy in the theory such as the regular spacing of services (e.g. shopping centres, government services such as schools and fire stations) explains the location of some services within central places, although Losch's (discussed below) offers better theoretical Support for the regular spacing of local monopolies. Individual consumers tend to travel the least distance possible to acquire goods and services, and this tends to explain why frequently purchased goods (e.g. milk) are available on a widely dispersed basis compared to occasionally purchased goods (e.g. automobiles). This causes "nesting" of retail central places. The economies of convenience associated with one-stop shopping has tended to support large shopping centres, and even auto dealer plazas and strips, where several competing dealers will locate close to each other to attract a greater relative amount of automobile shoppers. This would also be supportable by Losch discussed below. Trading area (population, area mean income etc) data also supports locational decisions for restaurant, fast food, muffler, stereo store and many other kinds of franchises and company owned stores

Often, firms or shopping centres will try to monopolize growing markets by locational decisions.

The analogy between Central Place Theory and the Diamond is interesting. If we consider deficit places as uncompetitive nations and central places as competitive nations, interesting conclusions are suggested. First, Christaller might suggest a nesting of nations based on their region serving importance. Perhaps several or all of the G7 nations would be considered central places, and several other economies secondary central places. Eastern block countries might be considered auxiliary places. Perhaps LDC's would be considered deficit places. Christaller's central places are dynamic and therefore change over time. The causes of the dynamism identified by Christaller include;

- competition among the three special forces of organization (marketing, transportation and administration);
- the arrangement of general factors of production, including distribution, density, structure of the population; type, price and production cost of central goods, transportation technology, natural resource location and the range of central goods; and
- the influence of internal and external forces, including the business cycle, long-distance trade, industrial development, industrial development, and unique local events.

These determinants are similar to Porters determinants. Central place theory is regarded as an economic base or input-output theory; a region will grow based on the goods that it produces and sells beyond its borders, rather than based on what it produces and sells locally. While Christaller was focusing on determining the centrality of a given region, Central Place Theory in fact offers an empirical validation of the necessity for a region (e.g. Canada?) to be export oriented to achieve growth, and ways of measuring that centrality.

3.3.4 August Losch: Comparative advantage and location theory

While many geographers developed variations and enhancements to the Weber model in the intervening years, August Losch departed radically from the pack in 1940 by comparing spatial economics with classic economics. Losch articulated a theory of regions which attempted to bridge the gaps between "firm" oriented locational theories (i.e. Weber) and a theory of general spatial equilibrium.

Losch's theory of locations starts out with many different premises than Weber;

- actual locations differ from optimum locations; thus there is only partial equilibrium in locations of industrial firms;
- there are multiple centres of both supply and demand, which can be scattered or centred;
- costs alone orient production only in extreme cases; other factors usually arise such as the location of the best market (defined either by quantity or price) among several markets;
- lowest cost (e.g. lowest transportation costs) only determines highest profit where revenues are fixed, but demand and prices vary geographically; and
- no single factor can determine optimum location.

Losch adopts von Thunen's agricultural land rent propositions but differentiates the industrial model from it. Towns, a given in von Thunen's theory, are created according to Losch to exploit advantages of position, site and the economies of concentration. The result was a series of equations that Losch was able to use to determine locations that were more accurate than those of Weber. Losch is perhaps more well known for his theory of regions, which seeks to integrate localized locational theories with theories of regional advantage.

Losch suggests that economic regions arise for each industry based on the fact of increasing transportation costs. He shows a rationalization of production based on the uniform plain assumption also used by von Thunen. Homogenous plains and straight line increasing transportation costs, felt Losch, tend to dictate the area in which a product (e.g. beer) can be manufactured and distributed without threat of competition from another. He thought this would result in a net of concentric rings representing the effective trading areas of each of the manufacturers, and to avoid 'gaps', he felt the hexagon shape most accurately reflected the trading area likely to emerge permitting the intersection of the regions (because a series of hexagons would fit together perfectly and therefore avoid gaps). Losch doesn't seem to postulate overlapping regions or competition within a region with markets "shared". Losch's net concept does explain the breakdown of regions into metropolises, lower order cities, then towns, then villages existing each with smaller 'trading' areas and offering different kinds of services. It also explains periodicy in retail services discussed above.

Losch, however, introduces many other elements into his formula, including economic, human, natural and political factors. Prices are considered in the context of areas subject to monopolistic competition, and pricing mechanisms are discussed. Losch concludes that demand is more elastic in an industrial economy than in an agricultural economy, and supply is more elastic in an agricultural economy. Local differences in transport rates are considered.

Losch is remembered for questioning many of Weber's and von Thunen's assumptions, postulating many more assumptions much more in tune with reality, and in developing a series of locational equations that were systematic and integrative. What is particularly interesting about Losch, in hindsight, is his Porter-like attempt to make locational geography more qualitative, and to expand greatly the list of relevant factors. Losch recognized that locational decisions are not perfect, suggesting he recognized early the tendency to satisfy basic needs (satisfying) rather than attempting to find the absolutely perfect site for a given use.

3.3.5 Other contributors to spatial economic theory

Some theories seem less apt now than perhaps when initially suggested. Hotelling's 1929 article linking competition to clustering of competing uses is still believed to be controversial, although the subject of much refinement and reference in the study of locations and markets. Hotelling was concerned with price economics as between two vendors who have different transportation costs. He believed several prices could exist for the same product and that two entrepreneurs (i.e. in a duopoly situation) have a tendency to equalize prices. Given these assumptions, and inelastic demand, two vendors will tend to share a market at the point which their costs are equalized. Thus, sellers locational equilibrium occurs at one point, and this tendency to concentrate creates central places. I have difficulty with this theory in the context of the 1990's world economy; I don't think two vendors try at all to equalize prices through a locational decision, although they may try to equalize prices. The principle of local clustering (a term which Porter has adopted in a similar context) has been considered in a number of ways, including the tendency of garment districts to grow in urban centres. However, Weberian economies of concentration may be a better explanation of these events than Hotelling.

Some new research has also focused on the locational characteristics of service industries, and the extent to which "footloose" or "propulsive" service industries can more effectively be used in fostering regional development. Coffey and Macrae (1989) have suggested, however, that capability of so-called footloose industries to enhance the economies of peripheral regions are unjustifiably optimistic, and that the potential for high order producer services to locate outside metropolitan areas is very limited.

> "Perhaps more fundamentally, we are led once again to the classic existential question of the regional science practitioner - is it really worthwhile to expend so much effort in attempting to resist the 'natural' market trends."

However, Coffey and Macrae make assumptions as to what 'natural' market trends are. Identifying successful businesses in otherwise remote locations may have been a more fruitful line of inquiry.

Many other approaches to location theory have been supposed and are useful. Some are deterministic or deductive; a model that has predictive capabilities if the underlying assumptions are true or are present. Others are probabilistic or inductive; models that don't attempt to explain by virtue of a formula based on outside factors but that attempt to infer the general factors from actual events.

3.3.6 Locational theories in perspective

The parallels to contemporary economics are significant, firstly because many of the models attempt to explain reality by reference to an equilibrium-based model, and secondly, because the firm-based models assumed rational decision making in the locational choice. Both of these factors existed in developing economics during the same period. On the other hand, the ecological approach taken by Hoyt suggested that equilibriums didn't exist over the long term, and that change ("ecology" in spatial economic terms) was ever present in respect of regional and urban land economics. In addition, the limits of the rational man assumption have been criticised since 1944 by von Neumann and others, who suggest that decisions are often made on the basis of less than perfect information, in anticipation of competitors responses, and for the purpose of satisfying rather than optimising. Accordingly, the locational decisions of today are exceedingly more difficult to model on the film level, although transport cost minimization will still exists as an important factor for lower order plant locational decisions. As Weber has suggested, if transport costs are low, labour costs and land rent become more critical determinants of location. Equilibrium models are less useful given the moving target of equilibrium, and one may have to have regard to central place theory, and the remaining true tendency of central places (not deficit places or auxiliary places) to continue to grow, to suggest that imputed or inductive locational theory and central place theory are very close. Firms like to locate at or near central places where they can be relatively sure that anticipated and future unanticipated needs can be met.

Scarcity of resources, a foundation of both locational geography and comparative advantage, also keeps changing. Agricultural goods were originally scarce, now supply typically exceeds demand in western economies. Energy was originally scarce, but now the power grid extends to almost all parts of western economies. Even information and knowledge, once scarce, is available globally through on-line databases. McLoughlin suggests we redefine scarcity all the time, and each of our personal definitions of scarcity is different.

Hall suggests that the locational theories of the "German Locational School" were discovered by North Americans in the mid 1950's, when planners were looking for tools to help them cope with the rapid demand and growth attendant upon the baby boom generation.

> A few geographers and industrial economists discovered the s of German theorists of location, such as .. Von Thunen (1826) on agriculture, Alfred Weber (1909) on industry, Walter Christaller on central places, and August Losch (1940) on the general theory of location; they began to summarize and analyze these s, and where necessary to translate them..
>
> Between 1953 and 1957 there occurred an almost instant revolution in human geography, and the creation, by Isard, of a new academic discipline uniting the new geography with the German tradition of locational economics...and, with official blessing, the new locational analysis began to enter the curricula of the planning schools..

Indeed, Hall suggests that the German locational theorists represented a paradigm shift in planning; from planning as a craft to planning as an apparently scientific activity. From that point forward, locational theories provide the spatial economic underpinning learned by city planners in undergraduate and graduate planning schools throughout North America Planners efforts at control and regulation is affected by the locational preferences of the marketplace, in turn

represented by locational theories, as they understand them. Since the science itself of locations has and likely will continue to evolve, given the lag effect between locational economics and land use regulatory change, it is understandable that friction has and will continue to exist between land use regulators and land users. This is one reason why zoning is, at initiation, a consultative process, and in changing it a quasi-judicial process. Zoning represents governmental presence in determining land uses.

Central markets for the exchange of agricultural goods, the need for a seat of government and necessary services to both were reasons for early town formation, the urban structure of von Thunen's time. The rise in manufacturing during the industrial revolution catalysed growth in towns since the labour required in manufacturing was high; the further rise in spin off activities, such as house builders, shopkeepers, tailors and the like either spurned new growth in the towns around the manufacturer's plants and the residential areas of the workers. These were the factors in Weber's time. Growing urban diversification and sophistication were the factors in Christaller's and Losch's time.

Locational theories provide a system of analytical tools that are helpful in understanding what has occurred. The most effective of the modem approaches appear probabilistic and ecological, rather than deterministic. Of these, tools based on transport cost minimization seem the most mechanical. Christaller, Weber and Losch, however, offer an insight into factors of regional growth less comprehensive than say a Michael Porter, but remarkably insightful given the time of publication and the state of capitalist economies in second-wave businesses. Weberian locational models, however, seem applicable only to a narrow type and range of industries.

> While there is little doubt that access to supplies and markets and the locational interdependence and market area frames provide some insight into the influences which operate upon the changing distribution of employment opportunities, it is necessary to be reminded that these ideas are appropriate to a limited range of firms and industries.

The field of locational geography remains, at the margin, cluttered and complex, and no clear set of comprehensive tools exist to help the public policy maker determine what policy initiatives to take to lower overall costs in an economy (the objective of most theories of industrial location) or to promote more central places or the nation as a central place. This is because most of the theories help explain reality as it existed at the time of the , and reveal locational models as static, and not particularly able, with a few exceptions, to explain change.

3.3.7 Economic geography and comparative advantage

Newer theorists have addressed many of the shortcomings of the earlier Weberian economic models, and tried to compare locational decisions (what locations were ideally

Heckscher and Ohlin devised a general equilibrium model (again assuming immobile resources between regions) where the costs that were the cause of desirable industrial location were also factored into the Weber cost-based industrial location model. Accordingly, factor price equalization it was suggested would eventually occur as the cost savings associated with the location of low cost factor inputs was offset by the higher land rent demanded. While I have not found direct evidence on this point, it is interesting to consider the rise in land cost in Japan as an example as it was transformed from a low labour cost country to an advanced industrial economy.

Will (or have) the other "Four Tigers" of the Pacific Rim also be transformed up the economic ladder for the same reasons? Is there a tendency for low-labour cost countries to migrate up the economic ladder once their low labour cost advantage is fully exploited? Factor price equalization as a theory has some new support in current economics (although perhaps for different reasons). The Purchasing Price Parity Theory ("PPPT") of international exchange rates, a theory that s in the long run, suggests that exchange rates between countries with floating rates will equalize over time so that common products can be purchased domestically for the same relative price in local currency.

Johnson (1956) has also attempted to combine Weberian industrial location and comparative advantage theories into a single unifying theory, an interesting concept given the international competitiveness debate that Michael Porter has rekindled. Johnson's results aren't particularly helpful, however, given the limitations of the model developed. More recently, Melvin (1987) and Norrie and Percy (1988) have developed models of traditional comparative advantage and added regional development features to develop equilibrium-based models.

A discussion of what factors of production are now internationally mobile, and the resulting skew to locational models might have been more interesting in Johnson's, since Ricardian comparative advantage appears now a less robust approach to current new plant locational decisions, except for the pure case of high wage content (which will obviously seek out low labour cost countries). Durable goods producers (and capital) seem to abhor instability, and prefer choice (in locations, in exit strategies, in staffing), two factors which may be responsible for many LDC's missing being sited for low-labour cost. Given Mexico's recent and expected further economic success, locational factors may still favour LDC's beside prosperous ones rather than LDC's that are more regionally isolated (e.g. Africa).

3.3.8 Locational decision making in practice

Locational modeling for certain uses, such as high schools, fire departments, shopping centres, gasoline outlets, and hospitals has grown in technical sophistication. Yet in other respects, site locational decision making for the firm has been shown to depend on the nature of the business, and the list of factors shows that transport cost minimization is not necessarily the determining or even the dominant factor. Weber only said that the isodapane expands if transportation costs are low. Recent studies have segmented by size and type firms to determine the actual locational decision making process for each segment. In most cases, the site selection process is based on imperfect knowledge and subjective assessments of qualitative factors as well as cost minimization.

It has been shown that for small firms almost no site selection process or evaluation occurs outside of the founder's home region, and that up to 90% of new firms are founded by local inhabitants of the region. If so, one would suggest that policy initiates aimed at small business formation and the availability of small business industrial areas would be effective in spurring job creation and new economic activity in a given area.

Larger manufacturing firms requiring components of low-skilled or semi-skilled labour may, where transportation costs are a small proportion of their costs, focus on jurisdictions with an adequate supply of non-unionised unskilled and semi-skilled labour with high productivity rates. Moriarity's 1983 study pg 530 manufacturing plants in North Carolina is an interesting exercise in locational geography since it is well outside the traditional "rust belt" of the United States. Listed factors of "high" relevance included labour cost, availability of labour, labour productivity,

degree of labour unionization, labour climate, the existence of right-to-work legislation, suitably of motor freight service (i.e. accessibility by truck), suitability of access roads and highways, proximity to regional markets, community attitudes toward industry, suitability of building codes, zoning restrictions, environmental regulations, electrical service, telephone service, water supply, state and local taxes. Many other factors were cited as being lesser but considerable importance.

While many of these factors can be regarded as quantifiable, many still are subjective (e.g. labour climate, community attitudes toward industry) and accordingly less susceptible to deterministic modeling. One would have expected different factors to have been important if Moriarity had studied a different sector of the economy, one for example requiring small amounts of highly skilled labour. Factors of increased and diminished importance would arise for still other sectors of the economy; for example health care, electronics, resource extraction, telecommunications, and entertainment. It is not unreasonable to suggest that the deterministic capabilities of minimum transport cost and labour cost focused models decreases as one gets farther away from resource based or durable goods based industries towards industries with a high knowledge component such as software programming.

Schmenner's 1982 study of locational factors, shown below, for 9 industry segments shows how locational factors can have varying relevance, and effectively shows how Moriarity's criteria can vary in importance, industry segment to industry segment.

Comparing locational values in Schmenner's study for high technology groups to, say, the industrial machinery sector shows little correlation of key factors. While many of the listed factors are Weberian (site rent = low land costs, on expressway and rail service=transport cost, low wage rates and favourable labour climate), many others are more Porter-esque (Government help with roads, sewers, water, and government financing, low taxes, college nearby). Shmenner's study shows the complexity of the locational decision making process from the firms point of view. Given imperfect information, and the importance of qualitative issues (e.g. labour climate), I believe we can view locational decisions, where transportation costs are not high, as highly subjective and segmented.

With scarce resources, Rugman and Christaller would all suggest that investments in export-creating or export-enhancing enterprises will have significant spin-off effects in the economy. However, one doesn't know which industries will be the export leaders of the year 2010, without "crystal balling" consumer demands, new materials availability and a host of other factors. Porter's implicit philosophy is to back the clusters that you have, but this can be counterproductive if the cluster is a declining one, such as industries with a high labour content such as textiles, shoes, and furniture or more to the point in southwestern Ontario, car radios, wiring harnesses and starter motors, now made in Mexico.

On this point, locational geography can assist analysts in determining clusters which have an international advantage on more fundamental levels, based on fixed and variable costs, rather than a cluster that has succeeded despite severe disadvantage. This at least permits the quantification of risk in picking winners, even if the end result isn't different.

3.3.9 Location theory in the Internet age

In early 2000, considerable debate emerged as to whether the existence of the Internet and the availability of business to consumer retailing over the Internet and business to business marketing and servicing over the Internet will change locational theory. Some authors have argued that the

existence of the Internet means that location is not so important anymore in doing business and that, conceptually, one can be anywhere. Anywhere where there is access to the Internet. While this will certainly be true from a marketing perspective, it is not necessarily so in respect of the delivery of services.

For example, the need for labour is a significant factor in determining the location of call centres in Canada. Thus, the availability of bilingual labour has made eastern Canada a desirable location for many North American call centres since it can handle communication in both English and French. The diverse and multi-cultural population of Toronto has been stated as a key locational factor for those call centres establishing operations here. In Toronto, a large labour pool exist of individuals who speak most of the languages of the globe. On the other hand, many global call centres are now operating out of India, where there is a large pool of highly educated, English speaking people to answer calls 24/7.

For Internet retailers, certainly their offices are more footloose that traditional service environments yet physical delivery seems to follow the same dynamics of transport costs minimization that Weber articulated over a century ago. Some authors have even argued that the Internet has its own locational dynamics; Internet start-ups need to be in Silicon Valley to have access to the network of highly skilled labour and venture capitalists in order to succeed. It is probably still early days to make judgments as to whether the Internet will create any new theories of locational dynamics or merely reinforce the old one.

4 Title and tenure in land in Canada

4.1 Introduction

Agreements regarding real property must be in writing to be valid. This is so whether the agreement is a deed to land or a lease regarding land or space in a building. It also is so whether it is an easement or a right of way. The point of the Statute of Frauds, a British statute from the sixteenth century, is that land, particularly in the sixteenth century, was much too valuable a commodity to rely on oral evidence of ownership. It would be too easy for several people to argue that an oral promise was made to transfer real estate. In order to safeguard against this type of fraud, registry systems evolved in the United Kingdom. These registry systems were fundamentally administrative offices where title deeds (or duplicates of title deeds) could be deposited, so that an independent third party would have a record of title ownership and instruments affecting land. Thus, any member of the public would be able to "search" in those registry offices and determine who the current owner of land was and also to determine who had an interest in that land as, say, a mortgagee (lender) or tenant.

Next, a system of determining who wins in the event of conflicting deposits needed to develop. That system was based on the rule that priority of registration prevails unless a party had actual notice to the contrary. In other words, if two people claimed that they had deeds to land, the party able to show true ownership will be the one whose written deed was first deposited into the local registry office. In registry offices, deeds are stamped with the date and time of registration (or it is assigned for electronically registered documents) and assigned a registration number. Thus, priority can easily be determined by reference to the time of registration and the registration number, which are ordered in sequence.

The same priority rules apply whether the document is a deed, a mortgage, or lease, or a right of way.

The only exception to the rule will be where a prior registrant had "actual notice" that its interest was not indeed, a prior interest. That actual notice can occur in many situations but, in the modern context, often is based on what did the registrant know or what must the registrant have seen prior to registering its interest in the land. This may refer to a new owner having actual notice of a tenant’s interests. It also may refer to a lender having notice of a tenant’s interests.

Registry or pure deposit-type systems are on the decline in Canada. This is because many Canadian jurisdictions have, over the years, evolved to a Torrens system, in which the government maintains a title register for each parcel of land and, to some extent, guarantee, title. In other words, it is not up to a new purchaser or a new registrant to search title to land and figure out who the current owners are, who the current lenders are, who the current tenants are, and who the current easements or right of way holders are. These are clearly stated on a parcel register that is maintained by the government department. Priority of registration still prevails; however, the government would then delete previous registrations. It would be unnecessary for searchers, as in a registry system, to go back in title to find out whether an interest registered, say, 30 years ago, still affects title.

A Torrens type government system (regulated in Ontario under the *Land Titles Act*) exists in northern Ontario, most of western Canada, and in southern Ontario subdivisions and

condominiums. In addition, most of southern Ontario is on track for a conversion to a limited Torrens type system that will be accessible by computer.

4.2 Types of tenure in Canada

Tenure describes the quality of one's title to the land. The most common and highest type of tenure is a "fee simple" tenure. This grants all of the property rights listed in the property rights section to this Reader, except as modified by statute. Other less common types of tenure which are possible, but not common, include the following:

- a life estate, which is an interest in land only for the natural life for the person holding the interest in the land, and then leads to an automatic transfer of the remainder of the interest over to certain designated heirs or assignees upon the life estate holder's death;
- a leasehold estate, which provides for quiet enjoyment of a defined piece of land or air or building for a term certain or a certain period;
- a licence, which is a right to use with no quiet enjoyment (meaning no exclusive possession of the premises subject to the licence); and,
- flats, strata title (British Columbia) and condominiums (Ontario) and homeowners association (United States of America), which refer to a fee simple or full tenure ownership of horizontally and vertically stratified land, subject to shared decision making on common interests and shared ownership of common areas and lands.

While time-sharing has been a growing phenomenon, the common law does not recognize time-sharing as a type of tenure. Time-sharing of recreational property, for example, is often affected by having a contract amongst co-owners, absent specific legislation.

4.2.1 Possessory title

It is generally difficult to have any tenure outside of the registration system, although adverse possession and other types of right by possession over a long period of time are possible. In these situations, it is usually necessary for those claiming some kind of a possessory title in land to prove open, notorious and undisputed possession and control over a defined piece of property for a certain period of time. Courts will often look at the indicia of open, notorious and undisputed possession and consider the following:

- was the land fenced in?
- did the claimant pay property taxes on the land?
- did the claimant maintain and improve the land?
- did the party whose land might be subject to the claim realize or know that the other party was doing all of the foregoing things?
- was there some kind of an agreement whereby this would be done only on a temporary basis?

In order to ensure that the physical boundaries of the land are consistent with the descriptions contained in any registered document, owners and purchasers often rely on surveys of property.

Surveys which show the boundaries of land and which may be deposited on title as a reference survey are called “reference plans” or “R-plans” for short. Generally, these surveys will show and monument the boundaries of lands and the relationship of a given parcel of land to adjacent parcels of land, often reconciling inconsistencies. Then, all references to that parcel of land can merely refer to the part number on that reference plan as opposed to what was formerly called a “metes and bounds description. A “metes and bounds” description is a description based on astronomic bearings (“north 16 degrees west 99 feet and 56/100 of a foot, then north 74 degrees east 81 feet, then south 16 degrees 99 feet, then south 74 degrees west 81 feet”) and measurement.

