

Real Estate Joint Ventures

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Overview of Topics

- Introduction
- Joint Venture Corporations
- Co-Ownerships
- General Partnerships
- Limited Partnerships
- Trusts
- Joint Venture Agreements
- Organizational Chart for a Typical Joint Venture Development

Introduction

- **Typically, parties wish to form a joint venture to:**
 - Access the expertise of others
 - Access the capital of others
 - Gain access to a project or asset that they would not otherwise have access to
 - Share the risk of a project or asset with others
- **Joint venture structures may be used to accomplish complex financings and/or increase the leverage on a particular project (i.e. mezzanine financings)**

Introduction (cont.)

- **Generally, there are three types of joint ventures in the real estate context:**
 - Corporations
 - Co-ownerships
 - Partnerships, be they general or limited
 - Trusts are also used in limited circumstances
 - Differ from the contractual “joint ventures” that may be used in non-real estate context

Joint Venture Corporations

- **Joint-venture corporations are generally created with a specific investment project in mind**
- **Legal Relationship –**
 - A corporation is a legal entity created by statute which exists separately from its shareholders
 - Shareholders are liable only for the amount of their capital contribution; limited liability
 - Shareholders generally do not owe a fiduciary duty to other shareholders
 - Each joint venture partner holds shares of the joint venture corporation
- **Documentation –**
 - The shareholders enter into a shareholders' agreement to govern their corporate relationship
 - The corporation itself may enter into any additional agreements with the shareholders, their affiliates or others for asset, development, property and/or leasing management services

Joint Venture Corporations (cont.)

- **Advantages**

- The advantages of a joint venture corporation are essentially the same as those enjoyed by corporations generally:
 - ▶ limited liability
 - ▶ ease of transfer of joint venture interests
 - ▶ ease of administration
 - ▶ the arrangement is governed by a set of well-understood legal and accounting principles, resulting in a certainty of rights and obligations
- Although the tax disadvantages (see below) generally outweigh the benefits of structuring a real estate joint venture as a corporation, there are some limited benefits to this approach, namely:
 - ▶ Formation – participants can roll real estate into the corporation on a tax-deferred basis allowing them to avoid a taxable event upon formation of the corporation
 - ▶ Disposition – A transfer of shares upon disposition of the corporation does not attract Ontario land transfer tax, whereas a sale under other types of structures usually would

Joint Venture Corporations (cont.)

- **Disadvantages**

- The corporation is not commonly used in the real estate joint venture context primarily due to its undesirable tax consequences:
 - ▶ Two-level Taxation – The predominant tax disadvantage of structuring a joint-venture as a corporation is that (as with most other corporations) shareholders bear income tax both at the corporate and the individual level
 - ▶ Discretionary Deductions – Since profits/losses are taxed at the corporate level, discretionary deductions such as capital cost allowance must be claimed at the corporate level
 - ▶ Pension Funds –
 - for tax-exempt Canadian pension fund realty corporations, there is little incentive to participate in a venture whose profits are taxable as a separate entity
 - however, if all the participants are pension fund realty corporations, they may participate together as shareholders of a tax-exempt corporation provided that the requirements of section 149(1)(o.2) of the *Income Tax Act* (ITA) are satisfied
 - a pension fund realty corporation may not involve itself as a real estate developer or manager without losing its tax-exempt status

Joint Venture Corporations (cont.)

- Liquidity – As opposed to other forms of ownership where a joint venture participant holds a direct interest in the property, when structured as a corporation, the individual participants own only shares; potentially harder to finance or sell than real property
- **Comparison to other Joint Venture Options**
 - The absence of fiduciary duties between shareholders, as opposed to the fiduciary duties existing between partners is beneficial, but is at least partially offset by the fiduciary duty owed by directors to the corporation
 - The liabilities of directors are generally more significant than duties imposed on managers of a partnership
 - Negative tax implications
- **Rarely used in the real estate context because of the negative tax implications and availability of other more flexible structures**

Co-Ownerships

- **In a co-ownership structure, the participants hold a direct interest in the underlying property**
- **Legal Relationship –**
 - A tenancy-in-common – a form of ownership whereby the participants hold an undivided interest in the entire property rather than each holding a separate and identifiable portion of the property
 - Each co-tenant is entitled to equal right of use and possession of the real property (unity of possession)
 - In the absence of a contrary provision in the co-ownership agreement (see below), every co-tenant has a right to receive a proportionate share but, unless contractually stipulated, has no obligation to fund any portion of the costs

Co-Ownerships (cont.)

- For tax and liability reasons, the co-owners will wish to avoid being characterized as partners of one another – the characteristics that the courts have considered in the past to distinguish a partnership from a co-ownership include (presence of one or more of the following points toward a partnership):
 - ▶ contribution by the parties of money, property, skill, efforts, knowledge or other assets to a common undertaking
 - ▶ joint interest in the subject matter of a joint venture
 - ▶ a right to mutual control and management
 - ▶ expectations and sharing of profits
 - ▶ whether or not the arrangement is limited to one project
- Historically, for this reason, many co-ownership structures have an operating entity to which the project is leased; to avoid a two-tier tax problem, substantially all of the income is flowed from the operating entity to the co-owners as rent under the project lease

Co-Ownerships (cont.)

