MINDEN GROSS LLP

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**TOPIC:**



# PROPERTY LEASING: Recent Developments of Importance

## Good News for Landlords – Letter of Credit Draws are Not Limited to a Landlord's Preferred Claim under the *BIA*

On October 28, 2020, the Ontario Court of Appeal released its decision in *7636156 Canada Inc. (Re)*, 2020 ONCA 681 ("*OMERS*"), on appeal from the decision of the Ontario Superior Court of Justice in *7636156 Canada Inc. v. OMERS Realty Corporation*, 2019 ONSC 6106. The case held that the Landlord was entitled to draw on the

full amount of a letter of credit obtained by virtue of its lease with an insolvent tenant instead of just the preferred claim equal to three months' worth of accelerated rent under the insolvency laws.

In *OMERS*, the Landlord leased its property to the Tenant for a term of ten years. After four years, the Tenant made an assignment in bankruptcy, and shortly thereafter, the Trustee disclaimed the lease. Schedule C of the lease required the Tenant to arrange for a letter of credit ("LOC") in favor of the Landlord as beneficiary. The lease stipulated that the LOC stood as security in the event of the Tenant's bankruptcy. In accordance with its rights under the lease, the Landlord drew down the full amount of the LOC after the bankruptcy. The Trustee moved for a determination of the total amount that the Landlord was entitled to draw on the LOC and sought repayment of any excess withdrawals by the Landlord.

The motions judge found in favor of the Trustee and rejected the Landlord's submission that it was entitled to draw on the LOC for damages suffered as a result of the disclaimer of the lease. The motions judge concluded the Landlord was only entitled to draw on the LOC for three months' accelerated rent for the following reasons: 1) a trustee's disclaimer of a lease operates as a voluntary surrender of a lease by the tenant with consent of the landlord, which extinguishes all obligations of the tenant under the lease; and 2) upon disclaimer of the lease, a bankrupt tenant no longer owes any obligations to the landlord under the lease. According to the motions judge, this conclusion was not affected by the SCC's in *Crystalline* because in *OMERS*, the bank's obligation to make payments (as the issuer of the LOC) was wholly dependent on the continued existence of the tenant's obligations under the lease.

The Landlord appealed. The Ontario Court of Appeal found that the motions judge erred in finding that the Landlord's entitlement to draw on the LOC is limited to its preferred claim under the *BIA*. The following points are worth noting: (a) the Court noted that the lower court did not have the benefit of the Court of Appeal's decision in *Curriculum*, which clarified that the trustee's disclaimer of a lease does not operate as a voluntary surrender of a lease with the consent of the

landlord for all purposes. Rather, a trustee's disclaimer of a bankrupt tenant's lease ends the rights and remedies of the landlord against the bankrupt tenant's estate for the unexpired term of the lease, apart from the three months' worth of accelerated rent provided under the *BIA* and the *Commercial Tenancies Act* (Ontario); (b) the principle of independence or autonomy (also referred to as the "autonomy principle") applies to LOCs because the issuing bank has an obligation to make payment to the beneficiary which is independent of the underlying transaction; (c) upon an in-depth review of jurisprudence, the Court found that the principles of insolvency law do not override the principle of autonomy of LOCs, nor do they limit the landlord's right to draw on the LOC in excess of its preferred claim under the *BIA*; (d) the Court recognized the recent SCC decision in *Chandos*, which deals with the "anti-deprivation rule". Applying the *Chandos* case, the anti-deprivation rule is not offended when commercial parties protect themselves against a contracting counterparty's insolvency by taking security, acquiring insurance, or requiring a third-party guarantee.

Canadian landlords can now breathe a collective sigh of relief since the Ontario Court of Appeal has overturned the troubling lower court decision in *OMERS* and confirmed that: (i) a landlord's entitlement to draw on a LOC in the event of a tenant's bankruptcy or insolvency is not limited to the landlord's preferred claim under the *BIA* for three months' worth of accelerated rent; and (ii) the anti-deprivation rule will not be offended when a landlord protects itself against a tenant's bankruptcy or insolvency by taking security or requiring a third-party guarantee.