A similar document is a building locations survey that, in addition to showing the boundaries of the land, would also show the location of any buildings on the land in relation to the property boundaries. This building location survey is critical for purchaser or owner to verify compliance with zoning by-laws (which may limit proximity of a building to a side lot line or front lot line for example) and to determine whether there are any encroachments of any building on the land onto any neighboring lands (which may enable the neighboring land owner to request removal of the encroaching part of the building, unless some claim for possessory title could be made). The building location survey also would show the locations of fences, driveways, and other physical improvements to the land.

In residential situations, a building location survey is very important for determining the existence of any encroachments as well as compliance with zoning by-laws, since houses are often packed in tightly in residential subdivisions and side yard and set-back requirements are often prescribed precisely.

To be distinguished from tenure is the issue of qualification of title. Certainly, title can be held by any individual or legal entity, such as a corporation. Two or more individuals can hold title together, in which case they may be held to be co-tenants of that land. Co-tenants each own an undivided interest, as specified in an agreement between them, of real estate and they can deal with their undivided interest by separate transfer, including by devolution pursuant to a will, unless those rights are otherwise constrained in some kind of a co-ownership agreement.

Joint tenants hold title together with rights of survivorship: the title of a deceased joint tenant automatically passes to the other. Married couples often take title to their matrimonial homes as joint tenants so that a surviving spouse is not at risk of having a one-half interest in that house devolve by will, perhaps to someone else or to avoid paying succession duties.

Individuals or corporations can also hold property as partnership property.

In addition, a party can hold property in several capacities, first, they can certainly hold property as an owner for themselves. This is clearly the case in almost all title situations. However, an individual or individuals or corporations can also hold title as a trustee for others. Often, property operated by associations of individuals (for example, a church) is held by specific individuals who are "trustees" for the "floating" group from time to time. This would make members of the association or parishioners in a church, for example, beneficial owners of that property from time to time. In other words, while they are not shown on the title register as the owner, they have their rights of ownership through a trustee. The law, both common law and statute, also recognizes and may distinguish rights and responsibilities for other types of ownership situations, such as a mortgage lender who enters into possession of a property after a default on the mortgage loan.

4.2.2 Structuring and priority issues in tenure in Canada

In real estate, understanding priorities and title, is critical. Often, tenants, lenders or other interest holders in real estate can be given leverage at a critical business time to extract concessions and other benefits if title priorities are not very carefully managed. Accordingly, it is important when acquiring real property to ensure that each interest in land is clearly understood and title risks are eliminated or effectively neutralized during the acquisition process. In Canada, this is usually achieved by obtaining title opinions on the government guaranteed title or registry title from solicitors acting on behalf of the purchaser or lender or other interest holder, as the case may be. Title insurance in Canada is still relatively rare, although gaining in popularity in special situations, in portfolio acquisitions and other niche type applications. Property insurance never had the foot hold in Canada that it has in the U.S. largely due to the highly organized and reliable title registry systems that evolved in Canada. Title registry systems did not generally evolve in such an organized fashion in the United States and, as such, without reliable registry offices, purchasers preferred an insurance system to ensure that their title was adequate.

Priority issues can be critical. For example, mortgage lenders will want to ensure that, if they are advancing monies on the security of a first mortgage, that their mortgage is indeed first in priority to all other registrations on title, not only including other mortgages, but possibly also including leases. This is because mortgage lenders may want to have the right to selectively terminate the leases of certain below market rent tenants if there is a default in the mortgage so that they can re-rent those premises, and sell the building perhaps under a power of sale remedy in their mortgage and thereby recoup their investment.

Mortgagees will also want to know that, as between themselves and other mortgages, there is a clear understanding of who has what priority in the event of joint defaults under all mortgages. Second mortgagees, for example, will know that they will not be entitled to any money on a liquidation of the property until the first mortgagee has been paid out in full, together with its costs. This makes a second mortgage more risky.

Generally, a mortgage even registered in priority to other mortgages, is only security for the amount of money actually advanced upon the mortgage registration date. This presents a problem for construction mortgagees who may be advancing monies over time as a building gets built. At each advance, that construction mortgagee will need to subsearch title to be sure that it still has its first mortgage priority in respect of that particular advance.

Similarly, priority issues affect tenants who will want to know that they have security of tenure for the negotiated term of their lease. However, a prior registered mortgagee can eliminate a tenant's tenure if there is a default on that mortgage, unless that mortgagee had actual notice of the tenancy. There are certain short-term leases that are sheltered by the *Registry Act* and the *Land Titles Act* in Ontario. However, for a commercial tenancy of, say, ten years, a commercial tenant will want to register notice of its lease on title, so as to get itself into the "queue" and give itself priority over all subsequent registrations. In addition, the commercial tenant will want to look backwards in title and find out whether it is vulnerable from any prior registrations. If, for example, there are one or several mortgages registered on title having priority over the notice of lease that it has registered, then the tenant may also want to either get what is called a postponement from such mortgages, whereby such mortgagees agree that, even though they were registered prior to the notice of the lease being registered, that they will regard themselves as having been registered after the notice of the lease. Many mortgagees will not, as a matter of policy, postpone to a notice of a lease unless it is a very critical lease to the project. A fallback

position, that is quite commonly used in commercial situations, is for the tenant to seek a "non-disturbance agreement" from the prior registered mortgagee, whereby such prior registered mortgagee agrees that, so long as that the tenant does not prepay the rent due under the lease, that it will agree that in the event of default of the mortgage, it will let the tenant finish out its term in accordance with the terms of its lease and accordingly not be "disturbed" by the lender either taking possession of the project, or selling it to a third party. However, it is to be cautioned that while postponements registered on title "run with the land" and therefore bind future owners, non-disturbance agreements are mere contracts, not capable of being registered on title or running with the land and accordingly the tenant still has some vulnerability to an unscrupulous mortgagee who might sell or assign its mortgage and not advise the purchaser of the mortgage of the existence of the non-disturbance agreement.

4.2.3 Matching maturities

It is also common practice to match maturity dates if there are several mortgagees on title. This is because the renewal of a prior mortgage, if terms are substantially altered, may cause it to lose its priority (i.e. go to the end of the line). In order to avoid this loss of priority and the potential problems it may create for the owner of the property, a subsequent mortgage should never have a longer term than a prior mortgage.

4.3 Review questions

1. When buying real estate, what is the most desirable quality of title one can acquire?
2. Why is it important to have a survey prepared when buying land?
3. How can priority issues make refinancing difficult?

5 Planning, zoning and land use regulation

5.1 Introduction

All land in Canada is subject to some form of regulation on its use and development. The scope of such regulation can vary from the simple to the complex, and can involve regulation by the federal, provincial and municipal (local) levels and by special purpose bodies. The construction and use of buildings is likewise subject to public regulation in all parts of Canada. With minor exceptions, one or more public permits or licences must usually be obtained before constructing, occupying, or making changes to the use of commercial and industrial buildings as well as residential properties.

Public regulations of land use across Canada are generally put in place following consultation with stakeholders, including property owners, in an orderly and open fashion. The existence and details of the regulations are publicly available and generally well known or readily accessible to all whose interests are touched by them, including land owners, architects, contractors and the like. Generally speaking, land use regulation across Canada has elements of flexibility and is subject to review and reconsideration to meet changing needs and objectives. Land use regulation is intended to produce a system which protects and advances private and public interests without officious or unfair interference in the use and enjoyment of land. The regulatory frameworks of most provinces provide appeal or review opportunities for persons who seek exceptions or changes to the regulations applying to their properties or influencing their interests. The nature and extent of these rights of appeal and review vary from the simple (for example, a request to a municipal building official to allow a variation in the use of building materials which is a satisfactory substitute for the literal requirements of a building code) to the complex (for example, a request to change the land use provisions on a large area of agricultural land to permit its development as a new urban community). The latter may involve administrative, political and quasi-judicial tribunal decisions at several government levels, possibly extending over several years.

With the exception of regulations aimed at fundamental health and safety matters, such as pollution or fire safety, land use regulations are normally not retroactive. Accordingly, land and building usages which have been established prior to the introduction of conflicting regulation are typically grand fathered and permitted to continue, in some instances with controls on expansion and change, without constraint from the new regulations.

5.2 What is the public interest in planning?

Health & Safety	**Convenience**
* sunlight	* parking
* water supply	* grouping similar and complementary uses
* fire protection	* homework
* sewage disposal	* recreation
* housing conditions for the working class	* school

* minimize noise
* hospitals
* clean air, water
* minimize use of cars in congested areas
* minimize traffic accidents, train grade separations, truck traffic on residential streets
* nuisance/hazardous activities
* privacy

* shopping
* wholesale - retail areas
* time and distance relationship
* arts
* sports

Efficiency
* infrastructure cost
* health care
* amenities
* public transit

Equity
* fairness and choice
* education
* assisted housing
* handicapped
* distribution of costs and benefits of public improvements
* Gender sensitive planning

Issues
* low cost housing
* automobile vs. transit
* tolerance for necessary uses, pubs, gas stations, landfill
* growth for what?
* economic restructuring
* heritage conservation
* housing

Environment and Energy
* oil crisis - low densities not good
* traffic - air pollution
* agricultural land protection
* agricultural self-sufficiency

5.3 History of planning

City Planning seems to have had a restart on a formal scale in the early 20th century.

In England, the enactment in 1909 of the *Housing and Town Planning Act* signified the start of town planning schemes. This was amended in 1932 by way of the *Town and Country Planning Act* so as to permit as of right uses, to stipulate forbidden uses and to list uses that could be carried out at the discretion of a planning authority pursuant to a development permit. After WW II ended, the 1947 *Town and Country Planning Act* was enacted requiring development plans to be in place for major British municipalities within five years specifically dealing with reconstruction. Since many pre-war official plans had long since lapsed, it was important for England to ensure that reconstruction efforts occurred pursuant to a plan. From 1962 - 1968, the nature of the plans split into Structure Plans and Local plans. A Structure Plan was a general plan that included statements of policy, whereas the Local Plans were more detailed. The Structure Plans and the Local Plans emphasized written description of policy more than maps, and Structure Plan making was delegated to upper tier municipalities.

A similar history occurred in the United States, where the first master plan occurred in New York City between 1911 and 1916, resulting in the creation of Central Park. In 1928, many states followed the federal *Standard City Planning Act*, although pursuant to that Act, planning was optional for cities. In 1949, master plans became mandatory for any city if Federal urban renewal money was to be applied for. During the period of 1950 - 1970, planning moved from a period of rigid master plan application to shorter term plans and special purpose plans, as social pluralism occurred, the need for coordination among various agencies became apparent, constituents lost faith in predictions greater than 5 years old, and as there appeared to be simply too many issues to plan. In the 1990s, however, master planning made a comeback in the US, to the extent that it was perceived as a reliable, known instrument and perhaps better than having no plan.

In Ontario, Canada, the *Planning and Development Act* was enacted in 1911 requiring community plans providing for the orderly development of municipalities. The Act remained in force until the 1947 *Ontario Planning Act* came into effect, which provided for coordination amongst various agencies of future development initiatives. The period of 1950 - 1970 was the heyday of provincial planning, resulting in the early 1970s creation of the Toronto Centred Region and the Design for Development series of provincial plans. In 1971, the 45 foot height by-law was enacted by David Crombie in the City of Toronto to stall development while a rethink could be undertaken. The existence of checkerboard subdivision schemes and the existence of large commercial developments locating just outside organized areas (e.g. "Multi Malls"), as well as the new towns of Kitimat and Elliott Lake, set the stage for further planning reforms, reflected in the reports of the Comay Commission and, more recently, the Sewell Commission. Since those days, the established approach of having broad policies contained in an Official Plan and more detailed and stringent regulations contained in the zoning by-law has continued, supplemented by ecosystem and watershed planning, a concern of gender issues in planning, sustainable development, affordable housing, transit and the concern about local funding, reflected in development charges and property tax reform.

At the same time, the science of planning has evolved from that of the Planner as expert, reflecting the modernist approach, to the Planner as facilitator, representing the post-modern approach. There are still aspects of science to planning, but there is also a widespread belief that Planners often substitute their own values for those of citizens in the community and accordingly, Planners now emphasize process and procedures, local involvement and small local solutions over large solutions.

5.4 Constitutional division of powers in Canada

The federal government of Canada, pursuant to the *Constitution Act*, 1982 and the *British North America Act*, 1867, has exclusive jurisdiction over aeronautics, shipping, telecommunications, as well as typical top-level jurisdiction over immigration, national defence, taxation, criminal justice, fiscal and monetary policy and postal services to name a few. On the other hand, the provinces have jurisdiction over property and civil rights.

Accordingly, planning legislation, property tax legislation, municipal government, most highways, hydroelectricity are all provincial jurisdictions.

The uses of certain lands and certain land uses are reserved for regulation exclusively by the federal government. For example, all lands owned by the federal government and airports and shipping and navigation uses are subject to exclusive federal control. In all other cases, the source of regulation will be the particular provincial government or an authority authorized by it,

whether it be a municipal government or a special purpose body such as a flood control authority or area specific planning authority like Ontario's Niagara Escarpment Commission.

Municipalities in Ontario have jurisdiction to create Official Plans.

5.5 What is an Official Plan?

An Official Plan is the basic land use planning document of a municipality. It is a policy document which sets out a municipality's long range goals and objectives for future development, and its principal purpose is to control and guide physical development. Indeed, the legislation governing planning in Ontario, the *Planning Act*, R.S.O. 1990, c.P.13, provides that an official plan is a document approved by an approval authority, and prescribes that a plan shall contain:

> " ... goals, objectives and policies established primarily to manage and direct physical change and the effects on the social, economic and natural environment of the municipality or part of it, or an area that is without municipal organization."

Contents of official plans vary from municipality to municipality. They may contain a municipality's goals and objectives for development, and may also contain measures and procedures proposed to attain those objectives and the methods of informing the public and obtaining their views in respect of any amendments or revisions to the plan or zoning by-laws. The scope and contents of the plans generally depend upon the nature of the municipality and the resources and infrastructure in place to respond to and provide for population growth and the anticipated social and economic needs of the municipality.

Over the years, official plans have tended to follow one of two concepts. One form is a master plan which assumes the actual location and quantity of development will be determined by private market decisions in accordance with predetermined principles and guidelines contained in the official plan, which are then applied to individual development proposals. The other form, becoming the standard in Ontario, is more deterministic and contains not only statements of planning principles, but also detailed locational and development policies for the various categories of residential, commercial, industrial, agricultural, rural and open space land uses, as well as policies respecting transportation, servicing and environmental controls, as well as procedures, among others.

Official plans provide a guide to future orderly development by setting out the municipality's intentions and commitments to future development of a certain type at a certain place at a certain time. An official plan should be firm in principle but flexible in detail, and should be given a broad, liberal interpretation as opposed to a narrow, strict one.

An official plan is developed through intensive study and consultation, and requires input and review by public agencies, as well as the public. Once a plan is adopted by a municipal council, it is submitted to the Minister of Municipal Affairs (or an upper tier municipality which has been delegated approval authority by the Minister) for further review and approval. The Minister may approve all or part of the plan, may modify it, may defer portions of it, or may refer all or part of the plan to the Ontario Municipal Board, a quasi-judicial tribunal empowered to resolve land use planning disputes. The *Planning Act* requires plans to be reviewed periodically (every five years) although given that it sometimes takes more than five years to have a plan approved, such reviews are often held less frequently. Official plans may be amended, either through municipal

initiatives, in response to development applications for specific lands or areas, or upon application by landowners or developers. The review, public input, adoption and approval mechanisms for amendments are the same as for the plan itself, although if an amendment is refused or not adopted by council within a prescribed period of time, the proponent may request that the Minister refer it to the Ontario Municipal Board for approval. The *Planning Act* contains detailed provisions with respect to the processing, adoption and approval of official plans.

Official plans are required to be prepared by all municipalities, including upper-tier (county, regional, metropolitan or district) and lower-tier or local (city, town, village or township). Lower tier plans must conform with upper tier plans. Lower- and upper-tier plans may deal with different or similar issues within their respective plans. There are also secondary or district plans, which set out more detailed policies for specific areas, and are usually regarded as amendments to an official plan and approved as such.

The *Planning Act* requires that official plans have regard to a comprehensive set of policy statements (dealing with Heritage and Environmental matters, Economic, Community Development and Infrastructure matters, Housing matters, Agricultural Lands, Conservation, and Aggregate Resources) approved by the Province.

5.6 What is a Zoning By-law?

Zoning By-laws are more detailed documents enacted by councils of local municipalities to implement the provisions of the official plan. By-laws may, according the *Planning Act*, be passed to (within the municipality or within any defined area or areas, or upon land abutting on any defined highway or part of a highway):

> i. prohibit the use of land for, or except for, such purposes as may be set out in the by-law;
>
> ii. prohibit the erecting, locating or using of buildings or structures for or except for such purposes as may be set out in the by-law;
>
> iii. prohibit the erection of any class or classes of buildings or structures on land that is subject to flooding or environmental constraints;
>
> iv. prohibit the use of land and the erecting, locating or using of any class or classes of buildings or structures on contaminated lands or sensitive areas, on lands containing natural features and areas, and on lands containing significant archaeological resources;
>
> v. regulate the minimum elevation of doors, windows or other openings in buildings or structures or in any class or classes of structures to be erected or located; and,
>
> vi. regulate the minimum elevation of doors, windows or other openings in buildings or structures or in any class or classes of structures to be erected or located; and,
>
> vii. require the owners or occupants of buildings or structures to be erected or used for a purpose named in the by-law to provide and maintain loading or parking facilities on land that is not a part of a highway.

Zoning by-laws may also establish and regulate pits and quarries and regulate mobile homes, and prohibit the use of land until such municipal services as may be set out in the by-law are available to service the lands or buildings. Zoning by-laws may not have the effect of legislating unequal treatment through discrimination based upon personal characteristics.

Zoning by-laws should be comprehensive in the details of land use and the area to be regulated, must conform to the official plan's policies, goals and guidelines, and must implement the plan's policies for specific lands and the municipality as a whole, while affording a reasonable measure of protection for residents from the intrusion of conflicting or incompatible uses.

Zoning By-laws, as noted above, may govern all of a municipality or a defined area or specific lands within a municipality, and may be amended, provided the change conforms with the official plan. If not, an official plan amendment will also be required. A zoning by-law or an amendment thereto is enacted by council after review and input by public agencies and the public, and once enacted, is subject to a period in which someone who is opposed to the by-law may appeal it to the Ontario Municipal Board for consideration. If there are no appeals however, no further approvals are required, although if an accompanying amendment to the official plan has not yet been approved, the by-law is not deemed to conform with the official plan until the amendment is approved.

Zoning by-laws may also be amended by means of a minor variance (a change to one or more of the provisions of a zoning by-law) provided the proposed variance is minor in nature, maintains the general intent and purpose of the official plan and the zoning by-law, and is desirable for the appropriate development or use of the land.

The *Planning Act* also establishes provisions for the creation of Holding by-laws (prohibiting development until such time as certain conditions are satisfied), Density Bonus by-laws (permitting increases in height and density of development in return for the provision of such facilities, services or matters as are set out in the by-law), Interim Control by-laws (prohibiting the use of land, buildings or structures within the municipality or within a defined area for a specific period while a review or study of land use policies is undertaken), and Temporary Use by-laws (to permit the temporary use of land, buildings or structures for a maximum of three years). However, other than for Temporary Use by-laws, the official plan must contain policies which permit council to enact such by-laws.

5.7 Municipal zoning and development charges

All but the most sparsely populated areas of Canada are governed by local municipal governments which, in most cases, exercise, through zoning and other controls, the most influential powers over land use. These powers are exercised in accordance with senior government policy and master policy plans as determined and laid down by the municipal council. These regulations are unique to each municipality, based on local preference. No generalizations can be made about the scope and nature of such local controls.

The Ontario *Development Charges Act* authorizes the municipalities to apply specific taxes or charges in order to pay for the infrastructure costs which the municipality might incur in any new development. These charges are intended to offset the additional costs and to ensure an adequate level of infrastructure and services for new developments.

If a developer or land investor feel that they are being unreasonably or unfairly withheld from bringing their land to its best and highest possible use via development, there are a series of procedures which could be followed. Firstly, any municipal by-laws or legal restrictions would have to be made in good faith and with "sound planning principles" as the cornerstone. A developer could first appeal the restriction to the municipal or local Planning department. If this is unsuccessful, an escalation can be made to the council of the municipality in general. The

Developer can appeal planning decisions to the Ontario Municipal Board (OMB). The OMB is a creation of the provincial government under the authority it commands over the municipalities and property rights in the province. The OMB is designed to take a "consistent" and "sober second look" at the appropriate use for land. The OMB is charged with the task of considering the planning principles involved.

5.8 Municipality authority to plan: Limits

The province gives the municipality under the Ontario *Planning Act*, or provincial equivalent, the right to regulate land use, and this includes the power to down-zone a property. This power is not absolute and there is a body of case law that determines how the municipality may use its regulatory powers. While these powers are drawn from a large body of case law, certain principles emerge that investors refer to upon in determining the risk before making an investment in real estate. Should these principles be violated, an investor can challenge such a down-zoning on the grounds that follow.

5.8.1 Ultra vires

The municipality under s. 27 of the *Planning Act* has the authority to regulate the use of land. The municipality has in many cases overstepped its statute-given authority and has attempted to dictate by way of by-law that properties are to have no land use. This has been considered to be outside the authority of the municipality as it constitutes expropriation. The municipality may not give a zoning designation which in fact has given the land no economic value.

Although the municipality may expropriate lands, it must provide proper compensation. Nor may it use by-laws to reduce the value of the land before a planned expropriation to reduce the amount of compensation payable.

In some cases where the down-zoning would give minimal economic use to the land, it may be in the best interest of the investor to negotiate that the land be expropriated, as the compensation will be for the full economic use of the land. This point stresses the need to understand the motivation of the planning department.

5.8.2 Good faith

The principle of "Good Faith" requires the municipality to use its planning authority for the purposes of implementing "Proper Planning Principles" in the best interests of the community. Should the by-law in effect not give any reasonable use to the land although it does permit a use, the by-law will be held to be in not in good faith.

A municipality cannot place a property into a "Holding Zone" for are unlimited time to determine the proper use of a property. This would provide the council with additional time to decide how to zone the property. This action was held not to be in good faith even though city council had the best of intentions. Therefore the request that a building permit be issued for the original use was granted. It is interesting to note that it was the intention that was held to be in not good faith and that a transcript of the city councilors' discussion of the true intention was accepted into evidence.

5.8.3 Proper planning principles

While the municipality has the authority to down-zone property, there has emerged a set of guidelines that determine how a municipality may use such powers. In Re: *Planning Act* and Ottawa, a down-zoning resulted in a claim against the municipality for down-zoning. The Ontario Municipal Board brought down a two step test for determining the property approach that must be applied to validate a down zoning. The first is that the municipality must *employ proper planning principles and proper procedure*. Although this is a somewhat abstract principle, it does provide the municipality with the burden of providing evidence of "adequate research" and "proper application of planning principles". The second requirement is that the loss to the owner of the down-zoned property be weighed against the benefit to the community. This comparison may be conducted on a financial basis or in a more general sense.

5.8.4 Discrimination

By-laws must apply to the general public and not be directed to any one individual or property. The evidence of proper planning principles cannot apply to certain lots and not to others. In Re Town of Huntsville Restricted Area, the town passed a by-law that up-zoned a nearby property and down-zoned the plaintiffs property. The town did not provide evidence that the down-zoning was in the best interest of the community. The Ontario Municipal Board was sympathetic to the appearance of discrimination between similar parcels of land and ruled the by-law void.

