Lang Michener LLP
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RealEstateBrief

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In This Issue

In our first article, Matthew German considers what actions tenants can take and what documents can be pursued to better protect their lease positions. Damon Chisholm then reviews a recent case in respect of builders (construction) liens that shows how the involvement of multiple parties and the operation of the legislation creates a number of priority rules and schemes.

We also reprint an article from our blog (lawoftheland.blogs.com) in which Bob Fraser reviews a recent case that looks at the standard provision of an agreement of purchase and sale that deals with the quality of title to be given to the purchaser.

Tenants in a Dangerous Time

Matthew German

It is no secret that the current economic environment has had its effect on Ontario's commercial leasing industry, as evidenced by the rise in vacancy rates across Ontario. During these times, landlords spend a great deal of energy determining how to best protect themselves from financially unstable tenants. While this is a valid concern for landlords, tenants should be equally concerned about landlords who may be encountering their own financial problems. Although most landlords conduct extensive due diligence on a potential tenant before entering into a lease, the same cannot typically be said for tenants. Many tenants know little about their landlords. This article is intended to highlight some of the key ways in which a tenant can better protect itself from a landlord who may encounter financial problems in these difficult economic times.

Know Your Landlord

The first step a tenant can take to protect itself is to increase the level of due diligence they carry out on a landlord at the offer stage. A tenant should not assume that all landlords are financially sound. This is even more important in the case of a subtenancy where a sublandlord is trying to divest itself of excess space, as this action could be an indication that the sublandlord is struggling financially. A tenant should be particularly concerned about a landlord's financial strength in situations where the landlord is required to pay the tenant an inducement allowance or if the landlord has significant construction, maintenance or repair obligations, especially when the landlord is an individual or not a well-known institution or public company.

Some of the ways in which a tenant can get comfort as to the landlord's financial position are by requesting a review of the landlord's financial statements, conducting a credit search or

requesting a bank reference as a condition precedent to the offer. Where a landlord is obtaining financing to complete the construction of a property, the tenant may also request a copy of the landlord's mortgage commitment with its bank. Obviously, for some of the major landlords this request may not be accommodated and is likely unnecessary. In cases where such due diligence reveals that the landlord is not financially sound, a tenant may question whether the landlord will be able to fulfill its obligations under the lease. A substantial tenant may be able to obtain security from the landlord for its obligations, such as a letter of credit, or some other remedy such as a self-help right where the tenant can set-off the cost of any actions it may have against its rent.

Subsearch of Title

One of the most important due diligence items for the tenant is to conduct a subsearch of title to the property before entering into a binding agreement. This can be carried out by the tenant's lawyer by reviewing the public registry records. The tenant's lawyer should review the records to confirm that the landlord actually owns the property in which it is purporting to grant a lease. The tenant's lawyer should also determine if there are prior interests such as mortgages, ground leases or easements to which the lease will be subject. If there are prior interests registered on title, these interests will have priority over the lease unless the tenant makes other arrangements with those prior interest holders. If the prior registered interest is a mortgage and the landlord defaults under the mortgage, the common law is well established that a prior lender is not bound by the lease and can force a tenant out of the premises by terminating the lease. Although a tenant may assume that a lender would not want to terminate the tenancy as the rental income would most likely be assigned to the lender, this may not be a safe assumption. A lender may, in fact, have reasons for wanting to terminate the tenancy such as redevelopment of the property, sale to a potential owner who wants to occupy the premises or simply a belief that they could get a higher rent from a new tenant.

If the prior registered interest is a mortgage and the landlord defaults under the mortgage, the common law is well established that a prior lender is not bound by the lease and can force a tenant out of the premises by terminating the lease.

The common law has also established that a tenant under a lease that is subordinate to a mortgage is likewise not bound by the lease if the mortgagee takes possession and, accordingly, the tenant may vacate the premises rather than recognize the mortgagee as its landlord. In tough economic times, a tenant may actually benefit from being able to terminate the lease if a mortgagee goes into possession.

Non-Disturbance Agreement

While there may be circumstances in which it would be beneficial for a tenant or a mortgagee to terminate the lease upon a mortgagee taking possession of the premises, generally mortgagees and tenants prefer to have the security of knowing that the lease will be preserved in the event that the mortgagee takes possession. A Non-Disturbance Agreement ("NDA") is the tool used to preserve the lease, as it alters the rights of termination provided by common law.