## Is there fraudulent intent if the tenant removes its goods when there are no rental arrears but stops paying rent after vacating?

Unique to the commercial landlord and tenant relationship is the landlord's right to exercise its right of distress if a tenant is in rental default. Because of the importance of this landlord remedy, s. 50 of the *Commercial Tenancies Act* (the "CTA") attaches costly consequences to any person who "willfully and knowingly aids or assists" the tenant in "fraudulently or clandestinely" removing, conveying, or carrying off the tenant's goods and chattels. If the landlord can establish such liability, the cost is double the value of the goods removed. In *Brantfield Management Ltd. v. Benevito Foods Inc.*, 2019 ONSC 1202, the Superior Court examined this extraordinary landlord right and shed some light on when fraudulent intent will be found.

The Landlord brought an action for unpaid rent and claimed that individual defendants were liable under s. 50 of the CTA for fraudulently or clandestinely removing the Tenant's goods. The lease provided that if the Tenant failed to pay rent or took any steps by way of dissolution, winding up, or liquidation of its assets, or made a sale of its assets in bulk, then the Landlord had an immediate right of re-entry on to the premises with a further right to sell the Tenant's assets found on the premises. After the Tenant lost its biggest customer, it became clear that the Tenant's business was no longer viable and an auction of their equipment was publicly advertised. The individual defendants each played a part in introducing potential buyers and/or selling or showing the equipment to potential buyers. There were no rental arrears when the equipment was sold and removed from the premises, but the Tenant stopped paying rent after vacating.

The Court found that the Landlord had the onus of proving that the individual defendants fraudulently removed and sold assets belonging to the Tenant in order to prevent the Landlord from distraining for arrears of rent and that they willfully and knowingly aided or assisted the Tenant in removing its equipment. The Court considered factors that indicated fraudulent intent. It found that given that the Landlord was aware of the auction, there was no removal of the Tenant's equipment at night or during non-business days, there was no evidence the Tenant had sought rental indulgences from the Landlord, the Tenant had not run up arrears of rent while formulating a plan to sell its business, and there was nothing to suggest that the removal of equipment was done in a manner other than in the open, ultimately, there was no fraudulent intent or a clandestine removal of the Tenant's equipment. The Court stated that the mere fact that the Tenant did not seek the Landlord's permission or give notice of its intention to sell and

remove its equipment from the Premises does not, in and of itself, result in a finding of fraudulent intent.

## Does a landlord owe an indemnifier a duty to mitigate?

Since the Supreme Court of Canada's decision in *Highway Properties Ltd. v. Kelly, Douglas and Co. Ltd.*, [1971] SCR 562, it has been a well-settled principle of law that if a landlord terminates a lease, it has a duty to mitigate its losses. In *Parc Downsview Park Inc. v. Penguin Properties Inc.*, 2018 ONCA 666, the Court of Appeal considers whether this duty owed to a tenant extends to an indemnifier under an indemnity agreement.

In 2010, the Tenant, National Squash Academy, entered into a lease with the Landlord. The Tenant defaulted and, as part of the negotiations for a new lease, the Landlord insisted on a guarantor to assure payment of the rental obligations of the Tenant. Mr. Goldhar, a regular at the Academy, agreed to have his company backstop a portion of the obligations of the Tenant under a new lease. A new lease and indemnity agreement were executed in 2012 with a term expiring in 2020. In 2013, the Tenant defaulted on its obligations to pay rent and, after almost two years of negotiations, the Landlord terminated the lease. The Tenant made a voluntary assignment into bankruptcy and in 2016, the Landlord gave notice of default to the Indemnifier under the indemnity agreement. The Landlord commenced an application seeking payment under the indemnity for unpaid rent, future rent, and other costs and losses. The application judge found that the Indemnifier had breached the indemnity but ordered that it pay the Landlord only amounts owing up to June 12, 2017 (the lease did not expire until August 31, 2020), on the basis that the Landlord owed the Indemnifier a duty to mitigate losses for rent due after June 12, 2017. The Indemnifier appealed on the basis of allegedly breached collateral, pre-contractual representations upon which it relied in giving the indemnity. The Landlord cross-appealed seeking to vary the judgment to include an order requiring the indemnifier to pay rent due from June 13, 2017, until August 31, 2020, less any rent it received from new Tenants during that period.