5.8.5 Rights solidified

A real estate investor’s rights are solidified when a building permit is obtained to construct a specific structure. At this time the municipality can down-zone the property, but the existing structure or development in progress will be considered legal but non conforming. If a building permit has not been obtained, then the down-zoning will have legal effect for any future development.

Recent cases have allowed the building permit to be submitted within seven days upon notice of a motion to down-zone the land.

5.9 Review questions

1. Why is it important that any use comply with planning regulations?
2. What is the position of the owner if the zoning changes while it is being used for a certain purpose?
3. What protection do owners have against "down zoning" by municipalities?
4. Are planners "experts" whose advise should always be followed or advisors whose advise should be balanced against other perspectives?

5.10 Bibliography

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Whitehead, Christine, "The Rationale for Government Intervention", Dunkerley, Harold, ed. Urban Land Policy, Oxford University Press, New York, 1983, pp. 108-131.

> The chapter utilized in this text uses general microeconomic theory to rationalize government intervention in the property markets. The rationale is then challenged by problems that may arise as a result of public interference in the free market. It concludes by suggesting that while government intervention is necessary to mitigate market failures, there are costs to the individual or society of doing so. These costs must be weighed against the benefits to society on a case specific basis.

Excerpts From Ontario Acts:

The Planning Act
The Environmental Protection Act
The Ontario Heritage Act
The Municipal Act
The Ontario Municipal Board

6 Buying, holding and selling real estate: General strategies

6.1 Introduction

Issues, concerns and strategies in buying, holding and selling all forms of real estate assets are often similar, from vacant recreational property to large portfolios of commercial income producing real estate assets. The purchaser will want to ensure that title is good. It is important to make sure that the seller (known as the "vendor") is able to sell you what you think your buying and in doing so, make sure there are no hidden liabilities assumed. Ensuring that the income from the property is properly documented and enforceable against those who apparently have the obligation to pay rent, is another concern that should be addressed. It is also essential to determine that the current use of the property is legal in all respects and that the attributes of the location are not threatened by any local land use changes. Finally, importance should be placed upon ensuring that there are no hidden contaminants or hazardous materials located in the soil or in the building.

These risks are mitigated and managed in several ways. Both the purchaser and the vendor should ensure that the agreement to buy the property is properly drawn, allows full disclosure and investigation, describes the property and buildings accurately, anticipates risks before closing, and assigns rights and responsibilities appropriately.

6.2 Purpose of the acquisition prescribes relevant issues

When thinking about a decision to buy real estate, the starting point should be your objectives in making the acquisition. Generally, you may be looking for:

- income producing property;
- development property; or
- property to be held for occupation and use.

6.2.1 Issues in purchasing income producing property

If you are considering purchasing income producing property, there are many factors that ought to be relevant to you and which ought to be addressed by management, in planning the acquisition and structuring the agreement of purchase and sale:

- the quantum of the cash flow generated by the income producing asset and its potential stability, growth, or decline over time;
- the level of expenditures on property maintenance, repairs, replacements, management and taxes needed to sustain that cash flow over time;
- capital spending requirements presently necessary for the building, to keep it economically competitive, such as repairs, renovations or replacement of the roof , lobbies, garage, security, life safety systems, heating, ventilating and air-conditioning ("HVAC"), or elevator;

- the quality of the lease documents in place supporting that cash flow, the extent to which such leases permit recoverable expenses, and the availability of statements from the tenants (called "tenant estoppel statements") to confirm that there are no potential expenses, claims or liabilities pending, thus barring the assertion of such a claim in the future;
- the recoverability under existing leases of future capital and operating expenses, after allowing for inflation;
- whether the building and the land use complies with all current land use and building laws and regulations, and the existence of or potential for any regulatory compliance costs;
- whether the permitted uses for the site, under applicable zoning by-laws, are flexible enough to allow some adaptability in the type of tenants attracted in the future, without a change in the permitted land use (i.e. a "rezoning") being required;
- whether the property complies with all applicable environmental laws and regulations or whether there are any hidden costs or prospective costs of environmental clean up (called "remediation");
- the insurability of the property, and at what price;
- the quality of existing building management if to be assumed, and future management issues;
- the existence of any service contracts for elevator maintenance, HVAC maintenance, roof maintenance, security systems, janitorial and the like, and the ability to both assume (i.e. continue on with) or terminate those service contracts and re-tender them to better operators on short notice as of the closing date of the purchase;
- access to a range of telephone companies and telecommunications service providers: is there fibre optic, wireless line of sight or other high bandwidth cabling available to the building so that tenants can have high speed service for internet based activities, or for data transfer;
- the ability to finance the asset and refinance it from time to time and the risk of not being able to do so; and
- what market risk is assumed between the date of acquisition of the purchaser's interest in the property and a potential closing date.

These issues, of course, affect the content of and the promises (known as "covenants") contained in an agreement of purchase of sale for an income producing property.

6.2.2 Issues in purchasing development property

Where purchasers are interested in acquiring land to be held for development in the future, terms to be emphasized in an agreement of purchase and sale are different. The development may include housing, industrial, resort, office, retail, multi-family residential or any combination thereof. Relevant factors for development property might include the following:

<u>Intended Use of the Property</u>

- the likelihood of obtaining permission to change uses to the intended development use (i.e. a rezoning or amendment to the local plan), and the length of time it takes to obtain that permission;

- the risk of the market for the intended use changing during the time it will take to get the permission to change the use;
- the amount of time it will take to physically develop the land to the intended use and the market risk during that period of time;
- any environmental concerns likely to create clean up costs or delay approvals;
- whether the soil will permit the construction of the development that you wish to proceed with, and whether there are any other physical or engineering constraints, or significant additional physical or engineering costs associated with development on that land;
- whether any archaeological, historical or natural heritage issues are likely to concern local residents or bring into play applicable legislation;
- access to municipal services, such as potable water, sanitary and storm sewers, availability of energy sources (i.e., electrical, natural gas), and service and access to high bandwidth telecommunications providers; and
- whether the development approvals are available in a shorter term (90-180 days) or a longer term (90 days +) and the effect this will have on the form of agreement that you may be able to secure with the vendor of the land (i.e. should it be an agreement of purchase and sale with a quick closing or an option to purchase only?).

Other Considerations, Risks and Expenses

- the existence of any conditions or restrictions attached to title that might otherwise prevent or modify the development that you intend to proceed with;
- the financing risk of proceeding with the development including the availability of and interest rate of financing for the interim, construction and takeout loans and whether the predicted financial results (typically contained in a building budget or pro forma) of the development are sufficient to justify the financing risk; alternatively, whether you ought to ask the vendor to take back some financing to minimize this risk (known as vendor take back ("VTB") financing);
- the expenses associated with developing the land, such as the property tax carry during the interim period, the existence of any development charges, impost charges or levies (all of which are charges demanded to be paid by the local municipality as a condition of allowing development to proceed) and the existence of any other charges, such as bonusing charges if additional density is sought; and
- the sensitivity of the previously documented predictions of the cash flows, budgets and cash flow pro formas to changes in any of the foregoing, including financing risk and market risk, and whether that should lead to "exit" strategies (rights to terminate, perhaps with a penalty) negotiated into the form of the agreement.

6.2.3 Issues in aquiring property for purchaser’s own occupation and use

Assets to be acquired for occupation and use create a new set of priorities, including:

- the suitability of the asset for occupation and use;
- access to municipal services, such as potable water, sanitary and storm sewers, availability of energy sources (i.e., electrical, natural gas);
- the availability of amenities such as parking, transportation access, public transit and a range of high bandwidth telecommunications providers;
- the cost of the asset;
- the availability of financing over the medium to long term for the occupation and use of the premises;
- environmental and occupational health and safety compliance of the existing land and structure;
- the compliance of the existing building with all applicable laws and regulations;
- the potential expandability of the structure, perhaps onto some unused land on site, assuming zoning by-laws allow expansion; and
- resale market liquidity and the consideration of a future sale strategy, particularly if the occupation and use is in conjunction with existing or future unique purpose buildings.

6.3 How to hold real estate

One has the choice of acquiring real estate through many different types of entities:

- - Individually;
- - Through a private or public corporation;
- - Through a trust;
- - With others through a partnership; and
- - With others through a limited partnership

Each entity has different characteristics in corporate law, at common law, and under Canadian tax laws and so it is important for individuals considering acquisition of real estate to think about how they might hold the real estate and, particularly, to seek independent tax advice in respect of that decision.

6.3.1 Corporations

Corporations have many benefits including limited liability for shareholders, flexibility in structuring classes of shares and therefore financial returns to shareholders, the ability to control management by way of a unanimous shareholders agreement, simplicity in dealing with the outside world in contracts, and tax treatment as a separate legal entity.

Many entrepreneurs enter into leases and enter into agreements of purchase and sale as purchaser through private corporations so as to be sure, if things go wrong before closing, that their personal assets are not subject to a potential lawsuit. On the other hand, many landlords in commercial lease situations and certainly lenders in loan transactions, may wish to see a statement of financial assets owned by the corporation and, if insufficient, may ask for a personal guarantee of an individual shareholder in respect of the lease, or the financing.

Ownership shares in a corporation can be divided up in many ways, and classes of shares can be established which, amongst themselves, divide up voting rights, the priority of a right to dividends, and the rights to receive the assets of the corporation upon dissolution or winding up. Because dividends pass tax-free between Canadian-controlled private corporations ("CCPCs"), sophisticated investors with significant assets will often use multiple companies to hold or invest in real estate with perhaps the company with the operating risk or significant liability risk conducting day to day business, and then a holding company owning most or all of the shares of the operating company. In this structure, funds are moved up by way of dividend in order to put them out of harms way with the operating company. Then, as funds are needed by the operating company, money can be lent down by way of unsecured or secured loan to fund the operating company's activities.

6.3.2 Partnerships

Partnerships are a common law vehicle, codified into statutes in many provinces throughout Canada. Generally, partnerships mean that each of the partners are jointly and separately liable for the debts and obligations of the partnership and jointly share in profits. Partners are said to be "agents" of one another and, under agency law, each principal is liable for the acts of his/her agent. Partnerships are like a small democracy, where not only does each partner have joint and separate liability, but each partner has a degree of control over the decisions and activities of the partnership in proportion to their partnership interest. Under the Canadian Income Tax Act, a partnership is not a separate taxable entity and all revenues and expenses, assets and liabilities of the partnership are passed through to each individual partner with the single exception of capital cost allowance, which must be computed at the partnership level. Generally, a collection of individuals, companies, trusts, or other legal entities will be seen as a partnership if they are carrying on business in common with a view to profit. Given the risks of joint and separate liability, many real estate investors are fearful of partnerships and take great pains to make sure that their investing relationships with others are not characterized as partnerships, but as joint ventures or limited partnerships. Partnerships are easy to create and structure and have considerable flexibility. Particularly, sellers of real estate are able to "roll in" real estate into a partnership and take back units of the partnership on a tax deferred basis. See the real estate taxation section of The Living Canadian Real Estate textbook for further details.

6.3.3 Limited partnerships

Limited partnerships are a creature of statute in provinces in Canada, and did not exist under the common law. They create limited liability for certain limited partners as long as those limited partners do not take part in the control or management of the partnership. Control is to be vested in a general partner who has unlimited liability. The rights and obligations of the limited partner and the general partner are typically prescribed by the statute authorizing the creation of the limited partnership. Limited partnerships are very useful as a real estate investment vehicle to the extent that they enable limited partners to have the benefit of the limited liability typical of a corporation but without creating a taxable entity between themselves and the investment, since limited partnerships, like partnerships, are a flow through for tax purposes. Furthermore, limited partnerships allow considerable flexibility in structuring the investment so that returns can be allocated amongst limited partners and the general partner often creatively. While the general partner has unlimited liability, often this is mitigated by creating a corporation who will be the general partner, and therefore have limited liability, and allocating a very minimal percentage of the overall partnership to the general partner.

6.3.4 Inter vivos trusts

Inter Vivos trusts or business trusts are common law vehicles, created by document and the settlement of property or funds, and which enable the separation of ownership from control. Trusts are taxable entities under the Canadian Income Tax Act and there is no pass-through tax treatment available unless special legislation applies (such as the case of real estate investment trust units: see The Canadian REIT Guide. Trusts are often used in situations where the owner cannot effectively manage the asset themselves, such as mental incompetents, beneficiaries under a will who are under age, church property, and other type of specialty situations. The separation of ownership from control of course also occurs with corporations, but because trusts are not subject to capital tax, trusts are often a useful tax-planning vehicle. Those in control of a trust, because of the potential for abuse, like Directors of a corporation, have a special fiduciary responsibility to beneficiaries of the trust which means that they must act in the utmost good faith and the best interest of the trust at all times.

6.3.5 Co-tenancies and joint ventures

Co-tenancies and joint ventures are not separate legal entities but are merely commonly used arrangements for real estate joint investment. Co-tenancy refers to the joint ownership at law of real estate. Joint venture is the business term that applies in business and real estate circles where two entities are joining together in a particular investment or development "venture". In joint ventures, the business objectives, decision-making scheme, dispute resolution processes, required investment, allocation of returns, are all dealt with by contract, notice of which is usually registered on title. Accordingly, when two entities join together to make an investment in real estate but do not want to be characterized as "partners", they will seek to characterize their relationship as a "joint venture". The joint venture agreement will govern the relationship between themselves, and their rights in respect of the underlying real estate, including rights to sell it, rights to buy it from each other, and rights to force a joint sale to a third party. Parties to a joint venture must be careful to consider break-up mechanisms and dispute resolution processes so as to make sure that every possible eventuality can be resolved without deadlock in the future.

6.4 Pricing considerations for a purchaser

One of the first questions a purchaser must consider is that of valuation, or pricing of the asset sought to be purchased. While market data may exist in most asset classes, there are always subjective elements that influence price and that ought to be considered by a prudent purchaser.

Purchasers generally make many assumptions in accepting market prices. Often these assumptions need to be carefully re-assessed for each acquisition. Such assumptions may include:

- there will be no government-imposed costs occurring post closing, such as for work orders to bring a building or site up to current regulatory standards, environmental clean up or remediation costs, costs to rectify fire code deficiencies, costs to obtain missing industrial permits and other such positive retrofit; and
- the purchaser is buying on an "as is, where is" basis, in other words, without any specific vendor warranties. In this respect, purchasers should assume caveat emptor (buyer beware) which generally applies except for deliberately concealed defects and defects that are a hazard to human health but not readily ascertainable during a physical inspection.

These and all other assumptions typically require a purchaser to exercise "due diligence" by investigating the physical, financial and environmental nature of the property and the feasibility of any intended change in use or new construction before a commitment is made to proceed to close a real estate purchase transaction.

6.4.1 What is market price

Market price information is generally available for office buildings, shopping centres, multi-unit industrial buildings, warehouse buildings and multi-tenant residential buildings. See for example, www.colliers.com, www.royallepage.com, www.jjbarnicke.com and www.cbrichardellis.com. Purchasers have the option of selecting their own real estate broker to estimate what the market price should be, hiring an appraiser to advise as to the market price, or trying to inform themselves by reference to published or online data. Price always has a subjective element to it and comparable properties may not be directly comparable. The cost to replace the property may not be the best indicator of what a willing buyer would pay to a willing vendor, where there are plenty of alternative properties.

6.4.2 Capitalization rate Valuation

Income producing property may be valued based on "capitalizing" the net income that is generated by the property, after all expenses and taxes are paid. A net income figure may be "capitalized" at a rate of between 5% to 12% or higher. The capitalization rate refers to the percent return that a buyer wishes to realize on its invested money. To acquire a premium property in a premium location, a buyer may accept a much lower rate of return on its investment (say to 6%) than a buyer who is choosing a risky income producing property in an area that might be subject to change (in which case the buyer may look for a 10% or greater return on its money). The rate of return on a buyer’s money (you and I might think of it as similar to the annual return we make on our bank savings or mutual funds) is similar in concept to the capitalization rate. The capitalization rate is merely the same interest rate or return measure applied to the actual income that is being generated to get to the investment amount required to reflect that percentage return.

By way of example, if an apartment building is generating $100,000 of net income a year and market data shows that investors in apartment buildings generally want an 8% return on their money, then the vendor of an apartment wanting to sell that building at the accepted market price would "capitalize" $100,000 net income by the 8% capitalization rate to determine a selling price of $1,250,000 ($100,000/0.08 = $1,250,000). In other words, a purchaser paying $1,250,000 and receiving $100,000 of net income a year is getting an 8% return on its investment.

6.4.3 Subjective valuation

While the "capitalization rate" approach to selling income producing real estate is very common, other elements may be at play such as the subjective value of the particular asset to the buyer. Buyers may set a new benchmark for capitalization rates (i.e. accept a lower than market rate of rent on their investment) if they particularly want an asset and want to outbid others for it for strategic or business reasons. Perhaps they see some additional movement, such as existing rents that can be increased, or expenses that can be reduced, that other buyers do not see. Curb appeal, locational attributes and other qualitative variables may also influence price.

Purchasers may gamble on the direction of the market. Some purchasers may look at real estate as a cyclical commodity and determine that properties should generally be increasing in value over the next 12 to 18 months. That purchaser may therefore choose to out bid other potential purchasers in expectation of rental income growth, or increased demand leading to a higher price for the asset in the future. The "time value of money" may be reflected in the price, as will the cost of funds to hold that asset for a period of time.

Price may also be discounted (i.e. the capitalization rate "bid" is higher than market) for perceive obsolescence of a particular real estate asset, or for difficulty in financing. Price may also be influenced by the motivation of the vendor: a vendor's urgent need for cash may create a discount for a quick closing not generally available. Unfortunately, good deals in housing often occur when the vendors are a divorcing couple, in which case the vendors are much more interested in getting whatever money is available out fast, rather than holding on to obtain the last dollar of potential value.

6.4.4 Vendor-take-back financing

Often, the willingness of a vendor to "take back" financing may influence price. Much of the "no money down" literature from the 70's and 80's advocated a combination of traditional first mortgage financing and VTB financing in acquiring property.

6.4.5 Illiquid and secialty markets

Pricing is much more difficult in situations where the market is illiquid or is a specialty market. Illiquid assets are those that are not readily convertible into cash because of a lack of demand, the absence of an established market or the substantial cost or time required for the liquidation the assets. Examples of these types of assets may include refineries, special process industrial plants, uniquely configured office or institutional spaces, churches, resorts and real estate that is also an active business (for example, a bed and breakfast). In these situations, one often needs to refer to national or international comparables or rely on replacement costs, and subjective value to arrive at pricing. From the buyer's point of view, there can be wide swings in what the buyer is willing to pay depending on whether the existing illiquid or specialty asset is suitable for the buyer's intended purpose, and the cost of alternatives available elsewhere. Often, vendor motivation is also a factor.

6.5 Buyers' strategies

There are many traditional buying strategies that have evolved to minimize buyer risk in achieving one of the three objectives described above. There are seven elements to effective buyer strategy including:

- making the purchase price inclusive;
- determining items of critical importance to vendor;
- managing risks;
- negotiating on price and non-price simultaneously;
- negotiating on two or more properties concurrently;
- considering renegotiating the price and terms prior to the expiry of the conditional period; and

- renegotiating prior to closing.

These items are discussed in more detail below.

6.5.1 Making the purchase price inclusive

Buyers need to be careful to avoid the vendor requesting additional monies for assets that the buyer thought were included, but turned out not to be included, in the description of the assets to be purchased. Buyers need to be very sure that their purchased assets not only include the obvious real estate and land but may also include:

- fixtures which are attached to the land or building;
- equipment and furniture (known as "chattels") necessary to the operation of the building such as security systems, cameras, mops and brooms, maintenance equipment and the like;
- trademarks that may go along with the property such as the names of shopping centres or office buildings;
- all title to Internet sites related to the asset including the name, software code for the website and all passwords, and assignment of the contracts with the sites' host, universal reference locators, internet protocol ("IP") addresses, and all other names associated with the property;
- drawings and printed marketing materials and all design marks such as those that might be contained on the website and brochures;
- all accounting records, records of receivables and tenant deposits; plans and specifications;
- a wiring diagram for telecommunications systems and in-building and inside wire, if owned by the landlord; and,
- the benefit of existing service contracts, customer or tenant lists, potential tenant databases, special software and any operating manuals.

For buildings containing telecommunications equipment, such as rooftop telecommunications equipment, the purchaser should be sure that these licenses (which typically do not automatically transfer upon the sale of the property) are included. The purchaser may also wish to obtain from the vendor a clause in the agreement of purchase and sale that prevents the vendor from soliciting any of the rooftop telecommunication tenants to move elsewhere within the vicinity.

6.5.2 Determining items of critical importance to vendor

Many brokers know that the secret to achieving transactions is to ensure that the vendor's needs are met. Thus, it is important for a purchaser to determine which terms are of critical importance to the vendor; indeed, the vendor's motivations in putting this property on the market for sale. Purchasers should ask themselves:

- does the vendor desire a fast closing?
- do they need to sell to spruce up its balance sheet?
- is there pressure from the vendor's lenders to sell?

- do they have a desire for an "all cash" transaction or are they willing to do VTB financing?
- do they prefer to sell "as is, where is" for less money, or to give an extensive list of representations and warranties as to the condition of the property, in return for a slightly higher purchase price?
- are they looking for an unconditional offer in return for a reduction in the purchase price, or will they allow a reasonable period of time for the vendor to investigate the property, and a right to terminate if not satisfied for a "market" price?
- are they looking for a reputable buyer with deep pockets, who they can trust to complete the transaction?
- do they have a preference for a closing before a certain fiscal year end date?
- are they looking for a purchaser to assume certain problems existing with the property, such as a pending refinancing date, problem tenants, ongoing disputes with the municipality, tenants with low lease rates, deferred maintenance issues associated with the building, or environmental problems?

6.5.3 Managing risks

Purchasers need to determine manageable and unmanageable risks in connection with the purchase process and adjust the terms of the agreement accordingly. Relevant issues under this heading will include:

- the purchaser’s access to financial resources sufficient to close the transaction or whether it needs to request VTB financing;
- the perceived market or financing risk between the date that the purchaser expressed and interest in the property and the closing date, and then between the closing date and the date that the development will proceed;
- when an occupation may occur; and,
- when rents may be stabilized or when a major costs is to be incurred.

In a poor tenant market, a vendor may be required to lease space with a wide ability to sublet in return for the vendor achieving a higher selling price. In an environment where there are rising high interest rates, a purchaser may consider requiring the lender to take a mortgage back at below market interest rates to mitigate this financing risk. If there is a long development horizon, such as with farm land to be re-zoned, a purchaser may require the vendor to hold longer term VTB financing, partial discharge privileges and require financing to be postponeable to construction financing.

6.5.4 Negotiating on price and non-price simultaneously

Purchasers need to recognize that non-price items do have value, although often it is subjective. In a negotiation process, the vendor may be willing to reduce the price in return for the purchaser agreeing to delete many required vendor "representations and warranties" about the nature of the asset, that the vendor is otherwise uncomfortable giving. In the initial rounds of discussion on the form of the agreement of purchase and sale, purchasers should always be willing to translate issues with other concerns to price. Purchasers will often recognize that the willingness of a vendor to provide financing on non-institutional terms (such as a mortgage that is open for

prepayment at any time, that allows a subsequent purchaser to assume financing without consent, that offers a below market interest rate, that offers deferred interest payments, etc.) will have value to the purchaser and may enable the purchaser to meet the vendor's asking price.