Once a subsearch discloses a prior mortgage, the prudent tenant should try to obtain an NDA from any existing mortgagee simultaneously with negotiating the lease or as soon as possible after the lease has been executed. While most NDAs will provide the tenant with the basic protection needed in the event of a mortgagee going into possession, the tenant should carefully review the form of NDA as there are several significant issues to consider when negotiating the document. For instance, most NDAs simply provide that the mortgagee will not disturb the tenant's possession so long as the tenant is not in default. However, a tenant should try to make the

mortgagee go one step further and covenant to be bound by the terms and conditions of the lease while in possession. Without such an obligation, tenants may find themselves unable to enforce important rights for which they have bargained.

In most cases, a mortgagee will not agree to be bound by the rental account that exists between the landlord and tenant. For example, many mortgagees will refuse to be bound by any prepayments of rent, security deposits or other sums that may be payable by the landlord to the tenant, so that the mortgagee does not find itself out of pocket for these items. Tenants are also often required to waive any rights of set-off, defences or claims that they may assert against the landlord.

Notice of Lease

A tenant should protect its leasehold interest against subsequent mortgages by registering its lease or notice of it on title with the local land registry office. The notice alerts the public that the property is leased and sets out the names of the parties, a description of the premises and the term of the lease, including any options to renew. Though not required, the notice should include any particulars of the lease that the tenant wants to protect, as registration constitutes notice of only the registered document's contents. These particulars might include exclusivity rights, rights to take additional space or an option to purchase. Following registration, the tenant's registered interests take priority over subsequent registrations.

If a tenant does not register notice of its lease on title and a subsequent mortgage is registered on title, the tenant's lease may still be considered to rank in priority to a subsequent mortgage provided the mortgagee had "actual notice" of the unregistered lease at the time the mortgage was registered. It should be noted, however, that given the relatively high standard for actual notice set by the courts, the prudent tenant should not assume that a subsequent mortgagee would be considered to have actual notice by simply seeing or knowing of the tenant's possession of the premises. Case law has shown that something "clear and distinct," such as knowledge of the specific terms of the lease, seeing a copy of the lease, or receipt of an estoppel certificate is required to meet the test for actual notice. As such, a tenant is safest to protect the priority of its lease from a subsequent mortgagee by registering a notice of lease on title to the property.

A tenant should no longer assume that as long as it pays its rent, the Landlord will abide by all of its obligations under the lease. The reality is that a tenant may find itself out on the street as a result of the financial difficulties of its landlord.

Conclusion

Although it has typically been the landlord who evaluates the financial strength of a tenant before leasing space, during these difficult economic times a tenant should spend the necessary time evaluating the financial position of the landlord before entering into a lease. A tenant should no longer assume that as long as it pays its rent, the Landlord will abide by all of its obligations under the lease. The reality is that a tenant may find itself out on the street as a result of the financial difficulties of its landlord. A tenant should make every effort to conduct the appropriate due diligence on both the landlord and the property prior to entering into a lease. In addition, registering a notice of lease and obtaining an NDA will help protect a tenant should a landlord default on its mortgage and a mortgagee is entitled to go into possession.

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Builders Lien Holdbacks – Who Has Priority?

Damon Chisholm

When a construction project faces financial difficulties there are usually a number of parties fighting for limited funds. These parties usually include the owner, the contractor and subcontractors, the lender(s) and government agencies. In these situations contractors and subcontractors have the added benefit of the *Builders Lien Act* (British Columbia) (the "Lien Act"), and similar legislation in the other common law provinces. The Lien Act gives contractors and subcontractors the right to lien (charge) the property where work was performed if they are not paid.

The recent case of *PCL Constructors Westcoast Inc.* v. *Norex Civil Contractors Inc.*, decided by the British Columbia Supreme Court, shows how the involvement of multiple parties and the operation of the Lien Act creates a number of priority rules and schemes. This case involved three separate actions that all dealt with competing claims for holdback funds under the Lien Act. In one of the actions, the competing claims were between the general contractor, who held back funds as required by the Lien Act, the defaulting subcontractor who provided the services, the sub-subcontactors who had lien claims due to the failure of the subcontractor to make payment to them, and Canada Revenue Agency ("CRA") which claimed priority under the *Income Tax Act* against the subcontractor for failure to remit employee deductions.