The Court found that the Indemnifier had not established that the Landlord made a collateral, pre-contractual representation that, if breached, would relieve it of its obligations under the indemnity. The Court also found that the application judge erred in implying a duty to mitigate, which was contrary to the plain language of the indemnity. The terms of the indemnity provided that it was "absolute and unconditional" and early termination of the lease did not relieve the indemnifier of its obligations as an indemnifier as those obligations continued "throughout the Term as though the Early Termination had not occurred." Accordingly, the Court found that the Landlord was entitled to rent up until what would have been the expiry of the lease but for the early termination, subject to any rent obtained from a new Tenant.

The Indemnifier applied for leave to appeal to the Supreme Court of Canada, however, leave to appeal was dismissed.

## Preconditions for the Exercise of a Renewal Option

In *1521141 Ontario Limited v. Upper Oakville Shopping Centre Limited*, 2018 ONSC 2808, the Tenant had an option to renew its lease for a third renewal term subject to the terms of the lease. The Tenant gave notice of its intention to renew but the Landlord decided that it would not renew the lease. The Tenant commenced an action when the Landlord refused to renew and sought interlocutory relief one week before the expiry of the lease.

The Court found that mutuality of intent and the performance of both parties were required to give effect to a renewal of the lease. There needed to be a willingness demonstrated by the advance notice from the Tenant to renew and to abide by the terms of the lease. It was then up to the Landlord to grant a renewal of the lease upon the satisfaction of the preconditions by the Tenant.

The lease required the Tenant to "duly and regularly" pay rent including percentage rent. In considering the meaning of due performance and whether this obligation was met, the Court, relying on *Sparkhall v. Watson*, [1954] 2 DLR 22, found that it did not necessarily have to be punctual performance but it was enough for the

Tenant to show that the covenants had been performed at the time when the applicable party was required to observe or perform its part of the bargain. In this case, the Tenant was habitually late paying percentage rent.

The Court went on to consider whether it had the power to excuse the non-performance of a condition precedent. Referring to *1043545 Ontario Inc. v. 3748355 Canada Inc.*, 1998 Carswell Ont. 2705, the Court held that it did not have the power to excuse non-performance of conditions precedent, but there was a narrow jurisdiction in equity to grant relief if a Tenant has made diligent efforts to comply with the terms of the lease but was unsuccessful through no fault of its own. Here, the Tenant was not an innocent party.

The Court also considered whether equitable relief may be available to the Tenant if it could show that the Landlord had waived strict compliance with the terms of the lease to duly and regularly pay the rent. The Tenant had not shown that the Landlord's conduct led it to believe that the Landlord would not insist on its strict legal rights under the lease. As a result, the Court found that the Landlord had not waived strict compliance for the Tenant to pay its rent duly and regularly under the lease and the Tenant's motion for relief was dismissed.

This case highlights that if a tenant has made diligent efforts to comply with the terms of the lease but was unsuccessful through no fault of its own or if a tenant can show that the landlord has waived strict compliance with the terms of the lease, the tenant may still be eligible for equitable relief.