6.5.5 Negotiating on two or more properties concurrently

While a purchaser should never have more than one offer outstanding at any one time, vendors prefer that their property be the only one on the market at any time so as to permit more of a monopoly pricing effect, rather than be told there are several alternatives readily available to the purchaser. The business of alternatives, within a reasonable price point of the purchaser's known objectives, creates an environment that provides incentive to the vendor to negotiate with the purchaser on price and non-price items.

6.5.6 Considering re-negotiating the price and terms prior to the expiry of the conditional period

Price and information are circular in the context of acquisition of large assets. Price is based on information about the asset, but that the same information about the asset is often not available, particularly not in a real estate context, until a purchaser has agreed to a certain price and has undertaken its due diligence in connection with a binding agreement of purchase and sale with a conditional due diligence period contained in it. At the end of that due diligence period, the purchaser has much better information about the nature of the asset it is acquiring and much of that information may affect the pricing assumptions made by the purchaser in submitting its original offer. Accordingly, it is not unusual for a purchaser to request a price adjustment at the end of a due diligence period based on new and material information obtained by it during the due diligence process, which was either undisclosed to the purchaser at the outset or inconsistent with some statement made by the vendor or the agent during the sales process.

Example

For example, the purchaser may have undertaken an environment Phase I inspection or even a Phase II inspection which has disclosed some environmental clean up risk not otherwise anticipated by the purchaser. The purchaser may require payment for the cost of its Phase I and Phase II studies and clean up by the vendor prior to closing or, alternatively, cash in lieu of the purchaser assuming these obligations. Furthermore, a building or fire inspection may have occurred or work orders may have been disclosed requiring deficiencies to be remedied. In this case, the purchaser may well insist the vendor rectify those problems prior to closing or may request the vendor to give it credit against the purchase price for the amount required by the purchaser to undertake the same work after closing for industrial acquisitions, some permits may not be available. A review of leases for income producing properties may have disclosed some previously undisclosed adverse terms in the leases. Adverse terms may have been discovered in service contracts to be assumed by the purchaser. Purchasers may have investigated the zoning and building by-laws and have discovered adverse indicia of convertibility, or development or political risk that should be accounted for in the purchase price. Often, there can be changes in the market during a due diligence period, such as a change in interest rates and therefore the cost of financing that will require a change in the purchase price.

6.5.7 Re-negotiating prior to closing

Re-negotiation of price prior to closing is not a frequent event, but often should be considered where a title issue has arisen or where further changes in the market place or in conditions affecting the vendor or the purchaser are prevalent. In those situations, it is first necessary to determine whether the purchaser has any contractual right to raise the issue or whether the purchaser can be forced to close without change. Generally, absent a title issue, purchasers will be forced to close. However, there may be a reason for a voluntary modification of the agreement such as in a situation where the vendor has reluctantly agreed to representations and warranties but is prepared to reduce its price on closing if the purchaser will provide a release of those representations and warranties. That way, a vendor may not need to account for the remaining possibility of a post-closing claim resulting from such representation and warranties subsequently found to be untrue in its financial statements. The Purchaser may achieve a reduction in price in a situation where perhaps it would not have placed any value on the vendor's promises in the first place.

6.5.8 Deposits

6.5.8.1 Purpose of a deposit

Deposits are a show of good faith; they are preliminary evidence of financial wherewithal and they are a commitment in return for access to information. They can range from 0% to 100%%. Typically, where brokers are involved in the transaction, the deposit is enough to cover the commission of the broker. The range is typically 1% to 5%. The deposit, is set relative to the degree of competition for the property, relative to the length of time until the closing date might occur, is a potentially ransomed sum for failure to close, and, from the purchaser's point of view, can be an effective limit on the amount of damages it may subject itself to if it fails to complete the transaction.

6.5.8.2 Who should hold the deposit?

Generally, deposits should never be paid to the vendor, but always held by a third party stakeholder, such as a registered real estate brokerage or a lawyer.

6.5.8.3 The effect of due diligence on the deposit

Most commercial agreements of purchase and sale, as described below, are structured to provide for a due diligence conditional period of 20 to 90 days. Often, vendors are looking for a commitment from a purchaser and accordingly may structure a two stage deposit, perhaps the second amount payable upon the purchaser being satisfied at the completion of the due diligence period. Occasionally, the vendor may request that a portion of the deposit become non-refundable.

6.5.9 Purchaser's control and due diligence

6.5.9.1 Control of the property by the purchaser

Agreements of purchase and sale are a critical instrument for a purchaser to obtain "control" of a property before expending significant amounts of money on due diligence. Generally, purchasers do not like to spend money making due diligence type enquires without knowing that, if their investigations are satisfactory, they alone have the power to elect to complete the transaction. Purchasers, conversely, are generally reluctant to spend any money investigating a property in great detail if there is a possibility that another purchaser could come along and acquire the property in the interim. In the case of larger portfolio sales, where multiple bids are solicited, often due diligence in is required to be completed advance.

6.5.9.2 Factors affecting the type of due diligence

The due diligence process is, in essence, a transfer of knowledge process. The type of due diligence undertaken will depend on the objectives of the purchaser in acquiring the asset. The availability of detailed representations and warranties of the vendor, backed up by the "covenant" and financial strength of that vendor, may eliminate the need for some investigation by a purchaser. On the other hand, if the purchaser sells the property on a "as is, where is" basis and without any warranty, then it is up to a purchaser to satisfy itself that it understands exactly what it is buying and the risks associated with it. While warranties and representations can be thought of as both a supplement and an alternative to due diligence, the warranties and representations, because they are mere promises, are only as good as the entity that has given them. It is not unusual, in situations where a representation or warranty has been breached by a vendor, for the purchaser to be delayed in having that claim satisfied by the vendor.

6.5.9.3 Components of a due diligence investigation

Certainly, due diligence work on a normal commercial property should include physical inspection, a review of the files of all regulatory agencies having jurisdiction in respect of work orders (building inspections, fire department, elevating devices etc.) as well as, typically, an environmental Phase I review of the property. During that due diligence period, when control of the property is obtained, purchasers will also look at tax issues in connection with structuring their acquisition of the property, financial feasibility, development feasibility, and the prospect for any necessary planning consents and approvals.

6.5.9.4 Due diligence providing the purchaser with leverage

Near the end of the due diligence period, the buyer typically has some leverage over the vendor to the extent that if the buyer does not proceed, the vendor has to commence re-marketing the property and start the entire process from scratch. Often, the ability of a purchaser to promise a quick closing at this stage in return for a reduction in price, regardless of whether the purchaser has found any problems, will give the vendor some incentive to adjust price, although if this leverage is abused, vendors may refuse on principle.

6.5.9.5 Options contrasted with due diligence periods

Purchasers also need to be careful to distinguish between an option to purchase, and a reasonable due diligence period in purchase offers. A 30 to 90 day "due diligence" or investigation period in a commercial agreement of purchase and sale may be usual and typical in the market place. To the extent that the purchaser can choose to terminate the transaction on or prior to the expiry of that due diligence period and receive its deposit back in full, it can be perceived as a "free" option. There is a cost to the vendor to the extent that the property has been held off the market for the 30 to 90 day due diligence period of time. Some vendors may take the point of view that to tie up a property for any more time than it ought to take a purchaser to satisfy itself on various inspections, amounts to a free option and the purchaser should pay for this. The vendor may request the purchaser to enter into a more formal option agreement, in which case an option price is paid which is non-refundable or, in the alternative, may structure a traditional agreement of purchase and sale a with a non-refundable deposit in order to pay for the perceived option value of the long due diligence period.

In summary, it is important for a purchaser to obtain control of property before spending money, to ensure its ability to proceed with the transaction if due diligence is satisfactory and to overcome the circularity of price and information.

6.6 Issues in selling

When selling real property, the first step is to understand clearly what the objectives are for the sale. While purchasers generally fall into three classes: those purchasing income producing real estate, those purchasing for development purposes and those purchasing for occupation and use, vendors may have many motivations in seeking to sell real property. These may include the following:

Financial Considerations

- realizing a profit on the sale of the asset or minimizing a loss
- recovering equity which is tied up in the asset, and redeploying it at a higher expected rate of return

Market Considerations

- pruning assets that do not meet a company's perceived market positioning
- market timing: achieving a higher price when markets are expected to go down

Business Considerations

- achieving a product mix, such as in residential subdivisions
- refocusing on core businesses
- to end unworkable joint ventures

Minimizing Risks

- minimizing the impact of a deteriorating tenant covenants, such as failing retail tenants
- minimizing the impact of deteriorating location, due to a new highway opening elsewhere or decline in the neighborhood
- due to a belief that the building requires more and more maintenance and

building system upgrades to stay competitive, or will diminish in value and become obsolete due to technological advances

- assigning contingent risks to someone else, such as a single tenant building where the tenant is in a risky industry

Laws and Regulations

- as a result of regulatory or statutory implication, such as bank/investment or reserve regulations

6.6.1 The vendor's pre-sale due diligence

Many vendors are very poor at pre-sale due diligence. A decision to sell often leads to a phone call to a broker to "market" the property. Astute vendors will often take steps to maximize the value of an asset before putting it on the market, which may include rezonings, re-leasing, renewing tenants, cosmetic or system improvements, or planning assumable non-recourse financing against the property. It is also important that vendors undertake pre-sale vendor's due diligence before making that call. The purpose of pre-sale due diligence is to effectively identify the sales objectives and needs of the vendor, while balancing these with the needs of a purchaser and recognizing any potential obstacles that may interfere with the sale of the asset. It is also to re-understand the property and develop a sales strategy from that current knowledge of title, building condition, site condition, zoning, environmental condition, availability of all documentation such as leases, plans and financial results, the condition of building systems and the financial status of all tenants. Components of a such an analysis may include the following:

Sales Objectives of the Vendor

- what is a reasonable time horizon to achieve a sale of the asset?
- how difficult is the sale and what should the commission be to an agent?
- which agent is most highly experienced in this area?
- can the property be sold without an agent through an alternative channel?
- determining a marketing plan: which community would value this asset the highest and how do we approach them?

Needs of the Purchaser

- determining the availability of information typically required by a purchaser: is the vendor generally able to satisfy a purchaser's due diligence requirements?
- determining the vendor's ability to make representations and warranties about the property: if so, what representations and warranties? Anticipate what a prudent Purchaser may require and investigate your ability to give those representations and warranties beforehand.

Structuring of the Transaction

- is the vendor is prepared to take back financing or will the vendor seek an all cash transaction?
- perhaps developing the form of agreement of purchase and sale that the vendor would entertain, rather than having the purchaser draft up the form of agreement of purchase and sale

Obstacles to the Sale of the Asset

- identifying the existence of any outstanding work orders

- verifying the current zoning and determining whether the use of the property currently conforms with the zoning regulations (if not, whether it is legally non-conforming and therefore can remain as is, or an illegal non-conforming use, in which case it must be brought into compliance)

6.6.2 Financial issues associated with selling

Financial considerations have a definite impact on the course a transaction will take, once a vendor has made the decision to sell the asset. In determining the financial issues affecting a sales program, the vendor must consider various factors that will affect the asking price, any potential obstacles to receiving the asking price, factors affecting the closing of the transaction and any accounting or tax implications of the sale. The following issues are relevant to such a determination:

6.6.2.1 Pricing

Pricing includes determining the true net income, and investigating and potential future growth in that net income, issues relating to the interest rate that will be used in calculating the present value of the future rent payments (called the "discount rate"), and the rates of return required by the market. The vendor must decide upon the source for determining the appropriate asking price: a broker, an appraisal, publication data, or some combination of the three. The determination of the appropriate asking price should taken into consideration any additional income from the property, such as parking income or daycare income, and what evidence the vendor is prepared to produce to confirm the additional income. The vendor must also settle upon which committee will decide the asking price, taking into account the above considerations, and how the offers that are received will be evaluated.

6.6.2.2 Potential obstacles to receiving the asking price

When an income producing property is going to be sold, it is helpful if the vendor can anticipate anything that the purchaser may find during a due diligence period that may justify a request for a reduction in the asking price. Whether or not all of the tenants have signed ("tenant estoppel statements")] a statement to the fact that they do not have any outstanding claims or disputes with the vendor, is a factor that may adversely affect the likelihood of the vendor receiving the asking price.

Prior to marketing the asset, the vendor should prepare, a budget that outlines the expected leasing income of the property being offered for sale. The vendor should ensure that this document shows all of the potential interruptions that may occur in the future leasing income. If, during the period of due diligence, the purchaser discovers that there are undisclosed adverse covenants within the tenants' leases such as future rent free periods, or non-recoverable operating costs associated with the property, this may be used by the purchaser to request an abatement in the asking price of the property.

In addition to the document detailing the expected leasing income of the property, the vendor should also prepare a zoning report and a title advice statement for the property.

6.6.3 Closing the transaction

Prior to closing the transaction, consideration must be had to whether the vendor is prepared to accept a vendor-take-back mortgage, a long closing or long conditional period. The vendor should determine whether any existing financing is technically assignable or assumable. If the existing financing is not assignable, the vendor should discuss the assumption of the mortgage by a new buyer, with its banker. In addition, the vendor should consider whether there are any other steps it may go through to re-qualify a new buyer to assume the mortgage. If the mortgage is not assumable or assignable, the vendor needs to determine if there will be sufficient cash proceeds from the sale to discharge the mortgage, after all cost of closing are paid.

6.6.3.1 Accounting and tax implications of the sale

The sale of any asset will invariably create accounting and tax implications. Prior the to closing of the transaction, the vendor needs to establish what the accounting treatment of the sale will be in the company's financial statements and how the resulting financial statements will impact on the company's stakeholders. The vendor also needs to identify the tax treatment of the sale, including recapture, terminal loss, capital gains and capital losses, and establish a plan for using or mitigating each of those numbers.

6.6.4 Physical condition of the premises

Another issue that affects selling is the physical condition of the premises. Prior to listing the property, vendors need to consider to physical condition of the property and consider making upgrades to improve the asset's value. Before the property is placed on the market, the following details should be considered:

6.6.4.1 Roof and other typical maintenance items

A vendor should expect a purchaser to commission a roof evaluation and the vendor should expect, unless it has been very clear in the agreement of purchase and sale in disclosing a poor quality roof, that the purchaser will expect a price reduction for the discovery of a faulty roof. The vendor should also make sure that all the other equipment in the building is in good working order.

6.6.4.2 "Curb appeal"

The vendor should ensure that the building has, where necessary, fresh cosmetic upgrades so as to give it "curb appeal". Such upgrades include making sure that the landscaping necessary to improve the appearance of the building has been undertaken. In addition, if a parking lot is located on the site, the vendor should ensure that all holes are patched and perhaps even have new lines painted on the lot.

6.6.4.3 Defects should be remedied or disclosed

The "buyer-beware" rule has at least two exceptions in Ontario: no concealment of damage and disclosure of hidden health risks. It is especially important that the vendor ensures that no over

zealous employee undertakes any act of concealment of any building defect such as a foundation crack or a crack in exterior walls.

6.6.5 Land use and regulatory issues

6.6.5.1 Uses that do not conform with by-laws

Vendors need to be clear as to whether they are selling a property which is in compliance with current zoning by-laws or whether it is somehow legally non-conforming (i.e. operating legally but not consistent with the requirements of current zoning or building by-laws). A non-conforming use that is permitted despite that fact that it is not in accordance with the current zoning by-laws will have limited future adaptability and may lead to a lessening of the purchase price from a purchaser. Furthermore, vendors should also determine if the tenants' uses of the premises comply with the current zoning by-law, and if there is a concern that a particular tenant may be using the premises in an illegal manner, this concern should be identified prior to the sale of the property.

6.6.5.2 Regulatory schemes affecting the property

Prior to selling the property, a vendor must consider whether there are any work orders outstanding under the building code, fire code, environmental laws, occupational health and safety, maintenance by-laws or any such similar regulatory scheme.

6.6.5.3 Environmental considerations

Vendors should undertake or review previous Phase I environmental reports for the property and ensure they understand whether there has been any necessary change in that situation as a result of building operations during the intervening period. Vendors should also make sure that problems disclosed by the Phase I report are remedied beforehand and a new Phase I obtained, or else disclose the problems to the purchaser in connection with an "as is, where is" sale, as appropriate.

6.6.5.4 Development or site plans

The vendor must be aware of the status of any development or site plan agreements affecting the property, and this knowledge must be imparted to the purchaser. In addition, if there is a need to replace any securities posted pursuant to any development agreements, the amount and the length of time of the securities must be posted, needs to be determined and passed along to the purchaser. This should be drafted into the agreement of purchase and sale.

6.6.5.5 Credits or liabilities for development fees

The vendor needs determine whether there any credits available for development charges, levies or imposts which the vendor can price into the purchase price and which are assumable by the purchaser. Conversely, if there are any development charges, levies or imposts pending, these ought to be disclosed to the purchaser by the vendor, prior to the sale.

6.6.6 Title and legal issues

Vendor's should ensure that they have an up-to-date survey obtained for their property, particularly showing any additions made to any structure on the property since the date of the last survey. Most purchasers will want an up-to-date survey so they are able to satisfy themselves as to compliance with all zoning and building by-laws. If an older survey only is available, a vendor needs to be sure that the purchaser is made aware of this and is required to obtain an updated survey, perhaps at its own cost.

6.6.6.1 Title searches

Prior to purchasing property, a title search is conducted on the land to determine whether there are any "clouds" on title. Land in traditionally registered within two separate systems; the Registry system and the Land Titles system. It is not required that property be registered in both systems, however vendors may consider putting Registry system land into the Land Titles system so as to ease the title search process by the purchaser and so as to be sure that there are no "clouds" on title which might affect closing timing and price. Conducting a subsearch of title before the sale and preparing the title advice statement referred to above, will allow the vendor to anticipate any title concerns that a purchaser may have. If the subsearch reveals any outstanding encumbrances on title, the vendor should determine whether or not they are dischargeable. Examples of outstanding encumbrances may include leases which have expired and may also include mortgages that have been paid off but not formally discharged from title.

6.6.6.2 Internal approvals required by the vendor

Vendors need to be sure about internal approvals required to facilitate the sale and who will manage the sale. This may include a review of the by-laws of the corporation or selling entity to see exactly who has signing authority in respect of a transfer of land. Often, for non-typical transactions, a purchaser's solicitors will require an opinion as to compliance with all internal by-laws of the selling entity.

6.6.6.3 Defects in the property

In addition to the precautions detailed above, the vendor should also survey the staff to ensure that there are no hidden defects on the property that would not be discoverable upon a purchaser's reasonable inspection that might be a health hazard, and that there has been no active concealment of any defects. Upon discovering any such defect, the purchaser may be entitled to revoke the agreement.

6.6.6.4 Municipal agreements

Vendors should also make enquires in advance of a sale, as to whether all of the municipal agreements registered on title are currently in good standing.

6.6.7 Issues in marketing

As discussed above, there are many issues in marketing that a vendor needs to consider before making the phone call to a listing agent. Questions that a vendor must ask itself before commencing with marketing the property include:

<u>Marketing Channel</u>

- what is the marketing channel that will be used: brokerage, auction, or active marketing vs. listing?

<u>Prospective Purchaser</u>

- who will the property be marketed to: an investor, a developer or an occupier?
- can the property be marketed to a current tenant?
- can it be marketed to a competitor?
- can it be marketed to a supplier?

<u>Terms of the Sale</u>

- is the property for sale "as is" or with representations, warranties, indemnities and financing provided by the vendor?
- is it based on present use or a potential future use?

6.6.8 Issues regarding the timing of the sale

Vendors need to consider the timing of the sale transaction. This will include the following:

- fiscal year end: should the sale occur within this fiscal year or should it be deferred to the next fiscal year?
- seasons: when does the property show best?
- calendar year: should a closing occur on December 31st to ease adjustments for any over or under collection of realty taxes or operating costs estimated at the start of the year and collected from tenants during the year.
- market timing: should the sale occur at a certain time in a cycle or prior to a certain news event, or after a certain new event?
- should a sale occur when certain personnel are available?
- should a sale occur when certain problems disclosed from pre-sale vendor's due diligence are fixed?

6.6.9 Pricing strategies

To some extent, the issues in vendors' pricing relate to, and often are the opposite perspective of, the issues in purchasers' pricing. Vendors generally prefer all cash transactions, sold on an "as is" basis, with a quick closing, high deposit, and no conditional period. While this is the vendor's wish list, this obviously is not reality in most situations. Vendors need to assess risk and match it with their objectives in thinking about pricing and terms. A small amount of cash available on closing and a long closing period are often the worst case scenario for a vendors. While pricing issues for vendors do relate to the pricing issues for purchasers, there are certain vendor strategies that may assist in maximizing the potential price to be achieved, from the sale of real property:

Market Capitalization Rate Applied to Captive Rents

- if rents from tenants of an income producing property will rise over the next several years, consider taking a three year or five year rental average as the rental income, apply the market capitalization rate to this amount, and then the vendor will get some of the benefit of the increasing rental income. In these situations, the purchaser may request that the vendor guarantee the rental income.

Added Value of Vendor Financing

- consider the amount by which the value of the property will increase, if vendor financing is made available to the purchaser.

Offer to Lease Vacant Spaces

- consider what the increased value might be of the vendor offering to lease certain vacant spaces in the income producing property, and then locate sublessors for those spaces.

Varying Rates of Interest for Various Sources of Income

- consider what increase in value might be obtained if different capitalization rates are applied to the future payments of different, segmented, sources of income in the income producing real estate. It may well be that the market values residential rental income higher than commercial rental income. If so, those two rental streams should be segregated and priced separately to arrive at an aggregated selling price.

Assigning the Vendor-Take-Back Mortgage to Mitigate Risk

- consider the down payment to be requested. If vendor-take-back financing is to be offered, consider the risk that a purchaser may find a defect in the property post-closing and seek to set-off the cost of clean up against the balance owing under the vendor-take-back mortgage. To mitigate this risk, prudent vendors may often assign the vendor-take-back mortgage or take it in a different company than the vendor itself. This way, a purchaser would not be able to set-off one party's debt against credit due to another.

Market Direction

- consider the direction of the market: go slow to accept offers in a risking market and fast in a declining one.

Inclusive Purchase Price

- is the purchase price inclusive or are there extras that the vendor can charge for?

6.6.10 Conditions of closing

The vendor should also consider its conditions for closing. Particularly, the vendor needs to consider any liabilities, that are not accounted for, that may depend upon the happening of a future event ("residual contingent liabilities"). What if they could be significant? How will that risk be controlled? Should there be a maximum placed upon the amount which the buyer can claim from the vendor anytime? Should the purchaser be forced to accept certain service contracts or employees to minimize the severance cost to the vendor?

6.6.10.1 User-occupied premises

Often purchasers see greater value to the place if it is occupied than if it is unoccupied, since they can visualize how their operations might occur on the premises. However, in other applications, such as industrial markets, the premises may have more value if vacant during the showing period. Vendors understand that when a property is under a contract, it cannot be marketed to other entities and accordingly, there is a potential market opportunity cost.

6.6.10.2 Reduction of transaction costs

The transaction costs for vendors for brokered transactions, can be reduced if brokerage fees are commission based as opposed to flat rate based.

6.6.11 Selling strategy

Typically, vendors set the asking price at the high end of an advised range. Vendors are best able to maintain that asking price if there is a high demand market or if they are able to determine and meet terms of critical importance to the buyer, such as a quick closing or availability of financing. Certainly vendors should try to have multiple buyers, anticipate buyers' negatives and have solutions in hand.