PCL Constructors Westcoast Inc. ("PCL") was a general contractor who had subcontracted various works to Norex Civil Contractors Inc. ("Norex"). During the course of construction of the project Norex defaulted on its obligations to PCL and its contract was terminated. Prior to the termination of the contract PCL had paid Norex slightly over $1,100,000 on its contract, with 10% being held back pursuant to the provisions of the Lien Act (the "Holdback"). PCL claimed that the amount that it had paid Norex under the contract exceeded the works performed by Norex, resulting in Norex owing back to PCL more then the sum of the Holdback. Various sub-subcontractors of Norex filed builders liens seeking payment of the Holdback. Lastly, CRA made claim to the Holdback pursuant to a Requirement to Pay with respect to monies owed by Norex for employee deductions that were not paid to CRA.

For the purposes of this article, I will refer to PCL (the general contractor) as the Owner, Norex (the subcontractor) as the Contractor and the sub-sub-contractors as the Subcontractor, as this is the more common scenario and the findings of this case would equally apply to that setup.

In the PCL case, the position of the Owner was that the Holdback is not due and owing to the Contractor by virtue of its right of setoff claims it has for overpayment to the Contractor under the contract.

The Holdback

The person who is primarily liable on a contract under which a lien may arise under the Lien Act must retain a holdback that is equal to 10% of the greater of the value of the work provided under the contract and the amount actually paid under the contract.

The Holdback acts as security for every person engaged by the person from whom the Holdback is retained. The Contractor is entitled to receive the Holdback upon completion of the project or expiration of the Holdback period specified under the Lien Act. If a lien is filed, the Owner is entitled to discharge the filed liens by paying the Holdback into court (and the funds in court then replace the lien as the security). The purpose of these provisions of the Lien Act is to limit the liability of the Owner against any claims that may exceed the amount of the Holdback.

In the *PCL* case, the position of the Owner was that the Holdback was not due and owing to the Contractor by virtue of its right of setoff claims it has for overpayment to the Contractor under the contract (the "Setoff"). The

Owner's position was that since no money is, or ever was, owed by it to the Contractor due to the Setoff, CRA is unable to claim any interest in the Holdback. The Subcontractors, who filed builders liens in relation to their work, also took the position that CRA was unable to claim priority over their lien claims to the Holdback.

The Setoff

A setoff right arises when there are mutual obligations between two parties which arise out of the same contract. Courts have held that it is not appropriate for one party to require payment owed to it without taking into account what may be owing the other way.

The Court here went on to state that a setoff arises as work is performed on a contract such that an amount due under that contract is subject to the right of setoff at any given time.

Holdback vs Setoff

Applying the principles of setoff, the Court stated that it would be unfair if the Contractor who completes work on a project but causes damage in the process is to be paid the entire amount of the contract before the Owner can sue for damages. The Court concluded that the Setoff, as claimed by the Owner, has the result of making the amount due under the contract unclear and the amount due must be determined first before the Contractor becomes entitled to the Holdback.

As discussed above, the Lien Act precludes the Owner from utilizing the Setoff against the Holdback until the possibilities of any liens arising under the Contractor by the Subcontractor are exhausted. The chain of priority and rights can then be summarized as follows:

- An Owner is required to maintain the Holdback
- Subcontractors have priority to the Holdback
- Once the Subcontractors' claims are satisfied, the Holdback is payable to the Contractor, subject to any claims to Setoff from the Owner

In the event of an Owner having a Claim of Setoff against the Contractor that exceeds the Holdback, the Contractor has no rights to any portion of the Holdback. As the Contractor has no claim to the Holdback, neither can CRA.

The Deemed Trust

CRA's position was that the Holdback is subject to a deemed trust in favour of CRA (the "Deemed Trust"). CRA, like certain other government agencies, has a super priority that gives it priority over other creditors and, in this case, submitted that pursuant to the *Income Tax Act* a Deemed Trust in the property of an employer is created in favour of CRA for any payroll deductions withheld by an employer at the time a deduction is made.

CRA submitted that the amount of the Deemed Trust created by the Contractor's failure to submit its payroll deductions exceeded the Holdback and, as such, the entire Holdback should belong to CRA.

In response, the Owner submitted that a Deemed Trust can only attach to property that belongs to the Contractor at the time the Deemed Trust arose. It submitted that as it had a Setoff against the Contractor for an amount that exceeded the Holdback, at no time did the Contractor have a claim to the Holdback, and as such, at no time could the Deemed Trust attach to the Holdback.

