FMC LAW

Focus on
Real Estate

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Landlord's and Tenant's Liability for Improvements under the *Construction Lien Act*

By Karen Groulx

Many contractors assume that their work on leasehold improvements automatically gives them a right to lien the landlord's interest as well as the tenant's interest in the improved property. In many cases, however, the landlord's interest in the leasehold premises that has been improved by the contractor's work, cannot properly be the subject of a construction lien, even where that landlord has provided a "leasehold improvement allowance" absent facts that support a finding that the landlord is the statutory "Owner" as defined under the *Construction Lien Act*, R.S.O. 1990 c. C.30. (the "*Act*").

Under many retail/commercial leases, the landlord has the power to pay liens and add the amount to rent. The presence of a lien on a leasehold interest can therefore be a strong incentive to facilitating early settlement. However, in cases where the lien claimant has done work for a commercial tenant who has abandoned the premises, the presence of a lien on the leasehold interest of the tenant will be unlikely to secure payment to the unpaid contractor. Unless the tenant can pursue the landlord as Owner under the *Act* due to its degree of involvement in the tenant's improvements or unless the tenant has provided notice to the landlord under section 19 of the *Act* (which is rarely done) the lien claimant's options as against an insolvent commercial tenant are likely limited.

There are only two ways to lien the landlord's interest in circumstances where a contractor has done work on leasehold improvements. One way is to provide the landlord with notice up front before the work is done pursuant to section 19(1)

of the *Act*. Another method is to argue before the Court that the landlord falls under the definition of "Owner" under the *Act*. Under section 19(1) of the *Act*, where the Owner is a tenant, the interest of the landlord will also be subject to the lien if: (a) the contractor gives the landlord written notice of the improvement before it is made; and (b) the landlord fails within fifteen (15) days of receipt of that notice, to provide notice to the contractor that the landlord assumes no responsibility for the improvement. The notice to be given pursuant to this provision has to be "sufficiently distinct and memorable" to allow a landlord to know when the fifteen (15) day period in which it would deny liability has begun. In this regard, the Courts have interpreted such events as the landlord attending meetings, reviewing plans or a simple awareness of the work being done as not being enough to constitute notice under this provision of the *Act*. In this regard, any notice must clearly signify the potential liability to the landlord.[1]

The definition of Owner, under the *Act* includes individuals other than the registered owner. The statutory definition of "Owner" under the *Act* is comprised of three essential elements: (i) that the owner has an interest in the premises; (ii) that the owner makes a *request* for the work (including requests that can be implied from all of the circumstances); and (iii) that the work be supplied on the credit or on behalf or with the privity or consent of or for the direct benefit of the Owner.[2]

In the decision of *Lincoln Mechanical Contractors, a division of Lincoln Plumbing and Heating Ltd. v. Cardillo*[3] the defendant was the owner of a commercial plaza whose tenant was a numbered company operating as Premier Fitness ("Premier"). There were provisions in the lease agreement with respect to improvements that were to be made to the leased premises by each of RioCan, the landlord, and Premier, as tenant. RioCan was generally responsible for the work regarding the shell of the premises, and Premier was generally responsible for the interior work and the work required to make the premises ready for business. RioCan agreed to pay Premier a leasehold improvement allowance of approximately $2.2 million to subsidize the cost of renovations. Premier hired the plaintiff mechanical contractors, Lincoln, to do HVAC work but did not pay them in full. Lincoln filed a claim for lien against both the landlord and the tenant claiming that it was owed $271,000 and claiming that RioCan was an Owner as defined in the *Act*. The plaintiff further alleged that the landlord had held back approximately $234,000 of the leasehold improvement allowance funds and claimed that the balance of these funds would be impressed with a trust pursuant to section 7 of the *Act* and should have been supplied to the lien claimant's outstanding account. The balance of the leasehold improvement allowance was paid by RioCan to Premier or set-off against monies owed by Premier to RioCan.