Shrewd vendors may consider transferring a property to a shell company so as to minimize the potential effect of breached sales warranties, given by that selling entity. Vendors should also be aware that in a situation where a buyer assumes an existing vendor's mortgage, the vendor still has the liability for repayment of that mortgage, if the purchaser should default. Accordingly, a vendor should always attempt to discharge existing financing and have a purchaser bring new financing or else negotiate a release for itself of assumed, recourse financing. Vendors should also try, where possible, to limit the term of representations and warranties to six months or a year or less, and limit the ambit of representations and warranties to the best of the vendor's knowledge and belief.

6.6.12 Acquisition due diligence: Telecommunications and E-commerce issues

Buyers and vendors can no longer simply rely on traditional physical due diligence in determining, respectively, suitability of land for purchase or preparations needed to put property on the market.

Buyers now need to add telecommunications consultants to their list of consultants in undertaking purchase due diligence. These telecommunications consultants need to:

- review all mobile (radio frequency) and wireless spectrum use in the building
- determine the location of entrance feeder cables, location of demarcation points and ownership of in building wire
- review all telecommunications access agreements
- determine whether telecommunication access agreements are terminable on short notice

- location of and expandability of the main telephone room and any co-location or point of presence rooms
- the Landlord obligations to maintain in building wire and any "jumper cables" between any existing main telephone room and any new point of presence or co-location rooms
- ownership and usage of in building wire

Vendors, on the other hand, need to undertake the foregoing due diligence to determine what representations and warranties and deliveries can be given to a willing purchaser. Representations and warranties may include:

- as to the ownership of the in building wire or any part of it
- as to the existence of all or any wireless rooftop, riser use and/or telecommunications access agreements
- as to the portion of revenues and operating cost attributable to telecommunications facilities and services
- as to the recoverability of such operating costs from tenants, actual and possible under existing leases

For Vendors, closing deliveries may include:

- copies of all telecommunications license and rooftop agreements
    - transfer agreement for any in building wire owned by the Landlord
    - confirmation from the original incumbent telephone company that in building wire was in fact transferred to the Landlord or a predecessor and delivery of a copy of the agreement
    - clean lien search in respect of in building wire
    - copies of any riser management agreements and any desired assignments of same
    - copies of all telecommunications access agreements from competitive local exchange carriers occupying space in the building or on the rooftop

6.6.13 Acquisitions and divestitures: websites and building intranets

Many Landlords are rolling out, in connection with building services automation and tenant retention strategies generally, active telecommunications management services, building Websites listing tenant services as well as leasing information, and potentially building marketing agreements where a range of non-traditional services are marketed to building tenants as a captive audience. These are collectively referred to as building e-commerce initiatives.

Given the existence of the foregoing, due diligence typically undertaken by a purchaser will again have to be expanded to include the following:

- review of all contracts to third party providers of building e-commerce services
- investigation of title to and proprietary interest in trademarks, trade-names, domain

names, URLs, and a review of any building Websites to determine copyright and assignability

- review of leases to determine ability to pass on any costs to tenants of building e-commerce services
- review of service contracts from which e-commerce services are provided

On closing, vendors will want to be clear of what closing delivers can be given and what representations and warranties can be made with respect to building e-commerce services. These representations and warranties may include, but not be limited to:

- title to and ownership of all trademarks, trade-names, domain names and URLs
- good standing of all building e-commerce service contracts and assignability of same
- rechargeability of any building e-commerce costs to tenants, both actual and possible under existing leases
- as to the good standing of all building e-commerce agreements

Closing deliveries may include:

- assignment of web page and software
- assignment of all trademarks, trade-names, domain names, URLs and copyright in Web page
- assignment of building e-commerce service provision agreements

6.7 Review questions

1. Should the general contents of Agreements of Purchase and Sale be the same in all situations? If not, when should they be different and why?

2. Describe the "capitalization rate" applied to income producing real estate and explain how it works.

3. Should someone planning to sell real property do any work before listing a property for sale? If so, what types of things ought the vendor do?

4. How do you determine the price for a particular property if there are not a lot of comparables?

5. What are some good Canadian web-based resources to use when shopping for investment property?

6. Can web-based services replace the work of a good real estate agent?

7. Review co-operative listing sites such as www.loopnet.com. How helpful are they in searching for investment real estate? What are their limitations?

6.8 Photo Gallery

Cliveden 1, Delta, British Columbia - Sun Life Financial Services of Canada

Westgate Shopping Centre, Maple Ridge, British Columbia - SunLife Financial Services of Canada

2150 Dunwin Street, Mississauga, Ontario - GWL Realty Advisors Inc.

400 Walmer Road, Toronto, Ontario - GWL Realty Advisors Inc.

Commerce Court, Toronto, Ontario - GWL Realty Advisors Inc.

Station Square, Burnaby, British Columbia - GWL Realty Advisors Inc.

7 Leasing space in Canada: Formalities of a lease

7.1 Introduction

In Canada (and for that matter the United States), occupants who are not otherwise owners of the buildings in which they choose to locate, usually structure their fixed term occupancy by way of a lease. The lease provides the tenants with exclusive possession of a part of a building for a fixed period of time and has the protection of law to ensure that the tenant gets the full benefit of the term negotiated with the landlord. For a lease to be binding, the lease must be in writing, must specify with reasonable certainty the space to be occupied, the term of the lease, the identity of the tenant and the rent payable. It must also provide for exclusive possession of all or a portion of the premises. A lease confers upon a tenant the following rights at common law:

- the right to quiet enjoyment (uninterrupted exclusive possession of premises);
- the right to assign or sublet;
- the right to seek court ordered relief from termination for non-payment of rent or non-performance of covenants;
- a remedy for breach of covenant to repair by landlord;
- protection from excessive distress (distress is the landlords common law right to seize a tenants goods if the rent is not paid); and
- rights to damages, injunctions, specific performance, termination and statutory remedies at law.

7.2 Formalities of an Offer to Lease or an Agreement to Lease

An offer to lease is an offer in writing from a landlord or a tenant to a tenant or a landlord respectively not yet accepted by the other party. It is a "offer" within the meaning of typical contract law. Once the offer to lease is accepted an if the offer to lease presumes the execution of a more formal lease document, then the offer to lease becomes an agreement for a lease or an agreement to lease. The agreement for a lease must be in writing and must be properly executed by each party. A witness is only necessary for evidentiary purposes; it does not affect the validity of the document.

A document which contains all material terms of the lease and which does not contemplate a further, more detailed document being executed may be considered a lease.

7.2.1 Term of lease - formalities

A lease must specify a term and generally must also specify a commencement date. Often, however, a commencement date is inferred by virtue of process, such as the time it takes to complete tenant's improvements or construction of a building.

7.2.2 Renewals and extensions of lease term

A renewal of a lease is in effect a new lease. The personal rights and obligations existing in the previous lease for the original term may not carry over. An extension, on the other hand, leaves the original contract intact for the extended period of time.

7.2.3 Options to lease additional space

Tenants anticipating growth in their business operations will often try to contract for rights to take additional space during the term of the lease at fixed point in time. Tenants are often more able to commit to a longer term lease if they have the option to lease additional space than if they do not, since the risk of the premises being able to accommodate their business's activities is enhanced. However options to expand constrain landlords to the extent the landlords are then forced to try to lease the optioned space for shorter periods of time. Accordingly, landlords often want a hard commitment to take up the space at the end of a certain period of time as opposed to an option.

Necessary descriptive elements for an option to expand include:

- specific identification of expansion premises;
- the period of time that the option must be exercised;
- the duration of the term for the expansion premises;
- the rent to be paid;
- the allowances to be given to the tenant; and
- the condition of the premises on the tenant taking possession.

7.2.4 Lease covenants that don't run with the land

Expansion rights, rights to renew, rights to parking, tenant inducements, free-rent periods, rights of first refusal, signage clauses, restrictive and exclusive use covenants are generally considered personal rights between landlord and tenant at law and generally don't run with the land. These rights may be made subject to the tenant being the original tenant and not an assignee or sub-lessee, or the tenant not having been (or never having been) in default of the lease and currently occupying all or substantially all the leased premises.

7.2.5 Lease distinguished from license

A license does not carry with it the right to exclusive possession and a license does not run with the land. Landlords may choose to structure rental arrangements that are short term and are intended to be revocable as licenses. Examples may include parking spaces, vendors in shopping centres who sell from mobile shopping carts, main terminal room occupancy by telephone companies, and occupants within a store who operate a sub-business from their locations, such as perfume kiosks or photo studios. A licensee is not entitled to any compensation in the event of expropriation of the property, whereas a lessee is.

It is a question of fact if an arrangement, in writing and containing all the formalities, is a lease or a license.

7.2.6 Leases affecting financing

Landlords should be sure to obtain signed leases from all tenants. Lenders on income producing real estate lend against cash flow that can be generated from a building. That cash flow is only enforceable if it is set out pursuant to the terms of a lease or an agreement to lease, with occupancy under it. Lenders clearly prefer that leases be executed with all tenants, since there is much less left to doubt. They will usually request a general assignment of rents and leases and a specific assignment of particular leases as part of the closing documentation in effecting a loan on an office, retail or industrial building. Lenders will often have significant concern if leases are not signed and tenancy is governed by only an agreement to lease or by letter agreements. Lenders are mindful of the possibility that they may be stepping into the shoes of the landlord in the case of default under the mortgage and in that case, they want the benefit of the detailed remedies contained in the lease.

7.2.7 Importance of lease use clauses

In office, retail or industrial use clauses, the landlord typically seeks to limit the uses to which the premises can be put. Typically, this might be expressed as general office or retail or industrial uses. The landlord wants to make sure that the tenant's use is not a nuisance or is not likely to disturb other tenants and wishes to make sure that, in some cases, an office use may not involve a lot of business from the public, such as in an employment and immigration office. In addition, the landlord wants to make sure that the tenant's use is covered by the building insurance. Furthermore, the landlord will want to make sure that the tenant's use can be managed by the building structurally, and expected heat and traffic load can be handled by the building's HVAC system and elevators respectively.

Generally, there will be provisions in a lease which make sure that the use complies with the uses permitted under zoning and other by-laws enforced in a given municipality. Zoning guides exist which tightly define uses. A landlord may also try to constrain the list of permitted uses in order to ensure that there is no overlap between a particular tenant's use and an exclusive use clause given to another tenant. On the other hand, tenants want to make sure that use clauses are broad enough to permit a change in their business operations from time to time and also to ensure that it has maximum flexibility on assignment and sublet to find an assignee or subtenant who might be in a different line of business, but still a permitted use, under the lease. Tenants must be careful that sub-uses within the space, such as cafeteria uses, computer rooms, training or seminar rooms, showrooms and other typical types of uses, do not fundamentally alter the uses authorized to be undertaken by the tenant or recharacterize the tenant's business. Tenants may also request exclusive uses to prevent others who are directly competitive with them from locating in the same building. Tenants may also want the right to request a change of permitted use on an assignment or sublet, with the consent not to be unreasonably withheld. As for other provisions of the lease, great care must be taken in drafting the use clause to ensure that these interests are properly balanced with wording that is clear and capable of enforcement, if necessary.

Where a lease is silent on the point, a tenant has the right to use the premises for anything he would like, provided that the use is consistent with the zoning in force for the lands. The law implies an obligation on the part of the tenant to use a property in a proper and tenant-like manner, without exposing the building to ruin or damage by acts of omission or commission. The insertion of a use clause in a lease by a landlord is not a representation that the allowable uses enumerated in that clause are necessarily permitted by the zoning bylaw. Tenants should check zoning to be sure.

Generally, covenants in restraint of trade in a lease are void at common law. However, covenants may be deemed to be lawful if they are in the mutual interest of the parties concerned and not otherwise contrary to the public interest. These covenants are mutually and reciprocally enforceable as between landlord and tenant and may be enforceable between tenant and tenant if it is sufficiently clear from the respective leases that a community of interest is created. A key element in this case is to establish that the offending newer tenant had actual notice of the other tenant's exclusive rights. The best way for a tenant to achieve this is to register notice of the lease with the exclusivity clause clearly set out.

There are several other elements in an office, retail or commercial lease which bear on the use which may be made of premises by a tenant. Rules and regulations in leases often may bear on a tenant's ability, for example, to have a cafeteria, a particular type of retail store or operate a certain commercial business. Limits on moving heavy goods or materials in and out of the building may prevent a tenant from carrying on any kind of operation which involves inventorying goods. Limitations on signage may prevent a tenant from effectively dealing with the public. Limitations on normal business hours may limit the type of operation or the costs of operation for certain tenants such as financial brokers in Registered Retirement Savings Plan ("RRSP") season (i.e., January 1 to the last day in February). These need to be dealt with upfront in a lease negotiation so that the form of the lease follows the business and operating style of the tenant, and not vice versa.

7.2.8 Identity and capacity of the tenant

From both the landlord's and the tenant's perspective and the buyers and sellers perspective, it is essential that the parties consider the nature of the legal entity that they are proposing to enter into a lease contract with, both so as to understand the power and capacity of that legal entity to enter into the relationship and so as to understand the nature of the covenant which is being given.

There are various types of legal entities which may be encountered; individuals, trusts, associations, partnerships and corporations.

7.2.9 Individuals as tenant

It is relatively unusual to encounter individuals as landlords and tenants in the world of office, retail or industrial leasing. However, individuals are occasionally encountered as indemnifiers or guarantors with respect to the obligations of an office, retail or industrial tenant. Dealing with an individual does not generally speaking, raise any special legal problems.

7.2.10 Trusts as tenant

While it is, again, fairly unusual to encounter a trust as a landlord or a tenant in an office, retail or industrial leasing situation, it is worth spending a few moments to discuss the legal implications. In its simplest form, a trust is a fiduciary relationship pursuant to which the fiduciary, or trustee, agrees to hold legal title to property (which could include an office, retail or industrial building or a tenant's interest as lessee of space in such a building) for and on behalf of one or more other persons or entities, usually referred to as the beneficiaries or beneficial owners. Unless otherwise stated, the obligations of the trust under a lease or other contract, are those of the trustee, who is personally liable for the performance of the trust's obligations. Therefore, if a trust is a tenant of space in a commercial building, the obligations of the tenant are those of the trustee and not the

beneficiaries. While a trustee usually has the legal right to seek compensation or indemnification from the beneficiaries of the trust for the trustee's lawful actions, parties contracting with the trust usually have no right to seek performance of the obligations directly from the beneficiaries. In the office, retail or industrial leasing situation where the tenant is a trust, the landlord can look only to the trustee for the performance of the tenant's obligations, such as the payment of rent.

7.2.11 Associations as tenant

Associations are not recognized as being separate legal entities in law. They are usually clubs or organizations and are unincorporated. Because associations have no separate legal existence there can sometimes be legal difficulties in enforcing their obligations under contracts. It is highly likely that any contract, such as a lease, which an association purports to enter into in its own name is a nullity at law, meaning that the contract is void and unenforceable. There is some case law which has found that in appropriate circumstances, the individuals who purported to enter into contracts, such as leases, as representatives of an association, were themselves directly and personally liable for the obligations under the contract. In other words, the Courts have found that notwithstanding that an association is not a separate legal entity, the individual persons who purported to enter into contractual obligations on behalf of the association were, themselves, directly liable for the contract.

7.2.12 Partnerships as tenant

It is quite common to encounter partnerships in the office, retail or industrial leasing context. Typically, it is the tenant rather than the landlord which is the partnership. There are two basic forms of partnership in common use today, the first being the general partnership and the second being the limited partnership. Business partnerships such as law firms and accounting firms may be general partnerships, with the consequence that each partner of the partnership is jointly and severally liable for all of the partnership's debts and obligations. These debts and obligations, of course, include any obligations of the partnership under any lease which it may have entered into. What this means, is that every lawyer in a law firm or every accountant in an accounting firm structured as a partnership (and not a limited liability corporation) is personally liable for all of the lease obligations, including the entire amount of rent payable. Obviously, this can expose each individual partner in such firms to far more financial liability than a partner could possibly be expected to be capable of answering for personally. In order to limit the liability of the individual partners, most partnerships seek to enter into leases through the interposition of a "management" company, which is owned by the partnership. This obviously raises certain issues of covenant strength, as the "management" company may have few assets beyond the lease.

Limited partnerships are special animals and are formed under the provisions of the applicable provincial legislation. Limited partnerships are different from general partnerships in that the limited partners of a limited partnership have no active duties or obligations in connection with the operation of the business undertaken by the partnership. That is, they are supposed to be strictly passive investors in the partnership business. As a consequence, limited partners are given limited liability, much in the same fashion as shareholders of a corporation have limited liability. Therefore, each limited partner is liable only to the extent of the amount of capital contributed by the partner to the partnership.

7.2.13 Corporations as tenant

The corporation is, of course, by far the most commonly encountered form of entity, both as a landlord and as a tenant. Corporations incorporated under the federal or provincial law statutes are the norm, and are generally well understood by those involved in office, retail and industrial leasing. The essence of corporations is that the shareholders have no personal liability for the obligations of the corporation. Except in the rarest of circumstances, the officers and directors of corporations are also exempt from personal liability for a corporation's obligations. Generally speaking, corporations incorporated under the federal or various provincial Acts, have all of the capacity, rights and powers of a natural person, and may thus freely enter into leases. Accordingly, it is safe for those doing business with such corporations to assume that they have the capacity and authority to enter into contracts such as leases. There are various other types of corporations, however, which have objects or business purposes which are limited, and in the case of any of these companies, their capacity or authority to enter into an obligation, such as a lease, may have to be examined. Examples of such corporations include nonprofit corporations such as charities, special purpose corporations such as those set up to perform a specific statutory function (such as a university), other municipal and governmental corporations, and corporations in the category of financial institutions such as banks, trust companies and insurance companies. In order to ensure that corporations in these categories have the power, capacity and authority to enter into and perform obligations under leases, it is necessary to examine the statutes which govern such corporations and to review their articles of incorporation. Clearly, if a corporation enters into a lease when doing so is beyond its powers at law, or where the entering into of such lease has not been duly authorized in accordance with the applicable statute or charter, there is a possibility that the lease obligation will be a nullity and will be unenforceable.

It may be necessary, for example, in the circumstance where a trust is signing a lease, to review the declaration of trust to ensure that the trustee has the power to enter into the lease. It may also be necessary, as noted above, particularly with respect to certain types of corporations, to review the incorporating statute or charter to ensure that the corporation has the power to enter into the lease. With respect to partnerships, it may be necessary to review the applicable partnership agreement, if there is one, to ensure that the business of the partnership contemplates the entering into of a lease.

In the case of corporations, ensure that the appropriate resolutions have been passed by the board of directors of the corporation. There is a convenient rule of law known as the "indoor management rule" which generally offers protection to third parties who enter into contracts with corporations governed by the provincial or federal legislation and which provides that, unless they have knowledge to the contrary, such parties are entitled to assume that the necessary authority has been obtained, with the result that the contract is binding upon the corporation whether or not, in fact, such authorization was obtained. In other cases, however, evidence of due authorization to enter into the lease obligation and of the authority of the individual signing may be necessary. In the case of partnerships, the general legal rule is that all partners should sign a lease. In certain circumstances, if the partnership agreement so provides, the lease may be signed by one or more representative partners on behalf of the partnership.

7.3 Review questions

Review questions for this section are found at the end of Section 10.

8 Leasing space in Canada: Guarantees and indemnities, letters of credit

8.1 Introduction

Prudent landlord's check the financial strength of a tenant before accepting an offer to lease or entering into a lease with them. The landlord will want to feel comfortable that the tenant will be able to meet with the financial obligations contained in the lease, particularly if the landlord must make an investment in the tenant's premises or if there are opportunity costs in going with this tenant over another tenant. Landlords may choose to review a tenant's financial statements, seek bank reference letters, undertake credit checks through credit reporting agencies, and view the tenant's business plans, or services. If the covenant does not appear to be of sufficient strength and there is an alternative or additional covenant available, such as that of a parent or related corporation or, perhaps, of individual shareholders of a corporation, one could enter into the lease directly with these entities or, alternatively, have them provide a guarantee or indemnity with respect to the obligations of the tenant. It is not unusual for landlords to provide tenants with inducements of a financial nature to persuade them to complete the lease transaction. Such inducements may take the form of cash or a leasehold improvement allowance to be paid to the tenant.

A guarantee is a promise to answer for the unpaid debt or obligation of another person. The guarantor's obligation will arise only upon the default of the person for whom he has guaranteed. In contrast, an indemnity is an agreement to accept primary and independent liability to pay a debt or perform an obligation. With an indemnity, the liability is not contingent upon default of a particular person but rather the liability arises immediately. The distinction between the two has important relevance in the context of commercial leasing. Upon the default of a tenant, a landlord holding a guarantee must first make a claim against the defaulting tenant. If the landlord is unsuccessful against the tenant, then the landlord can claim against the guarantor. For this reason, the tenant is referred to as being primarily liable and the guarantor is secondarily liable. However, if a landlord has received an indemnification, the landlord can claim directly against the indemnitor, as he has undertaken an independent obligation. By holding an indemnity, the landlord is in a stronger position than by holding a guarantee.

8.2 Personal property security

If a tenant's covenants is weak, but the tenant has valuable chattels it intends to locate the premises, a landlord may choose to take personal property security against those chattels. This is necessary because real estate security (i.e. a mortgage) only extends to land and building and fixtures appended to the land or building. Moveable chattels are not regarded a fixtures. Accordingly, a landlord may seek personal property security against chattels where a part of an allowance is going towards moveable objects. This is sometimes the case in restaurant leases, where a landlord allowance is to be used by a tenant to buy cooking equipment, furniture and utensils. If the landlord has taken a security interest in the tenant's personal property, the landlord needs to register a financing statement under the provincial personal property security legislation, indicating that the lease contains a security agreement. The registration of the financing statement is crucial because, in the event of default, it is only by registration that the landlord will have priority over subsequent creditors in the collateral, and in the event of the bankruptcy of the

tenant, the landlord will be a secured creditor under the bankruptcy statute. If the landlord did not register the financing statement, it would not have priority over other creditors who had obtained and registered their security in the same collateral. The landlord would only be a preferred creditor, in Canada, and get paid only if there were sufficient funds remaining after the secured creditors were paid and if the Trustee in Bankruptcy did not elect to disclaim the lease.

8.3 Set-off

A landlord's form of commercial lease may provide that rent is payable by the tenant without abatement, deduction or set-off. The tenant must then pay its rent regardless of whether it has any claim against the landlord for an amount which may be owing by the landlord to the tenant, or for claims based on the landlord's breach of covenant. Where a landlord has entered into a lease takeover arrangement (whereby the landlord agrees with the tenant to pay the tenant's rent at an existing leased location in consideration of the tenant entering into a new lease with the landlord) if the landlord fails to pay the rent at the former leased premises, the tenant may negotiate for the right to set-off against the rent owing to the landlord at the new location.

8.4 Letters of credit from a tenant as security

Tenants may be asked to provide letters of credit which may be called upon by the landlord in the event that the landlord or tenant, as the case may be, fails to make some agreed payment to the other. Through this device, a tenant may be able to secure the payment to it of a leasehold improvement allowance or other cash inducement which a landlord has agreed to pay to the tenant. Conversely, a landlord may be able to secure the payment, by the tenant, of rent under its lease, which rent the landlord must be certain it will receive in order to compensate the landlord for the cash inducements or leasehold improvement allowances it has paid, or to simply give the landlord security for non-payment of rent, generally. Many high-tech start-ups were required to post letters of credit for rent.