- **Documentation –**

- The co-owners will enter into a co-ownership agreement
- If a title nominee is used, a nominee agreement together with a shareholders agreement in respect of the nominee; the shareholders agreement needs to dove-tail with the co-owners agreement
- Cross-charge documents whereby each co-owner will charge its interest to the other as security for the obligations of the charger under the co-ownership agreement
- The co-owners (or the nominee on their behalf) may enter into any additional agreements with one or more of the co-owners, their affiliates or others for asset, development, construction, property and/or leasing management services
- When one co-owner wants to mortgage its interest, the co-owners will enter into a separate mortgage agreement
- Lease by the co-owners of the real property to an operating entity (if applicable)
- Shareholders agreement in respect of the operating entity (if applicable)

Co-Ownerships (cont.)

- **Advantages**

- **Flow-Through Taxation –**

- ▶ since a co-ownership is not a separate entity for tax or legal purposes participants are taxed at the individual rather than the joint venture level
 - ▶ the tax return of each co-tenant simply reports the co-tenant's percentage of gross revenues / profits

- **Limited Liability –**

- ▶ generally available for co-owners provided that the co-owner itself is structured as a limited liability vehicle (i.e. a corporation)
 - ▶ if their relationship is determined to be that of a general partnership, the partners will become jointly and severally liable
 - ▶ to avoid being found to be a partnership, a co-owners agreement will typically include:
 - an explicit statement that the relationship is not a partnership (although such a statement is not determinative)
 - a provision allowing co-owners to carry on competing businesses, which is in direct conflict with the notion that partners owe one another a fiduciary duty
 - a provision that each co-owner's liabilities are proportionate to such co-owner's interest
 - a provision that the day-to-day management of the property is delegated to a developer or property manager (to avoid the accusation that the co-owners are "carrying on a business in common")

Co-Ownerships (cont.)

- No Fiduciary Relationship – A co-ownership of property does not give rise to a fiduciary relationship amongst the co-owners
- Discretionary Deductions – Co-owners have the added flexibility, unavailable to participants of a limited or general partnership, of being able to determine their own discretionary deductions such as capital cost allowance
- Increased Liquidity – As owners of a direct interest in real property, co-owners are able to more readily mortgage, hypothecate or sell their interests to third parties; for this reason, co-ownership agreements must limit each co-owner's ability to mortgage, hypothecate or sell its interest
- Few obligations to other co-tenants – Unlike partnerships, there is no responsibility for the debts of other co-tenants, no right to act as agent for any other co-tenant and no fiduciary obligations are owed to any other co-tenant
- Tax Treatment on Disposition – Each co-owner is taxed separately

Co-Ownerships (cont.)

- **Disadvantages**

- Re-Characterization as a Partnership –

- ▶ the chief concern with co-tenancies is that they may be re-classified by Canada Revenue Agency (CRA) as a partnership
 - ▶ if a co-tenancy is deemed by CRA to be a partnership, many problems may arise:
 - for instance, CRA may re-classify the co-ownership after the period in which the section 97 roll-over provision of the ITA can be utilized
 - a declaration that an agreement is one of co-ownership and not partnership cannot overcome the actual nature of an organization or relationship

- Requirement that all cash and income be allocated in accordance with each co-owner's undivided percentage interest in the co-ownership – this eliminates the ability to have “preferred returns”, “promotes” or “carries”

- **Comparison to other Joint Venture Options**

- Unlike a partnership, there is no responsibility for the debts of other co-tenants, no right to act as agent for any other co-tenant and no fiduciary obligations owed to any other co-tenants

General Partnership

- **Partnerships are generally preferable to joint venture corporations in the real estate context; one of the greatest advantages of a partnership is its flexibility – subject to income tax legislation, the structure allows for a preferential, varying or other non-proportionate share of the profits**
- **Legal Relationship –**
 - Per section 2 of the *Partnership Act* (Ontario) a partnership is not a separate legal entity but rather “the relation that subsists between persons carrying on a business in common with a view to profit”
 - The participants of a general partnership will not benefit from limited liability
 - One partner has the ability to bind the partnership
 - Partners are jointly and severally liable for the obligations of the partnership
 - Although partnerships are governed by statute, the statutory regime is less specific or prescriptive than in the case of a corporation; as a result, there are very few statutory provisions specifying the rights and obligations of partners under the various provincial partnership legislation

General Partnership (cont.)

- **Documentation –**

- The partners may enter into a partnership agreement to govern their relationship; lack of a partnership agreement does not mean that there is no partnership, however
- The partnership itself may enter into any additional agreements with the partners, their affiliates or others for asset, development, construction, property and/or leasing management services

General Partnership (cont.)

- **CRA Interpretation Bulletin IT-90 “What is a Partnership” outlines, from CRA’s point of view, what constitutes a partnership**
 - the ITA does not define a partnership; reference should be made to the applicable provincial statute and such law will be viewed as persuasive by the CRA
 - a characteristic of a partnership is the sharing of profits rather than the sharing of gross returns; where the share of profits represents payment of an obligation as opposed to a partnership right to so share, any presumption of partnership relating to the share of profits is rebutted
 - where several participants form an association for the purpose of carrying on a business, the association will have the characteristic of a partnership; however, if the participants associate without accepting total liability for the association’s debts, and instead accept only an amount of liability equal to their proportionate contribution to the association, the association should not be viewed as a partnership
- **CRA Memo 2000-0001227 states that the specific intention to form a partnership is not necessary**

General Partnership (cont.)

