Concerns and Issues with the Additional Rent Component in Commercial Real Estate Leases

Research Project for Emerging Issues/Advance Topics Course

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ABBREVIATIONS

CAM	Common Area Maintenance
FA	Forensic Accountant
FOC	Final Operating Costs
OCTA	*Commercial Tenancies Act*, R.S.O. 1990, c. L.7
OLRC	Ontario Law Reform Commission
REITS	Real Estate Investment Trusts
TAX	Realty Taxes

1.0 PURPOSE

In a typical commercial real estate lease executed between the Lessor (hereinafter referred to as the “landlord”) and the Lessee (hereinafter referred to as the “tenant”), the landlord charges the tenant two rent components: Base Rent and Additional Rent - the Base Rent is the minimum rent the tenant pays on the leased premises; the Additional Rent is charged to cover the operating cost of the property within which the tenant leases the premises. The Additional Rent component is charged to the tenant in proportion to the area they occupy within the building or complex (hereinafter referred to as the “property”). This enables the landlord to recover the costs incurred to operate and maintain the property.

The focus of this research is on the Additional Rent, as it presents an opportunity for the landlord to manipulate the various components that form and/or impact the Additional Rent and allow for unfair recoveries from the tenant. The opportunity is created due to the imbalance of power between the parties to the lease. Not all tenants are sophisticated and have the bargaining power required to negotiate equitable lease terms. According to the 2020 Key Small Business Statistics, as of December 2019, 97.7% of business in Ontario were classified as being Small Businesses that employ between 1 to 99 employees (Innovation, Science and Economic Development Canada, 2020, p. 8). Not all of these businesses will have the financial expertise and/or legal resources to understand and challenge the Additional Rent component of their leases, especially if the lease terms

are not equitable and inherently made cumbersome for the tenant to obtain the information needed.

The purpose of this research is to:

- Explain how the Additional Rent component fits into a lease;
- Provide an understanding of the relevant issues that can affect Additional Rent;
- Canvass issues with the right to audit offered within a lease;
- Consider remedies if the right to audit is ambiguous;
- Explain the role and value of the Forensic Accountant;
- Make recommendations on various issues surrounding Additional Rent, including suggestions for Regulators;
- Consider the impact of the COVID-19 pandemic on the Additional Rent component; and
- Discuss the ethics of the issue through the Fraud Diamond theory

2.0 INTRODUCTION

In Ontario, a commercial lease document is drafted in adherence with the Ontario *Commercial Tenancies Act*[1] (hereinafter referred to as "OCTA"). The lease document serves as a binding contract that outlines each party's rights and responsibilities (Ontario, 2020). The rights of the party to a lease are stipulated under the OCTA, however, since a lease agreement is a binding contract, the terms and conditions may take precedence over

[1] Commercial Tenancies Act, R.S.O. 1990, c. L.7 [Commercial]

the OCTA. There is no Provincial or Municipal governing body that has the jurisdiction to be involved if a dispute were to arise between the landlord and the tenant, unlike a residential lease which is governed by a Provincial housing authority (National Bank, 2018). As such, under Part II of the OCTA, any disputes between the tenant and landlord will need to be determined in court.

There are various types of commercial real estate leases that exists – the common ones being a Gross Lease, Double Net Lease or Triple Net Lease (bdc, n.d). Under a Gross Lease, the tenant pays a fixed amount to the landlord whereas in every other form of a lease, the tenant is required pay a Base Rent plus an Additional Rent component that would cover some or all of the property related expenses. The focus of this research is on a Triple Net Lease where the tenant pays a Base Rent and Additional Rent on a proportionate share basis. The Additional Rent covers realty taxes, insurance, utilities and any other costs that pertain to the operations and maintenance of the property. The landlord is typically responsible for structural or foundational repairs only (bdc, n.d). A key factor of a triple net lease is that it appears to be transparent - the tenant can see the operating expenses they are being charged in relation to what the property incurs. At the end of a specified period, the landlord is to submit a final statement of operating costs that outlines the tenant's actual share of the costs (calculated on a proportionate basis by dividing the measured area of the tenant's premises over the measured area of the property) which is determined by the landlord based on what the property has expended in a period. The Additional Rent billed is compared to the actual cost incurred and the tenant is required to cover the difference or is refunded back any excess funds for the

period. In theory, a triple net lease may seem to be ideal given its transparency, however, the lack of regulation under the OCTA over the Additional Rent component presents an opportunity for the landlord to overcharge the tenant for any cost that can be recovered under this “grouping”.

There are many complexities involved in the determination and calculation of Additional Rent. This report intendeds to present a conceptual discussion on the components of Additional Rent and the various ways it can be manipulated. Case law is scarce on this matter as the landlord will prefer to settle these disputes outside of court. If the Court were to render a decision towards a tenant at the expense of the landlord, it would affect the relationship of the landlord with all its tenants (Israel, 1992). Hence, in such disputes, there is incentive for the landlord to settle.

3.0 METHODOLOGY

There are various types of leases (and lease terms) that can be negotiated between a Landlord and Tenant. As such, a standard lease “template” does not exist to illustrate the opportunities presented to manipulate the Additional Rent component. For the purposes of this research, the following assumptions are made based on standard industry practice in commercial real estate:

- Tenant signs a net lease, where the Landlord is entitled to a Base Rent and Additional Rent (Zion & Harbin, n.d);

- Tenant is billed Additional Rent in monthly instalments based off internal estimates developed by the Landlord (Alexander, 1988);

- Tenant is sent an operating cost statement at the end of a specified period (Alexander, 1988) - purpose is to compare the Additional Rent billed to the actual cost that has been incurred by the property where the tenant leases the premises. Common industry practice is to issue the statement after the end of the calendar year or after the landlord's financial audit is complete;

- Tenant will issue payment based on the operating statement received (Alexander, 1988) – common industry practice is to issue the Tenant a refund (or a credit on account) if the monthly instalments were more than the actual costs incurred; or Tenant is asked to cover the shortfall, if the monthly instalments were less than the actual costs incurred.

Exhibit A presents select lease excerpts from a fully executed Lease between a Landlord and Tenant in Ontario. Select information has been intentionally deleted to maintain confidentiality of the Lease and the Parties to the Lease.

Exhibit B presents select lease excerpts obtained from various commercial real estate related court cases on Additional Rent disputes and/or issues affecting the Additional Rent component.

Purpose of integrating Lease excerpts within this research is to illustrate the operating reality of a landlord-tenant relationship and how ambiguous and/or loosely worded lease terms can be used to unfairly maximize recoveries from a Tenant.

4.0 RESEARCH LIMITATION

Statistical information was requested from Statistics Canada and The Canadian Real Estate Association on:

1) Number of businesses (small, medium or large) that are "lessees" and have a commercial rent agreement in place with a Landlord; and

2) Data on the types of commercial lease agreement business (small, medium or large) are entered into – Lease agreement types could include Fixed Lease, Gross Lease, Triple Net Lease etc.

Statistics Canada was unable to provide the requested information - statistics on the above data is not available as a standard product and would be made available as a custom order[2]. This route was not considered for this research. The Canada Real Estate Association was unable to provide the requested information as they do not keep statistics on commercial sales/leases[3].

[2] H.Chhatriwala, personal communication, May 7, 2021
[3] H.Chhatriwala, personal communication, May 13, 2021

The purpose of including this particular statistical information in this research was to present information on the number of business that are parties to various types of commercial lease agreements. This information would help to quantify the number of tenants who potentially pay towards Additional Rent as part of their lease agreement.

5.0 ADDITIONAL RENT: HOW IT FITS INTO A STANDARD LEASE

Additional Rent is billed to the tenant by the landlord to recover the expenses the landlord incurs to operate and maintain the property. This component has Common Area Maintenance Expenses (hereinafter referred to as "CAM") and Realty Tax Expense (hereinafter referred to as "TAX") as its two broad categories. CAM costs include, but are not limited to, repairs and maintenance, common area utilities, snow removal, landscaping and cleaning / maintenance of the common areas. Tenants pay a proportionate share of these expenses since it is the tenants that use the property and the landlord operates the property on behalf of them, in exchange for being billed CAM costs. Similarly, TAX is also proportionately billed and recovered from the tenant. However, the allocation and methodology of TAX recoveries may differ from the CAM recoveries (discussed in *Section 7.0*).

At the time a lease is negotiated, the tenant is offered an estimated CAM and TAX rate (also known as the Base Year estimate) for the premises. Once the lease is executed, the tenant commences payment of the Base Rent and their proportionate share of estimated

CAM and TAX on a periodic basis (usually billed monthly). The tenant is billed on an estimate as the actual costs would not be available until the period has ended. The landlord offers to present the tenant with a Final Operating Costs statement (hereinafter referred to as “FOC”) at the end of a period which lists the actual costs incurred to operate and maintain the property. Objective of issuing this statement is to compare the estimates billed to the actual costs incurred to operate the property - if the estimates were less than the actual costs, the tenant will be asked to cover the shortfall. If the estimates were more than the actual cost, the tenant will be refunded back the excess (Newman, 2011).

The opportunity to manipulate CAM and TAX is presented at two stages in this process: 1) when the CAM and TAX estimates are developed; and 2) when the tenant is sent the FOC statement. Since the Additional Rent clause is not standardized, there is an inherent opportunity for the landlord to ambiguously word the lease to pass through costs to the tenant that may not be eligible for recovery. The unsuspecting tenant may not even be aware of what an eligible CAM cost pools might be if the landlord does not discuss it with the tenant beforehand or if it is not stated explicitly in the lease (Falcomer, 2015). Ineligible costs could be built into the estimates and also be carry forwarded (layered within a CAM cost pool) right through to when the FOC statement is issued to the tenant.

The definition of Additional Rent in the lease is often broad and covers a general category of costs that the tenant can be responsible for (see Exhibit B, para 1 and 2). The language can be tricky and leaves room for interpretation. Farbman Group located in

Southfield, Michigan had found that only 1 percent of its thousands of tenants review the reconciliation statement that breaks out the CAM costs (Neal, 2008).

6.0 ADDITIONAL RENT: MANIPULATION OF COMMON AREA MAINTENANCE

The opportunity to manipulate CAM expenses is presented at various stages: 1) when the tenant(s) Rentable Area is determined; 2) when the CAM estimates are developed; and 3) when the FOC Statement is issued at the end of a period.

6.1 Rentable Area of the Premises

The measured area of the premises is a key metric to determine the proportionate share of costs that will be billed to the tenant occupying the premises. The area referenced to in the lease is usually the Rentable Area on which the tenant pays the Base Rent and Additional Rent. The measurement of Rentable Area is often determined by the landlord using their own methods (Manley, 1988). In Canada, there is no set measurement standard (Daoust Vukovich LLP, 2017) and the landlord can adopt any measurement standards[4] which would be enforceable under the lease. If the tenant is offered space based on the Rentable Area measurement, this would include the Usable Area plus the tenant's proportionate share of the property's common areas (Kerry, 2014). Measurement

[4] The Building Owners and Managers Association Standard Methods of Measurement (BOMA) is widely used in Canada – BOMA has various measurement standards, such as: a) Office Buildings (1996); b) Office Buildings (2010); c) Industrial Buildings; d) Retail Buildings; e) Gross Buildings Area; f) Mixed-Use Buildings etc (Kerry, 2014). A technical discussion on the use of appropriate measurement standards is beyond the scope of this research.

of the Rentable Area is typically conducted by the landlord, using a measurement service provider of their choice. There is an opportunity present to inflate and gross-up the area calculation to include an arbitrary loss factor. For instance, the landlord could measure from the outside of one exterior wall to the other or could measure from gargoyle-to-gargoyle façade ornaments, which would be unrelated to the tenant's usable space (Manley, 1988).

