

Focus REAL PROPERTY

Internet changing face of commercial leases

As physical stores start closing, new flexibility needed in rental contracts



**Mylany David
Adèle Poirier**

At a time when consumers can purchase just about any goods or services — and even conduct financial transactions — through the Internet, retailers in multiple sectors and industries are voluntarily choosing or are being forced to close an increasing number of physical stores and branches.

In the years to come, such closures will lead to an increase in vacant commercial space. Tenants and their lawyers should be prepared for this new reality and the questions which arise: How should such commercial leases be managed? What are the best practices in terms of leasing for landlords and tenants alike?

According to the Insolvency Statistics in Canada for the year 2015 published by the Office of the Superintendent of Bankruptcy Canada, the retail sector was the third hardest hit area of the economy hit by insolvency in 2015. During that year, 385 bankruptcies were declared and 117 proposals were made to creditors. Given the evolution of the retail market as it becomes more and more geared toward online transactions, merchants and real estate owners are being forced to reassess and adjust their business practices in order to stay afloat and remain competitive.

Since an ounce of prevention is always better than a pound of cure, the parties to a commercial lease must be more flexible and creative when drafting the offer to lease, the lease itself and also when the lease is being extended or amended. This approach could help a tenant forced to reduce the number of its retail outlets and administrative offices from finding itself in a vulnerable situation, ripe with the potential for litigation, and one where its bargaining power has been significantly reduced.

When negotiating their commercial leases, merchant/lessees should try to negotiate shorter terms, with an option for renewal at the end of the term. Landlords who are prepared to accept such



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shorter terms will in return understandably want to reduce the scope of the work they are obliged to perform at their expense and the various inducements they habitually offer major tenants who sign a lease with a term of 10 years or more. Moreover, it is at this initial negotiating stage that a tenant will have the best chance of successfully arguing for the inclusion in the lease of an early termination clause in its favour. Success in this regard will of course depend on the tenant's bargaining power.

Some landlords grasp these issues and are willing to be flexible in order to avoid losses in their portfolio of tenants and all the problems associated with empty premises. Several landlords appear to be leaning more and more toward temporary and seasonal leases, as well as short-term leases with gross rent as a percentage of tenant revenues. Such agreements allow them to fill vacant units while continuing to search for more stable mid to long-term tenants.

In addition, landlords will find that it is in their interest to tighten their standard assignment and sublease clauses. Indeed, the increasing number of tenants in financial difficulty or seeking to reduce their number of retail outlets or administrative offices will inevitably result in a pronounced increase in requests to sublet or assign the lease. When drafting the initial lease, landlords should therefore bear in mind the strong possibility of

future request to sublet or assign. Thus, in addition to ensuring that the tenant remains responsible for its obligations under the

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Langlois Lawyers

lease in the event of an assignment, a landlord who wants to preserve the image of its shopping centre, for example, will

want to ensure that the lease specifically prohibits uses of the leased premises that are incompatible with current standards, and which specifies more precisely the primary use of the leased premises.

Finally, in a context of frequent reorganizations and potential closings of retail outlets and administrative offices by merchants, landlords must pay closer attention to the types of security provided for in the lease which are designed to guarantee the tenant's obligations. They should insist on security that they will be able to enforce in the event of the tenant's insolvency, such as a bank letter of guarantee, one or more personal guaranties, or prepaid rent. And for the tenant, willingness to cooperate in this regard will give it increased negotiating power over other aspects of the lease.

Mylany David and Adèle Poirier are with Langlois lawyers and practise commercial and real estate law.

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