## Beware: Review Your Lease before Signing an Estoppel Certificate

The case of *1960529 Ontario Inc. v. 2077570 Ontario Inc.*, 2017 ONSC 5254, serves as a cautionary tale on the importance of reviewing your lease before signing an estoppel certificate. The Tenant leased premises in a building owned by the Landlord and had a right of first refusal to purchase in the event the Landlord sold the property. The Landlord received and accepted an offer to purchase the property from a buyer but did not provide the Tenant with a copy of the offer. The Landlord later notified the Tenant of the sale and had the Tenant sign an estoppel certificate addressed to the buyer's lender confirming *inter alia* that the Landlord was not in default under the terms of the lease and the Tenant had no claim against the Landlord. The estoppel certificate did not refer to the Tenant's right of first refusal. After the sale, the buyer sent the Tenant a notice terminating the lease in accordance with a demolition provision contained therein. The Tenant brought a motion for declaratory judgment and injunctive relief in support of its claim for enforcement of its right of first refusal.

In the Court's decision, it stated that parties to a commercial real estate transaction are entitled to rely upon an estoppel certificate to prevent the signing party from taking a contrary position to the statements. The Court held that by signing the estoppel certificate, which confirmed the Landlord was not in default under the lease, the Tenant waived its right of first refusal.

**Note to tenants:** carefully review your lease before executing an estoppel certificate or else you may lose rights you negotiated in the lease.

## Balancing Landlord's Obligations to Conduct Repairs with Tenant's Right to Quiet Enjoyment

The case of *0824606 B.C. Ltd. v. Plain Jane Boutique Ltd.*, 2018 BCSC 1887, is an interesting case that examines the validity of the Landlord's distraint and whether the Landlord's actions in performing its repair obligations under the lease breached the Tenant's right of quiet enjoyment. The defendant Tenant was a clothing store that leased space on a high-profile downtown corner with great exposure. In June or July 2013, the Landlord became aware that the cornices near the top of the building were falling into disrepair. Because the Landlord could fit in the repair on short notice, notice was given to the Tenant on the same day the scaffolding went up. The Tenant had not received prior notice of the upcoming repairs or the possible consequences. The repairs necessitated the use of cranes and boom trucks as well as scaffolding over the first-floor sidewalk on both sides of the corner and were estimated to take 3–4 weeks to complete. Unfortunately, these repairs coincided with the Tenant's busiest time of the year and

took 10 weeks to complete. The Tenant was not able to plan for the reduction in business as its agreements with suppliers were made 6–12 months in advance and the store was filled with stock that it could not sell. The effect of the repairs and lack of notice persisted beyond the construction period as the store became bloated with old inventory that had to be significantly marked down and its customers continued to stay away. When the Tenant fell into rental arrears, the Landlord seized and sold the Tenant's inventory and terminated the lease.

In considering whether the Landlord breached the Tenant's right of quiet enjoyment, the Court considered the wording of the lease, which required the Landlord to refrain from *any* interruption or disturbance. The Court found that the wording of the express covenant of quiet enjoyment in the lease ought to operate more robustly than the implied covenant under common law. In this case, there was a breach of both the express and implied covenant of quiet enjoyment.

The Court found that the Landlord's obligation to repair must be balanced with the Tenant's right to quiet enjoyment. Neither provision trumps the other and the Landlord must act reasonably in carrying out repairs. In finding that the Landlord did not act reasonably, the Court pointed to the fact that the Landlord failed to give any prior notice, failed to consult with the Tenant on mitigating any potential impact of the repairs, and, once the work started, failed to apprise the Tenant that the work would take longer than expected.

The Court also found that the Landlord's actions in taking possession of the premises and excluding the Tenant resulted in a termination of the lease. Since the Landlord's right to distrain and to terminate the lease are mutually exclusive, the Landlord's distraint was illegal.

## Landlord's Unilateral Action in Moving Kiosk Found to Be a Repudiatory Breach

It is well established that an innocent party to a breach of contract may be entitled to treat the breach as repudiatory where the breach is fundamental because it deprives the party of substantially the whole benefit of the contract. In *Booster Juice Inc. v. West Edmonton Mall Property Inc.*, 2019 ABCA 58, the Court of Appeal considered, more specifically, whether the Landlord's unilateral actions in moving the location and orientation of the Tenant's kiosk amounted to a fundamental breach allowing the Tenant to terminate the lease.