Exhibit A, para 1 presents an excerpt from a Retail Lease (a form of a Triple Net Lease) communicating the Rentable Area that the Tenant will be occupying and paying rent on. The gross up factor for common areas is determined to be 1% on the total rentable area of 2,020 sqft; hence 99% of the remainder of the area is deemed to be usable by the tenant. However, the definition of Rentable Area (Exhibit A, para 6) within the same lease states that the Rentable Area is to include interior space even if it is occupied by *projections, structures or columns*. In effect, the usable area could be much lower than what the tenant is paying rent on. Normally, only 75% to 90% of the space the tenant pays for is considered to be usable (Manley, 1988). In this case, the tenant would be billed on 2,020 sqft out of which perhaps 90% of the space is truly being utilized (i.e. usable) by the tenant.

In a typical Retail Lease, the Rentable Area of the premises is generally the same as a Usable Area with no gross-ups for common areas. However, landlords can gross-up the premises to include a proportionate share of common areas such as mechanical rooms or equipment rooms (Grignano, 2009). The question of whether mechanical or equipment

rooms gross-up is to be included as a qualifying gross-up component is dependent on the tenant's negotiating power. However the issue to consider is whether the 1% gross up factor is appropriate and fairly determined by the landlord.

It is recommended that the tenant conduct their own area measurement on the premises they intended to lease, using the same measurement standard as used by the landlord, before signing the lease. The tenant will then be able to determine if the Usable Area based on which the rent is being billed is in fact the true usable space to conduct business. The tenant should also ensure that the Area Certificate provided by the landlord shows the Usable Area, Rentable Area and Common Area gross up factor. Once the lease has been signed and the tenant's premises has been made ready for move in, the tenant can also request an area measurement to be conducted at that stage to ensure the area the tenant will be billed matches the area of the premises they will be moving into and conducting their business from.

6.2 CAM Estimates and the Landlord's Operating Budget

The landlord will develop and update an operating budget on a periodic basis (typically annually) to determine the CAM costs component of Additional Rent. The operating budget provides a projection on the recurring and non-recurring costs the property is expected to incur, based on the current year actual expenditure. A CAM cost estimate is finalized for the property and then billed to the tenant - the lease terms governing these costs are loosely worded and kept general in nature as it is not possible to consider all

cost variables, and at the same time, keep the Additional Rent provisions consistent to apply to all the tenants at the property (Roberts, 2014).

At this stage, an opportunity is presented to inflate the estimated CAM costs that would be billed to the tenant. As there is no specified pool of costs, the CAM pool can be "structured" to pass down ineligible costs to the tenant and inflate the current year's estimates. There is usually no provision in the lease that provides the tenant an opportunity to review or ask for detailed accounting of the CAM estimate and/or the landlord's operating budget. A "right to audit" clause is typically present to review/audit the landlord's books for the actual costs of the period in question, not the estimate or the operating budget. As an example, the absence of a precise CAM cost pool presents an opportunity for the landlord to pass down overhead costs related to the management office, that would not necessarily be recoverable from the tenant under a typical triple net lease.

6.3 Final Operating Cost Statement

The tenant is billed their proportionate share of CAM cost monthly and at the end of a period is sent a FOC statement that compares the CAM instalments paid to the actual costs incurred to operate the property. At this stage, there are various opportunities present to manipulate CAM costs (directly and indirectly) to maximize recovery from the tenant.

6.3.1 Total Building Area

A typical lease does not state the total Building Area of the property in which the tenant occupies the premises. The lease only states the area of the tenant's premises. As seen in Exhibit A, para 1, the building in which the tenant occupies the premises is referred to as "*the retail section* of *the Business Centre in the building"*. The tenant is not provided with a precise Building Area on which its proportionate share would be calculated. Further, the proportionate share definition (Exhibit A, para 7), under the same lease, states that the denominator would be the Rentable Area of the Retail Section (i.e the Building Area). This could mean when the tenant's proportionate share of CAM cost is calculated and a FOC statement is issued for the period, the total Building Area to be used is based on the landlord's discretion. When the tenant is presented the FOC statement, there is no formal way to determine if the Building Area over which the CAM costs are allocated is indeed the total true area of the Building. Further, the CAM estimates that the tenant has been billed on could have been calculated on an understated Building Area which would then be carried forwarded in the FOC statement where the tenant would be presented (perhaps for the first time) the property's Building Area. An inherent opportunity is present to manipulate the Building Area – this would allow the CAM costs to be allocated in a manner which would either maximize the year end recoveries from the tenant or minimize the payout, if the tenant was overbilled and is owed back refunds at the end of the period.

6.3.2 Gross-up Factor

Commercial leases include gross-up provisions to calculate the tenant's share of operating costs. A gross-up provision allows the landlord to adjust the variable costs that fluctuate with the property's occupancy and vacancies. These costs could include, but are not limited to, cleaning services, waste removal, utilities and other common area related costs. The provision allows the landlord to gross up costs to reflect an amount if the property was fully occupied. In doing so, the landlord would be allowed to recover from the tenant their proportionate share as if the property were fully occupied. In theory, this methodology is acceptable and is illustrated with a simple example: Assume a single tenant occupies 70% of a property and the remainder 30% is vacant. If the landlord engages the services of waste removal and cleaning, it would be done for the purpose of the sole tenant who is occupying the property. In the absence of a gross-up provision, the tenant would only be responsible for reimbursing the Landlord for their 70% proportionate share of the occupancy, however, with the inclusion of a gross up provision, it is ensured that the Tenant would pay the landlord 100% of the cleaning and waste removal services as it is directly attributable to the space they occupy. As simple as this methodology may seem, there are various ways gross-up can be unfairly used that can be detrimental to the tenant.

Gross ups should only be attributable to costs that are directly variable to the maintenance and operations of the property (Grignano, 2009). Under Exhibit A, para 3, the Lease negotiated calls for a 100% gross up factor. The lease is silent on which costs the gross-up would pertain to. This could provide an opportunity for the landlord to unfairly

recover costs that would normally not fluctuate with occupancy. For example, property insurance, landscaping and snow removal – these costs are fixed and are assumed to be a required component to the operations and maintenance of the property. Regardless of the occupancy, the landlord will incur these expenses to ensure the property is clear of snow and is adequately landscaped to promote and market to their customers and potential future tenants. Further, the property will need to be insured whether it is 100% occupied or any less.

The gross-up provision also presents another opportunity for manipulation when the FOC statement is prepared. In any given year, if the actual occupancy of the property is less than 100%, the landlord could allocate the CAM costs over the total Occupied Area as opposed to the total Building Area (Santerre, Landlord's Fake Measurements - Case #1, 2018). Using this methodology, the cost of operating the vacant units is also passed on to the tenant. There is no requirement for the landlord to provide the tenant an area measurement of the property over which the tenant's proportionate share would be calculated. Hence, from the stage when the estimated CAM costs is determined to the stage when the tenant is sent the FOC statement, the total property area could be manipulated to maximize recoveries. Further, with a 100% gross-up clause and allocation over total Occupied Area as opposed to total Building Area, the impact to the tenant would be much greater.

Certain variable costs could have a fixed component which could also be unfairly recovered from the tenant. For example, a cleaning contract will likely have cleaning

services for vacant premises. The cleaning may not be frequent, but it may occur from time to time. If the cleaning services are treated as a variable expense and grossed up to recover the full cost from the tenant, the landlord would be passing on the expense related to the vacant premises on to the tenant for recovery. The same would apply for any other variable cost that would pertain to vacant premises.

6.3.3 Administrative Fee

The landlord could charge an Administrative Fee on CAM at the end of the period when the FOC statement is sent out to the tenant. If the tenant is in a refund position, this additional added cost could reduce the refund or if the tenant is in a payable position, this could further increase the payable amount. Exhibit B, para 2 illustrates this point – in the case of *C.C. Tatham & Associates Ltd. v. 2057870 Ontario Inc*[5]., the landlord was of the position that Administrative Fees were part of the cost associated with maintaining the property and billed the tenant for this cost. However, the court disagreed with the landlord and stated the administrative and management fee must be stated as part of the Additional Rent for the landlord to charge this cost to the tenant[6].

There could also be a possibility of the landlord "double-dipping "on Administrative Fees to obtain an unreasonable profit. It can be a questionable practice if the tenant's CAM estimate already has a built-in cost of site supervisor / property manager salaries, and the lease also allows for administration fees to be charged to CAM costs (Grandfield, 2018). As a lease is typically silent on issues relating to determination of CAM estimates and/or

[5] C.C. Tatham & Associates Ltd. v. 2057870 Ontario Inc., [2011] O.J. No. 3033
[6] *Ibid*., at para 15

disclosure relating to the operating budget where the CAM estimate is developed, the tenant would not be able to identify if the CAM estimates they are being billed has this component already included. Even if the tenant requests a supporting document from the landlord, the landlord is not obligated to provide this unless explicitly stated in the lease. If the tenant is charged an Administrative Fee for property management related services and the site supervision / property management salary is also passed on through CAM billings, then the tenant is essentially being billed for the same service twice. There have been numerous court cases over the years on this issue, however the Administrative Fees being viewed as a "profit-center" for the Landlord has never been resolved (Vukovich, 2009). Even if this practice is questionable, the court will refer to the language of the lease (Vukovich, 2009).

To remain equitable to the tenant, it is important to have a clear and specific language in the lease to ensure duplicate Administrative Fees do not get billed to the tenant indirectly. The tenant can also negotiate to have the landlord certify that CAM estimate being billed does not have any provision or estimates for site supervisor / property manager salaries especially if the tenant is being billed an Administrative Fee on CAM costs under the lease.

6.3.4 Utilities

Tenants of leased premises pay two types of utility charges: 1) direct consumption of utilities; and 2) common area allocated utilities of the property within which the premises is leased from.

The direct consumption is the utility consumed by the tenant's leased premises only. The tenant either has a utility meter installed and will pay the utility service provider directly, or in some cases where the entire property has one meter, the landlord will allocate the utility consumption based on their allocation methodology. In Exhibit A, para 4, if the utility is to be paid by the Landlord on behalf of the Tenant, the Landlord will then allocate the utility and pass it on to the Tenant. It must be noted that the lease is silent on the Landlord's allocation methodology to be used to allocate utility charges to the Tenant. The absence of a direct utility meter for the tenant can lead to questionable allocation methods used by the landlord. If the landlord allocates using proportionate share, it can be disadvantageous to the tenant if their business consumes a lower utility versus another tenant that uses a higher utility – under the proportionate share allocation, tenants with lower consumption would be subsidizing tenants with higher utility consumption. For the landlord, the objective is to recover 100% of the utility cost, which the landlord will achieve under the proportionate share allocation method. If the landlord uses another allocation factor where a premium is placed on a particular tenant's usage, that may also be questionable if utility is allocated proportionately to all tenants and a premium added on to specific tenants who have higher consumption of utility. The landlord could recover over 100% of the utility cost from the tenants and make a profit on the added premium.