The question before the Court was whether or not an implied request to do the work could be inferred on the part of the landlord from the totality of the circumstances. The Court noted that so long as there was a reasonable possibility of such an inference being drawn, the plaintiff's claim against the defendant RioCan would be allowed to proceed to trial. The Court also noted that the absence of direct dealings between the registered owner and the contractor is not necessarily fatal to the contractor's assertion that the registered owner falls within the statutory definition of "owner" under the *Act*. The tenant argued that the lease provided that Premier would deliver to RioCan a contractor's quote outlining the scope and cost of the work as well as

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[1] *1276761 Ontario Ltd. v. 2748355 Canada Inc.* (2005) 44 C.L.R. (3rd) 284 (Ont. S.C.) aff. 2006, 55 C.L.R. (3rd) 54 (Ont. Div. Ct.)

[2] Muzzo Brothers Ltd. v. Cadillac Fairview Corp. (1981) 34 O.R. (2nd) 461 (Ont. H.C.)

[3] Lincoln Mechanical Contractors, a division of Lincoln Plumbing and Heating Ltd. v. Cardillo (2011), O.N.S.C. 664, [2011] O.J. No. 362

a complete set of drawings and specifications. The work, drawings and specifications would then be subject to RioCan's approval. The lease also set out conditions regarding the payment of the leasehold improvement allowance including the provision that the work would be completed to RioCan's satisfaction. The tenant also relied on the fact that the leasehold improvement allowance of $2.2 million represented approximately one-half of the cost of the improvements to be made by Premier. The landlord argued that there was no direct contract between the lien claimant and the landlord nor were there any direct dealings. There was also no evidence that RioCan had ever received a quotation, drawing or specification in respect of the HVAC contractor's work nor was it ever asked to approve the HVAC contractor's work. In addition, there was no evidence that any RioCan representative ever inspected its work. The Court also noted that the HVAC contractor was not even aware that RioCan was making payments to the tenant Premier until the end of the contract. The court ruled that even though the landlord had certain rights under its contract with the tenant, without evidence that the rights were exercised, this fact did not support an inference that a request was made by the landlord for the work to be done. The court determined that there was no significant element of direct dealing on the facts of the case to support a finding that the landlord was a statutory Owner under the *Act*. The court found that for the work to be done for RioCan's benefit, there must be more than "the benefit to landlord as a reversioner and in the present case any benefit to RioCan would be the benefit as a reversioner".

In *Haas Homes Ltd. v. March Road Gym and Health Club Inc.*[4] the Court held that the landlord's agreement to contribute to the cost of the tenant's fit-up was an insufficient ground for a finding that the landlord was the statutory Owner. The Court held that the request had to be accompanied by one or more other elements set out in the definition of Owner under the *Act*. In this case, the offer to lease set out the respective scope of the landlord's and tenant's work required to renovate the upper floor of the property as a health club. The lien claimant delivered a quotation to the tenant, and dealt with the tenant only for payment and claims for extras. During the performance of the contract, representatives of the landlord were on the scene in addition to those of the contractor and the tenant who was exercising a general supervisory function over all contractors engaged in the work, including the landlord's own general contractor and subtrades as well as contractors for new tenants who are fitting-up their own premises. The court determined that there was not sufficient proof of significant direct dealing between the landlord and the lien claimant to establish that improvements were made to the property with the landlord's "privity and consent".

In short, the fact that a landlord has a right to approve or oversee work under a lease will not render the landlord an owner where those rights are not exercised. Also, a landlord may provide its tenants with an improvement allowance without attracting liability as a statutory Owner under the *Act* provided that advances on the landlord improvement allowance were not designed to flow through to the contractor. In *Lincoln*, the contractor submitted its invoices to the tenant not the landlord. While the request does not have to be direct and may be inferred, the courts look at the substance and not merely the form of the relationship between the parties in determining whether or not a landlord falls within the statutory definition of Owner under the *Act.*

So what can an unpaid contractor do in the situation where the tenant in a commercial lease abandons the leased premises? The ultimate remedy of a lien claimant against a leasehold interest is to sell the remaining term for which the tenant holds the land and its interest in the

