Minden Gross LLP

Summer 2021

TOPIC:

Recent Developments in Property Leasing PART I

Can a Tenant Stop Paying Rent as a Result of COVID-19?

When the government ordered the closure of all non-essential businesses, tenants quickly turned to their leases to see if the pandemic would qualify as force majeure and discharge them from their rent obligations. *Hengyun International Investment Commerce Inc. v. 9368-7614 Québec Inc.*, 2020 QCCS 2251, ("*Hengyun*") was one of

the first Canadian cases to consider force majeure in the context of COVID-19 government-mandated shutdowns. It sparked hope for tenants that rent relief was possible.

In *Hengyun*, the Landlord and the original Tenant, VFC, entered into a five-year lease to operate a gym. VFC soon made an assignment in bankruptcy and 9368-7614 Québec Inc. ("Québec Inc.") began operating on the premises. At issue was whether Québec Inc. had a right to occupy the premises and a right to reduced rent as a result of problems in the premises and the COVID-19 pandemic.

The lease contained a superior force (force majeure) clause, but it provided that it would not operate to excuse the Tenant from the prompt payment of rent. Québec Inc. argued that despite the language in the lease, it should be relieved from its obligation to pay rent because its inability to operate was caused by superior force. The Landlord argued that the pandemic did not qualify as superior force, and even if it did, the superior force clause obligates Québec Inc. to pay rent notwithstanding an event of superior force.

The Court concluded that Québec Inc. did not need to pay rent for March, April, May, and part of June 2020 (the period of the government-ordered closure). The Court relied on Article 1470 of the *Civil Code of Québec* ("*CCQ*"), which defines superior force as "an unforeseeable and irresistible event," and found that the COVID-19 pandemic was a superior force because: (i) it could not reasonably have been foreseen at the time the lease was contracted; and (ii) the requirement of irresistibility was satisfied as the government-mandated closure prevented any tenant in Québec Inc.'s situation from paying its rent and not just those who lacked sufficient funds. The Court determined the Landlord was prevented by superior force from fulfilling its obligation to Québec Inc. to provide it with peaceable enjoyment of the premises and, as a result, the Landlord could not insist on the payment of rent for this period in accordance with Article 1694 of the *CCQ*.

Because this decision was rendered under the civil law in Québec, its application to the common law provinces was uncertain until recently. The case of *Durham Sports Barn Inc. Bankruptcy Proposal,* 2020 ONSC 5938, ("*Durham*") has provided some certainty as the Ontario Superior Court considered this very same question.

In *Durham*, the Tenant operated an elite athletic performance centre. As with all non-essential businesses, the Tenant was forced to shut down from March 19, 2020, to May 25, 2020, and was only allowed limited operations during the later Phase II re-opening. The Tenant sought to rely on *Hengyun* and argued that because force majeure interfered with its quiet enjoyment, the Landlord could not insist on payment of rent.

The Court refused to apply *Hengyun*. It found that the doctrine of "superior force" in the *CCQ* (relied upon in *Hengyun*) is a doctrine that does not exist in Ontario. In addition, while the force majeure clause did relieve the Landlord from providing quiet enjoyment, it did not relieve the Tenant from paying rent. The Landlord's obligation to provide quiet enjoyment was subject to the payment of rent. Since the Tenant did not pay rent during the stated periods, the Landlord's obligation to provide quiet enjoyment did not arise. As a result, the Court found the Tenant was not entitled to any rent relief during the government-mandated shutdown.

Landlords have welcomed the *Durham* decision. It has provided some certainty that despite these unusual times, the law is as it should be, at least for now.

Does Resulting Physical Damage Under an Insurance Policy Require Actual Tangible Damage or Can It Include Loss of Use?

Where rent abatement for the COVID-19 pandemic is not available, some tenants have turned to their insurance to see if it covers business interruption caused by COVID-19. This coverage has not traditionally been available where there is no "physical" damage (or loss). However, the recent case of *MDS Inc. v. Factory Mutual Insurance Company* (*FM Global*), 2020 ONSC 1924, ("*MDS*") may have opened the door to the possibility of this coverage for COVID-19 business interruption losses.

MDS purchased radioisotopes from Atomic Energy of Canada Limited's Nuclear Research Universal Reactor (NRU), which it processed and sold for use in medical products. In 2009, there was a leak of radioactive tritium. The reactor was shut down for 15 months. The leak was localized and did not cause any damage to the NRU reactor core. Still, the forced shutdown resulted in a significant loss of profits to MDS.