Recommended allocation methodology would be to install Check Meters to measure consumption and track usage of tenants who may be known to use higher utility (Santerre, Additional Rent: Utility Consumption of a Commercial Building, 2018) (some

business operations may have higher consumption of a utility, such as restaurants). Ideally, check meters should be installed on all tenants' premises to ensure utility is allocated fairly and equitably. However, depending on the size of the landlord's operations and financial resources, it may be expensive to install.

For common areas, the utility consumption would be the same for all tenants, regardless of their utility consumption on their occupied premises. The common area utility should be excluded from the gross-up calculation as it does not vary to the occupancy rate. If the common area utilities are included with the other common area variable costs that are to be grossed up, the landlord is viewed to be profiting off the resale of utilities. According to the Ontario Energy Board, utility service providers are regulated and profiting off utilities is not allowed (Ontario Energy Board, n.d). A fair and equitable method in this case would be to allocate it on a proportionate share basis (Santerre, Additional Rent: Utility Consumption of a Commercial Building, 2018). Regardless of how many units/suites are vacant, the common areas of the property would always consume consistent utilities.

It is recommended the tenant clearly negotiate a provision in the lease to have the landlord provide copies of the utility bills at the time the FOC statement is provided to the tenant. Agreeing to a clause such as the one in Exhibit A, para 2 restricts the tenant to a "*statement of the amounts and costs…certified by the landlord"* and presented to the tenant within "*a reasonable time"* which does not promote transparency nor address the timeliness of the matter. A certification by the landlord does not replace the same level of

confidence a certification by a third party, such as an auditor, would entail. Further, the section is also silent on providing the tenant with documentary evidence of the billings for the cost that have been proportionately allocated to the tenant. The tenant could request copies of the utility bills from the landlord, however, since the matter is not clearly stated in the lease, it could be refused.

6.3.5 Structuring of Capital Expenditures

CAM costs should generally exclude capital expenditures; however, these items can be relabeled and find their way into the Tenant's CAM costs (Santerre, Sorting out the jargon, 2011). In the supreme court ruling *Montreal Light, Heat & Power Consolidated v. Minister of National Revenue*[7], expenditure relating to capital items was expressed to be "the expenditure made with a view of bringing into existence an advantage for the enduring benefit of the business" (Vukovich, 2009, p. 2). In Canada, cases pertaining to determination of whether an expenditure is capital in nature generally relied on this ruling. Under this definition of capital expenditure, there is often considerable debate on how capital costs are to be passed on to the tenants if they have a net lease (Vukovich, 2009).

As a work around, the landlord is inclined to "structure" capital costs as an operating expense so that they can be recovered through CAM from the tenant. This structuring of capital costs as a repair / maintenance item is seen in the case *of RioCan Holdings Inc. v.*

[7] Montreal Light, Heat & Power Consolidated v. Minister of National Revenue, [1942] S.C.R. 89

Metro Ontario Real Estate Limited[8]. RioCan (the Landlord) had incurred an outlay to resurface the parking lot which RioCan had internally classified as a repair costs and recovered it from Metro (the Tenant), through its proportionate share of Additional Rent billings. The court disallowed the classification of this outlay as a repair item (classified as such by the Landlord so that it could be recovered from the Tenant as an operating expense) on the basis that the "work done to rehabilitate the parking lot was a significant capital project" (Riocan v. Metro, 2012, para 2). RioCan took the position that the expenditure was a repair item as opposed to a capital items based on RicoCan's definition of "accepted accounting practice" (Riocan v. Metro, 2012, para 4) as stated in the Lease document. It is worthy to note that the lease did not define "accepted accounting practice" (Riocan v. Metro, 2012, para 5) and was open to interpretation if it meant GAAP or Tax accounting principles (Riocan v. Metro, 2012, para 8). Although this does not constitute as a direct manipulation technique, however the case does illustrate the opportunity that could be presented to a landlord to structure certain capital expenses as operating expenses and pass it on to the tenant by way of constructing an ambiguous worded lease that is open to interpretation.

6.3.6 Issuance of the Final Operating Cost Statement

The landlord develops a CAM estimate towards the end of the period and bills the tenant an estimate for recurring and non-recurring expenses the property will incur in the following year. The landlord may decide not to expend certain costs until some other future period – in which case, the tenant should be issued a refund at the end of the

[8] Riocan Holdings Inc. v. Metro Ontario Real Estate Ltd., [2012] O.J. No.1945

following year; however, the landlord may decide not to do so. This can take the form of the landlord simply refusing to provide the tenant the FOC statement at the end of the period or not providing one, unless asked by the tenant. If the tenant is in a refund position and the amount is significant, the landlord would have unfairly held on to refunds which rightfully belong to the tenant. As an example, assume a property has a total Rentable Area of 100,000 sqft. The Landlord develops an operating budget and estimates CAM to be $7.00 per square foot (annualized basis) for a particular year and bills all the tenants within that property on their proportionate share accordingly. At the end of the year, the Landlord determines the property only incurred CAM costs amounting to $4.00 per square foot (annualized basis) for the year. The Landlord must refund back all the tenants $3.00 per square foot (annualized basis). If the refunds are not issued or intentionally delayed, the Landlord would have unfairly withheld $300,000 worth of refunds rightfully owed to the tenants. Exhibit A, para 2 illustrates this point - the Landlord acknowledges it will deliver to the tenant a statement at the end of the period "*within a reasonable time";* however, the term *"reasonable time"* is not explicitly defined in the lease[9]. Further, if the tenant is sent the FOC statement that is questionable, the tenant is only provided six months to advise the Landlord or to question any errors, computations or allocation methodology by way of notice only. The process can be cumbersome for the tenant especially if a notice must be sent for every question or follow up question that could arise in this process.

[9] Lease document in Exhibit A was independently reviewed.

7.0 ADDITIONAL RENT: MANIPULATION OF REALTY TAXES

The value of a property in Ontario is assessed by the Municipal Property Assessment Corporation ("MPAC" or the "assessor") in accordance with the Ontario *Assessment Act*[10]. MPAC assesses the value of a property on a four-year assessment cycle. In 2016, MPAC assessed the value of "nearly five million properties to reflect the legislated valuation date of January 01, 2016" (MPAC, 2016, p. 4). The value assigned at the base year of 2016 is equally phased in over four years for the realty tax periods of 2017 to 2020[11]. The Municipality applies a tax rate to the assessed value to arrive at the realty tax amount to be billed to the property owner. The realty tax is imposed and collected by the respective Provincial Municipalities where the property is located.

MPAC assesses the value of the property using three approaches: 1) the direct sales comparison approach; 2) the income approach; or 3) the cost approach (MPAC, 2016, p. 8). Regardless of the approach used, MPAC requires the property owner (landlord) to submit financial data, in addition to MPAC's own sources of data collection, to determine the assessed value. On an annual basis, the landlord is required to file and submit their property income and expense information as part of the Property Income and Expense Return (PIER) program (MPAC, n.d). There is a narrow window of opportunity

[10] Assessment Act, R.S.O 1990, c A.31 [Assessment]

[11] As part of the Ontario Government's Budget released on March 24, 2021, due to the COVID-19 pandemic, property assessments for 2021 and 2022 tax year will continue to be based on Jan 01, 2016 assessed values: https://www.mpac.ca/en/AssessmentUpdate

presented for the landlord at this stage to intentionally manipulate the income and expense data provided to MPAC. According to Sec 11 of the *Assessment Act*[12], the landlord is required to "provide any information or produce any document relating to the assessment of land" (Assessment Act, 1990, s. 11) however, there is no requirement for the landlord to submit audited financial information. The landlord may be motivated to understate their income or overstate their expenses to attain a lower assessed value, which would result in lower realty taxes. Even though the realty taxes may be fully recoverable under the lease and may be seen as a cost to be passed on to tenant ultimately, the landlord still has an incentive to misrepresent the financial information to MPAC. A lower property assessment value would enable a property to be favorable when sourcing potential tenants as the landlord could market the premises as having lower a tax rate than the competitor properties. The lower assessed value would add a layer of "legitimacy" to the landlord's justification of the property being assessed at a lower value. It is acknowledged that MPAC would have its own checks and balances to ensure a property is assessed based on comparable market values, however, the financial data provided by the property owner is exclusive and can only be assessed via the property owner's submission. For properties under a Real Estate Investment Trusts (REITS), MPAC could validate the financial information through publicly available audited financial statements, however, for property owners that are private entities, there are limited resources available.

[12] Assessment, *supra* note 9 at sec 11

Once the property tax bill is issued, the landlord is liable to remit property taxes to the respective Municipality where the property is located. The landlord will then seek to recover the realty taxes from the property's tenants, if the lease document allows to do so (a standard lease will allow for recovery of realty taxes). Similar to CAM, the tenant will be billed TAX estimates on a monthly basis. At the end of the period, a final tax statement is issued which compares the tax installments billed versus actual realty tax expense incurred (typically included as part of the FOC statement). The tenant will then be asked to cover any shortfalls or be issued a refund if they have paid more than their share.

The realty tax allocation methodology used by the landlord can provide an opportunity to unfairly maximize recoveries from the tenant. In 1998, MPAC eliminated assigning specific assessment values specific to a tenant's leased premises (Posen, Messinger, & Kobi, MPAC Working Papers - Should they be Used or Not?, 2014). Currently, for a commercial property with multiple tenants, the assessment value is determined using the capitalization of income approach where the tenants are grouped by a broad range of categories such as restaurant, office, kiosk etc. and ascribed a market rent that is capitalized (Posen, Messinger, & Kobi, MPAC Working Papers - Should they be Used or Not?, 2014). A realty tax bill with one assessed value is then issued to the property. The record that shows the breakdown of the assessment by group is referred to as the "working papers" or the "assessors records" (Posen, Messinger, & Kobi, MPAC Working Papers - Should they be Used or Not?, 2014, p. 1) and is not part of the official tax notice that property receives. As a result, the landlord is not obligated to use the "working

papers" to precisely allocate the realty taxes to the tenants based on the assessed value of each of the premises. From an allocation standpoint, many tenants take the position that allocating realty taxes on a square footage proportionate basis would create a disparity in allocation of values to leases premises (Daoust Vukovich LLP, 2014). Under the capitalization of income approach, a tenant grouped under a high-income producing stream (for example restaurants with high foot traffic) would be allocated a higher assessed value than tenants under a lower income producing stream (office tenant). If the landlord were to allocate the realty taxes based on square footage, a tenant with a lower assessed value would end up paying more than they would have if they were allocated taxes based on the true assessed value of the tenant's leased premises.

