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Fundamental Breach: Digging to the “Root” of the Lease

The modern-day approach to the commercial lease incorporates both property and contract principles. However, this was not always the case. Historically, leases were regarded as mere personal contracts or as tools of commerce for lenders. Eventually, courts began to recognize leases as estates in land. Through this development, leases became proprietary interests governed by the rights and remedies of property law.

The Hybrid Nature of the Lease

In 1971, the Supreme Court of Canada rendered a decision of seminal importance in the area of commercial leasing law. The case is *Highway Properties Ltd. v. Kelly, Douglas & Co.*, and its key holding is that a commercial lease of real property is not only a conveyance of land but also a commercial contract for which contractual rights and remedies are available. Since that decision, there has been a palpable shift towards the contractualization of commercial leases. As a result, contract principles, including fundamental breach, are now available in the context of a commercial lease.

What is Fundamental Breach?

Commercial contract law recognizes that parties to a contract may not perform their obligations and that, in certain circumstances, it may not be sufficient for the wronged party to simply make a claim against the defaulting party while continuing to be obliged to perform its end of the contract. When the defaulting party has committed a breach of such significance as to deprive the other of the very essence of what it contracted for, the courts have said that the defaulting party has committed a “fundamental breach”, going

to the “root of the contract”, depriving the other party of “the very heart of what it bargained for”, and entitling the wronged party to treat the contract as terminated. This permits the wronged party to walk away from the contract, be freed of its obligations, and still have a claim against the defaulting party for any damages suffered as a result.

Applying Fundamental Breach to Commercial Leases

In the context of a lease of real property what is the “root” of the contract? The landlord provides space in which the tenant operates a business. The concept of a fundamental breach is difficult to import into this scenario - short of depriving the tenant of possession, how can a landlord ever commit a breach that deprives the tenant of the essence of what it bargained for, which is the right to occupy space?

An example is found in the Ontario decision 997484 *Ontario Inc. v. Extreme Properties Inc.* The Court held that the landlord had fundamentally breached the lease when it terminated the lease too early. This case concerned a dispute among a landlord, a tenant and a subtenant. The subtenant had vacated the premises on February 27, 2006, without notice to the landlord. However, the subtenant had paid rent up to the end of February 2006 and had never defaulted on its lease. When the tenant arrived at the premises on February 28, 2006, it discovered that the landlord had changed the locks. The landlord claimed that the subtenant’s abandonment of the premises constituted a breach of the lease and that the landlord was entitled to terminate. In

deciding that the landlord had breached a fundamental term of the lease, the Court held that the subtenant's abandonment could only be viewed as a breach of the sublease agreement, not the lease itself. On account of the fact that the landlord terminated the lease in the absence of any default on the part of the tenant, the Court found the landlord had fundamentally breached the terms of the lease and the tenant was entitled to treat the lease as at an end.

In the 1985 decision *Bramalea Ltd. v. Canada Safeway Ltd.* the Ontario High Court was asked to consider an application by a landlord for an injunction. In denying the injunction, the court obliquely stated - without having to decide the matter - that it was possible that by operating a flea market in the shopping centre on the weekends, the landlord had committed a "fundamental breach" of the lease that would have entitled the tenant to treat the lease as terminated anyway. The Court did not rule on the issue of fundamental breach, but the door was opened for future discussion.

Since the *Bramalea* decision, the courts have applied the concept of fundamental breach to commercial leases in a variety of situations, including:

- Landlord's failure to respond to a tenant's request to sublease
- Landlord's breach of its covenant to allow the tenant peaceful enjoyment of its premises
- Landlord's failure to honour its tenant's right of first refusal option
- Landlord's breach of its tenant's restrictive covenant
- Landlord's failure to repair the tenant's premises
- Landlord's failure to heat the premises in the winter or cool the premises in the summer



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A Recent Update on Fundamental Breach

A recent decision has further expanded the applicability of fundamental breach to commercial leases. In the Ontario decision *Diamond Robinson Building Ltd. v. Conn.*, a tenant claimed that its landlord had anticipatorily committed a fundamental breach of the lease by failing to provide the parking spots that the tenant bargained for. Under the lease, the landlord was required to provide the tenant with 22 underground parking spots. When the landlord failed to make the required parking available, the tenant elected not to go ahead with the lease. The landlord sued the tenant for damages in the form of lost rent and expenses.

The Court agreed with the tenant and held that the landlord had committed a fundamental breach of the lease. In making this decision, the Court determined that if the tenant was unable to offer its clients convenient, on-site parking, it would lose substantially all of the benefit of its lease.

Where is this Headed?

Recent case law shows a clear and steady movement toward contractualization of commercial leases in Canada. Based on the developments to date, there appear to be no limits to the instances in which a fundamental breach argument can be raised. As always, the specific facts of each case will drive a court's decision as to what constitutes a fundamental breach. The impetus towards contractualization has worked to increase the range of remedies available to landlords and tenants, and it is incumbent on landlords and tenants to think about their actions in terms of the potential for a claim of fundamental breach of contract.

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