8.5 Leased space description and boundaries

There can be considerable confusion as to the boundaries or limits of the leased premises, as to what physical features of the building are included within such premises, and as to the rentable and actual area of the leased premises as measured by the conventional standard of square feet. Which party, the landlord or the tenant, is responsible for maintenance and repair? The tenant will not want to maintain or repair any portion of the building structure or the mechanical or electrical systems which serve the building as a whole. Accordingly, leased premises in most office, retail or industrial leases will exclude the building's structure and building systems which do not exclusively serve the tenant, even if they are located within the boundaries of the premises as described in the lease document. The boundaries typically extend from the inside surface of exterior structural walls, to the mid-point of interior demising walls and partitions: and from the bottom surface of the floor above or a suspended ceiling, and from the upper surface of the structural subfloor.

8.6 Measurement and proportionate share calculation

The square footage measured usually forms the basis for the calculation of the amount of basic or minimum or net rent payable by the tenant (i.e. the rent is typically determined on a square footage or square meter basis). In addition, the method of measurement of rentable area will be of

critical importance, both with respect to the leased premises and with respect to the leasable area of the building, in establishing the definition of "proportionate share" for the purposes of determining a proportion of the operating costs and taxes for the building to be paid by each tenant. The rentable area for these purposes is not the same as the area of the premises for the purpose of describing the boundaries.

Of standards for the measurement of space one often uses, the most common is the American National Standard ANSI 265.1 - 1990 or 1996 "BOMA" (Building Owners and Managers Association) standard. It is important to examine the language of the lease to ensure that the method of measurement set out is fair. Some tenants may pay less per square foot for their proportionate share because the method of measurement for one floor is different than for another.

Particularly for the purpose of measuring office buildings, it is common to distinguish between "usable area" and "rentable" or ‘leasable area". The usable area is the actual floor space being occupied by the tenant. This information enables a tenant to allocate the space required among its personnel and furniture. The usable area is then converted into the rentable area by the use of a conversion factor called a "gross up" factor. Typically, the conversion or gross up factor is between 10%-15%. This rentable area measures the tenant’s pro rata portion of the entire office floor including corridors, washrooms, telephone and mechanical rooms and other similar areas but excluding any major vertical penetrations such as elevator shafts. Rentable Area is generally used to calculate the tenant’s rent and proportionate share of expenses.

It is common to exclude the area of the main floor lobby from the gross-up of rentable or leasable area on upper floors, on the basis that the lobby benefits all of the tenants of a building and not only those tenants on the ground floor. However, the BOMA 1996 standard (above) attempts to do just that.

8.7 Measurement and inducement calculation

The landlord may agree to pay a cash allowance based upon the Rentable Area of the premises, as the cash allowance is usually a function of the total amount of rent which the tenant is to pay over the term of the lease which is, in turn, usually, a function of the rentable area of the premises. In the case of a leasehold improvement allowance, however, where the amount being paid is intended to represent an estimation of the actual cost to the tenant to construct its leasehold improvements and otherwise fixture its premises, it is more common to see such allowance calculated on the basis of the expected total cost.

8.8 Landlord’s and tenant’s work in new space

It is important for landlords and tenants to be clear as to who will do what if a tenant is leasing space that is not been occupied before, such as in a new building. There is obviously a range of conditions in which the space could be turned over to the tenant from their concrete on the exterior walls, ceiling and floor, to lighting and ceiling grids, all dry-walling and partitioning, and carpet throughout. It is important in offer to lease and leases that the parties clearly establish who does what work and by what point in time to avoid problems and disputes, and to ensure that the risk of delay of commencement of the term in minimized. In addition, where tenants undertake a significant portion of work in building, landlords will often want to exercise a significant degree of control over those tenant plans.

Landlords should require quite detailed plans and specifications with respect to the tenant's proposed work, prior to giving approval. Often the landlord will insist upon certain work, such as work which affects the HVAC system, plumbing and electrical systems being done by the landlord's chosen contractors. The landlord wants the work to be done in a manner which is consistent with the design specifications of the building and its systems, which will not interfere with the ongoing operation and maintenance of the building or the availability of the services and facilities in the building and which will not cause increased maintenance costs.

Landlords will also want to be sure, if tenants are undertaking work in the premises, that they do so only within a specified time period, to avoid the problems of contractor overlap. Accordingly, a tenant "fixturing period" is often provided for in a lease of new space to allow the tenant's contractors (or the landlord's contractors doing work as per the tenant's specification) access to the premises without interference with contractors still undertaking "base building" work. Landlords will also want to specify the expected completion date of tenant's work which, in turn, will trigger the commence date of the lease typically. Landlord's who also want to be sure that any tenant contractors do not have the ability to maintain construction liens against the premises or the building in case the tenant does not pay those contractors. In such cases the lease will also provide that it is the tenants responsibility to remove from title those liens as soon as they are registered at the tenants expense failing which the lease will be able to be terminated by the landlord. The offer to lease and lease should also clearly set out the rules for the tenants contractors use of elevators, garbage removal and other building services during the fixturing period and will often require that the tenant pay the landlord a supervision fee for making sure that the tenant carries out its work in accordance with the above-noted and similar types of lease.

8.9 Landlord's and tenant's work in previously occupied space

In addition to the foregoing provisions applicable to new space, previously occupied space raises some additional issues. It is often not clear what internal systems and wiring have been left behind by the previous tenant, such as computer wiring networks and telephone networks. In addition, it is not always clear when partitioning is up in older space whether the walls behind the partitioning, if any, are load bearing or can be moved. Furthermore, re-partitioning often has to take into account the location of ventilation ducts and other mechanical features of the space. Many re-partitioned offices you will notice may have partition walls that "split" an air diffuser. Still other re-partitioning exercises may create rooms without ventilation. Landlord and tenant will need to work together to ensure that the tenant's plans for previously occupied space take into account all existing building systems, structural features and walls and also valuable amenities and systems that may have been left behind by the previous tenants.

8.10 Rights of first refusal and rights of first offer

Another devise often requested by a tenant to facilitate the expansion of its business in the future are rights of first refusal and rights of first offer. A right of first refusal on space that is vacant either at the lease commencement date or at a specified point in time in the future allows the tenant to match the terms of any third party offer that the landlord receives for those premises. The tenant's rights is not crystallized until a bona fide third party offer is received presumably on market terms and conditions. In a right of first refusal, the tenant literally has the right to demand that its name be interposed in place of the third party tenant. A variation of this theme is that the third party offer can be matched by the tenant as to rent, but all other terms and conditions would

be those of the tenant's current lease. Landlords generally dislike rights of first refusal since third party tenants who are aware that their offer to lease will be shown to an existing tenant and, indeed, the existing tenant may take the premises, will be disincented from making the offer to lease in the first place. Third party tenants may be choosing amongst several competing buildings for space and they may prefer to negotiate directly with the landlord who can make the deal rather than make the deal with a landlord who can only make the deal if one of its tenants does not exercise the right of first refusal.

A right of first offer, on the other hand, attempts to deal with the problem for the landlord raised by the right of first refusal described above by requiring the tenant and the landlord to first negotiate rental terms and conditions for available space within the building or specified space adjacent to the tenant's current premises before the landlord can offer it out in the market. The benefit of this approach is that, while requiring the landlord and tenant to negotiate for a specified period of time, allows the landlord, if that tenant is not interested, to go out to the market and enables the landlord to lease those premises to any other tenant without having to come back to the original tenant, as long as the rent negotiated with that arm's length third party tenant is not significantly discounted to the rent that the landlord was prepared to lease it to the original tenant. Typically, this percentage is somewhere between 90 to 97%. In other words, if the landlord has offered to lease available adjacent space to a current tenant in the building at $20 per square foot of rentable area on a net rent basis, but the current tenant refuses to lease at those rates, then the landlord is free to go and lease it in the market without having to come back again to the tenant as long as the landlord does not lease it for a rate materially less than the rate offered to the tenant. If the threshold percentage was 95%, then the landlord could not accept any rent below $19 per square foot per annum net (i.e. 95% of $20). If the threshold level was 90%, then the landlord could not accept any offer from the market at less than $18 without again going back to the current tenant.

A right of first refusal does not run with the land and accordingly, the right of first refusal must be specifically renewed in a lease renewal and specifically assigned in an assignment of lease or sublease. In the case of the tenant registering notice of lease, a right of first refusal should also be included in a notice of lease.

8.11 Relocation of tenants at landlord's sption

Many leases contain relocation clauses permitting landlord rights to relocate smaller tenants to premises elsewhere in the building at the landlord's cost. The landlord to be able to accommodate the growth expectations of larger tenants in the building from time to time. Tenants on the other hand seek to resist relocation on the basis of the interruption of their businesses that this causes, and also on the basis that space may not be directly comparable in terms of layout, amenities, view, proximity of the elevator and other such similar subjective criteria.

8.12 Net rent and gross rent

Rent is a periodic payment made by the tenant to the landlord for the use and occupation of the premises. Rent can be a single number or it can be the total of several numbers. If rent is expressed as a single number (for example $30 for a square foot of rentable area per annum), then the rent is referred to as gross rent and the lease is referred to as a gross lease. Typically in those situations the only other incremental costs payable by the tenant would be utilities consumed by it in the premises, although often this is also included in the gross rent. There are many urban areas in North America where commercial office rents are still calculated on a gross rent basis. Indeed,

some smaller tenants (such as medical, dental tenants) often negotiate for a gross rent so that they do not have the obligation to review calculations proffered by a landlord at the end of the year. Some gross leases may attempt to pass through the risk of inflation by providing that all realty taxes and operating costs as in the initial year of the term are included in the gross rent (in which case the leases are called "semi-gross" leases). However, the lease may provide that any increases over these amounts (called "base year amounts") will be paid for by the tenant by way of additional rent, if realty taxes increase by 5% in the second year of the lease, then the tenant, even though it has a gross lease, may be asked to pay its proportionate share of the realty tax increase. The same approach will be taken to any increase in operating costs caused by inflation.

However, landlords in most urban areas in North America in the past several years have "unbundled" the components of gross rent in order to ensure that any costs or expenses over which they have no control, which may rise or fall, or which may be subject to inflationary pressures, are directly passed through to the tenant. This way, landlords reduce the risk of volatility of third party costs that are typically incurred by landlords in the maintenance, operation and repair of the building and in respect of the taxation of the building and the premises in it. These "unbundled" rents are referred to as "net" rents and the leases structured this way are referred to as "net leases".

At this stage, however, the degree of "netness" of the lease leads to considerable subjectivity and the use of trade jargon. Leases may be described as "net", "net, net", or "net, net, net" (triple net) depending on which costs in the universe of possible landlord’s costs and expenditures can be passed on to the tenant. There is no standard definition of net, net net, or net net net; one must always look at the lease to determine which costs can be passed through to the tenant and which ones can not.

In net leases generally, there is a portion which is typically a defined or set amount of money which is intended to philosophically represent the return to the landlord for the use of the space and the value of the building alone. This may be referred to as the net rent, the minimum rent, or the base rent depending on which type of lease may be reviewed. The landlord's costs that are then to be directly passed through to the tenant and which are variable may then be referred to as additional rent, operating costs and taxes, common area maintenance ("CAM"), taxes, maintenance and insurance ("TMI") and combinations of the foregoing. Generally, however, these additional pass through costs generally represent the tenant's proportionate share of realty taxes and all building operating costs.

8.13 Percentage rent

Landlords of retail shopping centres may demand an additional rent category, in addition to basic rent, on their retail tenants. "Percentage Rent" is computed as a percentage of a retail tenant’s sales effected from retail leased premises. The theory behind percentage rent is that the landlord will participate in the success of the tenant, based on the favourable location of the store or shopping centre and the landlord’s efforts to maximize traffic for the store. Some retail tenants may not have any minimum rent or base rent payable; rent may strictly be percentage rent based. Some tenants may prefer this approach. Landlords prefer to have a percentage rent calculation that requires rent to be the greater of the minimum or base rent and the percentage rent. The percent that is applied in the lease will depend on the particular use or retail category represented by that retail tenant.

With Internet-based sales, a reality for many retail tenants, landlords are faced with several dilemmas. The first, the existence of the Internet and the ability to make retail sales over the Internet, may reduce the premium placed on location for certain product categories. How can a landlord suggest that it is contributing to high bookstore sales for a bookstore tenant because of the great location of a certain mall, when the same tenant may be able to dramatically grow book sales over the Internet? Furthermore, retail tenants with successful Web-based retail sales refuse to give landlord percentage rent. A second, and related issues is the extent to which percentage rent calculation can be reduced by online sales returned to a physical store. Will it be convenient for a landlord to conduct the level of audit necessary to differentiate store-based sale returns from Internet-based sale returns? Generally, there are significant negotiations between landlords and tenants as to what is included and what is excluded in the calculation of percentage rent. Tenants typically want employee discounts to be excluded, and returns to the store to be deducted from percentage rent sales. Landlords, on the other hand, do not want to create an incentive in the percentage rent clause for the tenant's manipulation of its sales techniques.

8.14 Review questions

Review questions for this section are found at the end of Section 10.

9 Leasing space in Canada: Realty tax by a landlord from a tenant

9.1 Introduction

It is the landlord who is generally liable for the payment of realty taxes to a municipality. However, the majority of office, retail and industrial leases contain clauses requiring the tenant to pay its share of realty taxes. In most provinces, realty taxes are determined by a two-step process. First, the value of the entire property is assessed by a provincial agency. Second, the realty tax is imposed and collected by the municipalities.

The assessor determines the value of the entire property by the use of one of three methods: (1) capitalizing the income stream; (2) the cost method -which is the market value of the land plus the net replacement cost of the building; or (3) direct comparison approach - comparing recent sales of similar types of property. A realty tax bill reflecting this assessment is rendered to the owner of the property (i.e.. the landlord), not to the tenants. The assessment is then apportioned amongst each separately occupied premises.

The resulting realty tax is then typically apportioned by the landlord amongst the tenants in the building based on a fraction, the numerator of which is the rentable area of the tenant's premises and the denominator of which is the rentable area of the building. Accordingly, it is the landlord who must pay the proportionate share of realty tax on vacant space. In provinces such as Ontario with a single tax bill, it is difficult, if not impossible, for the landlord to differentiate the realty tax bill on the basis of the differing value on the tenants premises. The mechanical fraction approach avoids this subjectivity. On the other hand, in mixed used projects, landlords may attempt to use different valuations, for example, amongst retail and office premises on the same property and then to allocate based on a proportionate share basis.

9.2 Recovery of capital tax

Capital tax is imposed federally in Canada and in several provinces (Ontario, Quebec, Manitoba and Saskatchewan in 2001) In the provinces, for corporations with taxable capital of less than $2 million capital tax, rates range from nominal (between nil and $500) to otherwise equal to 0.3% of the taxable paid up capital of the corporation. The taxable paid up capital is the measure of the total capital employed in the business. The tax is computed based on the corporation's financial statement and is payable regardless of whether the corporation earns income or not. Capital tax is not levied on any particular property and no appraisal of any particular property is required to be made by the province in computing capital tax.

Since 1990, landlords of some properties have been requesting capital tax be paid by tenants.

Landlords justify passing capital taxes onto tenants on the basis that the tax is a tax on the real estate generally and not the income of a landlord and accordingly is directly related to the bricks and mortar in which the tenant leases space. In this sense, capital tax is similar to a real property tax and unlike an income tax. In addition, if a tenant were to construct or purchase its premises instead of leasing them from the landlord, the tenant would be required to borrow and invest capital and therefore pay capital tax. Capital tax is also levied federally.

Landlords usually seek to include capital taxes as one of the items of operating costs, of which tenants pay their proportionate share. Some lease forms include capital taxes as part of the real property tax definition. Any clause in a lease that is intended to impose capital tax as a cost payable by the tenant, should specify a method for calculating the tax attributable to the building.

Tenants argue that capital taxes are not properly chargeable and are more in the nature of an income tax which is not a property related, even in a net lease. Tenants may also argue that since the taxable paid-up capital of a corporation is based on its financial statement, it can be affected greatly by the decisions and changes made by the landlord in connection with its general conduct of business. The tenant's obligation to pay capital tax under a lease may permit increases in the capital tax payable that has little or nothing to do with the operation of the property.

The federal government's large corporations tax is similar to the provincial capital tax and some of the same concerns set out above would apply. The tax is payable at the rate of 0.225% and applies only to taxable capital in excess of $10 million. The $10 million deduction is to be apportioned among related corporations at the discretion of the tax paying corporation. Tenants should obtain the landlord's agreement to compute capital tax on the basis of some kind of equitable apportionment of the deduction among the landlord's properties, based on the capital attributable to the property in relation to the total taxable capital of the landlord and its related corporate entitles. In this way a landlord would be defeated from allocating a greater capital deduction to a property where the tenants were not required to pay any amount in respect of capital tax.

9.3 Estimating tax and operating cost recoveries

Landlords generally resist committing to future estimates of realty taxes or operating costs, since they are subject to change and some unforeseen costs where inflationary pressures could arise. Tenants, on the other hand, are seeking to budget their occupancy costs as tightly as possible and want to be able to predict with reasonable certainty any growth in those occupancy costs during the term of the lease. Particularly, tenants may be concerned that a landlord's estimates of expected realty tax and operating costs may have been deliberately underestimated in order to attract a tenant to lease premises. Accordingly, to avoid those situations, tenants may aggressively seek a firmer and binding estimate of expected realty taxes or operating costs at least for the initial year or two of the lease term. In addition, tenants may seek to allocate some of the risk of inflation in realty taxes and operating costs by putting a limit on the percentage increase that can occur in those recoverable costs.

9.3.1 Drafting operating costs

Landlords will want to be able to recharge tenants appropriate generic costs pertaining to the building. Accordingly, a landlord's typical standard lease form will typically contain a list of potential costs that may be charged back to the tenant as an operating cost recovery. Landlords will resist any changes to this exhaustive list. Landlords typically argue that changes impact on their financial return, restrict their flexibility in operating and managing the development and create an administrative nightmare for the landlord. In addition, if too many changes are made, the landlord's property managers or auditors will have to create customized statements for operating costs for different tenants and this will result in additional costs being incurred which would have to be passed on to all tenants as part of operating costs.

A tenant may attempt to negotiate an amendment to a lease providing that the landlord acknowledges that (1) all of the costs specifically enumerated in the definition of operating costs are intended to be exhaustive, (2) items of costs that do not fall within the express wording of the lease are to be excluded and (3) any costs associated with the administration of the lease, or the landlord and tenant relationship, will be excluded except where expressly stated in the lease. However, the likelihood of success in this regard may be marginal. A tenant is more likely to succeed in having certain types of costs specifically excluded from the definition of operating costs or succeed under one of the next sub-headings.

9.3.2 Recovery of landlord capital costs

Operating Costs in most commercial leases includes capital costs. From an accounting point of view, capital costs are those costs which cannot be expensed in a year but which must be "capitalized" and a portion of that capitalized cost only can be expensed in any given year. The rules governing when costs can be fully expensed in a year and when costs have to be capitalized and amortized are generally the subject of Generally Accepted Accounting Principles. In Canada, Generally Accepted Accounting Principles are contained in the handbook of the Canadian Institute of Chartered Accountants and, in more detailed form, in the REALpac Accounting Practices Handbook titled “Recommended Accounting Practices for Real Estate Investment and Development Companies” (capital costs are essentially amounts expended to acquire or replace, add to, or make a major repair of the equipment, buildings or improvements forming part of a property). Because a capital expenditure produces an asset of long lasting value, the cost is usually spread out over the expected useful life of the asset.

Tenants may argue that basic or net rent should to cover the costs of acquiring and constructing the building, as well as the cost of major repairs and the replacement of major components of the building. A tenant may argue that any attempt to pass on to it a capital cost is a duplication of cost, akin to charging double rent. This argument lacks some merit as, even if the landlord could accurately predict the capital expenditures that would be required to be made over the term of the lease, the rent payable by a tenant is governed by the market place, rather than an analysis of capital costs and projected capital costs for the building.

Landlords generally take the position that the current portion of certain capital costs such as (1) the original cost of heating, ventilating and air conditioning machinery or energy conservation systems, (2) the cost of capital improvements that will result in an operating cost savings or would provide greater comfort to tenants and customers and (3) renovations to the common areas and facilities, should be included, in the form of depreciation, as operating costs, of which the tenants pay their proportionate share as additional rent under the lease. Landlords often also take the position that the cost of major repairs and the capital costs of replacements (including, for example, the cost of replacing a roof or repaving a parking facility) should also be included in operating costs, either as a charge falling due in the year in which the expenditure is made, or in the form of depreciation or amortization. Landlords argue that because these types of systems and equipment require periodic replacement, and to avoid the entire cost being charged fully in the year in which it is incurred, depreciation or amortization of this type of expenditure should be charged as an operating cost. Interest is also charged on the undepreciated or unamortized balance of the cost. The interest charges are meant to reimburse the landlord for the costs of funds which it has expended and made available to the tenants. The rate of interest is the rate of interest that would be charged to a typical borrower for the purpose of acquiring such items, rather than the rate of interest at which the landlord borrows funds. The landlord regards itself as a kind of bank

and charges a rate which is usually equal to at least two percent over the prime rate of interest charged by a referenced chartered bank.

Resisting the inclusion of capital costs as legitimate operating costs in a net lease may also prove counter-productive to the tenants use and enjoyment of the space. A landlord, unable to pass through capital costs for major repairs and replacements to a tenant may be incented to keep older and more inefficient equipment running so as to ensure the recoverability of the cost rather than replacing it with more modern equipment that would make the building operate better. In addition, the tenant may determine over time that the building is degrading since the landlord is not incented to make major investments in the building.

Landlords also argue in support of including capital costs in operating costs, that if the landlord were not to purchase the item, it would lease it and the cost of leasing would be included in operating costs. The ultimate cost to the tenant is, therefore, not that different if the landlord leases the equipment rather than purchasing it.

In keeping with the movement of tenants to control additional rent, a tenant may get some sympathy from a landlord to exclude the original capital cost of equipment and systems (for example HVAC systems) from operating costs. In other words, although the life expectancy of an HVAC system is shorter than the life expectancy of "bricks and mortar", all original costs of developing the property may be excluded from being charged back to the tenant. The tenant would be responsible for paying for the depreciation of the HVAC system once it is replaced and would then pay interest on the undepreciated portion of the capital cost. In this manner, a landlord cannot build a "slush fund" or a reserve for future expenditures.

It is in a tenant’s best interest, that when a capital expenditure is made which is included in operating costs, the cost be depreciated over the useful life of the asset for a period as long as possible and on a method of depreciation which is not an accelerated method of depreciation (i.e., resulting in higher depreciation charges during the earlier years of an asset’s life). If the full amount of a capital cost is charged in the year the cost is incurred, instead of depreciating or amortizing the cost, this would be inequitable to a tenant in the last years of its term, as it would be unable to benefit from the cost of the expenditure. Moreover, a landlord could elect not to use a generally accepted accounting method of depreciation or amortization. Although landlords prefer to have as much flexibility as possible to even out operating costs from year to year, this could result in a greater burden being placed on a tenant’s shoulders.

Tenants will object to being required to pay the costs of any capital improvements to a building necessitated as the result of an expansion, renovation or modification. Landlords and tenants should consider a compromise where all capital costs relating to new improvements are excluded from operating costs, other than those that reduce operating costs (such as energy conservation equipment, security systems that reduce vandalism or permit the reduction of security staff, or the installation of maintenance-free finishes in the common areas).

9.3.3 Operating cost exclusion

If a landlord wishes to pass on a particular cost, it should be expressly set out in the lease.

