Daoust Vukovich LLP
BARRISTERS & SOLICITORS

"NOT HAVE BEEN IN DEFAULT"

PREREQUISITES RELATING TO DEFAULT IN RENEWAL PROVISIONS

Prepared By: Natalie Vukovich
Law Society of Upper Canada
6-Minute Commercial Leasing Lawyer
February 15, 2012

Introduction

Renewal rights in commercial leases are often limited by a provision stating that the right is only available if the tenant satisfies certain conditions. These conditions generally include the qualification that the right to renew will only exist if the tenant is not/has never been in default, or in material or monetary default, under the lease. In the absence of a no-default precondition, a tenant is entitled to exercise an option to renew even though at the time it exercised the right it was in default.

The no-default pre-condition raises several issues that have been dealt with in the Courts over the last decade.

"Default"

Where a right to renew is contingent on some element of tenant default, the precise wording of the renewal provision is critical, particularly with respect to the nature and extent of the default. For example, many no-default conditions impose a minimum threshold for default, providing that only "material" and/or "continuing" defaults are grounds for nullifying the exercise of an option to renew. Other no-default conditions depend on notice from the landlord and an elapsed cure period. Some cases are more concerned with habitual, recurring default whereas others specify only current default.

"Material Default"

In *1556724 Ontario Inc. v. Bogart Corp.*[1], the tenant's option to renew was contingent on the tenant having "**not been in material default under the terms and conditions of this**

[1] [2011] O.J. No. 1940 (Ont. S.C.J.) (*Bogart*).

Lease". Throughout the term, the tenant (1) frequently paid rent late; (2) delivered NSF cheques on 10 occasions; (3) failed to pay fees for NSF cheques as required under the lease; (4) failed to deliver post-dated cheques on request; (5) failed to provide proof of insurance and to obtain insurance as required by the lease; (6) failed to engage pest control as required; (7) failed to pay for utility usage; (8) failed to pay taxes; (9) failed to pay interest on amounts owing; (10) represented that the landlord's property was its own to dispose of; and (11) operated an exhaust fan causing noise and nuisance to adjacent tenants in violation of municipal by-laws.

As a result of the tenant's breaches, the landlord locked the tenant out of the premises on two occasions. In 2008, the landlord delivered a notice of termination to the tenant. The tenant applied to the Court for relief from forfeiture. By Court order, the tenant was allowed to remain in operation subject to certain conditions. The landlord claimed that within 90 days of the Court order, the tenant began to breach the terms of the order and the lease by delivering NSF cheques and failing to pay a water bill.

On the basis of the tenant's numerous defaults, the landlord refused the tenant's request to renew the term of the lease. After purporting to exercise the option, the tenant continued to deliver NSF cheques to the landlord.

The tenant claimed that any breaches of the lease were not material, since the tenant promptly replaced the NSF cheques and rectified any other breaches. The landlord maintained that the tenant's past breaches were material, within the meaning of the

Court's decision in *Docupartners Inc. v. Keele Copy Centre Inc.*[2], where the Court held as follows:

> "…"material default" cannot refer to minor or technical default, but must mean a significant failure of a party to perform its obligations under the agreement. As such, a "material default" must mean a fundamental breach going to the root of the agreement or a substantial failure to perform obligations under the agreement that, if not cured… would relieve the party not in default from any further performance under the agreement"..

The landlord also argued that the burden of proof was with the tenant to establish that there were no material breaches, and that the tenant failed to do so.

The Court held that the tenant was in material breach of the lease on a number of occasions during the initial term. The Court noted that the tenant failed to satisfy the onus of establishing that it was not entitled to exercise the option. Further, the continued NSF cheques after purporting to exercise the option were an "aggravating factor which further support[ed] the Landlord's position that only a Tenant in good standing should be entitled to exercise a unilateral right of renewal".

Timing of the Default

(1) At the time of exercising

In *Fingold v. Hunter*[3], the tenant had an option to purchase that was contingent on "**the due performance of all the covenants**" in the lease. The tenant purported to exercise its option and the landlord denied the request on the basis that the tenant was in arrears of rent at the time of exercising the option.

[2] (2009), 67 B.L.R. (4th) 57 (Ont. S.C.J.).
[3] [1944] 3 D.L.R. 43 (Ont. C.A.).

The tenant claimed that its exercise of the option was valid because the arrears were later paid. The Court of Appeal held that where a lease contains a condition precedent to the exercise of an option, the time at which the tenant must establish performance of the condition precedent is the time when the tenant purports to exercise the option. If the tenant cannot prove performance of the condition precedent on that date, the tenant will lose the option. The Court of Appeal concluded that the tenant's subsequent payment of the arrears did not alter the landlord's position and the landlord was entitled to exercise its right to deny the tenant's option.