The Tenant had an existing lease for other premises in a different part of the mall but entered into another lease agreement for a second kiosk. While approving the Tenant's proposed design for the second kiosk, the Landlord unilaterally changed the location and directional orientations of the kiosk by approving the Tenant's proposed design *subject* to the change in location. At trial, the judge found that the overall location and configuration of the kiosk was fundamental to the lease and the Landlord's unilateral alteration to a spot farther away from traffic flow and with a different directional orientation substantially deprived the Tenant of the whole benefit of the contract. The Court found that the Landlord's actions amounted to a repudiatory breach allowing the Tenant to terminate the lease and this decision was upheld by the Court of Appeal.

It is interesting to note that neither the trial Court nor the Court of Appeal discussed relocation rights or whether such a right was contained in the lease. Assuming there was no express relocation right in the lease, the Courts could have simply relied on common law to find that the Landlord did not have the right to relocate the kiosk. But they did not.

## Good Faith

Since the Supreme Court of Canada recognized a general organizing principle of good faith between contracting parties in *Bhasin v. Hrynew*, 2014 SCC 71, the industry has been eagerly waiting to see how the Courts would apply this principle in commercial leasing.

In *Zenex Enterprises v. Promenade*, 2019 ONSC 3262, the Tenant tried to rely on *Bhasin v. Hrynew* in advancing a good faith argument against the Landlord. The Tenant, a high-volume discount retailer, entered into two leases with the Landlord to lease certain premises in the upper and lower levels of a mall. The Tenant took possession on an as-is basis with the understanding that the Tenant would repair the escalator and freight elevator

in due course. The Tenant subleased the upper-floor premises without the Landlord's consent but terminated the sublease shortly thereafter upon the Subtenant's default. The Landlord served the Tenant with notices of default for improperly subleasing the Premises and failing to repair the escalators and elevator and issued notices of termination exercising the Landlord's early termination right.

The Court found that the Landlord's default notice was invalid as it improperly claimed breaches of the lease. Although repairs to the escalator and freight elevator had not been completed, the lease did not specify a completion date and the Tenant had been reasonably diligent in arranging for necessary repairs. Importantly, the Landlord could not rely on the Tenant's unauthorized sublease as the breach had been remedied through termination of the sublease prior to the Landlord issuing a notice of default.

Although the Landlord could not terminate the lease based on the Tenant's default, the Landlord successfully terminated the lease using a mutual termination right in the lease that allowed either party to terminate the lease with 90 days prior written notice. The Tenant alleged that the Landlord had promised that it would exercise this termination right only if the mall was being redeveloped and asked the Court to apply such limitation. The Court refused to look at evidence of the intent of the parties, given that the language in the lease was clear and introducing such evidence would lead to making a new agreement.

Finally, the Tenant tried to argue that the Landlord acted in bad faith by invoking the termination provision under the lease in order to lease the upper-floor premises directly to the Subtenant under more favorable terms and at a greater profit, and that, in doing so, the Landlord breached its duty to act in good faith and honestly as required under *Bhasin v. Hrynew*. The Court found that, at most, these allegations would show dishonorable action but not to an extent that breaches the duty of honest performance. **Landlords and tenants should note** that the Court emphasized that the good faith obligation is a

requirement to act honestly by not lying or misleading the other party in the performance of the contract — a duty that the Landlord had complied with and which would not limit its right to terminate the lease and enter into another lease with a third party.

## Accelerated Rent — Enforceable?

Commonly accepted in many commercial leases is the landlord's right to collect three months' accelerated rent if the tenant defaults under the lease. The Court considered the accelerated rent provision in *Tropic Holdings Ltd. v Roots & Wings Enterprises Ltd.*, 2018 BCSC 439, and whether it is enforceable.

The Tenant, a daycare provider, leased premises from the Landlord. The Tenant fell into rental arrears and the Landlord terminated the lease and re-let the premises to a new Tenant for a longer term and at a lower base rent for part of the term. The Landlord brought an action against the Tenant for rental arrears, six months accelerated rent, damages for the unexpired term, and interest.