Tenants often request that the cost of repairing structural defects or weaknesses or any work, repairs or replacements as a result of faulty design, construction or workmanship be excluded from operating costs and borne by the landlord. Landlords argue that they should not have to take

the risk for any errors made by architects and contractors, no owner can control every aspect of the design and construction of a project, and to make the landlord responsible, is in effect to make the landlord the guarantor of the work for the term of the lease which would exceed the length of any normal construction warranty, and it would put the tenant in a better position than if it owned the property.

The benefit of any warranties could be passed along to the tenants of the development and any structural defects could be excluded from operating costs.

9.3.4 Administration fees

A tenant may request the right to audit the landlord's records with respect to the calculation of operating costs and have the right to receive a detailed operating cost statement and the right to request receipt of specific invoices in connection with operating costs.

Tenants should consider listing a number of items which should not be included in operating costs. Some possible exclusions are costs arising from the negligence of the landlord, the costs of enforcing other tenant's leases, the costs of leasing space (including inducements paid and leasing commissions), any fines or penalties that the landlord incurs in connection with any failure to perform obligations, such as late payment of realty taxes, the costs of original construction of the building, adding new improvements to the building and repairing other tenant's premises, landlord's mortgage payments or ground rentals, advertising costs, and costs associated with surplus lands which the landlord retains as part of the building for future expansion purposes.

In addition, certain deductions from operating costs are routinely negotiated, including recoveries from contractors' warranties, insurance proceeds, and recoveries that reduce operating expenses received by the landlord from defaulting tenants.

In addition, the tenant should require the landlord to deduct from operating costs various items of revenue which it receives in the operation of the property such as parking facility revenue, licence fees in connection with temporary uses of the parking facility, amounts collected from third parties in connection with costs included under operating costs and any amounts contributed towards operating costs by tenants (such as day care centres) whose spaces are excluded from the denominator of the fraction that determines the tenant's share of operating costs.

The leasing of space for telecommunications service providers in buildings may also open up new areas for potential abuse to the extent landlord receives income from telecommunications service providers by way of access fees or rent for premises, that charges the operating costs in respect of same as a building costs.

9.3.5 Full occupation gross up

Where an office building is only partially occupied the lease will usually provide the landlord with the right to increase ("gross up") operating costs, to the amount that the landlord estimates would have been incurred if the building had been fully occupied. Although this appears unfair at first blush, if the specific items of operating costs gross up are proper, the concept is not unfair. For example, if the tenant were the only tenant in the commercial building (which has substantial vacant space), it would be unfair for the tenant to pay only its proportionate share of the janitorial cost, as the janitorial costs incurred for the building relate primarily to the tenant's premises. In

this case, the grossing-up of the janitorial services to an amount that equals the total for a fully occupied building (to which the tenant's proportionate share will subsequently be applied) is a mathematical means of bringing about a fair result. On the other hand, the grossing-up of property insurance in the building or liability insurance would not be fair because those costs are not specific to the occupancy of any specific tenant. Consequently, where a lease provides for the grossing-up of operating costs when the building is not fully occupied, each item of costs should be carefully considered by the tenant to ensure that an equitable result is achieved.

9.3.6 Tenant contraction and early termination rights

Tenants who are in businesses with their space needs are difficult to predict and tenants who perceive that they have bargaining power perhaps in times of high vacancy may negotiate for specific early rights of termination of the entire lease, or may negotiate for rights to reduce the space they occupy and pay rent on throughout the term (tenant "space puts"). The advantage to the tenant in having rights of termination and space puts is that it gives it self flexibility to deal with business downturns or out sourcing throughout the lease term. On the other hand, the existence of early termination rights and space puts will render that portion of the projected income stream for the rental to be contingent to the landlord. This, in turn, may reduce the landlord's ability to obtain financing as it will reduce, potentially, the amount of income, assuming no difficult to the tenant covenant, that the landlord can necessarily expect to receive in respect of the lease from the tenant. As a result, many landlord will either refuse to grant early termination or space puts or, if so, will try to extract some kind of a financial penalty if the tenant chooses one of these options. The financial penalty will be designed from the landlord's point of view to give it equivalent income either to the end of the term or during a reasonable period of time which it expects it may take before it can effectively release the premises.

The following are some negotiating points for both landlords and tenants in respect of tenant early termination rights and space puts:

For Tenants	**For Landlords**
1. Start off offering a shorter lease term, so as to offer to extend the initial fixed lease term with cancellation right and minimize "loss" landlord will claim it will suffer. Argue landlord is not better off compared to the short term tenant was initially offering. Alternatively, tie right to terminate or put to entire package and resist efforts by landlord to separate it out and cost it.	1. It may be financially more advantageous (depending on, inter alia, rental rate escalations, commissions, and present value interest rate for inducements) for landlords to negotiate for a longer initial fixed term subject to cancellation penalties than shorter terms with rights of renewal, since there is no payment for failure to exercise a renewal, but the cancellation penalty could be substantial. Be sure to cost out termination and put rights; always get unamortized costs (commissions, T1's etc.) since these are not "penalties" but losses.
2. Consider depreciation of tenant funded leaseholds and impact of early termination on unamortized costs - is it better to structure the deal with	2. Consider lending criteria; how do local lenders view and price termination provisions, and how is project financeability, saleability impacted by

several renewals before the cancellation right so as to fully deduct leaseholds and other associated capitalized costs earlier in the process and avoid a windfall capital loss that may not be useable in a particular year?	rights of early termination? Match lenders' requirements with tenant requirements if possible (i.e. for security or additional covenant). If termination/put penalty is formula based, negotiate for low discount rate (reinvestment rate).
3. Link rights of early termination with major business events, such as the end of a major supply contract, change of government, completion of a major project; consider having several possible termination dates with renegotiated cancellation fees so as to have "exits" if necessary.	3. Limit early termination events to one if possible: try to tie termination or put right to actual business situation (i.e. loss of major contract); consider impact of early termination on desire to mix lease maturity dates (uniform rollovers) in commercial project.
4. Create "put" rights of blocks of space so as to deal with major downsizing/recessions in your industry and again prenegotiate the downsizing penalties/exit costs.	4. Ensure strong restoration/maintenance and repair covenants in lease so as to be sure of condition of premises upon early termination.
5. Provide for as little notice as possible; say 30 days given at any time within the last year.	5. Provide for as much notice as possible, say 1 year in advance within a narrow 30 day window.
6. Do not link termination payment to notice.	6. Require termination or penalty cheque to accompany notice for it to be valid.
7. Provide for the assignability of put and cancellation rights pro rata; try to limit conditions landlord puts on right to put/terminate.	7. Limit the assignability of put and cancellation rights altogether or provide a minimum space occupied requirement. Eliminate right if expansion option exercised.
8. Avoid posting security for termination penalty since its covenant risk the landlord would bear anyway if the termination right was not exercised. (Depends on the amount of up front inducements amortized and deferred rent bumps). If early termination/put fee is formula based, negotiate for high discount rate (reinvestment rate).	8. If potential lease termination penalty high, consider asking for security and/or guarantees to ensure fee actually payable (depends on the amount of up front inducements amortized and deferred rent bumps).
9. If rents are perceived to be "low" and expected to rise, lock in the long term with rights of early termination and puts, since it is the low rent only that is being provided for the purposes of the exit/put costs.	9. Get the right to relocate a tenant who puts space back to the landlord.
10. If rents are perceived to be high	10. Constrain termination and put rights

and expected to drop, stay short with rights of renewal at market.	to situations in which lease singed, tenant's lease in good standing, lease never been in default, security for termination/put fee posted with notice or paid in full with notice, pre-termination/put inspection and rectification of maintenance and occupancy standards deficiencies; restorations completed if required and monies posted prior to vacancy to allow for cost of restoration plus rent for the time space tied up doing the restoration. For puts of space, eliminate special signage rights, and reduce storage and parking entitlements. 11. The opposite of tenant's #7 and 8.

9.4 Review questions

Review questions for this section are found at the end of Section 10.

10 Leasing space in Canada: Assignment, sublet and lease takeover provisions

10.1 Introduction

Tenants have rights to assign and sublet at common law, by statute and, typically, under the lease document itself. The common law right to assign goes back to at least 1798 and provides tenants flexibility in case their needs change. In addition, provincial legislation regulating landlord and tenant relations, typically provides that unless a lease expressly states otherwise, a clause requiring consent to assign the lease or sublet the premises is deemed to provide that the consent is not to be unreasonably withheld. Commercial leases can prohibit assignment or subletting.

An assignment operates to break the "privity of estate" between the assignor and the original landlord. However, an assignor is still liable under contract to the landlord, even though the assignee is now in occupation under the lease. The general rule about assignees is that since they are not a party to the original contract between the lessor and the lessee, they are only liable because of privity of estate and are bound to perform only those covenants that run with the land and then, only so long as the privity of estate exists. A covenant is a promise that is written into the deed or another instrument, agreeing to the performance or nonperformance of certain acts or requiring or preventing certain uses of the property. A covenant is said to run with the land when either the liability to perform it or the right to take advantage of it passes to the assignee of the tenant. Accordingly, most landlords require an assignee to execute an agreement whereby the assignee agrees to be bound by all of the terms and conditions of the lease.

The right to assign, in other words, is an incident of the estate in land. A covenant not to assign without the consent of the landlord, is one which runs with the land and binds any assignee of the lease. The covenant not to assign without the landlord's consent is not broken by an assignment taking place by operation of law, such as on a bankruptcy, unless the lease expressly includes that case. In a situation where the lease contains a covenant by the tenant not to assign or sublet without the consent of the landlord, there is implied by statute, unless there is an express provision to the contrary, a proviso that the consent is not to be unreasonably withheld. A delay can be construed as a "withholding" in certain circumstances.

There does appear to be some relationship between the reasonableness of the consent and the quantum of the rent at issue, since courts may be more willing to relieve the tenant of onerous rent by permitting assignment and subletting. Mere dislike of the assignee is not a reasonable ground. On the other hand, the tenant must permit the landlord time to investigate the references as to the character and responsibility of a proposed assignee or subtenant. The fact that the proposed subtenant does not intend to occupy the demised premises, may be a valid reason for the landlord's refusal to consent. This may bear directly on lease takeover situations. In these cases, fear of vandalism and increased insurance, and difficulty renting adjoining premises may be sufficient grounds for the refusal. The landlord cannot prefer its own interests in considering whether to grant consent. In other words, where a landlord desires to regain possession for itself before the end of the term and intends to refuse to consent in order to coerce the tenant into surrendering the lease, the landlord will be found to have acted unreasonably.

If the landlord has unreasonably refused to consent, the tenant does not necessarily have an action in damages or even the right to repudiate the lease. However, a tenant does have the right to complete the assignment or sublet or to refer the matter to a judge for an order permitting the assignment or sublease to be made. In these cases, the burden is on the tenant to prove that the consent was unreasonably withheld. A breach of the covenant not to assign or sublet without leave may entitle the landlord to nominal damages but not, it seems at least as a rule, to more than nominal damages.

There are many variations possible in drafting of an assignment clause in a commercial lease. Some of these are:

- permitting "as of right" assignments to any affiliate of the tenant as that term is defined in the relevant provincial statute governing business corporations;
- listing the criteria that will be used by the landlord to determine whether to permit an assignment or a sublet;
- prohibiting any assignment or sublet during an early period of the lease (i.e. the first four years) or only permitting it as long as a certain "means" test is met for either the existing or the proposed tenant;
- requiring a long notice period of a request to assign or sublet of six months or more; and
- giving the landlord certain rights upon a request to assign or sublet including:
    - the right to terminate the lease in lieu of consenting to the assignment or sublet;
    - the right to step into the shoes of the tenant and become the landlord of the subtenant;
    - the right to receive any increase in rent obtained by the tenant on the assignment or sublet; and
    - the right to prevent any interest which does not run with the land from being assigned or sublet to the subtenant.

Examples of this latter point may include extra parking rights, extra rights to storage, extra rights to signage or dish antenna, exclusivity clauses, right of first refusal and options, and other such rights deemed to be unique inducements given to the original tenant alone.

Landlords typically demand a direct agreement with the assignee or sublessee, so that the landlord has privity of covenant as well as privity of estate against the assignee. In cases where there are guarantors or indemnitors to the lease, these should be made a party to any consent agreement, especially if it has the effect of modifying or deleting personal rights given to the original tenant.

While a solicitor for the landlord will provide for the most of the foregoing, the solicitor's hands are often tied if the agreement to lease is negotiated without consulting the solicitor and it does not provide for the some of the foregoing provisions. It is often difficult for a landlord's solicitor to subsequently negotiate many or all of these provisions into the lease document, when the tenant's solicitor may take the position the provisions are not customary in a lease and accordingly, they cannot be insisted upon at this stage of the negotiations. Accordingly, lawyers who only see the transaction at the lease stage often thank the diligent agent who has thought enough of the foregoing provisions to insert them in the agreement to lease.

Where a tenant may be a shell or holding corporation, a landlord does not want to permit indirectly (i.e., a change in control of the holding corporation) that which the tenant cannot do directly (assign without consent). In these cases, it is not uncommon for the landlord to insist on a "change of control" clause to be inserted in the lease, requiring a tenant to seek the landlord's consent in the event that a change in control is sought for the tenant which is a shell or holding company. "Control" is usually defined by reference to voting shares. Tenants, in turn, may resist these clauses to the extent that it constrains them in selling a business as a going concern. In the commercial lease situation, landlords typically prevail. On the other hand, the existence of a change of control clause in a lease may not help the landlord unless the landlord can compel the delivery of financial and shareholder information say, annually, and is prepared to go to the trouble of monitoring a tenant's shareholders during the term of the lease. Few landlords, follow up with the tenant with this level of detail. Indeed, there may be tenancies in the greater Toronto area that have change of control clauses in the leases, but where a change of control has in fact occurred. In these cases, landlords may have no way of knowing.

Comparison of Methods: Lease Takeovers

Indicia	**Assignment**	**Subletting**	**Rent Indemnity**
Liability for Rent	Assignor (original tenant) and Assignee (new tenant)	Only sub-landlord (original tenant)	Only original tenant
Consent Required from Original Landlord	Yes	Yes	No (unless occupancy covenant)
Distress Remedy Available on New Tenant	Yes	No (provided subtenant has paid all its rent)	N/A
Risk of Forfeiture of Head Lease	No	Yes; Risk on Subtenant	No
Preferred By	Old landlord, tenant	Tenant	New landlord
Time and Expense	High	High	Low

10.2 Landlord liability and indemnity to tenant

Most commercial leases should provide that the landlord has no obligation to indemnify the tenant for various types of damage or injury, even where the damage or injury is the result of the negligence of the landlord or its employees. There is often a lengthy argument as to whether the landlord should be liable for its own negligence or wrongful acts. Often, the parties will compromise on language such as "wrongful willful act or gross negligence". While it is reasonable to expect the landlord to argue that it seeks to limit its liability in order to reduce the insurance which it must carry on the building (which is being paid for by all the tenants), there are nevertheless some limits to this concept and these very often involve some careful negotiation and attention on the part of both parties. On the other hand, tenants may argue that the tenant's out right liability to the landlord is unfair given the landlord's limited liability to the tenant in similar circumstances. Tenants may argue that landlords can insure themselves against these typical liabilities not otherwise a breach of the lease and that it should do so to the greatest extent possible, since that insurance coverage is, in turn, paid for by tenant in a net lease situation.

10.3 Tenant liability and indemnity to landlord

Commercial leases typically contain a provision whereby the tenant agrees to indemnify the landlord for any damage or injury which may be caused by the tenant or anyone who enters the building or the leased premises to do business with the tenant. This has the effect of shifting squarely onto the tenant's shoulders, the necessity for maintaining sufficient insurance to cover this potential liability. Accordingly, leases may provide that the landlord is not responsible or liable to the tenant in the case of any interruption in the tenant's as a result of fluctuations in temperature, failure of any major mechanical equipment, lack of adequate heating, ventilation and air conditioning, failure of the end of elevators to operate, interruption in power to the building or other such similar events otherwise and accident. Typically, the landlord will obligate itself to diligent seek to cure any such problems within a reasonable period of time. With the possibility of the landlord acquiring in building telephone wire and being involved in the provision of telecommunications services, prudent landlords should also amend leases to provide the same limited liability protection in the event of any interruption in telephone service, including local exchange services, long distance, data interchange, Internet and wireless transmission.

10.4 Waiver of subrogation

The right of subrogation is the right of an insurer, who has compensated an insured party for an injury or damages which it has suffered at the hands of another party, to "step into the shoes" of the insured party and to take over the right of action which the insured party has against the party whose action or negligence caused the injury or damages in the first place. In the landlord and tenant situation, a right of subrogation arises where the landlord's insurer pays insurance monies to the landlord as compensation for damage or injury accidentally caused by a tenant, and then turns around and sues the tenant to recover the amount paid out to the landlord. From the tenant's point of view, this is a highly unfair situation in a net lease context, since the tenant has been paying for the that insurance protection for which it is now being sued. One way to avoid this situation is to obtain from the insurer something called a "waiver of subrogation". Insurers in these circumstances may agree, if requested, to provide an endorsement to the insurance policy whereby they waive their rights of subrogation, usually without any penalty or increase in the insurance premium as against a tenant in a net lease context. Landlords will typically agree to use their best efforts to obtain a waiver of subrogation from the insurer, but sometimes want to avoid having an absolute obligation to get such a waiver, in case the insurer won't agree to provide it.

Leases will typically require that the tenant will provide the landlord with a waiver of subrogation from the tenant's insurers, notwithstanding that the landlords don't actually contribute to the cost of the tenant's insurance. So long as such waivers can be provided at no additional cost, most tenants will accept this.

The landlord and the tenant each release one another from claims they may have against one another, to the extent that they are insured or required to be insured under the terms of the lease. Since an insurer can only exercise by subrogation any claim which its insured might have, the granting of such mutual releases effectively prevents an insurer from making any subrogated claim. In most instances, insurance policies available today will permit such releases to be granted, although this should be checked in advance. This scheme of exchanging mutual releases is also preferable insofar as it avoids the necessity for each party needing to remember to approach its insurer to obtain a waiver of subrogation when it arranges or replaces its insurance policies.

10.5 Landlord and tenant repair obligation

Most office, retail and industrial building leases set out a regime dealing with the obligations of each of the landlord and the tenant to repair in the event of damage or destruction, either to the leased premises or to other parts of the building. Essentially, the tenant is obligated to repair any damage to its premises, including its contents and leasehold improvements. The tenant will have a general obligation to maintain the premises but may negotiate for an exclusion of reasonable wear and tear. For this reason, the definition of the "premises" and its boundaries will be very important. A tenant will not want to be obligated to repair damage to the structure of the building or its systems which serve the building as a whole. The landlord is obligated to repair damage to the building structure and systems and to the common areas of the building. The landlord may obligate itself to repair damage only to the extent that it actually receives sufficient proceeds of insurance.

10.6 Termination and abatement of rent

The seriousness of damages is typically determined in lease clauses by reference to the period of time likely to be required to repair the damage or to reconstruct the building, If damage to the building is sufficiently serious the lease will often permit the landlord to elect to terminate the lease. Landlords may negotiate the right to terminate a lease where there are insufficient proceeds of insurance to reconstruct or where a mortgagee has elected to repay itself out of the proceeds of insurance, thereby leaving insufficient proceeds for repair or reconstruction. These provisions are likely to be of concern to a tenant where market rents may rise significantly during the term of the lease with the result that, if serious damage occurs, the tenant could be prematurely forced to look for new premises at higher market rents. As a practical matter, there is generally little a tenant can do about such provisions except to add that they cannot be exercised by the landlord in a capricious or arbitrary fashion and, sometimes, that the landlord will not terminate the tenant’s lease unless it also terminates the leases of the other tenants similarly affected by the damage. Landlords will usually agree that the right of termination can only be exercised in the event of truly significant damage to the building. In some cases, it is possible to negotiate to delete the right of termination where proceeds of insurance are insufficient to cover the costs of repair, on the grounds that it is the responsibility of the landlord to carry adequate insurance.

Tenants are sometimes concerned about their obligation to await the repair of the building in the event of damage or destruction. It could, quite conceivably, take six months or more to repair a building to the point where the tenant would have access to begin the repair of its leasehold improvements, etc. During this period, the tenant would be forced to seek temporary accommodation elsewhere. Sometimes tenants are able to negotiate for a right of termination on their own part, permitting the tenant to terminate the lease in the event of substantial damage or destruction of the premises or other parts of the building if the premises are thereby rendered untenantable, especially if the damage or destruction occurs in the last year or two of the lease term.

10.7 Mortgages, subordination and attornment

There are few commercial buildings which are not subject to some form of financing. Landlords include in their standard leases, language to the effect that the tenant recognizes the rights of the existing and all future mortgagees and agrees that the mortgagee’s interests in the building will have priority over any interest in the building which the tenant has under its lease. The tenant in

these circumstances is said to have agreed to "subordinate" its leasehold interest to the mortgagee's interest in the building. The lease usually provides that the tenant will, in addition, "attorn" to the mortgagee, meaning that it will recognize the mortgagee as its landlord if the mortgagee exercises default proceedings and will pay its rent directly to the mortgagee in such circumstances.

The mortgagee, however, may, upon default under the mortgage, decide that it should replace the tenant with one who will pay a higher rent. A mortgagee whose mortgage has priority over a lease, may treat the lease as not being binding upon the mortgagee and mortgagee may require the tenant to immediately vacate the premises, without notice, as soon as the mortgagee takes possession of the building upon default under the mortgage.

A similar situation regarding priority exists where the landlord of a building is in fact not the owner of the underlying land or, in some cases, is not the owner of the building. Many landlords, particularly of downtown Toronto office buildings, are simply tenants themselves. Sometimes they are tenants of the building as a whole and sometimes they are tenants under a ground lease. In either case, the landlord is usually the tenant under a lease, the term of which will exceed the length of the term of the lease to be entered into with the tenant of the premises. Again, in either case, there is an issue regarding the priority of the interest of the long term landlord or ground landlord over the interests of tenants of the premises in the building. The same basic considerations apply as apply in the case of a mortgagee. The lease will require that the tenant recognize that its lease is subordinate to the interests of the ground or long term landlords of the building, with the consequence that if the head or ground lease is terminated for default, the tenant may lose its lease, too.

Tenants who find themselves in the position of being forced to subordinate their leases to either mortgagees or ground or superior landlords, should insist upon first receiving from each such existing mortgagee or landlord, their agreement that the mortgagee or landlord will not, if it elects to exercise its remedies under its mortgage or superior lease, disturb the possession and occupation by the tenant of the premises so long as the tenant is not in default under its lease and does not prepay its rent. The tenant should also insist that the lease be modified to provide that its agreement to subordinate its lease to any future mortgage is conditional upon receiving a similar non-disturbance agreement from the future mortgagee.

10.8 Registration of the lease

A tenant will want to make sure, after going through a lengthy and expensive process of negotiating a lease of the premises, that it gets the full benefit of the lease term that it has negotiated. Many tenants do not seem to know that they are vulnerable to having their lease arbitrarily terminated in the event their landlord goes into default under a pre-existing mortgage. In the event of any considerable improvement in the leasing market, a mortgagee newly in possession of a building may be tempted to terminate the leases of tenants who are paying a low rental rate and re-lease them to other tenants who may be prepared to pay a significantly higher rate.

In order to protect themselves from this concern, all tenants ought to register notice of their lease on title, and ought to obtain a postponement of priority from any prior registered financial encumbrancers. This will ensure that no default under an existing mortgage can prejudice a tenant's lease. In the event postponement of the prior encumbrance is not available, at least a non-disturbance agreement should be sought, whereby such prior mortgagee will confirm that so long

as the tenant does not prepay its rent, it will not throw the tenant out in the event of default of the mortgage with the landlord.