In the Supreme Court of Canada decision *Sail Labrador Ltd. v. Navimar Corp.*[4] the Court ruled that, unless the provision states otherwise, a past or spent breach will not preclude a tenant from exercising an option in a lease. In that case, a charterer entered into an agreement to charter a vessel. The agreement contained an option to purchase in favour of the charterer subject to "**full performance of all its obligations**".

In the fifth year of the term, the charterer delivered one NSF cheque to the owner, which was the result of a bank error. The charterer promptly made payment to the owner and all subsequent payments were made on time. The owner denied the charterer's request to exercise the purchase option on the basis of the charterer's default.

The Supreme Court of Canada held that if an option is conditional upon the performance of covenants, "the optionee will not be prevented from exercising the option because of past breaches of the covenants if the breaches are "spent", in the sense of not giving rise to a subsisting cause of action at the time the optionee seeks to exercise the option". The

[4] [1999] 1 S.C.R. 265.

Court relied on the English decision *Bass Holdings Ltd. v. Morton Music Ltd.*[5] for the proposition that a no-default precondition is intended to apply to subsisting breaches only, and not to all outstanding claims for breach of the covenant that were previously satisfied or spent, because to do so would put the tenant at the mercy of the landlord. The Court concluded that, in this case, the charterer substantially performed its obligations under the agreement and that it had not lost its option because the previous breach had been remedied by the time the option was exercised.

Similarly, in *1290079 Ontario Inc. v. Beltsos*[6], the tenant had a right to renew, which was subject to the following qualification: "**provided the Tenant is not during the initial Term in default under any of the provisions or covenants of this Lease**". The tenant sublet the premises to a subtenant who assumed all the tenant's obligations under the head lease. A slip-and-fall injury was later sustained on the premises and the injured party brought an action for damages against the landlord, the tenant and the subtenant. The subtenant did not have proper insurance in place on the date of the accident. However, the subtenant amended its insurance policy the following day to comply with the tenant's obligations under the lease.

When the tenant sought to exercise its option to renew, the landlord maintained that the tenant was disentitled from doing so because it had breached the lease by failing to properly insure the premises. The tenant maintained that its failure to properly insure on the date of the accident did not invalidate its right to renew, because it had cured the breach when it amended its insurance policy the day after the accident. Accordingly, the

[5] [1987] 2 W.L.R. 397 (Eng. Ch. Div.).
[6] [2011] O.J. No. 1970 (Ont. C.A.) (*Beltsos*).

tenant claimed that the breach was spent and that there was no default at the time it exercised its option to renew.

The Court of Appeal ruled that a spent breach will not preclude a tenant from exercising an option to renew so long as the lease is "effectively clear" on the renewal date. However, if a landlord has a subsisting cause of action against the tenant that is rooted in the breach, the tenant will lose the right to renew. The Court of Appeal held that that the tenant's breach of the covenant to properly insure the premises was not spent, because the claim from the slip-and-fall injury was still before the Courts. Therefore, the tenant's breach was subsisting and the tenant lost its right to renew.

(2) At any time in the term

Some rights to renew may be drafted to the effect that the right is dependent on the tenant never having defaulted under the lease. For example, in *5000 Kingsway Ltd. v. F & A Enterprises Ltd. (c.o.b.) Peachy Keen Restaurants*[7], the lease contained a clause that stated that the right to renew was exercisable by the tenant provided it "***is not and has not been in default (a default being one which the Tenant has not cured within 10 days after receiving written notice from the Landlord outlining, such default…***)". Although the tenant paid rent late throughout the term of the lease, all rent was paid on time during the final year of the term. In that case, the Court held that, based on the wording of the renewal clause, the fact that the tenant's defaults were cured did not preserve the tenant's renewal right.

[7] [1994] B.C.S.C. No. 60.

(3) After the exercise

What if the tenant validly exercised its right to renew but prior to the commencement of the renewal term the tenant defaulted under the lease? In *Fitzgerald v. Barbour*[8], the renewal clause in the lease stated that the option was conditional on the tenant **having performed all its covenants and agreements contained in the lease.** The tenant exercised its option to renew, but prior to the end of the initial term, the tenant assigned the lease without obtaining the landlord's consent, as required under the lease. The Supreme Court of Canada held that despite the fact that the tenant already exercised its option to renew, the landlord was justified in refusing the renewal, because the right was dependent on the tenant fulfilling the covenants until the expiration of the initial term of the lease.