The Court found that the Landlord had not wrongfully terminated the lease given that the Tenant was still in arrears after notice and the Landlord's right to terminate the lease for non-payment of rent was clear in the lease. The Court also found that the Tenant's liability for six months of rent for non-payment of rent was a penalty and its enforcement would lead to an unconscionable result given its outsized and disproportionate effects on the lease and the Tenant. In reaching its decision, the Court considered whether the payment was stipulated *in terrorem* of the offending party or as a genuine pre-estimate of damage. It also considered the inequality in bargaining positions of the parties and whether there was a substantially unfair bargain benefitting the stronger party. Although questionable in law, the Court noted that it should be careful to strike down penalty clauses where there is no oppression against the breaching party.

The Tenant also argued that the Landlord failed to mitigate its losses and should not be entitled to damages for the difference in rent between the terminated lease and the new lease. The Court rejected the argument noting that the Tenant failed to gather sufficient evidence to prove that the Landlord's decision to take a longer-term tenant at a slightly lower rent was unreasonable. As a relief to all landlords, the Court held that even when a duty to mitigate applies, such duty does not engage a standard of perfection or require that a new contract be on precisely the same terms as the old one for the landlord to have discharged its duty.

## Sublease for Entire Term NOT Necessarily Assignment

At common law, it has been well-settled up until now that if a tenant subleases the entire premises for the entire balance of the term, the sublease will be considered an assignment. To avoid this result, it is common for tenants intending to sublease to reserve the last day of the term. In the recent case of *V Hazelton Limited v. Perfect Smile Dental Inc.*, 2019 ONCA 423, the Court of Appeal held that contrary to years of case law, a sublease for the entire remaining term *can* be a sublease if there is sufficient objective evidence that the parties to the sublease did not intend to create an assignment.

The Landlord leased commercial premises to the Tenant for seven years with a five-year renewal option. The Tenant later sublet the premises without reserving the last day of the term. When the Tenant later purported to exercise its renewal option, the Landlord maintained that the Tenant had no right to exercise the renewal option. The Tenant applied to the Court for relief. The principal issue was whether the Tenant had effectively assigned the lease and forfeited its rights due to its failure to reserve the last day of the term. Instead of deciding this issue, the Court held that the Tenant suffered no damages and dismissed the application. The Tenant appealed.

The Court of Appeal allowed the Tenant's appeal. Although the Court recognized that there were years of case law that defined the requisite reversionary interest as a term-related one, it considered other cases, outside of Ontario, that recognized a tenant's reversionary interest beyond temporal reservations. The Court of Appeal acknowledged that these cases were outliers, however, and refused to import these cases into Ontario law, choosing, instead, to rely on section 3 of the CTA which reads as follows (in part):

> The relation of landlord and tenant does not depend on tenure, and a reversion in the lessor is not necessary in order to create the relation of landlord and tenant, or to make applicable the incidents by law belonging to that relation….

This section made clear that a reversionary interest is not required for there to be a landlord and tenant relationship. In the context of existing case law, the Court of Appeal interpreted this section to mean that there *may* be a sublease even if the last day of the head lease is not reserved, but only when there is sufficient evidence to show that the objective intention of the parties, as reflected in the sublease, was not to create an assignment.

The Court reasoned that because a commercial lease is a contract, Courts should be permitted to consider the objective intentions of the parties to a purported sublease to determine the nature of the impact on the tenant party vis-à-vis its rights under the head lease. Here, the sublease provided sufficient evidence that the parties did not intend an assignment given that the Subtenant did not have a right to renew under the sublease and the Tenant was not obligated to exercise its renewal option on behalf of the Subtenant. Accordingly, the Court of Appeal concluded that the Tenant's sublease was not an assignment and the Tenant had the right to renew its head lease.

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# Firm News

## Welcome!

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### Congratulations Samantha Prasad!

We are excited to announce that Samantha Prasad (Tax Law) has been elected by the partnership to Minden Gross LLP's Executive Committee.

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