In Exhibit A, para 5, the Lease states if the property does not receive an official tax notice that clearly identifies the assessed value, the realty taxes will then be allocated on a proportionate share basis as determined by the landlord. In this case, the tenant will have to accept any allocation methodology used by the landlord. The lease is silent on using any other approaches that would fairly allocate the realty taxes to the tenants. Further, the lease is also silent on a use of consistent allocation methodology year after year to allocate taxes to the tenant. This presents an opportunity for the landlord to switch realty tax allocation methodology from proportionate share basis in one year, to some other allocation methodology in the next year (or retroactively in prior year periods) that would enable to maximize recoveries at the expense of the tenant. In the case of *OGT Holdings Ltd. v. Startek Canada Services Ltd*[13], the landlord elected to use a separate tax

[13] OGT Holdings Ltd v Startek Canada Services Ltd, [2009] OJ No 5270

assessment method for fours year, and then switched to proportionate share and applied it retroactively as that yielded a higher tax recovery. The tenant was billed an additional $346,692.80 for the adjusted balance as a result from the change in methodology. The tenant disputed this arrangement and the court agreed with the tenant's position that once the landlord elected to use a methodology, the landlord could not subsequently change the methodology and retroactively apply it. However, since the lease provided the option to change the calculation methodology, the landlord could do so by providing the tenant with a reasonable notice (Posen, Messinger, & Kobi, Realty Taxes, n.d). Considering the judgement ruled on OGT v. Startek, in the Lease excerpt presented in Exhibit A, para 5, the lease states the allocation will be determined and allocated by the landlord – this would allow the landlord to use any methodology that would maximize recoveries and/or even retroactively apply it after the tenant has been issued the FOC statement for a particular year (under the same Lease, para 2 allows the landlord to subsequently "render an amended or corrected statement"). This could be extended to various tenants within the property depending on which allocation method yields the maximum benefit to the landlord - some tenants could be billed on proportionate share whereas others could be billed on some other methodology. Since the leases are individually negotiated, only the parties to the lease are privy to the lease terms. If the landlord has negotiated all the leases within a property with similar terms, there is opportunity and motivation for the landlord to use an allocation methodology, or a combination of varying allocation methodologies for each tenant, which would yield the maximum recovery.

Since 1998, many attempts have been made to rely on the assessor's records (i.e MPAC working papers) as a basis for allocating taxes (Posen, Messinger, & Kobi, Realty Taxes, n.d), however they have not been successful. In *Orlando Corporation v. Zellers Inc*[14], the lease between the landlord and tenant stated that if the Tenant's building is not assessed and taxed separately, the realty taxes would then be allocated proportionately (Orlando v. Zellers, 2002, para 23). The Tenant wanted to rely on the assessor's records for allocating realty taxes, however the court held that the assessor's records did not constitute as a basis for separate assessment and the provisions of the lease would apply. Similarly, In the case of *Sophisticated Investments Ltd. v. Trouncy Inc*[15], the lease between the landlord and the tenant stated that in the absence of a separate tax bill if the landlord is not able to charge based on assessed value, then the tenant would pay taxes calculated on a proportionate share basis (Sophisticated v. Trouncy, 2003, para 18). The Court held that "the working papers would not constitute an assessed value of the lease premises…the proportionate basis for calculation was to be used" (Sophisticated v. Trouncy, 2003, page 1). In the case of *Indigo Books & Music Inc v. Manufacturers Life Insurance Co.*[16] the court specifically questioned the reliability of MPAC's working paper files and concluded it was within the landlord's discretion to allocate the taxes within the terms of the lease, which is proportionate share (Indigo v. Manufacturers, 2009, page 1). On the same case, the court also ruled that MPAC's working paper files were not intended to apply to individual premises and was meant to arrive at a value for

[14] Orlando Corporation v Zellers Inc et al [Indexed as: Orlando Corp v Zellers Inc], 62 OR (3d) 220, [2002] OJ No 4284
[15] Sophisticated Investments Ltd. v. Trouncy Inc., [2003] O.J. No. 3107
[16] Indigo Books & Music Inc. v. Manufacturers Life Insurance Co., [2009] O.J. No. 1121

the entire property (Posen, Messinger, & Kobi, MPAC Working Papers - Should they be Used or Not?, 2014).

From the case rulings discussed above, it would be ideal to have it clearly stated in the lease that if specific assessment were not available, other information would be obtained from official sources to determine the value attributable to the specific premises (Daoust Vukovich LLP, 2014). In the case of *Terrace Manor Ltd. v. Sobeys Capital Inc*[17], the lease stipulated that if separate assessments were not available, then both parties would use "their reasonable and diligent efforts to have such separate assessment made or, failing that, to obtain sufficient official information to determine what such separate assessments would have been if they had been made…" (Terrace v. Sobeys, 2012, para 6). The courts sided with the Tenant stating that MPAC's working papers qualified as "sufficient official information" (Terrace v. Sobeys, 2012, para 6) and municipalities are required by law to use MPAC's assessment data to levy taxes (Posen, Messinger, & Kobi, MPAC Working Papers - Should they be Used or Not?, 2014).

As seen in the case of *Terrace Manor Ltd. v. Sobeys Capital Inc*, the tenant was able to garner a ruling in their favor due to the fact the language of the lease was clear, and the lease terms and conditions was drafted by "sophisticated commercial parties using legal counsel and possessing equal bargaining power" (Terrace v. Sobeys, 2012, para 50). For the tenant to ensure realty taxes are not unfairly allocated to their premises by the landlord, precise wording in the lease is required. Additionally, it is also recommended

[17] Terrace Manor Ltd v Sobeys Capital Inc, [2012] OJ No 2144, 2012 ONSC 2657 [Terrace]

the tenant negotiate a provision in the lease that calls for an expert to fairly determine the allocation of realty taxes. The expert can apply the appropriate method to determine the realty tax allocation and then compare it to what the allocation would have been should the tenant's premises have been separately assessed by MPAC (Daoust Vukovich LLP, 2014). Further, the lease should also indicate that the landlord provides the tenant with a copy of the MPAC's working papers, official tax notices and realty tax bill when the FOC statement is issued to the tenant, to ensure there is full disclosure and transparency. It is acknowledged not all tenant may possess the sophistication and negotiating power to have this included in the lease, however, adequate documentation and clear lease terms, at the minimum, will ensure the tenant is fairly allocated its share of realty taxes.

Before signing a lease, the tenant should also request the landlord to provide the current and prior Base Year MPAC assessment notice to understand the change in the assessed value of the property over the four-year assessment cycle. The tenant can then determine if the realty taxes estimate being charged to them is reasonable or intentionally manipulated to entice them to enter into the lease. In addition, obtaining this document will also enable the tenant to understand if the landlord has appealed to lower their assessed value - the change in assessed value will be reflected in the official notices issued by MPAC. Reduction in assessed values translates into the landlord receiving a reduction in realty taxes, the benefit of which should be passed on to the tenant (if the lease allows for the landlord to recover realty taxes from the tenant). When the landlord issues the FOC statement along with a copy of relevant tax documents, the tenant can determine if the landlord has received a reduction in the assessed value and if that benefit

has been passed on to the tenant. If the landlord fails to provide the tenant with the MPAC notice, the tenant is entitled to request the information directly from MPAC (MPAC, n.d). Another option the tenant may consider is to negotiate an arbitration clause in the event both parties do not agree with the allocation methodology and the issue cannot be resolved mutually. The matter under dispute could be submitted to binding arbitration in accordance with the provisions of the Ontario *Arbitrations Act*[18].

8.0 A TENANT'S RIGHT TO AUDIT

A tenant's ability to prove that the landlord has unfairly recovered excess CAM and TAX charges is dependent on whether the lease allows the tenant the right to audit the landlord's financial records. Without this right, the tenant is not privy to the landlord's actual cost incurred for the property and passed on to the tenant (Schorr, 2008). The tenant must settle with the documentation that the landlord provides (if any) when the FOC statement is issued or the landlord's assertion/representation of those costs. As previously discussed, the landlord's representation of actual CAM and TAX expenses may be questionable and not reflective of the true costs eligible to be recovered from the tenant. Many commercial leases are silent on the issue of a tenant's right to audit the CAM charges (Schorr, 2008) and the tenants are inclined to ask for supporting documentation only when there appears to be some error. Some landlords will comply with requests to provide with this information, others refuse unless the lease explicitly provides for such rights (Newman, 2011).

[18] Arbitration Act, 1991, S.O. 1991, c. 17 [Arbitration]

If the tenant can negotiate adding a right to audit clause, it should be tied to a reasonable time frame, one that is aligned with the provincial statute of limitation periods. This will ensure the tenant is protected and is provided with a reasonable period to review / challenge the charges being billed, and not automatically dependent on the landlord's assertions. If the right to audit is one with a short turnover time-period, it is often done so to make it cumbersome for the tenant to exercise that right (Harris, 2004). Not all tenants will have the capability to review or initiate an audit within the time frame provided by the landlord.

In Exhibit A, para 2, the landlord offers the tenant "*six months*" to bring to the landlord's attention any computational errors in the FOC statement provided to the tenant. After the six month period, the tenant is left with limited options (or no options) if the tenant determines they have overpaid their share of costs based on erroneous landlord billings. The six-month period provided to review/audit the FOC statement is much shorter than Ontario's Limitation Period of two years under the *Limitation Act*[19]. A two-year limitation period would apply if a tenant were to claim for overpayment of rent which was confirmed in the judicial decision made in the case of *Ayerswood Development Corp. v. Western Proresp Inc*[20] (Posen, Messinger, & Kobi, Limitation Period - Authority for Landlords, n.d).

[19] Limitations Act, 2002, SO 2002, c. 24, Sched. B, Section 4
[20] Ayerswood Development Corp. v. Western Proresp Inc., [2011] O.J. No. 1052

For a tenant under the lease terms presented in Exhibit A, para 2, the landlord is allowed to provide a FOC statement within a "*reasonable time"* which is ambiguous and open to interpretation. Further, if the tenant has overpaid, the landlord will refund the excess within a reasonable time after delivery of the statement, whereas if the tenant has been underbilled, the tenant must remit the difference on the next month's rent payment. The term of the Lease is not equitable for both parties in this case. The period should be reciprocal in nature where the tenant and landlord is offered the same time period to review / challenge the costs presented on the FOC statement. Tenants should be allowed the minimum period as per the Limitation Period to challenge billings and recoup any amounts they are billed erroneously and/or as a result of misrepresentation. The landlord is required to retain financial documents for a minimum period of six years in accordance with Subsection 230(4) of the *Income Tax Act*[21]. Therefore, it would be reasonable for the tenant to request financial records within the Limitation Period and for the landlord to provide them. Most landlords would not like tenants to challenge historic billings unreasonably and over a longer elapsed time, hence it is fair and equitable to provide tenants the required time as per Provincial regulation. If the landlord takes the position that they are unwilling to provide the tenant access to financial information as they risk disclosing information to their competitors and/or do not want the tenant to become aware of their billing practices, the tenant can sign a confidentiality agreement with landlord to protect both parties interest (Harris, 2004). The landlord may require a location limitation (Jenny & West, 2013) to be added in to ensure confidential information is reviewed at the landlord's location of choice. However, this creates a

[21] Income Tax Act (R.S.C., 1985, c. 1 (5th Supp.))

deterrent as it is cumbersome and costly for the tenant to conduct an audit at the landlord's location. In current times, there are various means through which the landlord can securely transfer the required documents electronically using a secure file share service or through the landlord's own digital file share service giving the tenant exclusive access to review the documents.