At the time of the shutdown, MDS had a worldwide all-risks policy with Factory Mutual Insurance Company. It included coverage for losses to MDS, such as loss of profits, flowing from physical damage to a supplier "directly resulting from physical loss or damage of the type insured by this Policy." MDS submitted a claim for loss of profits but was denied coverage on the basis that the loss did not result from any "physical loss or damage." MDS sued for breach of contract.

Since the policy did not define "physical damage," the key issue was whether resulting physical damage required actual tangible damage to the NRU reactor core or whether it included loss of use of the NRU.

The Court ultimately concluded that the resulting physical damage contemplated loss of use of the NRU.

In *MDS*, the Court broadly interpreted the term "physical damage" to include the "impairment of function or use of tangible property," but only after it considered the policy's specific language, the factual matrix, and the parties' reasonable expectations. This careful approach must be taken in any claim for COVID-19 business interruption loss. It remains to be seen whether COVID-19 business interruption losses will be covered until we have a case dealing with such a claim.

Limitations Act vs. *Real Property Limitations Act*

In *Stonequest Management Inc. v. Andritz va Tech Hydro Ltd.*, 2019 ONSC 3273, the Landlord sought to recover alleged underpayment of utility costs from the Tenant. Under the lease, the Tenant was responsible for paying all of its separate accounts for electricity, but due to a problem with unlabeled or mislabeled meters at the property, the Tenant was undercharged.

The Tenant brought a motion for summary judgment dismissing the Landlord's action as statute-barred. *Ontario's Limitations Act, 2002* provides for a two-year general limitation period. The *Real Property Limitation Act ("RPLA")* provides for a six-year limitation period for the recovery of rent arrears. Under the *Limitations Act,* the Landlord's claim was statute-barred since the Landlord issued its claim two years and 13 days from the date the Landlord knew or ought to have known that it had a claim against the Tenant.

The Landlord argued that the six-year limitation period should apply instead, since utilities fall within the definition of "additional rent" in the lease. The Court rejected this argument and concluded that "rent" under the *RPLA* means the payment due under a lease between a tenant and landlord as compensation for the use of land or premises. The Court found that to conclude otherwise would allow parties to shelter a claim under the *RPLA* by simply designating the disputed amount as "rent" under a lease. As a result, the Court concluded that the six-year limitation period under the *RPLA* was not available to the Landlord.

It is questionable whether this decision was decided correctly. However, landlords should err on the side of caution when it is unclear whether the arrears relate to compensation for the use of land or premises and initiate an action within the two-year limitation period.

Coping With the Aftermath of Co-Tenancy Failure—Is Your Co-Tenancy Clause Enforceable?

In *Old Navy (Canada) Inc. v. Eglinton Town Centre Inc., 2019* ONSC 3740, the Tenant brought an application for declaratory relief and the refund of overpaid rents for an alleged co-tenancy failure. The Letter of Intent ("LOI") and lease contained a co-tenancy provision naming Danier Leather as one of a small number of key tenants and providing for a reduction in rent if there was a co-tenancy failure. There was a notable and unexplained discrepancy between the version of the co-tenancy in the LOI and the lease. The co-tenancy in the LOI included a reciprocal termination right if a co-tenancy failure continued for a period of six months or longer. In contrast, the formal lease only had a tenant termination right.

More than 15 years into Old Navy's term, Danier Leather declared bankruptcy and ceased conducting business in the shopping centre. Even though its sales did not suffer because of such closure, Old Navy sought to assert its right to the reduced rent. It claimed Danier's closing amounted to a co-tenancy failure.

The Landlord argued that the co-tenancy provision was poorly drafted, unreasonable, and did not reflect the intention of the parties, which was that occupancy by the key tenants was only applicable during the initial opening and it was the 80% occupancy test that was applicable during the term.

The Court favoured the Landlord's position. It found that the provision is not a commercially reasonable position. It offends the business efficacy rule of interpretation for the Landlord to be bound for an indefinite period to accept rent that barely covered common area expenses and resulted in the Landlord receiving no rent for the actual use of the premises.

