

To Include or Not to Include:
The Effect of Leasehold Improvements on the Determination of Fair Market Rent
for Renewal and Extension Terms

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Provisions in commercial leases providing tenants with options to renew or extend can create problems when not drafted carefully. An important element of such provisions is the determination of the rent payable for the renewal or extension term. One method for such calculations is to base the rental rate on the “fair market rent” for the premises in question.

The concept of “fair market rent” is typically employed by the parties based on the assumption that it provides a mutually acceptable method for determining an equitable rental rate. A broad and generally accepted definition of “fair market rent” is the rent that would reasonably be obtained by a willing landlord for similar premises from a willing tenant or tenants dealing at arm’s length in the prevailing market, for a term commencing on the relevant date and having regard to all relevant circumstances. However, to assume that the concept of “fair market rent” results in an expedient negotiation is flawed, as both parties are seeking to achieve divergent results. Landlords search for sources of additional value to achieve the greatest possible rent, while tenants attempt to maintain the rental rate at the same or similar level as set during the initial term.

A source of considerable debate has arisen over whether to include the value of a tenant’s leasehold improvements in the determination of “fair market rent”. The value of a tenant’s leasehold improvements can have a significant impact on the overall value ascribed to “fair market rent” at the time of a renewal or extension.

Leasehold Improvements

A tenant will typically require the installation of leasehold improvements at the outset of or during the term of a lease. Leasehold improvements can be paid for by the tenant out of their own finances, or through a tenant allowance furnished by the landlord. Such an allowance is then paid back, in whole or in part, over time by the tenant through an increase in the basic rent

payable over the course of the initial term of the lease. Therefore, at the end of the lease term, all leasehold improvements have been paid for either directly or indirectly by the tenant. Generally, a landlord aims to increase the rental rate for a renewal or extension term by including the value of the leasehold improvements in “fair market rent”. While not true in all cases, a landlord bases this assertion on the argument that a higher rent can be obtained from a new tenant because of the benefit provided by the leasehold improvements. Arguably, existing leasehold improvements could be an impediment or redundant to a new tenant if they are not suitable for its use.

Case Law

The jurisprudence on the topic is somewhat confusing. Some cases indicate that tenants will not be required to pay increased rent for a renewal or extension term based on the value of leasehold improvements paid for by the tenant. This was established in *Re Allen and Nasmith (1900)*, 27 O.A.R. 536 (C.A.) and expanded on in *Canada (Attorney General) v. Lynwood Industrial Estates Ltd. (1983)*, 146 D.L.R. (3d) 381 (B.C.C.A.). These cases deal with the question as to whether improvements made by a tenant to a property entitle the landlord to receive increased rent based upon the enhanced value of the premises. In those cases the Courts determined that making a tenant pay increased rent based on the inclusion of leasehold improvements made during the term of the lease would “make him pay rent upon a value created by his authorized expenditures, and so diminish the worth of his leasehold estate”. Therefore, the Court stated that when calculating “fair market rent”, the property must be examined in an “as was” condition, being the state of the premises prior to the addition of the leasehold improvements, rather than an “as is” condition. This position was affirmed in several cases including *Revenue Properties Co. v. Victoria University (1993)*, 62 O.A.C. 351 (Div. Ct.).

However, in coming to the opposite conclusion, the case of *Fire Production Ltd. v. Lauro* [2007] 1 W.W.R. 605 (B.C.C.A), focused on the use of the term “market”. The lease in question provided that all improvements made by the tenant became property of the landlord upon affixation. The renewal provision stated that the rent payable for the renewal term is the “fair market rent” for the premises. The parties were unable to agree on the fair market rental rate and the matter was submitted to arbitration. The arbitrator determined that the value of leasehold improvements should be included in the determination of “fair market rent”. The British Columbia Court of Appeal agreed with the arbitrator and stated that the term “market”, in the

context of “fair market rent”, is the rent the premises would attract if exposed to the general market at the time of the renewal. This definition of “market” precluded the exclusion of the tenant’s improvements in calculating a rental rate for the renewal. The Court concluded that “fair rent” is a subjective determination between the parties, as opposed to “fair market rent”, which is an objective determination based on market factors.

Despite the conflicting views outlined above, where a lease specifically provides, it is acceptable to include the value of leasehold improvements in the determination of “fair market rent”. The decision in *VAV Holdings Ltd. v. 720153 Ontario Ltd.* [1996] O.J. No. 4008 (Ont. C.A.) stands for the notion that whether an "as is" or "as was" approach is applied to determine an appropriate rent for a renewal or extension term, it should turn on the specific provisions of the lease.

Conclusion

Whether or not the value of leasehold improvements is to be included in the determination of “fair market rent” of a renewal or extension term can be a contentious issue. In the absence of language to the contrary, the leasehold improvements will likely be excluded in the determination. However, when the phrase “fair market rent” is employed, there is a strong case to be made for the inclusion of leasehold improvements in the valuation process.

In order to avoid complications and ensure fairness, the parties should seek to set out the parameters of determination in the renewal provision during the negotiation and drafting stage of the lease. To achieve a more favourable outcome, a landlord will seek to include the value of leasehold improvements and a tenant will seek to exclude such value. A reasonable compromise might be to include language describing the property as “suitable for tenant’s purposes”. Language to this effect will prevent any misunderstanding between the parties as to whether or not the value of leasehold improvements will be included in the valuation of the rental rate for the renewal or extension term. Therefore, before signing a lease which includes renewal or extension provisions, both the tenant and the landlord must ask themselves: “To Include or Not to Include?”