Recall the earlier comment in the *Bogart* decision where the Court observed that:

> "the fact that the Tenant appears to have breached the Lease by delivery of further NSF cheques for rental payments after purporting to exercise its right to renew the Lease on November 30, 2009 is an aggravating factor which further supports the Landlord's position that only a Tenant in good standing should be entitled to exercise a unilateral right of renewal"[9].

The Giving of Notice of Default by the Landlord as a Prerequisite to the Loss of the Right to Renew

Unless the lease provides otherwise, a landlord is not obligated to give notice to the tenant of its default. In *1383421 Ontario Inc. v. Ole Miss Place Inc.*[10], the Court of

[8] [1909] 42 S.C.R. 254.
[9] *Supra* note 1.
[10] (2003) 67 OR (3d) 161 (*Ole Miss*)

Appeal found that "nothing in the renewal clause required the Landlord to give notice of default. This is by way of contrast to other lease provisions that expressly require that notice be given by the Landlord." The tenant in that case was in breach of several provisions in the lease stemming from its operation of the business as a bar. The tenant's patrons were chronically intoxicated and their behaviour was, to say the least, unfortunate. At the low end of the spectrum, their offensive acts included harassing other occupants of the building and causing nuisances. The landlord denied the tenant's request to renew the lease on the basis of the tenant's defaults. The renewal clause in the lease stated that the tenant would be permitted to renew the lease provided that, *inter alia*, the tenant "**is not in default under the lease**".

The tenant argued that the landlord never notified it of the breaches, and continued to accept rent. The Court of Appeal rejected the tenant's argument, concluding that the acceptance of rent after the known breaches was not relevant to the option to renew. The Court of Appeal determined that there was nothing in the renewal clause that required the landlord to give notice to the tenant of the default in order to refuse renewal.

On the other hand, in *Firkin Pubs Metro Inc. v. Flatiron Equities Limited*[11], the lease contained a renewal right that was contingent on an "**Event of Default**" having not occurred under the lease. In this case, "Event of Default" was defined as a default that remained unremedied following the landlord giving notice to the tenant of the default.

The landlord claimed that the tenant was in arrears of rent when the renewal notice was delivered, and as a result, the tenant was disentitled from exercising the option to renew.

[11] [2011] O.J. No. 4039 (Ont. S.C.J) (*Firkin*).

The tenant argued that the renewal was valid, because the landlord had not provided notice to the tenant of its default as contemplated by the definition of Event of Default.

The Court noted that pursuant to the lease, an "Event of Default" could only occur after the landlord had given notice to the tenant of the default, and the default was not remedied within a stipulated time/period. The landlord actually gave a notice of default to the tenant, but not until after the tenant exercised its option to renew. Accordingly, the Court held that there was no "Event of Default" that could invalidate the exercise of the option, as that term was defined, and the tenant had validly exercised the option to renew.

Drafting Advice

Tenants should seek to temper any no-default condition in the lease by incorporating amendments to the effect that (1) the tenant is only required to be in good standing at the time it exercises the option to renew; (2) only "material" and/or "continuing" defaults will be grounds for nullifying the exercise of an option to renew; and (3) the option will be available if at the time the tenant gives the landlord notice of its intention to renew, there is no default for which the landlord has given the tenant written notice and in respect of which the tenant has failed to perform the remedy/cure within the cure period allowed in the lease.

All landlords are loathe to grant renewal rights to a tenant who has repeatedly breached its obligations under the lease during the initial term. Some landlords will also be eager to "pounce on" a tenant who missteps at the critical moment when an option to renew is to be exercised. Many landlords will resist imposing a threshold with respect to the nature and timing of a default that would deprive a tenant of its renewal option, on the basis that

"materiality" is too flexible and that all defaults are material to the landlord. That said, "absolute and precise compliance by the tenant with every single covenant throughout the period of the lease prior to the operative date is virtually impossible of attainment"[12]. Using precision when crafting default-based preconditions to a renewal right will prove to be helpful in the long run, and certainly, some moderation, as to the degree and timing of default causing the loss of an option is also appropriate in the circumstances.

Relief from Forfeiture

Section 20(1) of the *Commercial Tenancies Act*[13] states that where a landlord is attempting to enforce a right of re-entry or forfeiture against a tenant, whether for non-payment of rent or for other cause, the tenant may apply to the Superior Court of Justice for relief. The Courts have typically granted relief from forfeiture to tenants who committed an inadvertent or trivial breach of the lease, or who seriously attempted to correct a breach but were terminated nonetheless[14].