If a tenant is able to negotiate the right to audit, it is recommended the tenant negotiate a right to audit with no limitations to provide full access and review rights of the Base Year period (the period when the base year billings estimate was generated, or the operating budget for the base year period) in addition to current period review rights. This will ensure the tenant has proper comparison of the increase or decreases in costs that are being billed (Harris, 2004). As an example, a tenant should have the right not only to review specific vendor billings that are being charged to them, but also common area billings such as landscaping and snow removal service contracts and parking lot repairs and maintenance that form the proportionate share of their leased premises costs.

If the right to audit is one with a limitation where it calls for the tenant to rely on the landlord's independent audit of the CAM and TAX statements, the landlord's auditor reviewing the statements may not necessarily look for exposure to fraud and as a result may not review the complete financial records where discrepancies may reside (Rosenthal, 2010). Regardless of the auditor's requirement to be independent and perform the audit with an objective mindset, the conventional audit methodology and scope looks for material misstatement and does not actively seek out areas that could be

manipulated. Further, the landlord's appointed auditor may not have the specific expertise to truly understand the specific nuances and language of the lease and how it applies to each tenant's scenario. Even if the landlord provides the tenant with a certified and/or audited CAM and TAX statements, the tenant should consider engaging the services of a specialized lease audit firm to review the billings. A lease audit firm will have the resources and expertise to navigate through the wordings of the lease. If the tenant suspects the landlord may have intentionally misrepresented the costs, the tenant can consider using the services of a Forensic Accountant to thoroughly investigate the pass through of costs from the landlord to the tenant.

In the event the lease terms are ambiguous or silent in the matter relating to the tenant's right to audit, and the issue leads to litigation, the courts will assess the lease on the covenant of good faith to assist in interpreting the intentions of the parties to the contract when the parties rights are unclear as a result of ambiguity or contractual silence (Posen, Messinger, & Kobi, Implied Duty of Good Faith? Duty to Mitigate Damages?, n.d). However, Canadian Courts have taken a cautious approach, the rationale being that if parties are negotiating a contract freely, the parties will act in entirety in their own interest and imposing a positive duty to negotiate in good faith would conflict with the requirement to negotiate freely (Posen, Messinger, & Kobi, Implied Duty of Good Faith? Duty to Mitigate Damages?, n.d). If the tenant does decide to take the landlord to court over not providing fair access to its books and records, it may prove to be a costly remedy for the tenant. The process can be time-consuming and may takes a fair bit of time to reach a judgment. At the same time, the landlord would still have possession of the

tenant's excess funds up until the courts reach a resolution or the landlord wishes to settle.

9.0 BEYOND THE TENANT'S RIGHT TO AUDIT

If the tenant is not able to negotiate a right to audit, or if the clause is present, but not equitable to both parties, the tenant may wish to consider other remedies if they suspect that the landlord has unfairly recovered Additional Rent over and above the tenant's fair share.

The following options can be considered at the time a Lease is being negotiated:

9.1 Mediation

This may be an economical option for the tenant to have negotiated in the lease as opposed to a default option of litigation. It may be advantageous for the landlord to trigger a litigation in a dispute given the resources and information they may possess. The landlord after all has full access to financial records and possess information about the property and the tenant's premises that the tenant may not have. The benefit of mediation is that the Mediator has no authority to impose a solution, instead the resolution must be agreed upon by both parties (Daoust Vukovich LLP, 2007). From the perspective of the tenant and landlord, mediation would help facilitate a frank and free conversation on a without prejudiced basis (Daoust Vukovich LLP, 2007) which could encourage both parties to preserve their professional relationship and reach a settlement that would

remain confidential. However, since the outcome of the mediation is confidential, no precedent is set unlike a court decision. From the viewpoint of the commercial real estate industry, having a precedent set on issues relating to Additional Rent overcharges may provide some stability and equitable negotiating powers for all parties.

9.2 Arbitration

Unlike mediation, arbitration is binding to both parties and is conducted in accordance with the Ontario *Arbitration Act*[22]. The Arbitrator acts like a judge and makes the decision that is final and binding. The key difference between arbitration and litigation is that in arbitration, both parties select the arbitrator and are in control of the process (Daoust Vukovich LLP, 2007). In order to commence arbitration, the parties to the lease will require a provision in the lease to use this as an option for dispute resolution. If this option is present, and the landlord decides to bypass and go straight to litigation, the court will halt the proceeding and order the parties to arbitrate if the lease has such a provision (Daoust Vukovich LLP, 2007). Arbitration may be beneficial as the Arbitrator is agreed upon by both parties and will usually be an expert in the legal and business issue at stake. In a litigious setting, the parties do not have an option to "shop" for a judge (Daoust Vukovich LLP, 2007). Similar to mediation, the decision made in the arbitration process is also confidential and no precedent is set. The decision is only binding on the parties involved in the process. Having these issues resolved "behind closed doors" may benefit specific parties at the heart of the issue, however, since no precedent is set, the issues and their resolutions are not made public. Interested parties may not be able to refer to and

[22] Arbitration, *supra* note 18

understand the varying issues present within a commercial lease or at the minimum, the common issues to be aware of.

9.3 Withholding Payment

Tenants should negotiate the right to withhold paying unexplained CAM and TAX increases up until the landlord can present documentation and detailed summary of costs to justify the CAM and TAX billing being charged. The tenant should ensure this is negotiated in the lease and does not constituent as a default.

9.4 Base Year Supporting Documents

Require the landlord to present the base year supporting documents and/or operating budget so that the tenant can understand how the estimated CAM and TAX billings were determined. As previously discussed, the estimated CAM and TAX billing can be artificially inflated from the onset to consistently bill the tenant at a higher rate. Or the CAM and TAX can be intentionally deflated to entice the potential tenant to sign the lease. Once the tenant is bound by a Lease and if the terms pertaining to CAM and TAX are ambiguous or loosely worded, the tenant can be at a major disadvantage when presented with the final operating cost and realty tax statement, as limited recourse is available at that point.

9.5 General Supporting Documents

Require the landlord to present copies of actual invoices to support the period end final operating costs and realty tax statements.

9.6 Financial Information

Require the landlord to present the tenant with financial information relevant to the property in which the tenant leases the premises. The financial information provided should allow the tenant can conduct their own examination of the costs to verify if the landlord has allocated the share of costs to the tenant's premises equitably and fairly.

9.7 Define Terms

Require the landlord to clearly define ambiguous terms such as "*reasonable period"* (Exhibit A, para 2), and present greater clarity on wordings such as "*allocated or attributed by the Landlord"* (Exhibit A, para 5)

9.8 Capped CAM

The Tenant can consider adding a cap on CAM costs to protect themselves from large increases in CAM. This would provide the tenant with some financial certainty, however there are additional challenges involved with Capped CAM pertaining to the validity and necessity of the charges (Jenny & West, 2013). At a minimum, if the tenant is locking their lease into a pre-determined CAM increase, this may allow the landlord to increase the tenant's CAM costs even during periods when the operating cost of the property is lower than the prior year. As an example, during the COVID-19 pandemic, landlords may

have experienced reduced operating costs due to mandated closures and/or restriction on maintenance work and/or capital projects that could be performed during a Province wide shut down period. However, if the tenant has a periodic capped CAM increase, the landlord may still be able to increase the tenant's CAM costs even if the actual cost of operating the property is lower. There are many nuances involved in negotiating capped CAM; the tenant should consider seeking legal advice before considering this as an option and ensure sufficient remedy is available within the lease in the event a discrepancy exist between the capped CAM billed versus the actual CAM cost (Jenny & West, 2013).

9.9 Independent Verification

Require the landlord to have the period end operating cost and realty tax statement prepared by an independent accounting professional or audited by an independent professional. Inclusion of such a provision may depend on the tenant's influence and bargaining power with the landlord.

The following options can be considered after the lease is fully executed:

9.10 Lease Audit

Engage services of a Lease Audit firm[23] to evaluate if the costs passed through to the tenant are in compliance with the terms of the lease. If the tenant suspects there is

[23] Detailed discission on lease audit techniques is beyond the scope of this research.

intentional misrepresentation of costs and/or any component affecting Additional Rent, an Enhanced Lease Audit can be considered (discussed in *Section 10.0*).

9.11 Neutral Case Evaluation

This technique involves both parties agreeing to using a professional who is an expert in the matters of interpreting lease terms (Daoust Vukovich LLP, 2007). This option would be of particular use for tenants if the right to audit clause is ambiguous, open ended or silent on certain issues. The expert may be able to take a holistic view of the lease and interpret the terms different than would the tenant or landlord if reviewing on their own, with their individual interests at stake.

9.12 Joint Audits

Tenant can consider engaging in joint audits where tenants who are in the same property or have the same landlord can be represented by a common auditor (Gordon, 1998) or a professional who has expertise in assessing and reviewing CAM and TAX costs based on the individual tenant's lease terms and conditions. If the tenant were to review these costs on their own, the landlord may not be willing to provide answers or documents easily. Even if the tenant has the right to audit, it may prove to be too costly and cumbersome for the tenant to fully exercise that right. Joint audits would allow tenants to engage the services of a professional which would otherwise be costly to do so if they were to engage such services on their own (Gordon, 1998). It is likely that the landlord would have drafted leases for tenants within the same property with some fair consistency with specific nuances depending on each of the tenant's nature of business. With a joint audit,

there is one professional / firm reviewing multiple tenant leases within the same property. This would provide a level of protection to the tenants and ensure the tenant is not being unfairly taken advantage of by the landlord especially within areas of the lease that are standard. Confidentiality could be an issue especially if there is one professional / firm representing multiple tenants within the same property. However, the professional can maintain confidentiality and ensure their findings are reviewed by each tenant individually and not jointly by all the tenants (Gordon, 1998). The question may arise of tenants sharing their lease information or findings of the joint audit with other tenants. This is not an issue just specific to conduct of joint audits that would make this an unfavorable option. In a normal scenario where there are multiple tenants leasing premises within the same property, provisions of a standard lease may already address the issue of confidentiality and sharing of information with other tenants. A joint audit is an option provided to the tenant who many not have the financial resources to challenge the landlord on CAM and TAX issues. Before a tenant considers this option, legal advice must be sought out to understand implication of such options.

10.0 ENHANCED LEASE AUDIT - ROLE OF THE FORENSIC ACCOUNTANT

Conventional lease auditing of Additional Rent billings consists of conducting a detailed review of the tenant's occupancy costs against the tenant's lease terms. The purpose of the process is to ensure the Additional Rent billings are compliant with the terms of the

lease and the landlord has not overcharged the tenant (Santerre, 2011). The scope of the lease audit focuses on compliance to the lease. Lease auditing ensures the rent billed is in accordance with the lease terms; however, there are other areas that could be overlooked during this process – especially if the lease does not have a right to audit provision, or one with limited access to the landlord's financial information. As previously discussed, the Additional Rent component can be manipulated right from the onset when the tenant is presented with the Additional Rent estimate to the final stage when the period end FOC statement is issued. Various areas within the lease present opportunities to manipulate and maximize recoveries from the tenant. There is potential for a Forensic Accountant (hereinafter referred to as "FA") to be involved in this process to closely examine these overlooked areas and tactfully carry out the investigation to obtain the required information. The FA's skillset should not be considered as a last resort option to be used in the event of litigation or potential litigation but can be considered for an enhanced lease audit where the conventional lease audit may fall short. Tenants should consider using the services of a FA from the very start when the first FOC statement is issued.