Although the Court elected not to render judgment on whether the co-tenancy provision was an unenforceable penalty, parties should be careful when drafting a co-tenancy provision to ensure that: (i) any reduction in rent is commensurate with damages suffered by a tenant; and (ii) the co-tenancy clause includes a sunset clause with a stipulated time limit on any rent relief.

Liquidated Damages vs. Penalty

Where a contract stipulates a monetary consequence upon breach, a term that imposes damages that represent a genuine pre-estimate of the damage will generally be enforceable as "liquidated damages." In contrast, a term that does not represent a genuine pre-estimate of damages will be deemed an unenforceable penalty.

The case of *Health Quest Inc. v. Arizona Heat Inc., 2019 NLSC* 52, reviewed the difference between liquidated damages and penalties. The lease included a requirement for a $50/day fee for the late payment of rent. The Landlord had agreed to use its "best efforts" to have the premises ready for occupancy by a specific date, but there were delays, and, as a result, the Tenant refused to pay for the fit-up work and minimum rent for November and December.

The lease imposed a $50/day charge for late payment of rent. The Tenant argued that this fee amounted to a penalty and was unenforceable. The Court confirmed whether a payment is a genuine pre-estimate of damage or a penalty required the entire agreement to be considered. If it is a pre-estimate of damage suffered by the Landlord, it is enforceable. If it is a threat held over the Tenant *in terrorem*, it is not enforceable. In this case, the Court sided with the Tenant. It held that the $50/day fee was a penalty because the amount was arbitrary and there was no evidence relating the fee to costs actually incurred by the Landlord for non-payment.

It is important to remember that although parties may agree in writing that amounts are a genuine pre-estimate of damages, they must *actually* be a genuine pre-estimate of damages to be enforceable. To avoid an unenforceable finding, parties should ensure that they can demonstrate a careful and reasoned analysis showing a link between the fee charged and the costs incurred on default.

Landlords Beware: Do Your Own Due Diligence

In *JCP Drugs Limited v. Daniels Leslieville Corporation, 2019 ONSC 5295,* the Court considered the enforceability of an Agreement to Lease and whether the Landlord breached this agreement by refusing to grant the Tenant possession until the Tenant signed the standard form lease prepared by the Landlord.

The Tenant agreed to lease premises for "a pharmacy and family medical clinic." After signing the Agreement to Lease, the Landlord learned that the Tenant intended to dispense methadone from the premises. The Landlord informed the Tenant that dispensation of methadone was not a permitted use under the agreement and sought assurances from the Tenant that the premises would not be used for this purpose. The Landlord later delivered its standard form lease, but with additional covenants, agreements, and conditions about the use of the premises relating to the dispensation of methadone. The Tenant refused to sign the lease and commenced this application for relief.

The Court held that the Agreement to Lease was binding and enforceable and that the Landlord breached the agreement by denying the Tenant possession unless it signed the lease with additional use restrictions not contemplated in the Agreement to Lease. The Court found the Tenant was not obliged to disclose its methadone sales or its extent to the Landlord. There is no general duty to disclose material facts relevant to another party's decision to enter a contract except in limited circumstances. In this case, a sophisticated commercial entity, like the Landlord, should not be able to challenge the enforceability of a valid agreement due to its own failure to ask questions about "intended uses" and to exercise due diligence before signing the agreement.

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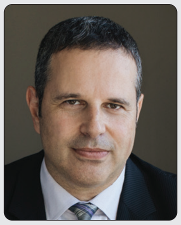

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Stay tuned for **PART 2** *in our Fall 2021 issue.*

Firm News

Welcome!

Minden Gross LLP is pleased to welcome the following lawyers to our firm:

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Congratulations to our Summer Students!

Minden Gross LLP congratulates our 2021 Summer Students who will join us in 2022-2023 for articling.

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Canadian Legal Lexpert Directory

The *2021 Canadian Legal Lexpert Directory* acknowledged our lawyers as leaders in their fields. The firm received leading rankings in Property Leasing and Property Development and congratulates **Joan Jung** (Estate & Personal Tax Planning); **Reuben Rosenblatt, QC, LSM** (Property Development); **David Kutner** (Property Development); and **Michael Horowitz**, **Christina Kobi**, and **Stephen Posen** (Property Leasing).

Top 10 Regional Law Firm

Minden Gross LLP is again recognized as a 2021 Top 10 Ontario Regional Law Firm by Canadian Lawyer magazine! Thank you to all of our clients, friends, and colleagues who voted for us.

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