- **Advantages**

- Partnerships have the advantage of being easier to establish and maintain than a corporation, and are generally easier to dissolve
- There are a number of tax benefits:
 - ▶ Flow-Through Taxation – Although taxes are determined at the partnership level, income flows-through to the individual partners thereby avoiding the entity-level taxation of a traditional corporate structure
 - ▶ The losses of a partnership can be flowed through to the individual partners who can use these losses to offset income from other sources; partners are allowed to deduct their share of investment tax credits, business losses and property losses to the extent of their “at-risk amount” and losses that a partner is unable to use to offset income in that year may be carried forwarded indefinitely
 - ▶ Roll-Overs – Roll-overs are generally available for partnerships (with Canadian partners only) under section 97(2) of the ITA and may be used for either inventory or capital property
 - ▶ Flexibility for Reorganization – Since the partnership interest is a separate property distinct from the underlying real property, there is more flexibility for a re-organization of holdings on a tax-free basis

General Partnership (cont.)

- **Disadvantages**

- No Limited Liability – A general partnership is not a legal entity and therefore its partners do not benefit from limited liability protection
- Joint and Severally Liability of Partners – Any one partner can bind the partnership; all partners are jointly and severally liable for the obligations of the partnership
- Capital Cost Allowance Deductions – Deductions for capital cost allowance must be claimed at the partnership level thereby prohibiting individual partners from selecting which deduction to claim
- “At-risk” Rules – A partner may also be subject to the “at-risk” rules under which only that individual participant’s proportionate share of the partnership’s losses may be used to offset other income
- Land Transfer Tax –
 - ▶ generally, for Ontario land transfer tax purposes, every transfer of a partnership interest is treated as a beneficial transfer of the underlying real estate and attracts land transfer tax – 5% exception

General Partnership (cont.)

- Other Tax Implications –
 - ▶ a distribution of property by the partnership to its participants will generally give rise to a taxable event if the property has a fair market value is greater than its cost base to the partnership, subject to certain limited rollover rules
- **Comparison to other Joint Venture Options**
 - More flexible – the partnership structure allows for a preferential, varying or other non-proportionate share of the profits

Limited Partnership

- **A limited partnership affords its participants the benefits of flow-through taxation and limited liability**
- **Legal Relationship –**
 - Like a general partnership, a limited partnership is also not a legal entity
 - A limited partnership is a special type of partnership that consists of at least one general partner and one or more limited partners
 - Generally speaking, subject to the *Limited Partnerships Act* (Ontario), general partners have unlimited liability, while limited partners have limited liability up to the amount that they contribute or agree to contribute to the limited partnership
 - Filing a Declaration, Form 3, under the *Limited Partnerships Act* (Ontario) signed by all of the general partners forms a limited partnership
 - Extra-provincial limited partnerships must also file a declaration with the Ministry of Government Services to carry on business in Ontario

Limited Partnership (cont.)

- In exchange for their unlimited liability status, limited partners are prohibited from managing the day-to-day operations of the limited partnership
- The limited partnership carries on business through its general partner, whose mandate is governed by the limited partnership agreement
- It is through the general partner of the limited partnership that a limited partnership acquires and conveys title to real property, including leasehold estates – the transferee should not be the limited partnership or the individual limited partners;
- Legal title to real property acquired by a limited partnership, including leases and transfers of leases, is held by the general partner(s) and should be recorded in the name of the general partner(s) or a title nominee

Limited Partnership (cont.)

- **Documentation –**

- A limited partnership declaration filed by the general partners
- The partners may enter into a limited partnership agreement to govern their relationship
- The general partner on behalf of the limited partnership may enter into any additional agreements for asset, development, property and/or leasing management services – limited partners will only do so through affiliates to avoid losing limited liability

Limited Partnership (cont.)

- **Manitoba Limited Partnerships**

- Provincial legislation surrounding limited partnerships is fairly uniform, with the notable exception of Manitoba
- In most jurisdictions, a limited partner becomes liable as a general partner when it becomes involved in the management of the partnership
- However in Manitoba, a limited partner who takes an active part in the management of a limited partnership is only liable for debts to a person whom it deals with on behalf of the partnership and who does not know that it is a limited partner

Limited Partnership (cont.)

- Unlike most other jurisdictions where all that is required for a limited partner to lose its unlimited liability status is for that partner to take an active role in the business, in Manitoba there are three criteria that must be satisfied for a limited partner to be generally liable for the debts of the partnership:
 - ▶ the limited partner must take an active part in the management of the partnership
 - ▶ the limited partner must deal with a third party on behalf of the partnership
 - ▶ the third party must not know that the partner with whom it is dealing is a limited partner
- Additionally, under Manitoba law, the timeframe of a limited partner's liability is restricted and extends only between the time the limited partner first dealt with the third party and when the third party acquires actual knowledge that it was dealing with a limited partner

Limited Partnership (cont.)

- **Advantages**

- Generally, the same as for a General Partnership (see above)
- Limited Liability for Limited Partners – In a limited partnership, limited partners enjoy limited liability while the general partners remain liable for the obligations of the limited partnership

- **Disadvantages**

- Generally, the same as for a General Partnership (see above)
- Active Management – In all provinces except for Manitoba (see above), the limited partners are prohibited from becoming actively involved in the management or decision-making of the partnership, for fear that they lose their limited liability status

Limited Partnership (cont.)

- **Ways in which the limited partner can control the partnership without losing its limited liability:**
 - **Board Supervision –**
 - ▶ limited partners may hold shares in the general partner corporation and appoint a representative to its board, thereby allowing it to influence the decisions of the general partner's management
 - ▶ to reduce exposure to the limited partners, affiliates of the limited partners often hold the shares in the general partner
 - **Advisory Committee –** An advisory committee may be set up to give the limited partners a degree of oversight over the activities of the general partner
 - **Limited Partnership Agreement –** The limited partnership agreement will often contain safeguards/restrictions, requiring the general partner to adhere to specific investment policies (i.e. predetermined leverage ratios?), notification requirements and to obtain consent for transactions involving a conflict of interest

Limited Partnership (cont.)