The Subcontractors, as builders lien claimants, joined with the Owner in asserting that CRA can make no claim to the Holdback. They argued that the provisions of the Lien Act entitle them to be paid their lien claims out of the Holdback and that CRA had no legal basis for interference.

Deemed Trust vs. Setoff

The Deemed Trust creates a strong claim to the property of a tax debtor regardless of when the property was acquired or what security interests it may have subsequently been charged with.

The Court, however, determined that the Holdback, while said to be held in trust, does not create an ordinary trust. An ordinary trust occurs when the beneficiary has an unrestricted beneficial interest. The Holdback was held not to be such an unrestricted interest. Instead, the Holdback is a fund that the Contractor *may* become entitled to.

The Court held that the Deemed Trust could not result in CRA obtaining a greater beneficial ownership than that of the Contractor. In other words, the Deemed Trust will only give CRA a beneficial right to the property of the Contractor that the Contractor actually holds. The Holdback is a conditional right, and when the Contractor's right is appropriated by CRA through the Deemed Trust, CRA's interest is exactly the same as that held by the Contractor.

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The Deemed Trust will only give CRA a beneficial right to the property of the Contractor that the Contractor actually holds. The Holdback is a conditional right, and when the Contractor's right is appropriated by CRA, CRA's interest is the same as what was held by the Contractor.

Deemed Trust vs. Lien Claims

The Court, in assessing the applicable provisions of the *Income Tax Act*, held that the Subcontractors, as lien claimants, are akin to secured creditors. As CRA takes priority to an employer's property, regardless of any secured interests in such property, CRA would take priority to the Holdback over the Subcontractors.

Conclusion

The above priorities create a situation where an Owner's Setoff trumps CRA's Deemed Trust, a Subcontractor's lien claim trumps the Owner's Setoff and CRA's Deemed Trust trumps the Subcontractor's lien claims.

The Court held that in order to effectively work through this scenario the starting point must be whether the Owner has a claim of Setoff.

If there is a provable Owner claim of Setoff then:

- if the Setoff exceeds the Holdback:
  - CRA has no claim to the Holdback
  - the Subcontractors are entitled to their lien claims from the Holdback
  - the Owner is entitled to whatever remains of the Holdback
- if the Setoff is less then the Holdback:
  - CRA is entitled to the amount by which the Holdback exceeds the Setoff
  - the Subcontractors are entitled to their lien claims from the remaining Holdback
  - the balance remaining, if any, goes to the Owner

If there is not a provable Owner claim of Setoff then:

- CRA would first get paid from the Holdback
- the Subcontractors are entitled to their lien claims from the remaining Holdback, if any
- the Contractor would be entitled to whatever remains of the Holdback

These priority rules can result in a situation where CRA may be required to litigate on behalf of the Subcontractor to get the Holdback. This situation will arise when the Owner has no claim of Setoff and, thus, no interest in the Holdback, and where CRA's claim is greater than the Holdback leaving no funds for the Subcontractor. Neither the Owner, the Contractor nor the Subcontractor will have any interest in the Holdback, leaving CRA to claim the funds as Holdback moneys.

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The Purchaser's Right to Rescind: Easements Materially Affecting Use

Bob Fraser

Typical language in an agreement of purchase and sale provides that the purchaser agrees to accept title "subject to any easements for sewers, drainage, public utilities, phone or cable lines or other services that do not materially affect the present use of the property." Language such as this is usually found in either a preprinted form that may be used by the parties or in specifically negotiated "Permitted Encumbrances" in larger deals.

In Ontario, the test for whether an easement materially affects the use of a property is set out by Justice Moldaver in *Stefanovska* v. *Kok* (1990), 73 O.R. (2d) 368 (Ont. H.C.):

> …the test to be applied is whether the vendor can convey substantially what the purchaser contracted to get. In this regard, all of the surrounding circumstances must be considered to determine if the alleged impediment to title would, in any significant way, affect the purchaser's use or enjoyment of the property.

Justice Forestell, in *Ridgely* v. *Nielson*, [2007] O.J. No. 1699 (Ont. S.C.J.), outlined four factors to be considered in determining whether an easement is material: the location of it; the size of the easement; the point of access; and the owner's enjoyment of the property.