There are two systems under which land, and consequently a lease may be registered; the Registry System and the Land Titles System. While each of these systems offers tenants protection through the registration of the lease, each system also contains an exception to the registration requirement, to which a tenant may avail itself. For land that is registered under the Registry System, a tenant who is under a lease for a term not exceeding 7 years and who is in actual possession of the premises, is automatically protected against a new purchaser or a mortgagee. Accordingly, where a lease with renewal rights could exceed 7 years, notice of the lease ought to be registered under the Registry System.

Alternatively, for land that is registered under the Land Titles System, tenants will find protection in the corresponding provincial legislation. Title of land registered under this system is subject to any lease or agreement for a lease with a period yet to run of less than three years, if there is actual occupation under it.

Registration of the lease is the best evidence of actual notice and indeed this permits reliance upon the provisions of the provincial legislation corresponding to the Registry System and the Land Titles System, with respect to priority. Priority of registration prevails unless there is actual notice of a prior instrument. Accordingly, tenants who delay occupancy under a new lease may be particularly at risk.

10.9 Landlord's repairs

A typical office, retail or industrial lease contains very little concerning the repairs which are to be made by the landlord. A tenant should seek to have the landlord agree to make all repairs not required to be made by the tenant. At the very least, it is important that the tenant ensure that language such as "the landlord shall maintain and repair the building, including the common areas, structural components and building system as would a prudent landlord of a building similar in age, location and type to the Building". Sometimes, a tenant can achieve a higher obligation on the part of the landlord requiring it to maintain it to some standard such as "first class" and eliminating the references to age, Much depends upon the kind of building which is being discussed. While issues of the standard of the landlord's day-to-day maintenance are not usually too contentious in new properties such issues deserve much more attention when it comes to older and class B or Class C space. Tenants would be well advised to specify at the offer to lease stage that any obvious items of non-repair be corrected before the lease term commences (such as repairs to common areas and corridors which will be seen by the tenant's clients and customers) and that very clear and specific language will be included in the lease concerning the ongoing requirements of the landlord to maintain and repair the building and its facilities. It should clearly be stated that the failure of the landlord to perform such repairs and maintenance will constitute a default by the landlord under the lease permitting the tenant to exercise remedies which might include, in the most serious situations, the right to terminate the lease or withhold rent or to perform the landlord's repairs and set off the cost of so doing against the rent payable under the lease.

10.10 Tenant rastoration

The landlord's lease should generally state that all leasehold improvements made by the tenant are the property of the landlord. The lease should grant the landlord the option, at the expiry or termination of the lease, to require the tenant to remove all or such parts of the leasehold improvements as the landlord may stipulate, at the tenant's expense. The rationale for this, from the landlord's point of view, is that a new tenant may not wish to use the leasehold improvements which were installed by the original tenant and the original tenant should therefore remove them and return the leased premises to the base building condition in which it presumably found the premises. In addition, certain of the tenant's leasehold improvements may be highly customized to the tenants' unique business and may not suit typical tenants. Tenants, however, should be aware that the cost of removal of leasehold improvements from a commercial building, represent quite an expensive obligation to have to incur at the end of the lease term.

There are a number of possible compromises concerning "make good" and restorations clauses which can be reached between a landlord and a tenant, the most popular of which seems to be to provide for a cap or maximum cost of removal, either per square foot or as a total number. Sometimes, it is agreed that the tenant will have the option to either do the removal work itself or pay the landlord a fixed charge and leave the work to be done by the landlord.

10.11 Tenant alterations

The issues concerning alterations are similar in many respects to the issues surrounding landlord's and tenant's work. With respect to tenants' alterations, the landlord is concerned with ensuring that it reviews the plans and specifications before the work is done and it approves of the improvements. The landlord is also concerned that the alteration work is done properly, in accordance with permits properly obtained, with proper insurance, and in such a manner as to minimize any disturbance of other tenants in the building. Furthermore, the landlord is also usually concerned that no construction liens will arise which may effect the landlord's interest in the building as a consequence of the tenant's alterations. The landlord will also wish to ensure that any work, such as electrical or mechanical work which might affect the base building system, is done by the landlord or its consultants or by consultants approved by the landlord.

10.12 New leasing isues: Telecommunications

CRTC Telecom Decision 97-8 allowed, as of May 1, 1997, new competitors into the local exchange service field. This means that the incumbent telephone companies such as Bell Telephone in the east, B.C. Tel and Telus in the west were no longer monopolies, but were subject to competition from new entrants. CRTC Telecom Decision 97-8 prohibited any telephone company from entering into exclusive arrangements with landlords for local telephone service, and mandated that end-users (i.e. tenants) were to have access to the telecom service provider of their choice for local phone service. The landlord community has responded by allowing a limited number of new competitors into their buildings as long as those new competitors signed access agreements and paid reasonable fees for the use of space. The industry's general position on telecommunications access can be found on REALpac's website at www.realpac.ca .

The practice of creating new spaces either within or outside of the main telephone rooms for these new competitors, and the active management now required of those spaces has created new

landlord costs and new issues to address. Certainly landlords need to expand the operating cost definitions in their leases to enable them to recharge tenants for the construction of or enhancement of main telephone rooms and rooms where the new competitors can put their equipment (known as "co-location" rooms, "point of presence" rooms, or "POP" rooms). Landlords will need to be careful that the descriptions of potential costs that can be recharged to the tenant are wide enough to not only include one time costs such as room construction, the creation of HVAC services to such rooms, electrical and power feeds, telecom jumper cables between rooms and other such services but also ongoing costs such as maintenance, security and riser management. In addition to these general charges, landlords will want to be able to charge specific tenants who have individual telecommunication requirements, for supervision and co-location of tenant's equipment as additional rent together with, as in appropriate cases, supervision or management fees. Landlords may also consider charging tenant for use of riser space for tenants' intranets particularly where riser space is scarce, and for rooftop access for tenant who want wireless telecommunications service or who have their own satellite based networks. Landlords will want the right to establish rules and regulations from time to time dealing with telecommunications service provision.

Landlords should also anticipate the acquisition of the in-building wire from the incumbent telephone company at some point in time in the future and will need to consider the ability to recharge the tenants the capital costs of organizing cleaning up, tagging and/or replacing that in-building wire. It is likely that building rewiring by a landlord will be treated from an operating cost perspective as a capital costs and will need to be amortized over a reasonable period of time.

Tenants have the right to choose the telecom service provider of its choice, but that should not mean that the tenant's choice in telecommunications service provider necessarily gets access to the building. The landlord will want to maintain the right to decide which telecommunications service provider gets to put its equipment in the building, and others will have to lease a local loop from the closest central office of the incumbent telephone company to get to the tenant. Accordingly, each tenant should acknowledge in its lease that its right to choose a telecommunications service provider is subject to the landlord's approval which may be unreasonably withheld if that telecommunications service provider needs facilities in the building. Tenants should be cautioned that any telecommunications contract they enter into does not run with the land and does not bind the landlord. Landlords may also want to provide for themselves exclusive rights in unregulated telecommunications services such as building Internet services, electronic or digital concierge services. Landlords should also be able to obtain from tenants in some for of an estoppel statement details of services they receive from telecommunication suppliers, including a breakdown between local, long distance service, data, Internet and other such services. The operating cost recovery clauses of the leases should also enable the landlord to pass through as a building cost any additional insurance required by the landlord in respect of the acquisition of and the operation of in-building wire at any time in the future and from time to time. Lastly, the landlord should have the unilateral right to set service standards for telecommunications service providers from time to time and impose them throughout the building.

10.13 Leasing isues: Energy management

New leases need to take into account emerging and potential landlord strategy in respect of energy management initiatives. Again, the primary focus will be on ensuring recovery of costs through the language in the operating cost section of lease. Landlord strategies could potentially including block buying, peak shaving and interval consumption management to name a few.

Block buying refers to the practice of joining up with either a similar group of users (for example, other office building owners in the vicinity) for volume discount purposes, or other users with a different and opposite consumption profile (for example, office building owners teaming up with apartment owners such that energy consumption is roughly flat for 18 hours a day).

Peak shaving refers to the strategy of eliminating the highest consumption points for a particular building during the day since hydro is not only billed on the basis of consumption, but also on the basis of maximum demand. The so called "peak" of the consumption profile is lessened ("shaved") so as to reduce the overall costs of the energy consumed. This can be done by the use, for example, of backup generators or other alternate sources of energy, and by demand management with the tenants in the building. The practice of interval management refers to monitoring micro-cycles during the day so that the demand curve is smooth and spikes such as those that might occur when major pieces of equipment cycle on and off are eliminated. The lease should explicitly permit the landlord to make forward purchases of energy in good faith on behalf of building tenants and pass those costs through to the tenants, regardless of spot price fluctuations from time to time. The landlord should also be permitted to utilize combinations of bulk buying in a forward contract and spot price buying to minimize total costs. Potential operating costs inclusions from the foregoing strategies might also include sales commissions and energy management fees. Capital costs may include the acquisition of generators, the acquisition of capacitors and other such similar energy management equipment, the replacement of check meters with an interval management system and other types of energy monitoring equipment, reduced energy consumption equipment throughout the building and the cost of education and training programs for tenants.

10.14 The need for standard forms of lease

With so many leasing transactions in Canada, it is remarkable that no standard form has developed. This is a considerable waste of landlord resources and tenants resources, and possibly diminishes the perceived integrity of the industry in the eyes of tenants.

Certainly, there is much variable information in a lease pertaining to the usual business terms, description of the premises, and description of landlord’s work and tenant’s work to name a few. On the other hand, there is much in the lease that could be balanced and standardized throughout Canada. In Ontario, the Greater Toronto Home Builders Association prepared and endorse a standard and fair Agreement of Purchase and Sale after a consumer fiasco with delayed closing dates several years ago. That new form is in widespread use by many home builders now and it provides a fair and balanced approach to the needs of consumers for protection, and the needs of home builders for flexibility. The Canadian Construction Documents Committee ("CCDC") also confronted this problem several years ago in developing standard forms of tender documents that splits out the basic terms into general conditions of the Contract and variable terms into special conditions of the contract. This simplifies the tendering process in Canada. In addition, trade groups such as the Ontario Association of Architects and the Canadian Council of Architectural Committees have developed standard form Architects Agreements. In early 2000, Equity Office, a giant office REIT in the United States, announced that it had developed and made available to tenants a new simplified form of office lease that was only half as long as the previous lease. The new form of lease was apparently well received by tenants.

Perhaps more importantly, the recent development of business to business portal sites, and supply chain sites, means that standard lease forms are now a roadblock to more efficient and streamlined leasing transactions. A standard office lease form (single tower and multi-tower) has

now been developed in Canada. Refer to www.realpac.ca > Standards for copies of these standard documents.

10.15 Review questions for sections 6, 7, 8 and 9

1. Why is it important to understand whether the tenant is a legal entity?

2. How can you protect yourself against a tenant's inability to pay rent?

3. What is a net lease and how is it structured?

4. What types of capital costs ought to be recoverable from a tenant in a net lease and why? Which ones should not be recoverable and why not?

5. How ought a tenant protect itself in respect of its tenant telecommunications and energy needs through the lease negotiations?

6. What is the importance of use clauses in leases and how do they affect building systems, zoning and building structure?

10.16 Photo Gallery

Great Plains Industrial Property, Calgary, Alberta - Morguard REIT (This building won the "Calgary Industrial Building of the Year Award, 2001")

Alberta Treasury Branch Building, Calgary, Alberta - Morguard REIT (This building won the "Calgary Building of the Century Award")

77 City Centre Drive, Mississauga, Ontario - Morguard REIT

Coquitlam Shopping Centre, Coquitlam, British Columbia - Morguard REIT

Place Ste-Foy, Ste-Foy, Quebec - Ivanhoe Cambridge

Metropolis at Metrotown, Burnaby, British Columbia - Ivanhoe Cambridge

Oakville Place, Oakville, Ontario - Ivanhoe Cambridge

11 Construction and development

11.1 Introduction

In Canada, the construction of almost all structures intended for human access will require the obtaining of a building permit from typically a local government authority. The building permit will generally not be issued unless drawings of the proposed building are accompanied by, or under seal of, an accredited architect or engineer licensed in the province. Thus, the starting point for any owner of land wishing to construct a building in Canada will be the retaining of an architect and/or an engineer to design the building and to make sure the structure is suitable for its intended purpose.

Building code statutes regulate the construction and erection of buildings and structures so as to promote health and safety of those who inhabit them. Municipal councils in Ontario, for example, have authority under the *Ontario Building Code Act* for promulgation of the local Building Code and regulation. The *Ontario Building Code Act* also attempts to ensure that fires do not spread and are prevented. Pursuant to Section 35(1) of the *Ontario Building Code Act*, councils of municipalities do not apparently have any right to impose stricter standards than those prescribed by the provincial Building Code Act. The National Research Council (Canada) also plays a role, developing and enhancing National Building Codes.

Building code by-laws generally do not apply retroactively. Where a building predates a by-law a safety provision does not apply since it could not be said that the by-law was retroactive. However, building code amendments can be retroactive if explicitly stipulated. The *Ontario Planning Act* can also apply standards retroactively for maintenance and occupancy so that an owner can be compelled to maintain a building in accordance with standards adopted subsequent to the date of construction of the building.

11.2 Retaining the architect or engineer

Most provincial architectural associations, and some engineering associations, have standard form or model agreements that can be utilized by an owner in retaining that professional entity. Obviously, standard forms prepared by an industry association will tend to prefer members of that association over the retaining client. Accordingly, owners proposing to construct the building on real property must be careful to ensure that their interests are protected in entering into such agreements.

Architectural Agreements are available through the Committee of Canadian Architectural Councils (see for example the Canadian Standard Form of Agreement between Client and Architect: Document 6) or provincial associations such as the Ontario Association of Architects or the Royal Architectural Institute of Canada ("RAIC") (see for example RAIC Document 6). Both of these documents are similar to the American Architectural Association documents.

It is important to note that the architect is an independent contractor (in respect of the design of the proposed structure) but the architect is also often the owners agent in respect of administration of the construction contract with a general construction contractor. This agency role requires the architect to be impartial in interpreting the owner-contractor agreement. Some times, the architect

can be put in a conflict of interest position if a claim for extra costs made by a contractor in turn results from inadequate or incorrect working drawings prepared by the architect.

Under a construction contract, progress payments are monitored by an architect and a holdback is maintained pursuant to the provisions of applicable provincial construction lien legislation.

Architects can be compensated in several ways, including a percentage of the overall construction costs, a flat fee, or a per diem rate.

11.2.1 Construction contracts in Canada

While many contractors will have their form of construction contract, and indeed, sophisticated owners may also have their standard form of construction contract, the Canadian Construction Document Committee ("CCDC") also publishes several forms of standard form contract which can be used by owners in respect of construction contracts. These standard contracts have been published since the 1970's. A common contract, for example, is CCDC-2, which is a stipulated price contract in respect of any particular construction work.

Again, it is important to note that the Canadian Construction Documents Committee has no significant owners representation. Accordingly, it is important for owners to carefully review the standard form of contract to make sure that it is suitable for an owners needs and that the owners interests are protected.

Many construction contracts will provide for a financial assurance that the project will be completed by way of surety bonds. The type of surety bonds that exist include performance bonds, bid bonds, and labour and material bonds. Often, there will be a three party agreement made between the owner, the contractor and the surety whereby the surety agrees to step into the shoes of the contractor if, during mid-construction, the contractor goes bankrupt or is unable to perform under the construction agreement. This would be a suitable approach where damages would be an inadequate remedy. Often, owners will provide contractually for alternative remedies. A surety is different than an insurer under an insurance policy since a surety is bound to make good the default or non-performance, but an insurer is only obliged to pay a loss, measured in a certain way, of a defined contingency.

The existence of standard form contracts such as the CCDC-2 form, makes tendering a complex construction project somewhat easier. Many governments in Canada are required to tender i.e.. put out for competitive bids, all construction jobs. The tendering process includes a call for tenders through, for example, advertising in a local newspaper, trade publication or the MERX website. The tender may be accompanied by deposit or a bid bond, described above, from a surety. The tender would require the execution of a construction contract in a prescribe form by the winning tenderer before that tenderer would be given the construction job. The tender process generally applies the law of contract: that is, the tender itself is the offer and the winning bid is acceptance of the offer at the winning bid price.

Where there is litigation surrounding tendering, it often focuses on mistakes made by the bidder because the winning bidder has made a calculation mistake in submitting its bid. This puts the owner in a tough situation: should it compel the bidder to complete the construction job for that potentially uneconomic price knowing that the contractor will be reluctant to do so? Earlier cases were based on revocation by a bidder prior to acceptance by the tendering party or an obvious error in the price on the face of the document. In those situations, courts have held it to be

inequitable to allow the tenderee to take advantage of the obvious mistake. Accordingly, a tender process needs care and attention by both parties. Tenderers might consider submitting supporting calculations to make sure that they have a remedy in the event of the mistake. It is typical in larger projects to require a bid bond. Most larger projects will at least require a performance bond and a labour and materials bond for at least 50% of the price. However, the issue is always the cost of these bonds, since this cost is often passed through in the tender cost to the owner.

11.2.2 Construction liens

There are construction lien acts in all provinces in Canada. They enable a certain class of creditors to gain priority over other creditors in relation to work, services or materials supplied to construction projects.

Previously known as mechanics liens, they are strictly a creature of statute and have no history in the common law. Section 14.1 of the *Ontario Construction Lien Act*, for example, grants a person who supplies services or materials to an improvement for an owner, contractor, or subcontractor, a lien upon the interest of the owner in the premises for the price of the services or materials. All of these individuals and terms are defined in the Act. Chattels are not included. Under Section 3 1(1) of the *Construction Lien Act*, the Lien must be registered against the real property within 45 days of the date that a certificate of substantial performance of the contract is published in the Daily Commercial News or the date the contract is completed or abandoned.

Otherwise, the lien of the contractor or material supplier expires 45 days after the occurrence of these dates if it was not registered. Some lien creditors are able to "shelter" under a lien registration of someone else registered in time. This only applies if a contractor above them in the chain has registered a lien. The requirements of a certificate of substantial performance are set out in Section 32 of the Act. Substantially performed means the improvement to be made under the contract or a substantial part thereof is ready for use or is being used for the purposes intended or, when the cost to complete is less than or equal to 3% based on a prescribed formula.

The construction lien process is a two-step process. The first step is a registration of the lien on title. The second step in perfecting the claim is accomplished by instituting an action by filing a Certificate of Action against title to the property. The Certificate of Action must be commenced and registered within 45 days after the last day that the lien claimant would have been entitled to register a claim for lien and accordingly this would be within 90 days from the delivery of the last supply or service or the date of publication of a Certificate of Substantial Performance.

Where a lien is registered against title but the action has not yet been heard, an owner or an interested party may "bond" off the lien from title by posting to the Court in which the action is to be heard, payment of an amount not less than the claim's total value, plus 25% to cover costs.

Each "payer" must hold back 10% from all progress payments made on account of work performed as trust money under a construction contract. These monies must be held for 45 days from the date of each such progress payment to make sure that no liens are registered in respect of the payment made. This is referred to as the "basic" holdback. The finishing holdback is equal to 10% of the value of labour, services and material supplied to the project from the date of substantial completion to the date of total completion.

Liens have priority over construction mortgages but not as to prior mortgages that were not taken out for the purpose of financing an improvement in Ontario (refer to Section 78 of the *Construction Lien Act*).

11.2.3 Building permits and occupancy permits

There is no authority to permit a building inspector to allow deviations from the building by-law. Although the *Building Code Act* and the Building Code apply to all municipalities throughout the Province of Ontario. Section 31 of the Act imposes the duty of enforcing them on the Council of each municipality. Under the *Municipal Act*, Ontario councils are given additional authority to regulate certain aspects of construction

Some municipalities have adopted provisions by by-law that prohibit occupancy without the issuance of an occupancy permit. In Ontario, it is mandatory for a council to appoint a chief building official and such inspectors as are necessary to enforce the *Building Code Act*. Once an applicant has made an application for a building permit in accordance with the by-law governing the procedure, an inspector has a duty to examine the plans and, if suitable, to issue the permit. Once the application is complete and the proposed building will comply with the *Building Code Act* and will not contravene any other applicable law, the chief building official is under an obligation to issue the Building Permit. The *Ontario Building Code Act* authorizes an inspector to enter a building without a warrant and, if he finds non-compliance with the Code or the Act, to issue a Compliance Order. If the Compliance Order is not followed, he is entitled to issue a Stop Work order. The statutory right to enter private property in Ontario is narrowly stated.

In Ontario, there is a Building Code Commission to hear disputes with respect to the applicability of the Code to a certain issue.

A building permit, once issued, grants a privilege to construct a building at a certain location and in a certain way.

11.2.4 Building permit fees and development charge levies

Building permit fees may be charged for inspection and approval of plans. The amount of the building permit fees are fixed by by-law. A reasonable fee only may be imposed. A permit usually expires within reasonable time after its issuance. Under the *Ontario Development Charges Act*, development charge levies are also exigible at the building permit stage.

Leasehold improvements (i.e., by a tenant of commercial space) also require a building permit. A specialized industry exists dealing with space planning and construction of leasehold premises.

Construction loans are structured in a similar fashion to normal first mortgage loans, with the critical differences being;

- a construction loan typically requires evidence of a "take out loan" which would repay the construction loan upon the completion of construction and the meeting of certain performance criteria and;
- the construction loan is only made in incremental advances over time as certain stages of construction are reached. The stages of construction are certified typically by an independent third party or the project architect and the construction lender

always holds back an amount sufficient to complete the project if there are any difficulties with the contractor or the owner (i.e., insolvency) during the construction process. This is because an incomplete project is almost impossible to sell, but if a lender has enough money held back to finish the project itself, then it may do so and sell the project as a completed project.

There are additional risks to a construction lender in making a construction loan, including the assessment of whether the developer has the skill and experience necessary to construct the project, or whether the developer has its own money at risk and the amount that it has at risk and the risk of cost overruns and unforeseen expenses. Financing loans could be used for land assembly, land servicing and development as well as construction. Financing typically now requires a prior commitment for not only a long term take out mortgage but also pre-sale or pre-leasing commitments from individual purchasers in the case of condominium developers or residential projects or from credit worthy tenants in the case of commercial projects. Many lenders these days are combining construction loans and take out loans into two stage financings. In this case, the amount available for the permanent financing will depend on pre-leasing efforts and the applicability of certain underwriting criterion to the opening day net cash flow. These types of two stage loans are typically only available to financially strong developers and in the situations where the commercial project is substantially pre-leased. The amount of construction loan is generally up to 75% of the total construction cost and the appraised value of the raw land. There are usually significant fees in construction loans.

11.2.5 Tactical issues in construction

- Always ensure compliance with provincial Building Code Act and Fire Marshall's Act in undertaking due diligence for any acquired properties
- Ensure that a building permit is obtained for all work in progress and all required interim inspections have been made
- Review the local building by-law prior to construction to understand local policies.
- Consider the effect of the Fire Marshall's Act (or provincial equivalent outside of Ontario) and current regulations in construction.

11.3 Review questions

1. What are the various roles that architects play in the construction process?
2. What are the risks involved in tendering a construction project?
3. How ought an owner organize payments to a contractor in order to be sure that no construction liens can arise in respect of the services the payment represents payment for?
4. What other requirements might there be from governmental agencies before someone can occupy premises?