- **Comparison to other Joint Venture Options**
 - Preferable to a corporation because:
 - ▶ a limited partner has the right to more extensive information regarding partnership than does a typical minority shareholder
 - ▶ a limited partner may demand the return of all or part of its capital contribution by giving six months' notice (although the limited partnership agreement could alter this right)
 - Preferable to a general partnership because of limited liability
 - Preferable to a co-ownership because of the ability to provide for a preferential, varying or other non-proportionate distribution of the profits

Trusts

- **Aside from Real Estate Investment Trusts (REITS) and mutual fund trusts, the trust is rarely used for structuring real estate joint ventures**
- **Legal Relationship –**
 - A trust is not a judicial entity, but rather is a relationship between the trustees and the beneficiaries with the trustee acting as agent for the beneficiaries with respect to the trust assets; not referring to a nominee / bare trustee situation (where the trustee is compelled to do the bidding of the beneficiary)
 - The trustees' powers are limited to those conferred by the declaration of trust which must provide the authority for the trustee to sell trust property
 - A REIT can only hold real estate which is capital property, and therefore cannot participate in real estate speculation
 - SIFT rules – beyond the scope of this presentation

Trusts (cont.)

- **Advantages**

- Flow-Through Taxation – Although the trust is a separate entity and its profits/losses are therefore taxed at the trust level, special rules under the ITA apply to trusts in most real estate joint venture contexts to allow for flow-through tax treatment

- **Disadvantages**

- Losses – Although a REIT is a flow-through entity for the purposes of distribution of income, unlike a limited partnership the losses of a REIT cannot be flowed through to the individual unit holders but may be deducted by the REIT in future years
- No Limited Liability – In Ontario, beneficiaries do not have limited liability protection except in circumstances where the trust or REIT is a reporting issuer under the *Securities Act* (Ontario)
- Land transfer tax is assessed at the beneficiary level in Ontario – other than exemptions for mutual fund trusts (including REITs), this creates problems when beneficiaries of the trust transfer their interest

Joint Venture Agreements

- **All three types of joint venture agreements (shareholder, co-ownership and partnership) share common characteristics and will address many of the following issues:**
 - **How is the venture capitalized?**
 - ▶ do all participants have to contribute equally?
 - ▶ is the venture capitalized by way of equity or debt by the participants?
 - ▶ how are capital calls made?
 - ▶ defaulting participants –
 - no right to vote for defaulting participant
 - non-defaulting participant has the right to:
 - make the contribution for the defaulting participant and dilute its interest – priority right to return of such contribution is typical
 - right to advance the money on behalf of the defaulting participant at a punitive interest rate – this is usually secured by the cross-charges given to secure the participants' obligations under the joint venture agreements – again, a priority right to the return of such contribution is typical
 - acquire the defaulting participant's interest at a discount – insolvency issue (i.e. 100% for an event of insolvency, 80% for event of default)

Joint Venture Agreements (cont.)

- How are profits and losses allocated for tax and accounting purposes – not necessarily the same as distributions of profit?
- How are profits distributed?
 - ▶ in what priority? (partnership structures allow for a preferential, varying or other non-proportionate share of the profits)
 - ▶ is one participant entitled to a preferred return of its capital (plus interest)?
 - ▶ is one participant entitled to a disproportionate allocation of the cash / profits?
 - ▶ sometimes referred to as the “waterfall”
- How decisions are made?
 - ▶ what decisions are major decisions?
 - ▶ what decisions require majority approval / unanimous approval by the participants?
 - ▶ representatives of the participants on a management committee
 - ▶ operation of the venture in accordance with an annual budget and business plan approved by the joint venture participants (or their representatives); variation from the approvals requires further approval

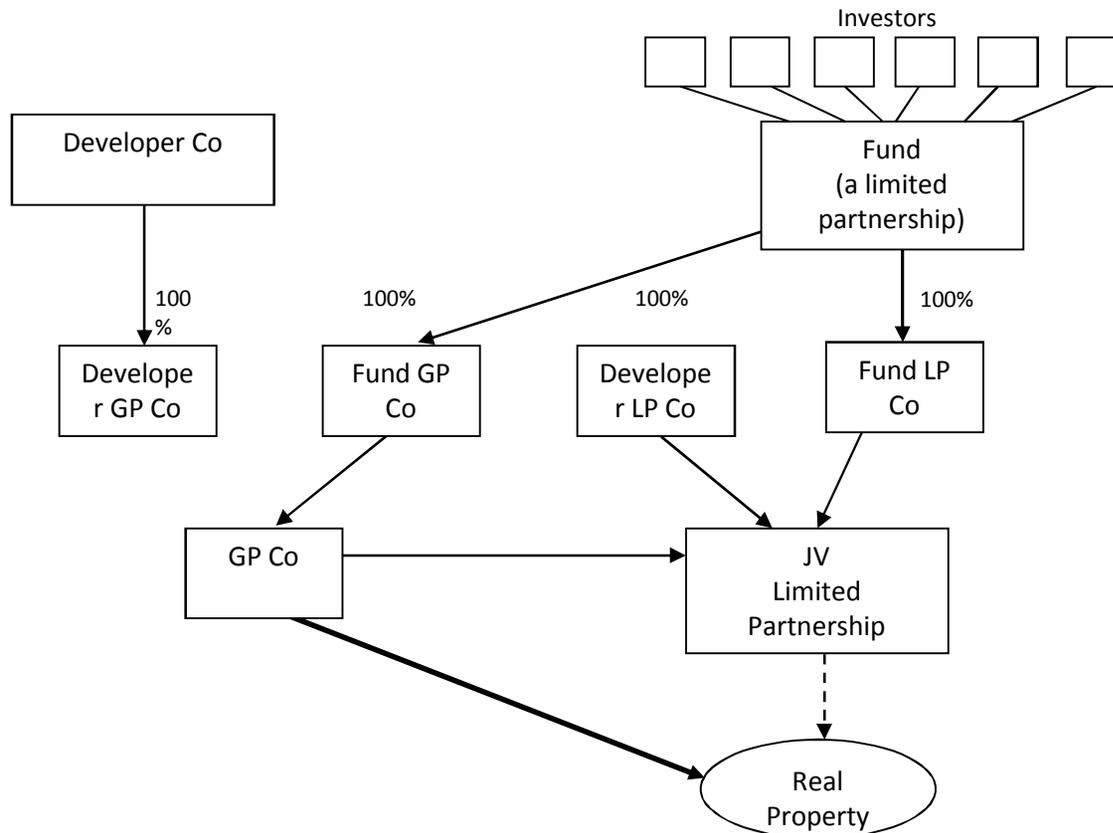
Joint Venture Agreements (cont.)