If the tenant is able to negotiate the right to audit in the lease, the FA can request the necessary and relevant landlord's financials to be reviewed. If the tenant does not have the right to audit or if the right to audit is one with limitations, if a dispute were to arise, the tenant can then seek additional remedies such as mediation, arbitration, or possible litigation. In any event, there is a potential for the FA to be retained and engaged in the context of a lease audit and/or a pre-litigious or litigious setting. The scope of the engagement could be specific to a component of Additional Rent or could include more

than one of the many components. Below are some of the precise areas the FA can review and assist with:

10.1 Area Measurement

If the tenant has not conducted their own area measurement at the time they signed the lease, when the FOC statements and lease is reviewed, an area measurement can be conducted at that time to determine the actual Usable Area. Depending on the gross-up factor negotiated within the lease, the Rentable Area can then be determined to see if the tenant's area measurement yields the same results as provided by the landlord (which the landlord uses to calculate the tenant's proportionate share of costs). It is acknowledged that once a tenant executes the lease and agrees to be billed on a particular area measurement, little recourse is available. However, if the investigation on the area measurement determines the Rentable Area has a material variance than what the tenant is being billed for, the tenant can ask for an amending agreement to be issued to rectify this error. Conventional lease auditing may just compare the square footage on the operating cost statement to the lease to ensure the square footage is compliant as per the terms of the lease.

10.2 Assessing the Base Year estimate of Additional Rent

The tenant will likely be provided with a Base Year estimate of Additional Rent at the time they sign the lease – this would be the estimate the tenant will be billed on through the year up until the estimate is changed by the landlord. Unless the lease provisions state the landlord must provide details on the methodology of how the initial Base Year

estimate was arrived at, conventional lease auditing may just compare the estimates billed to the actual costs at a period end with the focus on ensuring validity of the actual cost being passed down to the tenant. An investigative mindset is required to question if the estimate the tenant is being billed on (or has been billed on) is a fair representation of the landlord's true operating costs and/or if the projected operating costs reflects the expected operating reality. The landlord could be motivated to intentionally offer a lower estimate to entice the tenant to sign the lease or offer a slightly higher estimate to justify keeping the actual costs inflated so as to avoid a large variance year over year between the estimates billed versus actual costs. The FA can consider the following in order to determine the validity of the Base Year estimates:

1. Compare the estimate billed to the tenant to that offered on other similar properties within the tenant's geographic area. This information can be found either on the landlord's website or can be obtained from real estate broker firms that market the vacant premises on behalf of the landlord. This can be a good starting point to understand the Additional Rent rates in the market. FA should ensure the Additional Rent data clearly provides a breakdown on the CAM and TAX component for comparability purposes.

2. Ask the landlord to provide a breakdown of the costs that have been included to formulate the Base Year estimates. The landlord may not be willing to share their full operating budget, however, the landlord can be asked to provide a high-level breakdown of the major cost categories that add up to the estimate – such as Utilities, Waste Removal, Common Area Repairs and Maintenance, Parking Lot

Repairs and Amortization, amongst other categories of costs. Having this information can be valuable for the FA to understand which categories represent the highest costs.

3. If the tenant is offered a Base Year estimate that is much lower than the prevailing market rates, the FA should inquire if the landlord is "subsidizing" a portion to remain competitive. In this case, it should be clarified with the landlord if the subsidy would be offered throughout the term of the lease or for a specific period only. A situation could arise where the Base Year estimate is intentionally lower and at the end of the period when the landlord bills the tenant the actual operating costs, the subsidy would be eliminated which would put the tenant in a large payable position. The tenant would have no option but to settle their due as non-payment would be considered a default.

10.3 Review of the total Building Area

A typical lease does not provide the total Building Area over which the tenant's proportionate share is calculated, unless a tenant has the negotiating power to have a static Building Area included in the lease over which the tenant's proportionate share will be calculated. A lease audit may request an official document to confirm the total Building Area to validate the proportionate share calculation, however, the issue lies beyond presentation of such document. Additional confirmation is needed to ensure the Building Area is not intentionally manipulated. Below are suggested procedures to review the accuracy of the Building Area measurement:

1. Compare the area reported on the document provided to the tenant with the landlord's insurance documents. Landlord's insurance will represent premiums adjusted based on occupancy. If the landlord is passing through insurance premiums to the tenant, then this is a document that can be potentially requested from the landlord. This may not be a standard document that the landlord would include as part of the insurance backup typically presented to the tenant.

2. Request the landlord to submit a report generated from their system to assess the occupied and vacant unit areas.

3. Request the landlord to provide MPAC assessed worksheets on which units and the area of the building are documented.

10.4 Detailed Review of Costs

Certain costs should be closely examined and questioned even if terms of the lease state the costs are recoverable. Some of the issues to consider are:

1. Structuring of Costs - Costs that should have been capitalized but are expensed in the year by the landlord for rapid recovery. The FA should question the landlord on their accounting treatment of capital items. A large capital outlay, such as a roof replacement, if completely expensed can pose as a significant cost to a tenant who may have a short term remaining on their lease as opposed to a tenant who has a longer term remaining. The benefit of the major project would be realized

more so for the tenant with the longer-term lease term remaining as opposed to the tenant with the shorter term, especially if that tenant does not have an option to renew their lease or does not intend to renew.

2. If there are costs eligible to be billed through to the tenant, ensure it excludes those which are specific to a tenant. A good starting point would be to identify material variances in cost categories when compared to the prior year. Also, if a new cost category appears on the FOC, it should be flagged and reviewed. In either of these cases, the FA should request the landlord to provide invoices to determine if the work pertains for a specific tenant. If no such details are presented on the invoice, the supplier can be contacted to obtain a work order to identify which tenant the work was performed for. The FA can also request the landlord to provide General Ledger reports from the accounting system to identify questionable costs and request further information from the landlord. With the General Ledger data available, additional analytical procedures can be conducted on the data to verify the reasonability and accuracy of the costs being passed through to the tenant.

3. If the lease allows for amortization to be billed, amortization schedules should be reviewed to understand the amortization methodology and if a consistent methodology is used year after year. Also ensure that the term over which the capital item is amortized is adequate and not intentionally shortened to recover the expenditure faster. FA should also review additions made to the cost base of the

capital item being amortized to ensure the cost of the capital item has been incurred and is not added as a “provision” for a future cost to be expended, in order to increase the amortization expense for maximizing recoveries from the tenant.

4. If the lease allows for a gross-up, ensure only the variable portions of the common area expenses are grossed up and allocated adequately. Fixed expenses such as landscaping, snow removal and property insurance should not be grossed up as it does not vary with the property being vacant. If the lease is silent on gross-up or vaguely defined, then further clarification should be obtained, and the issue brought to the landlord’s attention.

5. If the landlord has Accruals included in FOC statement, obtain a copy of the invoice to confirm the work has been completed and the landlord has paid the expense in the next period. When the tenant is issued the next period’s FOC, ensure and the same expense is not charged to the tenant again and the accruals have been reversed. If the landlord has used an estimated accrual, the accrual being billed should be based off a work order, commitment or some verifiable source as opposed to the landlord’s assertions. Any accrual amount in excess of the actual expense incurred should then be adjusted on the next FOC statement.

6. The realty tax component on the FOC statement should also be examined. The landlord’s allocation methodology should be reviewed, and the FA should check

with MPAC and the local taxing Municipality to see if the landlord has filed any appeals and if they have been granted. These adjustments should be reflected in a timely manner on the period end FOC statement or passed through to the tenant by means of an adjustment of their realty tax instalments within the same year (depending on when the landlord receives refunds for the realty tax appeals).

In any of the scenarios that the FA is retained, a competent FA not only understands conventional lease auditing methods, but also should understand the financial implications of the lease term, the objective of all parties involved and the implications the accounting methods and accounting policies could have on the costs that are being passed through to the tenants.

11.0 RECOMMENDATIONS FOR REGULATORS

A commercial lease is a written contract which is drafted in accordance with the OCTA which addresses the right and responsibilities of all parties to the lease. Unlike the Ontario *Residential Tenancies Act*[24] which outlines a set of rules that cannot be overwritten by a lease agreement between the parties (Levy, 2010), the OCTA does not offer the same protection to commercial tenants. As a result, there is no real motivation for the landlord to consider an equitable interest for the tenant and the lease document can end up being drafted in the landlord's favor (Carl, 1994). The negotiating power lies

[24] Residential Tenancies Act, 2006, S.O. 2006, c. 17

with the landlord unless the tenant occupies a large space or is highly reputable (Levy, 2010). This was outlined in the case of *Terrace Manor Ltd. v. Sobeys Capital Inc*[25] where the Tenant was able to negotiate a clear language in the lease due to the Tenant being large and having an equal bargaining power[26]. Not all commercial tenants are large and sophisticated or have the legal resource to draft leases which are equitable. The tenant is presented with limited opportunities to get the lease terms and conditions equitable, which is only at the stage when the lease is being negotiated. Once the lease terms are agreed upon, any issues thereafter will likely be governed under the lease agreement with little protection offered under the OCTA. The next best option for the tenant would be to get the existing lease amended by the landlord, which can be difficult to negotiate as there is no real motivation present for the landlord to do so.

The following recommendations can be considered to enhance the OCTA and add a layer of protection for the tenant. These recommendations are not presented from a legal point of view, instead is meant to address the operating reality of landlord-tenant relationship.

1. Commercial tenants should be offered a medium to resolve disputes, outside of Litigation and/or dispute resolution negotiated in the lease, similar to the option offered to Residential Tenants through establishment of The Landlord and Tenant Board (LTB) (Tribunals Ontario, n.d).

[25] Terrace, *supra* note 17
[26] Terrace, *supra* note 17 at para 50

2. OCTA requires an overhaul to address the current legal issues. Sophisticated parties have the legal resources at their disposal to navigate the legal complexities by creating detailed and comprehensive lease contracts. Not all parties seeking to enter into a commercial lease have this advantage or sophistication. The OCTA should provide the parties with a consistent legal framework which is flexible enough to allow all parties to tailor the lease as it suits their needs (British Columbia Law Institute, 2009, p. 19). Currently, with no such legal framework present, there is an inherent imbalance of power.

3. At present, under the OCTA, any disputes between the landlord and tenant must be settled through litigation[27] unless the lease calls for alternate dispute settlement remedies. The inclusion of such settlement remedies is dependent on the bargaining power of the tenant. The OCTA could be enhanced to include a provision whereby parties are to have a section in the lease addressing dispute resolution remedies in addition to the default option of litigation.

4. Some direction is required on the issue of Additional Rent. It is acknowledged that this component has many complexities and is too vast for a framework to be developed. The Additional Rent is dependent on the type of lease and operational uniqueness of the property, however some guidance should be presented in the OCTA on:

[27] Commercial, *supra* note 1, at sec 66(2)

a. Clarity on the verbiage of Additional Rent to reasonable satisfaction of both parties
b. Agreement on an allocation methodology and a provision of notice to all parties if allocation methodology is to be changed; and
c. Requirement to present a minimum set of documents to the tenant to confirm the Additional Rent charges being billed.

The basic requirement of providing documentation to validate financial transactions being made by one party to another (i.e the tenant paying the landlord Additional Rent for operating the property) under a contractual setting should not be conditional on the tenant's bargaining power or the ability to negotiate for.