[4] Haas Homes Ltd. v. March Road Gym and Health Club Inc (2003), 29 C.L.R. (3rd) 243 (Ont. S.C.)

building, if any. Such remedy is rarely exercised, however, and is of little appeal to the unpaid contractor. Another option might be to analyze the financing of tenant improvements as trust funds and use section 13 of the *Construction Lien Act* to hold anyone liable who might have diverted such funding for tenant improvements to other start-up costs of the commercial tenant at that location.[5] In reality the options of a contractor caught in this situation are limited. The easiest way for a contractor to ensure that the landlord is subject to the obligations imposed upon "Owners" under the Act is to provide notice to the landlord in accordance with section 19(1) of the *Act,* before the work starts. In the event that the landlord gives the contractor written notice within 15 days of receiving the notice from the contractor, that the landlord assumes no responsibility for the improvement to be made, the contractor can then decide whether or not it wants to proceed with the work for the tenant, without some additional form of security that it will get paid for the improvements to be made to the leased premises.

Reasonable Wear and Tear: Why You Should Care

By Jennifer Wong

Commercial leases commonly contain a tenant's covenant to maintain the leased premises in a state of repair at least equal to that in which the leased premises were found at the commencement of the lease. However, this covenant to maintain and repair is in most cases qualified by the phrase "reasonable wear and tear excepted". How is the tenant's obligation to maintain the leased premises tempered by the reasonable wear and tear exception?

The law in Canada with respect to the interpretation of "reasonable wear and tear" was stated in *Haskell v. Marlow*, [1928] 2 K.B. 45:

> "…[r]easonable wear and tear means the reasonable use of the house by the tenant and the ordinary operation of natural forces. The exception of want of repair due to wear and tear must be construed as limited to what is directly due to wear and tear, reasonable conduct on the part of the tenant being assumed…"

Thus where reasonable wear and tear is excepted, the tenant must still act reasonably by ensuring that the leased premises do not suffer more than the operation of time and nature would effect and by applying reasonable efforts to keep the leased premises as near as possible in the same condition as at the commencement of the lease.

In considering what wear and tear is reasonable, the courts have considered factors such as the age, nature and use of the building, the duration of the tenancy, and the nature of the use for which it was intended and to which it was actually put during the tenancy.

For instance, in *Kreeft v. Pioneer Steel Ltd.* (1978), 8 B.C.L.R. 138, the landlord sued its former tenant for damages in relation to cracks in the warehouse floor and parking lot caused by the tenant's storage of steel. The tenant in *Kreeft* successfully brought itself within the reasonable wear and tear exception because the court found that the strength of the warehouse floor for the purpose of storing steel had been in the minds of both the landlord and tenant at the beginning of the lease.

In *Darmac Credit Corp. v. Great Western Containers Inc.*, 1994 CanLII 9213 (ABQB), the tenant operated a drum reconditioning business on the leased premises. The terms of the lease provided that the tenant would make all necessary repairs and replacements to both the

[5] *Structural Contracting Ltd. v. Westcola Holdings Inc.*, [2000] 48 O.R. (3rd) 417 (Ont. C.A.) as cited by David Debenham in his paper entitled "Using the Construction Lien Act to Your Client's Advantage: Do You Need a Magic Bullet? Seven Simple Solutions to Persistent Pernicious Problems in Your Practice",

exterior and interior of the building, and restore the leased premises to the physical condition existing at the commencement of the lease, reasonable wear and tear excepted. When the tenant terminated its lease after nine years, there were such extensive roof leaks that the roof had to be replaced. The landlord brought a claim for environmental and structural damage to the leased premises.