- Dispute resolution –
 - ▶ status quo until the parties can agree
 - ▶ one party has the deciding vote (rare)
 - ▶ arbitration by an expert
 - ▶ shotgun buy/sell
 - not a good idea where there is an imbalance in financial strength (at least from the weaker party’s standpoint!)
 - amount of time required to respond to the offer can make a difference – a longer period permits the recipient more time to seek financing (or a third party purchaser to replace the initiator) so it is not forced to be the seller
 - participants often agree that no participant shall have the right to trigger the shotgun during development as:
 - it is disruptive to development
 - will “spook” the construction lender – if a demand facility, this is a real problem
 - the project is not readily saleable and further financing is not easily obtained
 - informational imbalance as developer partner has greater information than the financial partner

Joint Venture Agreements (cont.)

- The extent to which a participant may deal with its interest in the venture (sale or mortgage):
 - ▶ consent of other participants required for arm's length sale (less typical)
 - ▶ absolute prohibition (more typical), subject to exceptions for permitted transfers to affiliates, buy/sell, right of first refusal, etc.
 - ▶ permitted transfers to affiliates
 - ▶ separate mortgages permitted so long as the mortgagee enters into a separate mortgage agreement with the other participant that provides, among other things:
 - notice of defaults by mortgagee to other participants and *vice versa*
 - the mortgagee can't interfere with the venture
 - limited remedies – i.e. the mortgagee may not appoint a receiver or manager
 - realization is subject to the terms of the joint venture agreement, including approval rights on any sale of the mortgaged interest
 - the separate mortgage is subordinate and postponed to any cross-charges
 - ▶ right of first refusal – sale of interest only or 100%?
 - ▶ right of first offer – sale of interest only or 100%?
 - ▶ drag along right
 - ▶ piggy back right
- Valuation of the Joint Venture – typically, this is only important on default or at the end of the term of the venture

Organizational Chart for a Typical Joint Venture Development



Agreements

- 1 Limited Partnership Agreement re: JV Limited Partnership among GP Co, as general partner, and Developer LP Co and Fund LP Co, as limited partners.
- 2 Unanimous Shareholders Agreement re GP Co among Developer GP Co and Fund GP Co, as shareholders, and GP Co, as the subject corporation.
- 3 Development Management Agreement between JV Limited Partnership by and through GP Co, as owner, and Developer Co, as development manager.

Legend:

- = company/limited partnership
- = real property
- ↓ = registered real property ownership
- .-↓ = personal property and beneficial real property ownership
- ↓ = share/unit ownership

Conducting a Thorough Due Diligence for Real Estate Transactions

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Overview of Topics

- **Type of Transaction**
- **Other Considerations**
- **Title to the Real Property**
- **Off-Title Searches**
- **Corporate Searches**
- **Zoning Analysis**
- **Environmental Due Diligence**
- **Soils / Geo-technical Report**
- **Building Condition Report**
- **Appraisals**
- **Lease Due Diligence**
- **Mortgage Due Diligence**

Type of Transaction

- **The nature of the due diligence is often dependent on the type of transaction:**
 - **Asset Purchase**
 - **Share and/or Limited Partnership Purchase**
 - ▶ In addition to all the due diligence the buyer would conduct on the real property, the buyer has to conduct due diligence on the target entity, including:
 - minute book reviews
 - reviewing target's financial statements and tax returns – consider other liabilities including for past transactions
 - existing title opinions and title insurance policies for the subject property
 - change of control issues
- **Financing**
- **Look for enforcement issues; if default, there is the possibility that Lender will have to enforce its security to sell the asset or end-up owning the asset**

Type of Transaction (con't)

- It also depends on the type of property involved:
 - Office
 - Retail
 - Industrial
 - Multi-res
 - Re-development of an existing project
 - Vacant land for development

Other Considerations

- **Detective work is required – the buyer and its advisors need to synthesize all the information rather than looking at one aspect in isolation**
- **When evaluating the due diligence materials, do not just consider what you, as the buyer, think is acceptable; think about what prospective lenders and future buyers will consider acceptable**
- **The buyer needs to undertake a cost-benefit analysis when conducting its due diligence process – thorough due diligence is expensive, uses resources and is time consuming – the buyer has to weigh the cost against the possible risks**

(Note that this presentation focuses on the due diligence involved in the acquisition of real estate in Ontario pursuant to an asset purchase agreement.)

