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Drafting and Negotiating Tenant Allowance Clauses and Tenant Remedies if a Landlord Fails to Pay

A key element of any commercial lease negotiation is the amount paid as base or minimum rent. The rate per square foot is negotiated based on a number of factors, including market rates, ancillary costs of the deal, such as brokers' fees, and incentives, such as rent free periods and landlord performing certain work at its cost. A popular form of tenant inducement, a "tenant allowance", refers to an amount payable or credited by a landlord to a tenant as reimbursement or toward the tenant's costs to improve the leased premises to make it suitable for the tenant's use. The allowance amount is factored into and increases the base or minimum rent per square foot—in effect the costs of the allowance and other incentives are paid in part by the tenant as part of an increased base or minimum rent.

When negotiating tenant allowance provisions, consider the needs of your client, be it the landlord or the tenant, and determine what protections they need.

The following key considerations should be kept in mind when drafting a tenant allowance clause from the perspective of both the landlord and the tenant:

Timing: As a business term of the lease, and a major component of the base or minimum rent calculation, the tenant allowance should be negotiated at the offer to lease (vs. lease) stage of negotiations. This will include the amount of the allowance, and the conditions and timing of payment.

Calculation: The tenant allowance clause should clearly stipulate the following:

- The amount of the tenant allowance or how the amount is calculated. HST should also be accounted for in the allowance clause. If the lease contains a cap on leasable area for the calculation of rent, consider applying the cap to the tenant allowance calculation also.
- The timing of the payment—is it a reimbursement of amounts spent by the tenant, a payment in advance, or a combination thereof?
- If the tenant allowance is a reimbursement, can it be applied towards all of tenant's costs, or only specific costs, such as tenant fixturing? From the landlord's perspective, a key element is to ensure that it is reimbursing only costs the tenant has invested in the leased premises.
- If the tenant is entitled to the full amount of the allowance whether or not it spends the full amount? And if the tenant is entitled to the full amount, is the remaining balance provided to the tenant as a cash payment or a credit against rent next due? At whose option?

Construction Lien Issues: Under the new *Construction Act* in Ontario (the “Act”), landlords can no longer disclaim liability for a construction lien by a tenant’s contractor. Rather, a landlord’s interest in the premises is now exposed to 10% of the amount of the leasehold improvement payment by the landlord. Furthermore, a landlord must be mindful of not being deemed an “owner” as defined in the Act, in which case the landlord would be subject to the full liability for the lien amount.

- **Landlord Considerations:**

- Retain at least 10% of the tenant allowance amount as a holdback, and release only upon the expiry of the lien period and confirmation that either (i) no liens have been registered, or (ii) any liens have expired or otherwise have been satisfied. This issue arises when the allowance is paid in progress payments, it is not an issue in a lump sum payment as the standard condition requires all lien periods to have expired allowing the landlord to release the full amount without holdback.
- Require the tenant to vacate liens on demand and indemnify the landlord for any losses resulting from asserted liens by its contractors.
- Include an express right for the Landlord to pay the lien claimant directly or have the lien vacated by payment into court, with the costs offset against the allowance.
- Carefully consider how involved the landlord is in the tenant’s improvement process. The following types of activities may classify a landlord as an “owner” under the Act and exposing the landlord for the full liability of the lien: (i) significant dealings with contractors, such as the landlord directly retaining its preferred contractors to perform portions of the tenant’s work, (ii) requiring the tenant’s improvements include improvements of a capital nature that are required to be left at the end of the lease term.

- **Tenant Considerations:**

- Prefer only 10% of the tenant allowance amount be held back and require the release occur immediately following the expiry of the lien period and confirmation that either (i) no liens have been registered, or (ii) any liens have expired or otherwise have been satisfied.

Disbursement of the Tenant Allowance:

- **Landlord Considerations:**

- Prefer paying the allowance only once the lease is fully executed, the tenant has completed its improvements, all lien periods have expired, a certificate of occupancy has been received, and the tenant is operating in the leased premises (and if a retail lease, the tenant is fully staffed and stocked and open to the public).

- Consider paying the allowance in the form of a rent credit vs. cash payment to the tenant, or a combination of the two.
- Require the tenant to submit evidence of payment of costs for tenant improvements to the leased premises only (e.g., receipts or statutory declarations).
- Consider making the allowance personal to the tenant (i.e., if the tenant assigns the lease, the assignee is not entitled to the allowance).
- Tenant Considerations:
 - Consider cash flow requirements.
 - Prefer to have allowances paid in advance or in periodic disbursements, such as fixed time periods (e.g., every 30 days) or upon completion of milestones (e.g., key deliverables, percentage of completion), with minimal conditions upon release. The likelihood of progress payments depends largely on the tenant's negotiation power and financial covenant.
 - Ensure that the scope of costs which the tenant allowance may be applied is broad to cover both the tenant's hard and soft costs (e.g., space planning fees).
 - Ensure that any excess allowance may be used by the tenant (e.g., applied against rent payable).
 - Ensure that the tenant allowance is available to the tenant, permitted transferees, and in the event the tenant subleases any of its space.

Termination of Lease Considerations:

- Landlord Considerations:
 - If early termination, require unamortized tenant allowance to be repaid and recoverable from the tenant, same as a remedy in an event of default by the tenant.
- Tenant Considerations:
 - Prefer there be no obligation on the tenant to repay any portion of the tenant allowance in the event of early termination, particularly in the case where the landlord exercises an early termination right, such as for redevelopment of the property.

Consider Other Forms of Tenant Inducements: In addition to, or in lieu of, a tenant allowance, both landlord and tenants should consider other similar forms of tenant inducements including:

- *Free or Reduced Rent Period:* Often used in conjunction with a tenant allowance, the landlord can also offer a free or reduced rent period, usually in the form of a “fixturing period” prior to the commencement date.
- *Landlord’s Work:* To the extent the improvements to the leased premises are general in nature and may benefit the leased premises for future tenants, consider having the landlord perform such work as “Landlord’s Work” in lieu of a tenant allowance. This gives the landlord full control over the construction process, but any delays and cost overruns are now a risk of the landlord.

Tenant Remedies Where the Landlord Fails to Pay: Tenants and their counsel should consider what remedies should be available if the landlord fails to pay the tenant allowance.

- *Tenant Considerations During Negotiations:*
 - Include a landlord breach of covenant provision—add a specific clause setting out the tenant’s rights upon landlord default. This clause can include:
 - Provided the tenant the express right set-off unpaid tenant allowance against rent next due.
 - Rent being automatically reduced to a lower amount (effectively deducting the allowance factor).
 - The tenant’s right to sue for damages.
 - Where the tenant’s set-off rights are not limited in the lease, the tenant may obtain a court order for set-off.
 - Clearly define the conditions for disbursement of the tenant allowance in the lease and limit the ability of the landlord to apply its discretion. Also set deadlines for payment by the landlord following the attainment of a milestone.
 - If the tenant has significant bargaining strength in the negotiations, consider the following:
 - Require the tenant allowance funds to be paid into a trust or escrow account with express conditions/deadlines for disbursement.
 - Require the landlord to post a letter of credit or require an indemnifier or guarantor with respect to the tenant allowance.