5. In the event the tenant identifies a material breach in the lease agreement, the OCTA should allow the tenant to withhold rent payments and remain in possession of the leased premises (British Columbia Law Institute, 2009, p. 47) for a reasonable time up until action is taken by the landlord to remedy the issues. Most leases constitute non-payment of rent as a default and have the right to remove the tenant from the premises. Under Section 18 of the OCTA, the landlord can repossess a leased premises fifteen days after the tenant fails to pay rent and remedy the failure to pay rent. Some level of protection should be offered to the tenant to provide an opportunity to seek equitable remedy to the issue – not all disputes can be resolved within fifteen days. In the absence of an equitable provision, if the landlord fails to deliver on their contractual obligation

(such as intentionally delaying to provide a FOC statement or failure to provide a FOC statement in any given period) the tenant would still be required to continue paying rent to the landlord; failure to do so would result in the tenant being issued a default under the lease or under Section 18 of the OCTA.

6. Some leases may require the tenant to agree upon the minimal requirements to enter into a lease agreement and may have certain key areas unaddressed (British Columbia Law Institute, 2009, p. 48) – for instance, in Exhibit A, para 2, the use of the term "*reasonable time",* or in Exhibit A, para 3 the use of the term "*as are allocated by the landlord in accordance with reasonable practices"*. If these terms are left undefined, the tenant is still obligated to comply with the provisions even if there is disagreement with the landlord's implied definition of those terms and/or the definitions itself is ambiguous and does not provide clarity. Some regulation is required on the use of ambiguous provisions, if not already defined clearly in the lease. Regulation should require a lease provision relating to delivery of financial information to all parties.

7. Regulation is required on area measurement standards to be used for measuring commercial premises. There is no set regulation in Canada that requires a landlord to use a particular measurement standard (Daoust Vukovich LLP, 2017) or to remain consistent in use of a measurement standard within the same property.

8. The OCTA should make mandatory for the landlord to provide the tenant with the right to audit the landlord's financials. It should also make mandatory for the tenant to be able to obtain access to relevant information as deemed essential for the tenant to verify the costs that are being passed on to them.

In 1976, The Ontario Law Reform Commission (OLRC) had published the Report On Landlord and Tenant Law addressing major issues for which a draft legislation change was not proposed (British Columbia Law Institute, 2009, p. 20). Since the issuance of that report by the OLRC, no other reports have been issued or major changes proposed to be passed through legislation to enhance the OCTA. It was only when the COVID19 pandemic was declared in Ontario, measures were taken by the Government of Ontario to offer tenants further protection. Various Bills was enacted, such as:

- Bill 229, Protect, Support and Recover from COVID-19 Act (Budget Measures), 2020
- Ontario Regulation 763/20 - which introduced further protections for tenants under the OCTA (Dentons, 2021); and
- Bill 192, Protecting Small Business Act, 2020

Enacting a regulation or policy change may offer considerable protection for the tenant, however such legislative change requires a major economic impact to have taken place or significant lobbying efforts. As an alternative, the following can be considered:

1. Regulators may consider implementing a mechanism where complaints can be filed and reviewed by the appropriate governing bodies, similar to the mechanism employed by Professional Associations to promote ethical conduct by its members. This can be either implemented by a tribunal[28] established under the OCTA or can be assigned to an Ombudsman[29]. Once the complaint or issues have been reviewed and dealt with, certain elements of the matter can be made public (while ensuring there is no breach of confidentiality and privacy) to provide parties to a commercial lease information on issues that can commonly arise, or at the minimum, provide an opportunity to understand some of the issues common with commercial leases. In the absence of specific case law on the many possible issues surrounding Additional Rent, this can be a useful mechanism to restore balance of power between all parties and ensure parties to a lease conduct themselves ethically.

2. Establishment of a Legal Aid Service to help tenants review commercial leases. This can be particularly useful for tenants who do not have the resources or legal expertise to obtain independent legal advice on terms and conditions of the lease. The Legal Aid service can serve to help tenants review their leases and understand the financial and legal implications of the terms – especially since a standard legal framework does not exist for commercial leases. Once the tenant understands the implications of the lease terms being offered by the landlord, the

[28] Potentially to be staffed by subject matter experts such as real estate lawyers, real estate accountants and forensic accountants

[29] Under current regulations, The Ombudsman has no jurisdiction over private companies: https://www.ombudsman.on.ca/have-a-complaint/who-we-oversee

tenant can negotiate and ask questions accordingly. This can also benefit the landlord as it will ensure there is greater transparency and could potentially reduce the disputes that could arise. Law Society Referral Service offers a thirty-minute free consultation to commercial tenants; however, no legal advice is provided (Ontario, 2020).

The OCTA requires an overhaul to address the realities of entering into a commercial lease in the twenty-first century. Other ancillary services can also be implemented to ensure commercial tenants have resources at their disposals to navigate through the complexities of entering into a commercial lease.

12.0 COVID-19 IMPACT

The COVID-19 health crisis was declared a worldwide pandemic by the World Health Organization on March 11, 2020 (Staff - The Canadian Press , 2021). On March 16, 2020, Ontario declared a state of emergency (Rodrigues, 2020) under the *Emergency Management and Civil Protection Act*[30]. The COVID-19 outbreak has posed significant challenges for landlords and tenants, especially pertaining to the operation of a property. There have been additional costs that the landlord would have incurred and will continue to incur well over the next few years as a result of the COVID-19 outbreak. Some costs may or may not be eligible to pass through to the tenants especially if the lease terms and provisions were agreed upon in the "pre-COVID19" period where such operational

[30] Emergency Management and Civil Protection Act, R.S.O. 1990, c. E.9

changes were not expected or accounted for. For tenants whose lease term began in 2020 or will being in 2021, the landlord may make provisions or modify the lease accordingly to ensure the maximum amount of COVID-19 related expenditure can be passed down to the tenant. Of the various COVID-19 related legislation addendums that have been implemented to address the impact to commercial tenants, none of the addendums address the issue of Additional Rent or transparency on areas that impact Additional Rent. A brief discussion on some of the pressing issues is presented below considering a new operating reality may emerge post the COIVID-19 periods.

12.1 Impact on the Additional Rent Estimates

The estimate for Additional Rent that is billed to the tenant is established when the landlord develops a forward looking annual operating budget. In the pre-COVID-19 period, the operating budgets could be developed with a degree of predictability on the recurring and non-recurring expenses to be incurred for the property and the tenant would be billed an estimate accordingly. During the COVID-19 period, there is significant unpredictability surrounding certain expenditures and eligibility of pass through to the tenants (BOMA International, n.d, p. 4). The landlord will try to normalize these expenses as much as possible, however, the tenant should ensure the estimate being provided reflects the operating reality of the period and the estimates are not inflated. Tenants who have commenced leases in 2020 or will be commencing leases in the remainder of the COVID-19 period, should ensure the initial Additional Rent estimates being offered is adequality determined and should ask for historical years estimates for comparison purposes. If the estimates are not much different than the prior years and/or

have significantly increased, the tenant must question the operating expenses that would be impacted by the government mandated closures and/or other legislated mandates put in place on the operation of commercial properties[31] – for instance, cost savings on janitorial expenses and waste removal (BOMA International, n.d, p. 4) as a result of reduced occupancy in the property; or possible cost increases due to extra sanitation / deep cleaning, additional cleaning or property re-opening or shut down costs related to government mandates (BOMA International, n.d, p. 4). Tenants should review the impact of government mandates to a commercial property and question these costs accordingly. Not all tenants may have the knowledge, sophistication or resources to isolate these costs and question them. There is a call for mandated transparency of these estimates more now than ever.

12.1 Impact on Gross-Up Provisions

A gross-up provision enable the landlord to normalize the operating expenses to a pre-determined occupancy level. This research has illustrated how the gross-up provision can be manipulated to the benefit of the landlord. However, in the COVID-19 operating reality, the gross-up provision can still allow the landlord to normalize the operating expenses despite 2020 and 2021 being periods when the operating expenses are expected to be much lower than the normal operating periods due to higher vacancies (Opall, 2021) as a result of Provincial / Federal Government mandated closures, amongst other challenges hampering business to be fully operational. Tenants must fully understand the

[31] At the time this research paper was being authored, the province of Ontario mandated closures of certain businesses and/or allowed business to operate with strict limitations.

gross-up provision in their lease – for instance, does the gross-up provision allow to normalize expenses if the property has experienced reduced physical occupancy or reduced leased occupancy? (Opall, 2021). If the lease is silent on the definition or the terminology is ambiguous, the landlord can unfairly gross up expenses even in a period when the property has truly realized a cost savings because of mandated closures. For example, personal care services have been mandated to remain closed for an extended duration. During this period, it is unlikely the premises will have required daily cleaning and as a result the landlord is incentivized to scale down on such services, the benefit of which should be passed down to the tenants. It would not be appropriate to gross-up cleaning costs to normal occupancy levels.

Landlords will be required to implement many physical changes to existing properties to accommodate tenants unique needs and to adhere to public health measures and best practices. There will be certain costs that are common to the property, such as upgrading the property's HVAC system and frequent changing of air filters. Some costs will be tenant specific, such as a restaurant premises may requires more frequent cleaning due to higher foot traffic for take-out orders in comparison to office premises which may have experienced reduced physical occupancy due to its tenants ability to work remotely. The landlord's transparency of costs is beneficial for the tenant to determine if the pandemic related costs that are being passed down to them are common or tenant specific. A loosely worded lease or ambiguous lease terms could pose a disadvantage to the tenant especially as there is limited legal precedence currently available on the unique challenges of the COVID-19 pandemic and resulting impact to commercial tenants. In

addition, the legislated changes that have been implemented have not stood the test of time. A good starting point for the tenant (or potential tenant) would be to understand the costs that have been passed down historically, especially for the periods of 2018 and 2019. For an existing tenant, a financial review of the historical costs that has been billed will provide a benchmark to understand the cost savings or cost increases the property has incurred during the COVID-19 period.

13.0 ETHICS

From a business and legal point of view, a commercial landlord is in an advantageous position – the landlord can exercise leverage over drafting and negotiating lease terms; has the advantage of having the detailed knowledge of the operations of property; and controls the financial records to be disseminated to a tenant. The tenant on the other hand is merely a party to this transaction with little control over any of these aspects. Even if the tenant tries to seek some remedy from the OCTA, the lease document will still take precedence in most cases. If the tenant is large, sophisticated and has adequate resources at their disposal, the best they can do is negotiate equitable terms for some components in the lease such as audit rights, which can be challenging to have the landlord agree to a full financial disclosure.

