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BASICS OF COMMERCIAL LEASING IN ONTARIO

Commercial leasing is a broad term that governs the relationship between landlords and tenants over a wide range of commercial real estate, including office premises, retail stores, warehouses, and industrial manufacturing plants.

In Ontario, the general principles of commercial real estate leasing differ significantly from residential leasing. Residential leases in Ontario are highly regulated to the effect that certain legislated rights cannot be modified even if a landlord and tenant purport to alter those rights in a written lease. In other words, the legislated rights are paramount. By contrast, commercial leases are subject to little regulation and the rights and obligations of landlords and tenants are primarily a matter of agreement between the parties.

The Leasing Process

The process of negotiating a formal commercial lease agreement usually commences with the landlord and tenant entering into an offer to lease or letter of intent. These documents are short outlines of the agreed upon principal business terms, such as the type of lease (*i.e.* a net lease or gross lease), the rental rate, the length of the term, options to renew or extend, exclusive use, and the right to transfer. Typically, an offer to lease or letter of intent is not binding on the parties. Most offers to lease include a provision whereby the tenant agrees to enter into the landlord's standard form of lease. From a tenant's perspective, this provision in the offer to lease should be resisted because the lease will set out very important terms and conditions that will have a significant financial impact on the tenant. These include clauses dealing with repair, maintenance and insurance obligations, and environmental liability. Not surprisingly, most landlord standard forms of lease are drafted to ensure that only the landlord's rights are protected. Therefore, tenants should always modify the offer to lease or letter of intent so that it is conditional upon the landlord and tenant entering into a formal lease that sets out terms and conditions that are acceptable to both the landlord and the tenant.

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It is important to note that, notwithstanding the non-binding nature of offers to lease or letters of intent, even if the parties do not sign a formal lease document, a lease agreement may be implied and enforceable if the parties conduct themselves in a manner consistent with a lease being in force. For example, if a tenant takes possession of the premises and starts paying rent, and the landlord accepts the rent payment, a lease agreement will very likely be implied.

Gross Lease vs. Net Lease

A commercial lease is often described as either a "gross" lease or a "net" lease. A gross lease establishes that the landlord is responsible to pay for all of the costs associated with the property, such as realty taxes, insurance, utilities, repairs, and maintenance. In a gross lease, the tenant pays to the landlord a single base rent. However, it is to be expected that the landlord will have factored into its calculation of the base rent the anticipated carrying costs for the property.

With a net lease, the tenant pays a fixed base rent plus the actual additional costs associated with the property.

The lease terms will typically set out which additional costs must be paid by the tenant. In a multi-tenanted property, each tenant pays its proportionate share (on a square foot basis) of such additional costs.

Significant Net Lease Terms

The terms and conditions of a net lease have important financial implications for both the landlord and the tenant. For example, a net lease will define which party is responsible to carry out and pay for the ongoing maintenance and major capital repairs and replacements of the premises and the building within which the premises are located. Some maintenance, repair and replacement costs are very significant and can include major capital expenditures, such as repairs and replacements to structural aspects of the building (*i.e.* roof, foundation and mechanical systems that serve the leased premises and the building). During a commercial lease negotiation, determining the party responsible for, and the method of calculating, such costs is a source of constant tension between the landlord and tenant.

Other commercial lease terms that must be examined carefully due to their potential financial impact include security deposits, rights to audit the calculations of additional rent, options to renew, exclusive use, the opportunity to appeal property taxes, and abatement of rent in the context of damage to or destruction of the leased premises.

A competently negotiated lease agreement that clearly defines the economic consequences for the landlord and tenant can be a critical factor in the ultimate success or failure of a business. Each commercial lease is unique to the circumstances of the parties. The negotiation of a lease can be complicated by a wide range of issues that arise depending on the nature of the property. For example, a lease for a retail store will invariably include terms and conditions that differ significantly from a lease for an industrial building. As a result, there is great benefit in engaging the services of an experienced commercial real estate lawyer to help navigate the lease negotiation process.

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