Title to the Real Property

- **Tenure of Ownership**

- Does the vendor on the purchase agreement match the registered owner on title?
- Consider registered vs. beneficial ownership
 - ▶ The buyer wants the covenant of the beneficial owner
 - ▶ If the buyer has notice of the beneficial owner, the buyer needs a conveyance of the beneficial owner's interest in addition to the nominee's registered or legal interest in the real estate

Title to the Real Property (con't)

- **What is the tenure of the ownership of the lands?**
 - Freehold / fee simple
 - Leasehold
 - ▶ Need to have a comprehensive understanding of the terms of the ground lease
 - ▶ Consents?
 - ▶ Leasehold lender agreements?
 - ▶ Is there a charge by the landlord of the freehold interest? If so, what non-disturbance arrangements are in place with the freehold lender?
 - Condominium / Stratified Title
 - ▶ Terms of the Reciprocal Agreement
 - ▶ Insurance Trust Agreement

Title to the Real Property (con't)

- Undivided interest or a co-tenancy interest
 - ▶ Need to have a comprehensive understanding of the terms of the co-ownership agreement
 - ▶ Consents?
 - ▶ Are other co-owners' interests charged? Is there a separate mortgage agreement?
 - ▶ Can the buyer charge its co-ownership interest? What are the restrictions on doing so?
 - ▶ Rights of first offer / rights of first refusal in favour of the other co-owner(s)?

Title to the Real Property (con't)

- **What are the boundaries?**

- Does the legal description on title match what the buyer thinks it is getting?
- Access – is it via another's property / a signalized intersection? (i.e. some leases require full movement signalized intersections)
- Parking
 - ▶ Is it entirely on the subject property?
 - ▶ Does it meet municipal requirements?
 - ▶ Does it satisfy parking covenants to the tenants?
- Encroachments – Do the structures lie wholly within the boundaries of the subject property? Do they encroach into any easements and, if so, is it permitted by the terms of the easement?
- Set-backs – Are they adequate for municipal / fire code purposes; sometimes there is a limiting distance agreement

Title to the Real Property (con't)

- **Encumbrances (other than Mortgages – see separate topic below)**
 - Easements burdening the subject lands
 - Easements for the benefit of the subject lands
 - ▶ Are they properly recorded on title to the servient lands?
 - ▶ Have all mortgagees of the servient lands postponed their security to the easements?
 - Restrictive Covenants
 - Rail siding agreements
 - Cost sharing arrangements with neighbouring land owners
 - ▶ positive covenants do not run with the lands
 - ▶ may provide for a charge in favour of the other parties

Title to the Real Property (con't)

- Municipal Agreements
 - ▶ Subdivision Agreement, Section 37 Agreement, Development Agreement, Heritage Easement Agreement, Site Plan Agreement Agreements with school boards
 - ▶ Are they in good standing? Are there outstanding obligations under them? Are the obligations limited to the subject property or are there any obligations against abutting properties? If so, how are such obligations secured – indemnities, collateral such as LCs or deposits? Is there a proper agreement with the neighbouring land owner to ensure that the neighbouring owner fulfills its obligations under the municipal agreement?
- **Consider whether there are any notice or consent requirements under any of these, and whether specific assumption agreements are required. Were they obtained for past transactions?**

Title to the Real Property (con't)

- **Survey**

- Is it up-to-date?
- What does it show? Not all surveys are created equal. Is it a building location survey? Does it show the location of all boundaries, easements, structures, curb cuts, driveways, overhead wires, sign pylons, etc.?
- ALTA standard required by US lenders
- Reliance Letters (address to buyer and buyer's lender)

Title to the Real Property (con't)

- **Solicitor's Title Opinion or Title Insurance**

- The buyer will have to assess with its counsel how best to ensure title is as expected
- If title insurance is sought, the buyer needs to understand what is and is not covered by the policy
- Typically, the buyer's lawyer gives the solicitor's title opinion or arranges the title insurance policy; however, in some circumstances, the vendor's lawyer may do so and it is up to the buyer's lawyer to negotiate the form of opinion / title insurance policy on behalf of the buyer

Off-Title Searches

- **General Comments**

- Consider what type of lands are being purchased – vacant land for development, redevelopment lands, retail, office, multi-res or industrial land
- If title insurance is being sought, some of these searches may not be necessary – risk can be insured over (sometimes, it is not appropriate to do so – i.e. development lands)

- **Realty Taxes**

- Tax Certificate from the Treasurer of the relevant municipality
- Assessment Review Board on-line search for appeals
- Municipal Property Assessment Corporation for supplementary assessments
- Assessment Roll maps
- Check to make sure the thumbnail descriptions for each of the assessment roll numbers cover all of the subject lands to ensure the buyer is not missing any assessment rolls
- Arrears constitute a lien on the property

Off-Title Searches

- **Local Improvement Charges / Development Charges**
 - Typically part of the information that is included on the tax certificate
- **Building Report**
 - Confirms which zoning by-law is applicable to the subject lands
 - Typically confirms the permitted uses under the applicable zoning by-law
 - Rarely confirms compliance with performance standards (i.e. set-back, lot coverage, etc.)
 - Notice of open building permits, work orders, infractions, etc.; need to analyse these to determine whether they are tenant or landlord matters (this may involve checking the relevant lease to see if the tenant is in fact responsible for the subject work)
- **Electrical Safety Authority**
 - Notice of open building permits, work orders, infractions, etc.; need to analyse these to determine whether they are tenant or landlord matters (this may involve checking the relevant lease to see if the tenant is in fact responsible for the subject work)

Off-Title Searches (con't)