The landlord's leveraged position in a commercial lease transaction creates a situation that can be explained using The Fraud Diamond theory developed David T. Wolfe and Dana R. Hermanson. There is perceived *incentive*, *opportunity*, *rationalization*, and

capability (Wolfe & Hermanson, 2004) by the landlord to intentionally manipulate the Additional Rent component at the expense of the tenant. There is a perceived *incentive* presented to the landlord to draft the lease in their favor as opposed to drafting it somewhat equitable for the landlord and tenant. The incentive is created given the landlord is in a position of power and the OCTA does not provide a formal legal framework that promotes for an equitable lease document. There is perceived *opportunity* at various stages of the lease transaction to manipulate the Additional Rent - right from the development of the operational budget to the period end issuance of the FOC statement to the tenant. The landlord is well *capable* of drafting favorable lease terms and has the financial knowledge and finer understanding of the operating reality of the property than the tenant would. The landlord has the technical knowledge on how to structure Additional Rent and possibly camouflage certain expenses within the Additional Rent billings to unfairly maximize recoveries from the tenant. The tenant may not have the financial resources to fully understand what they are being billed for or challenge the landlord. As a result, the Landlord can *justify/rationalize* engaging in such behavior mainly due to lax regulations present to protect the tenant and hold the landlord responsible. The tenant may not necessarily know the costs that can be challenged or the information that can or cannot be requested to further investigate the costs being passed on to them. Further, the landlord understands that the option of litigation as a recourse for the tenant may not always be exercised due to the time and resources that would be expended to take the landlord to Court.

14.0 CONCLUSION

The Additional Rent component of a standard lease allows the landlord to pass through to the tenant the operating expenses for the tenant's premises and the common areas of the property. At first glance it may appear to be fair and reasonable as the landlord is incurring expenses that are necessary for the tenant to carry on their business activities within the leased premises, however this may not always be the case. There are various opportunities present for the landlord to manipulate the Additional Rent component to maximize recoveries –from the stage when the landlord develops the operating budget to the final stage when the tenant receives the final operating cost statement. There are other components in the lease such as area measurement and gross-up that are tied to the Additional Rent calculation which can be indirectly manipulated to maximize recoveries.

The opportunity to manipulate is enhanced as the landlord has the capability to do so – the Ontario *Commercial Tenancies Act* provides little protection to the tenant and the lease document will often take precedence if the matter leads to litigation. The landlord is able to leverage its knowledge and resources to draft leases that may not be equitable to all parties, especially if the tenant is not sophisticated or does not possess the bargaining power that the landlord may possess. If the lease does not provide the tenant the right to audit the landlord's financials to verify the accuracy of the Additional Rent billings, there are remedies the tenant can possibly consider outside of the right to audit provisions. If the tenant suspects the landlord may intentionally be manipulating the Additional Rent to the disadvantage of the tenant, a Forensic Accountant can provide valuable services to

investigate the matter. The Forensic Accountant's knowledge and skills can be utilized at many stages as a preventive and detective mechanism to ensure the Additional Rent component is allocated fairly to the tenant and the allocation is challenged when the lease may be ambiguous or requires the tenant to rely on the landlord's representation.

The Ontario *Commercial Tenancies Act* can be enhanced to add a layer of protection for tenants. The COVID-19 pandemic has led to some changes in regulation to ensure tenants are protected during this unpredictable period, however, these changes may be temporary. It is acknowledged that a policy or regulation change may pose significant challenges and requires lobbying efforts, hence regulators could consider offering ancillary services such as an anonymous reporting tool, assign an independent third party or establishment of a legal aid service made available for commercial tenants.

The opportunity to manipulate the Additional Rent component is created partly due to the imbalance of power between the landlord and tenant. This exacerbates the opportunity, incentive and justification of the landlord to unfairly maximize recoveries at the tenant's expense – simply because the landlord is capable of doing so.

DEFINITIONS

Accrual	A financial adjustment made in a period to account for an expense that been incurred, but not yet invoiced for.
Additional Rent	Rent amounts over and above Base Rent. Additional Rent is charged to the recover any costs that pertains to operations and occupancy the tenant's leased premises.
Administrative Fee	A fee charged by the landlord to the tenant on services (services as determined by the terms negotiated in the lease).
Area Certificate	Document issued and certified by a professional which states the measured area of a premises.
Base Rent	The minimum amount of rent payable for the leased premises, as determined and set by the landlord. The Base Rent is net of any pass-through costs that may be charged to the tenant under Additional Rent.

Building Area	The total area of all the combined premises within the property. The Building Area is not dependent on physical occupancy.
Capped CAM	A predetermined increase for common area maintenance expenses negotiated in the lease.
Check Meter	Device that measures units of a Utility being delivered to a specific premises.
Common Area	Areas within the property that are not leased to tenants and are designated areas for the benefit and use of all tenants.
Common Area Maintenance (CAM)	Cost that pertains to the operations and maintenance of the common areas of the property (not part of a tenant's leased premises).
Double Net Lease	Tenant pays base rent plus additional rent under which some operating cost components is paid for by the tenant, the landlord covers the remainder of the operating costs.

Gross Lease	The tenant pays an agreed upon rent amount and is not responsible for any other additional costs pertaining to the operations and maintenance of the Property or the tenant's leased premises.
Gross-up Factor	The total common areas of a property expressed as a percentage of the total property area.
Occupied Area	The total area of the occupied premises within the property at any given time. Does not account for vacant premises.
Operating Costs	Any cost that pertains to the operations and maintenance of the Property and tenant's leased premises.
Proportionate Share	Calculated as a fraction which has the numerator as the tenant's leased area and denominator as the leasable area of the Property.
Realty Taxes (TAX)	Property taxes issued by the local municipality within which the property is physically located. The property taxes is issued directly to the property owner (landlord).
Recoverable Costs	Costs which can be passed through to the tenant.

Rentable Area	Area on which the tenant typically pays rents. Rentable area is comprised of usable area plus a gross up factor for common areas.
Retail Lease	A type of lease where the leased premises are to be used for retail business (such as operate a restaurant or a retail "shop").
Triple Net Lease	Tenant pays base rent plus additional rent under which all operating costs are passed through to the Tenant for recovery.
Usable Area	The actual area of the premises that is to be occupied by the tenant with no gross-up factor.
Utility	Services such as water, hydro or gas
Utility Meter	Device that measures consumption of Utility
Vacant Area	Area of the premises which are not leased and/or physically occupied.

***Note**: The definitions presented are the Author's own which are based on industry obtained experience and practices common in the commercial real estate sector. Standard definitions do not exist as definitions of terms are unique to a Lease and is negotiated between parties to a Lease.*

EXHIBIT A

Excerpts from a Retail Lease Document obtained from a Confidential Source

[1] Premises

The Premises shall be those retail premises known as **[unit number intentionally deleted]**, comprising a Rentable Area of approximately 2,020 square feet (which area includes a gross up factor equal to 1% representing the Tenant's share of common areas of the Retail Section of the **[business name intentionally deleted]** Business Centre (the "Centre")) in the building municipally known as **[business location intentionally deleted]**…

[2] Payment of the Tenant's Proportionate Share

Within a reasonable time after the end of the period for which estimated payments have been made, the Landlord will deliver to the Tenant, (a) a statement of the amounts and costs referred to in Section 5.01 together with a statement of the Tenant's Proportionate Share of those amounts and costs, and (b) a statement certified by the Landlord of the actual costs and expenses incurred referred to in Section 6.02 together with a statement of the Tenant's Proportionate Share of those costs and expenses. The rendering of such statement shall not affect the Landlord's right to subsequently render an amended or corrected statement. If the Tenant has paid more than a statement specifies, the excess will be refunded within a reasonable time after delivery of the statement. If the Tenant has paid

less than a statement specifies, the Tenant will pay the deficiency with the next monthly payment of Basic Rent. If a Rental Year is greater or less than the period of the estimate, such payment will be adjusted on a per diem basis. Tenant may not claim a readjustment in respect of such costs for such period for which a statement is delivered if based upon any error of computation or allocation except by notice to Landlord within six (6) months after delivery of such statement.

[3] Common Expenses

In each Rental Year, the Tenant will pay to the Landlord its Proportionate Share of the costs and expenses of owning, maintaining, managing/administering, repairing, replacing, operating and insuring the Retail Section, the Common Elements as if the building were 100% occupied by tenants during the Term and the Retail Section's allocation of costs and expenses with respect to the Shared Common Elements, as are allocated by the Landlord in accordance with reasonable practices relevant to a multi-use development.

[4] Charges for Utilities

The Tenant will pay to the Landlord an amount (the "Charge") which is the total, without duplication, of: (i) the costs incurred by the Landlord for water, fuel, power, telephone and other utilities (the "Utilities") used in or for the Premises or allocated to them by the Landlord;….

[5] Taxes Payable by the Tenant

(a) If there are separate real property tax bills and separate real property assessment notices (collectively "Tax Notices") for the Premises and the non-leasable areas of the Retail Section, the Tenant shall pay when due or required by the Landlord, as Additional Rent, to the Landlord or to the taxing authorities if the Landlord so directs: (i) all Taxes that are levied, rated, charged or assessed from time to time against the Premises or any part thereof, on the basis of separate Tax Notices; and (ii) its Proportionate Share of all Taxes levied, rated, charged or assessed against the Common Elements together with the Retail Sections portion (as allocated by the Landlord) of Taxes levied or assessed against the Centre.

(b) If there are not separate Tax Notices for the Premises and the non-leasable areas of the Retail Section but there are separate Tax Notices for the Retail Section as a whole, the Tenant shall pay monthly in advance or otherwise as the Landlord directs…its Proportionate Share of the Taxes levied, rated, charged or assessed against the Retail Section, including a portion of Taxes against the Centre allocated or attributed by the Landlord to the Retail Section.

Definitions:

[6] "Rentable Area":

means the area from, (a) the exterior face of exterior walls, doors and windows;

(b) the exterior face of interior walls, doors and windows separating Rentable Premises from the Retail Common Elements; (c) the exterior face of interior walls that are not party walls, separating Rentable Premises from adjoining Rentable Premises and (d) the centre line of interior party walls separating Rentable Premises from adjoining Rentable Premises. Rentable Area includes interior space even if it is occupied by projections, structures, or columns, structural or nonstructural and if a store front is recessed from the lease line the area of the recess is included within the Rentable Area of the Premises….

[7] **"Proportionate Share":**

means a fraction which has as its numerator the Rentable Area of the Premises and as its denominator, the Rentable Area of the Retail Section.

EXHIBIT B

Lease Excerpts obtained from Public Sources

[1] In addition to the Base Rent as aforementioned, the Lessee agrees to pay its proportional share of the Lessor's costs and charges required in the general day to day operations of the property, including but not limited to: Property taxes, building insurance, common area utilities, water and sewer charges, property management, garbage, grounds maintenance, repairs and upkeep. It is agreed that the Lessor will provide the Lessee with an accounting and budget for each fiscal year, commencing October 1, of each calendar year.

Source: BYMR Yoga Studio Inc. v. Gosee Holdings Corp., [2014] B.C.J. No. 1883, para 5

[2] 9.02 It is the Intention of the parties that this lease shall be a completely carefree lease to the Landlord and that the Base Rent herein provided to be paid shall be net to the Landlord and clear of all taxes (except Landlord's Income taxes), costs and premises forms a part (including the demised premises) or to the use and occupancy of the demised premises and that the Tenant shall pay as Additional Rent the Tenant's Proportionate Share of all exists, charges, impositions and expenses of every nature arising from or relating to the Property and Building of which the demised premises terms a part (including the demised premises) and to

their use and occupancy and default of the Tenant, and the Tenant hereby covenants with the Landlord accordingly.

Source: C.C. Tatham & Associates Ltd. v. 2057870 Ontario Inc., [2011] O.J. No. 3033, para 10

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