The point at which an easement "materially affects" a purchaser's use of a property was recently considered by the Ontario Superior Court of Justice in *Macdonald* v. *Robson* (2008), 76 R.P.R. (4th) 156.

In this case, the parties entered into an agreement of purchase and sale for a two acre property. The purchaser gave evidence at trial that the property suited his interests as its lay-out would enable him to build a structure on the west side of the property to house his tractor.

The real estate listing for the property made no reference to any easements. However, in fact an easement in favour of the Town of Flamborough affected approximately 25% of the property. The terms of the Easement Agreement permitted access to the property by the Town to deal with sewer systems and required the property owner to keep the easement area free of all obstructions, including buildings and structures. The restrictions imposed by the easement would have prevented the purchaser's planned construction of a shed and future building projects.

On discovery of the easement, the purchaser's lawyer requisitioned its removal on the basis that it materially affected the purchaser's intended use for the property. The vendor's lawyer countered that given the size of the property there were alternate areas where a shed could be constructed. An application to court was launched.

On discovery of the easement, the purchaser's lawyer requisitioned its removal. The vendor's lawyer countered that given the size of the property there were alternate areas where a shed could be constructed.

At trial, Justice Wilson of the Ontario Superior Court of Justice considered the tests in *Stefanovska* and *Ridgely* (outlined above). Given the purchaser's intention to use the property to indulge his building hobby, and given the size and location of the easement, it had a material effect on the present use of the property. Justice Wilson ordered the return of the deposit and held that the purchaser was entitled to rescind the agreement of purchase and sale.

On appeal, Justice Carnwath of the Ontario Superior Court of Justice (Divisional Court) upheld Justice Wilson's decision.

This case is important as it provides insight into when an easement crosses the line between a permitted encumbrance and something that has a material effect on the benefit received by the purchaser. Whether an easement is "material" will be determined on an objective basis, taking into consideration the view of the purchaser.

This case also highlights the importance of a thorough title investigation early in the purchase transaction.

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This article also appears in Lang Michener's Commercial Real Estate blog at www.lawoftheland.blogs.com.

News and Events

News

Lang Michener Expands Into Asia

In May 2009, Lang Michener LLP announced the opening of its office in Hong Kong, in association with local law firm Angela Ho & Associates. The Hong Kong office will provide Lang Michener's clients with greater access to its Canadian legal experience in corporate finance, private equity, M&A, banking, real estate, litigation and international trade.

Henry Krupa Joins Lang Michener

We are pleased to announce that Henry Krupa has joined the Commercial Real Estate Group in the Toronto office as counsel. Henry has significant expertise in environmental law, energy and government relations. Before his return to private practice Henry was the Director of Legal Services for the Ontario Ministries of Environment and Energy, and an Adjunct Professor at the University of Western Ontario.

Robert Standerwick Appointed Queen's Counsel

We are pleased to announce that in January 2009 Robert (Bob) Standerwick was appointed Queen's Counsel. Bob is a partner in the Real Estate and Banking Law Group in the Vancouver office.

Steve Michoulas Joins the LTSA Advisory Committee

Steve Michoulas, an associate in our Vancouver office, has joined the Land Title and Survey Authority ("LTSA") Stakeholder Advisory Committee ("SAC"). As chair of the Canadian Bar Association's ("CBA") Real Property Subsection (Vancouver), Steve is acting as a representative of the CBA on the LTSA Advisory Committee.

The LTSA is an independent corporation formed to ensure the continued integrity of the land title and survey systems in British Columbia.

The Stakeholder Advisory Committee meets regularly to provide advice to the CEO relating to the LTSA's mandate to operate the land title and survey systems in accordance with B.C.'s legislative framework.

Events

Practising Commercial Real Estate in a Changing Environment

Presented by Osgoode Professional Development

September 22, 2009
Toronto, ON

Bill Rowlands, Chair of Lang Michener's Real Estate Group in Toronto, will be giving a presentation entitled "Negotiating and Amending Key Lease Terms" at the "Practising Commercial Real Estate in a Changing Environment" seminar.

RealEstateBrief

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Brief offers general comments on legal developments of concern to business and individuals. The articles in Brief are not intended to provide legal opinions and readers should, therefore, seek professional legal advice on the particular issues which concern them. We would be pleased to elaborate on any article and discuss how it might apply to specific matters or cases.

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