- **TSSA – Elevators, Fuel, Boilers**
 - Notice of recent inspections and any deficiencies
- **Fire Department**
 - Notice of recent inspections and any deficiencies; often need to analyse these to determine whether they are tenant or landlord matters (this may involve checking the relevant lease to see if the tenant is in fact responsible for the subject work)
- **Health Department**
 - Notice of recent inspections and any deficiencies; often need to analyse these to determine whether they are tenant or landlord matters (this may involve checking the relevant lease to see if the tenant is in fact responsible for the subject work)
- **Ministry of Labour**
 - Notice of recent inspections and any deficiencies; often need to analyse these to determine whether they are tenant or landlord matters (this may involve checking the relevant lease to see if the tenant is in fact responsible for the subject work)

Off-Title Searches (con't)

- **Agreement Compliance**

- Typically, one can write to the municipality to determine whether the municipal agreements registered against title are in good standing and whether there are any outstanding obligations under them
- Very unlikely that utility companies will respond
- Dealing with private third parties to confirm agreement compliance is often time consuming

- **Committee of Adjustments**

- **Heritage Status of any Improvements**

- **Conservation Authority**

- Very important if the buyer plans on developing land

Off-Title Searches (con't)

- **Ministry of the Environment**
 - Typically ordered
 - However, of limited value – usually obtained as part of getting an environmental report, often they take months to get, and they provide little information
 - There are other environmental searches that can be done (i.e. Brownfield site database, wells, waste disposal site, etc.)
- **Unregistered Easements (Hydro One and Local Municipality)**
 - Unregistered hydro easements can run with the lands – especially important if the buyer plans on developing the subject lands

Off-Title Searches (con't)

- **Utility Accounts (Hydro, Gas, Water, Sewer)**
 - Typically these do not constitute a lien against the property (save for water and sewer if added to the tax roll)
 - However, the buyer will want to ensure that arrears are dealt with, meter readings and final bills are provided for and new accounts in the name of the purchaser are opened for closing
- **Crown Patent**
 - Is there one?
 - Any subsisting reservations to the Crown?
- **Others**
 - Cemeteries, Ministry of Housing, Ministry of Transportation (i.e. access to 400 series highways), to name but a few
 - Depends on the facts

Corporate Searches

- **Confirm corporate existence of vendor**
- **Conduct Personal Property Security Act (PPSA) searches against the vendor**
 - **Either to be:**
 - ▶ assumed as part of any mortgage assumption / equipment leases that form part of the Purchased Assets
 - ▶ discharged
 - ▶ require a no interest letter from the secured creditor
- **Section 427, Bank Act – Similar to PPSA**
- **Bankruptcy / Insolvency Searches**
- **Litigation Searches**
 - Even if the buyer is not assuming the litigation related to the property, the buyer does not want to find itself joined in a law suit

Zoning Analysis

- **Whether a fully developed site, a site for redevelopment or vacant land, the zoning of the subject lands should be analyzed by the buyer**
- **Zoning typically covers the following performance standards:**
 - Use
 - Set-back
 - Height
 - Density
 - Parking

Zoning Analysis

- The zoning is typically evaluated by an architect, land use planner or an experienced municipal lawyer and a written opinion is provided; it is only as good as the assumptions and qualifications made by the author
- **Block zoning**
 - Need agreements with the neighbouring land owners within the block as to how the zoning permissions will be deployed and how future applications can be made

Environmental Due Diligence

- **Environmental consultants are engaged to prepare environmental site assessments of the subject site**
- **Often, the vendor makes all existing environmental reports in its possession or control available to prospective purchasers**
- **The prospective purchaser may:**
 - be satisfied with the existing report and only require a reliance letter from the environmental consultant (addressed to buyer and buyer's lender)
 - be dissatisfied with the existing report and either:
 - ▶ have it peer reviewed by its own environmental consultant
 - ▶ engage its own environmental consultant to conduct a fresh environmental audit
- **There are three levels of evaluation – a phase I environmental audit, a phase II environmental audit and a phase III environmental audit**

Environmental Due Diligence (con't)

- **Phase I environmental audits do not involve any invasive testing; merely based on visual observations, historical records, etc.**
- **If a phase I environmental audit recommends further investigation, a phase II environmental audit will need to be performed; phase II environmental audits involve the drilling of bore holes and the evaluation of samples taken from the site**
- **The existence of, or the need for a phase III environmental audit, indicates a problem site**
- **Review limitations, qualifications and assumptions contained in any report**
- **Does the consultant have adequate insurance?**
- **Consider whether any environmental issues will result in increased costs to the buyer and incorporate into financial model**

Soils / Geo-technical Report

- **Development properties or vacant land**
- **Prepared by a professional engineering firm to assess the suitability of the soils for development**
- **Consider whether soil deficiencies, water table, etc. will result in increased costs to the buyer; those increased costs need to be incorporated into the buyer's financial model**
- **If the vendor has supplied the report and the buyer is satisfied with it, a reliance letter from the author of the report should be obtained (addressed to buyer and buyer's lender)**

Building Condition Report

- Existing developments
- Prepared by a professional engineering firm to assess the structures on the subject property (including parking lots and driveways) to assess their remaining useful life and ensure that there are no unexpected capital expenditures
- Consider whether structural deficiencies will result in increased costs to the buyer and incorporate into financial model; consider whether any of these costs can be passed on to the tenants based on lease due diligence
- If the vendor has supplied the report and the buyer is satisfied with it, a reliance letter from the author of the report should be obtained (addressed to buyer and buyer's lender)