With respect to the claim for damage to the roof, the landlord in *Darmac* successfully proved on a balance of probabilities that the roof deterioration was not caused by reasonable wear and tear and in fact occurred prematurely due to the tenant's business activities, specifically the reconditioning process, which was not discussed with the landlord at the time the lease was negotiated. The roof in question had a normal life expectancy of 18 to 22 years but the building was approximately 12 years old at the time it had to be replaced. The court found the tenant responsible for one-third or six of the 18 years by which the roof aged prematurely, and therefore liable for one-third of the roof replacement cost.

What does this mean for landlords and tenants? A landlord will not be prejudiced by the wear and tear exception if the wear and tear arises from use or misuse which was not contemplated at the time the lease was negotiated. If the deterioration of the leased premises is not a "reasonable" consequence of the use to which the leased premises should have been put, the tenant should be responsible. On the other hand, although the wear and tear exception does not relieve a tenant of its obligation to maintain the leased premises in the same condition as at the commencement of the lease, it does qualify this obligation by applying a standard of "reasonableness" which acknowledges the natural deterioration of the leased premises over time. The interpretation of the reasonable wear and tear exception therefore involves the consideration of multiple factors and the outcome of any claim involving the exception will vary on a case-by-case basis. To avoid uncertainty in the application of the concept and language of the wear and tear exception in circumstances where it is critical to one party or the other that the leased premises or a portion thereof be maintained to a certain level, the parties should expressly include in the lease specific details regarding the level and state of repair required.

Are You Charging Too Much Interest?

By Jonathan Ryder

Do your loan agreements charge excessive administrative fees or step up interest rates immediately prior to maturity? If so, a recent Master's decision in the Alberta Court of Queen's Bench has determined such charges may be rendered null and void as they may be in breach of section 8 of the *Interest Act*, RSC 1985, c. I-15.

Section 8 of the *Interest Act* can be summarized as prohibiting the charging of a greater rate of interest on money in arrears than that charged on money not in arrears. As an example, it is a breach of section 8 of the *Interest Act* to increase the interest rate from 5% to 10% when a borrower is in default under a loan. Similarly, it may be considered a breach of section 8 of the *Interest Act* to charge an administrative fee upon an event of default occurring under a loan. Such a fee may be deemed to be a penalty pursuant to section 8.

In the recent case, *Equitable Trust Company v Lougheed Block Inc., Neil Richardson, Hugh Daryl Richardson and Heritage Property Corporation*, 2011 ABQB 193, Master Hanebury in the Alberta Court of Queen's Bench analyzed the circumstances in which section 8 is breached. She identified the following three principles that courts should consider when determining whether there has been a violation:

1. Ignore clever drafting devices and consider whether the effect of the interest provision is to increase the interest on money in default over that paid on money not in default (i.e. if you

step up interest rate one month prior to maturity of a loan to encourage repayment then you may be in breach);

2. If the provisions does have such effect, next consider the substance of the transaction by examining the terms of the agreement and the circumstances of the loan objectively to determine if there is a legitimate business reason for such a hike in interest rates or a certain administrative fee); and

3. Permit the interest provision to stand if the parties are knowledgeable and it does not appear to be coercive, unfair, abusive or a penalty.

In the event that a breach is found, interest on the remaining outstanding balance may be charged in accordance with the previously set rate.

As for the issue of excessive administrative fees, Master Hanebury found that if the business purpose of the administrative fees is not evident and appears on its face to be punitive, it will also offend section 8 and will not stand.

To obtain more information about whether your loan agreements are in good standing, please contact Jonathan Ryder or Kelly Marcotte.

Recent Highlights for the National Real Estate Group at FMC

The second half of 2011 has been another successful 6 months for FMC's National Real Estate Group in serving our clients. A sample of some of the significant matters we have assisted our clients with and other highlights are as follows:

Toronto

- The Commercial Leasing Group recently completed a due-diligence lease review involving over 150 locations across the country in a proposed share-purchase transaction;
- Acted for, and currently acting for GWL Realty Advisors, the winning proponent in connection with the RFQ and the RFP for the demolition of an existing office tower and the construction of a new office and retail complex for the federal government concerning the 90 Elgin Street property in the City of Ottawa. Our lawyers assisted in the negotiation and implementation of all project documents, including the ground lease, lease-back, retail sub-lease, development agreement, construction and initial pick-up agreements, financing, insurance trust and bonding arrangements, and property management agreement;
- Acted for a major developer and pensions fund in connection with the acquisition and financing of the 90 Harbour Street property in the City of Toronto, including providing legal advice with respect to the demolition of an existing building, the preservation of certain heritage aspects of the existing building, and the joint venture agreement to develop the site for condominium towers, office and retail uses, which included work related to planning and development matters, severance issues, construction issues and take-out financing;
- In September of this year, the Toronto office hosted another successful real estate client seminar. It was attended by over 100 clients who heard speakers on a variety of commercial real estate, commercial leasing, municipal and condominium development topics.

TIFF BELL LIGHTBOX

On May 30, 2011 Fraser Milner Casgrain LLP ("FMC") completed the transfer of title to the Toronto International Film Festival Inc. of its new permanent home – the TIFF Bell Lightbox on King Street West in the City of Toronto. This was the

culmination of a formal process of over eight years and many years of planning before that.

The TIFF Bell Lightbox is not only a stunning piece of architecture, designed by Kuwabara Payne McKenna Blumberg Architects, but innovative in its legal structure. All legal aspects of the transaction, apart from the financing, were handled by the FMC team consisting of David Moscovitz, Douglas Quick, Paul Bleiwas, Angelo Gentile, Cathy Charlton and Fran Coffin.

The Project is a multi-component complex consisting of the TIFF Bell Lightbox, a residential condominium tower (the "Festival Tower" Condominium Complex), a separate retail/event space component and the underground parking component (itself split into the parking area for the residential condominium and a commercial parking garage for TIFF and the retail component). Construction took place under tiered construction contracts with separate project management and progress advances split and paid by TIFF and Daniels for their respective shares. In order to avoid the uncertainty of late stage *Planning Act* consents, the City of Toronto agreed to pass a Part Lot Control Exemption By-Law at the outset providing certainty to the lenders and facilitating closing immediately following the surveying settling of the as constructed component boundaries.

FMC is proud to have been a part of creating this major new cultural centre in the heart of Toronto's Entertainment District.

Ottawa

- Acted for Wabun Tribal Council on behalf of certain First Nations as equity participants in the development & construction of four (4) hydro-electric power dam projects situated on the Kapuskasing River, to be operated by HydroMega Services Inc under a FIT agreement with Ontario Power Authority including the related project financing with Sun Life Assurance Company of Canada.
- Together with the Toronto office, acted for Dominus Capital Corporation as successful proponent in respect of the City of Brampton's P3 "South-West Quadrant Renewal" Project including the related construction loan & hedge facilities extended by Bank of Montreal.
- Acted for Morguard Investments Ltd. in its capacity as financial advisor for certain undisclosed pension funds, in the acquisition of the remaining fifty percent (50%) interest of the Telesat campus located in Ottawa, Ontario, and the negotiation of the related space lease with Telesat as the principal tenant.

Vancouver

- Acted for The Cadillac Fairview Corporation Limited and Ontrea Inc. in the completion of a restructuring of the ownership and management of Richmond Centre Shopping Centre which is co-owned by Ivanhoe Cambridge. Richmond Centre is a large regional shopping centre located in Richmond, British Columbia with 240 shops and services.

Seven New Lawyers Join the Real Estate Group

Fraser Milner Casgrain is pleased to welcome seven new lawyers to its National Real Estate Group. The Montréal office is being joined by Simon Gauthier and Dominique Quirk who are returning as first year associates after recently being called to the bar. In the Toronto office Karen Groulx is joining us as a partner, Janet MacNeil is joining us as an associate, Michael Toshakovski is returning as a first year associate after having recently been called to the bar. The Edmonton office has gained consultant, Steven Phipps. Returning to the Vancouver office as a first year associate after having recently been called to the bar is Jennifer Wong.

Their respective contact information is set out below:

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