Appraisals

- Report prepared by a real estate appraiser accredited with the Appraisal Institute of Canada
- Opinion as to market value
- Typically, based on the highest and best use - "that use which, at the time of appraisal, is most likely to produce the greatest net return, in money or amenities, over a given period of time"
- Arrived at through a variety of methods
- Need to understand methodology – are there assumptions or qualifications made by the appraiser that prove to be inaccurate as a result of the buyer's due diligence? This can undermine the utility of the appraisal
- If the vendor has supplied the appraisal and the buyer is satisfied with it, a reliance letter from the author of the report should be obtained (addressed to buyer and buyer's lender)

Lease Due Diligence

- **Rent Roll**

- Buyer's financial model begins with the rent roll
- Is it accurate? Review leases to determine if this is the case
- Buyer to assess credit risk of major tenants / consider whether tenant mix of the subject property exposes the buyer to too much risk at the property and within its overall portfolio
- Buyer to assess the rent roll to ensure that lease roll-overs and rent escalations are satisfactory

Lease Due Diligence (con't)

- **Lease Review**

- See form of Lease Summary – Appendix 1
- Review each tenancy to ensure that:
 - ▶ the buyer has a complete set of all the documents comprising the lease (including all notices and amendments)
 - ▶ all documents are signed
- Confirm that the lease provisions match the rent roll and the buyer's own financial model
- Assess the tenant's covenant
 - ▶ Is it the operating entity or a lesser covenant?
 - ▶ Is there a guarantor / indemnifier?
 - ▶ Has the tenant posted other security such as a large security deposit or a LC?

Lease Due Diligence (con't)

- From the buyer's perspective as the future landlord, there are many potential issues that can arise out of the lease review exercise; they include:
 - ▶ tenant termination rights
 - ▶ outstanding rent free periods
 - ▶ unpaid tenant allowances
 - ▶ outstanding landlord work obligations
 - ▶ tenant ability to set-off or abate rent
 - ▶ capped operating costs and taxes, material exclusions from recoveries and other points of "leakage" from an otherwise fully net lease
 - ▶ uses or rights conflicting with exclusives or other rights given to other tenants or under other encumbrances (i.e. agreements with "shadow tenants" and other neighbouring property owners)

Lease Due Diligence (con't)

- ▶ breaches of “no build” covenants to tenants
- ▶ ability of tenant to “go dark” – if it is a major tenant, there can be co-tenancy implications in other leases
- ▶ in the case of a development property, the inability of the landlord to terminate the lease, relocate the tenant or, if permitting the tenancy to continue, to redevelop the property with the tenant in place
- ▶ leases of free standing buildings for terms of 21 years or more (including renewals) where no subdivision consent has been obtained and for which there is no exception – such leases are void under Ontario’s *Planning Act*
- ▶ tenant rights of first refusal or first offer to acquire the subject property
- ▶ tenant rights of first refusal or first offer on other space within the project

All of the foregoing need to be accounted for in the buyer’s evaluation of the subject property

Lease Due Diligence (con't)

- **Right to Meet with Major Tenants**
 - Buyer may seek the right to meet with major tenants for purposes of assessing such tenants' intentions for the property (i.e. renewals, disputes, etc.)
 - Vendor is usually present
 - May not be necessary if the buyer has a pre-existing relationship with the relevant major tenants and can just "pick-up the phone"
- **Review of Tenant Lease Files**
 - Buyer can review the correspondence to determine if there are any disputes, on-going negotiations, etc

Lease Due Diligence (con't)

- **Estoppel Certificates**

- A certificate from the tenant to the buyer (and the buyer's mortgagee) confirming the terms of the tenancy; due to the reliance of the buyer on the statements in the certificate, the tenant is said to be "estopped" (or blocked) by his own statements in the certificate – i.e. if the tenant makes an unqualified statement that the lease is in good standing, the tenant cannot subsequently take a different position
- Buyer will want to ensure that they match the results of their lease due diligence
- Any outstanding disputes will be noted
- It is not unusual for the buyer to receive problematic estoppels just prior to closing; usually the vendor is negotiating with the tenant to resolve issues with that tenant to get a "clean" estoppel

Mortgage Due Diligence

- **When the mortgage debt is to be assumed by the buyer, a detailed analysis of the existing mortgage loan is required**
- **Mortgage Review**
 - See form of Mortgage Loan Summary – Appendix 2
 - Review the mortgage loan to ensure that:
 - ▶ the buyer has a complete set of all the mortgage loan documents (including all notices and amendments)
 - ▶ all documents are signed
 - Confirm that the terms of the mortgage loan match the buyer's own financial model

Mortgage Due Diligence (con't)

- **Typical issues on a mortgage assumption include:**
 - Obtaining the mortgagee's consent to the assumption
 - ▶ typically only a conditional approval is provided before the parties waive their condition for the mortgagee's approval
 - ▶ can all the conditions be satisfied for closing?
 - ▶ rating agency approval – no down-grade letters?
 - ▶ additional covenants or security?
 - ▶ releases of the vendor and existing covenantors?
 - ▶ consent to new property management
 - Whether the loan is limited recourse to the property; sometimes it is not, but the vendor is a single purpose entity – in this case, one needs to consider who will be the buyer (i.e. if the buyer is not a single purpose entity, the buyer may want to negotiate to amend the mortgage to make a *de facto* limited recourse loan into a *de jure* limited recourse loan)
 - ▶ Events of Default
 - ▶ Cross collateralization / default of the mortgage
 - ▶ Ability to prepay the existing mortgage – understand the penalties
 - ▶ Interest rate buy-downs

Mortgage Due Diligence (con't)

- **Mortgage Assumption Statement**
- **Mortgage Assumption Agreement (and related documentation)**