Where a commercial landlord elects to terminate a defaulting tenant's lease prior to the expiration of the initial term in lieu of granting the option to renew, the landlord may be faced with a valid claim for relief from forfeiture. In such circumstances, the landlord is proceeding to enforce a right of re-entry or forfeiture under the lease within the meaning of those words in Section 20(1) of the *Commercial Tenancies Act*. As stated by the Ontario Court of Appeal in *Maverick Professional Services Inc. v. 592423 Ontario Inc.*[15], the wording in Section 20(1) is intended to cover situations where a tenant is in default

[12] *Supra* note 5.
[13] R.S.O. 1990, C. L.7.
[14] *Conwest Exploration Co. Ltd. et. al. v. Letain*, [1964] S.C.R. 20.
[15] (2001), 42 R.P.R. (3d) 59 (Ont. C.A.)

under some provision of the lease, resulting in the landlord terminating the lease (aka "re-entry or forfeiture"), and the jurisdiction of the statute is to grant relief, in appropriate cases, from the harshness of this result.

The Courts also have an inherent jurisdiction to grant relief from forfeiture in appropriate circumstances by virtue of Section 98 of the *Courts of Justice Act*[16], which states that "a court may grant relief against penalties and forfeitures, on such terms as to compensation or otherwise as are considered just." In *1497777 Ontario Inc. v. Leon's Furniture Ltd.*,[17] the Ontario Court of Appeal noted that relief under the *Courts of Justice* Act may be concurrently available in some situations where *Commercial Tenancies Act* relief was expressly denied.

Question: Is relief from forfeiture available to a tenant who has lost the right to renew on the basis of its default?

The case of *Ross v. T. Eaton Co.*[18] stands for the proposition that the Courts do have jurisdiction to grant equitable relief in limited cases involving the loss of a renewal right where a tenant "has made diligent effort to comply with the terms of the lease, which are unavailing through no default of its own". The Court noted that, as a condition of the Court's jurisdiction, the tenant must show diligence in the protection of its valuable right to renew.

[16] R.S.O. 1990, c. C.43.
[17] (2004) 238 D.L.R. (4th) 574.
[18] (1992) 11 O.R. (3d) 115. (*Ross*)

However, in the 2007 British Columbia Court of Appeal decision *Clark Auto Body Ltd. v. Integra Custom Collision Ltd.*[19], the Court rejected the finding in *Ross* and held as follows:

> "In my opinion, it is essential to distinguish between the court's equitable jurisdiction to grant relief from forfeiture for the non-observance of covenants in an existing lease and from the failure to comply with conditions precedent to the exercise of an option to renew a lease. In the former, equity recognizes that a tenant may be permitted to cure its default and be relieved from forfeiture to allow it to retain the balance of the term of the lease. In the latter, there is no compulsion on the tenant to exercise the renewal option, but if it does so, the tenant must comply with the conditions precedent. *If the tenant fails to comply, it does not suffer a penalty or forfeiture of existing tenancy. Equity will not intervene*" [emphasis added].

Recently, the Ontario Court in *Bogart*[20] (April, 2011) denied the tenant's request for relief, on the basis that relief against forfeiture is not an appropriate remedy for the loss of the option to renew. Or in effect, relief against forfeiture is not available for the failure to crystallize or acquire a right. But the Court was saved from having to decide the matter solely on that basis, as there had been a previous relief from forfeiture ruling that expressly prevented the tenant from obtaining relief from forfeiture again.

Similarly, in *Beltsos*[21] (May, 2011), the lower declined to grant relief from forfeiture, on the basis that the Courts do not have the discretion to grant relief from forfeiture where the "forfeiture" is merely a right of renewal predicated on the tenant's performance of a condition precedent. The Court noted that, even if it was wrong and the Court did have the discretion to relieve against forfeiture, it would not exercise that discretion in favour

[19] [2007] B.C.W.L.D. 1351 (*Clark Auto Body*)
[20] *Supra* note 1.
[21] *Supra* note 6.

of the tenant in that case, as the equities did not favour the tenant. On appeal, the Court of Appeal noted that it would not interfere with the trial Court's exercise of discretion in refusing to grant equitable relief, but in doing so, it failed to address the question of whether relief was even available.

By contrast, the Ontario Superior Court of Justice in *Firkin*[22] (September, 2011) commented (albeit in obiter) that the tenant would have been entitled to relief from forfeiture had it lost its right to renew as a result of its default. In so deciding, the Court relied on the principles in *Ross*, noting that the equities of the case were clearly with the tenant. The Court noted that the landlord had conducted itself in such a way as to lead the tenant to believe that it had effectively exercised its option, and prevented the tenant from correcting the alleged inadequacy in the notice in time. The Court made no mention of the decisions in *Ross, Clark Auto Body*, *Bogart* and *Beltsos*.

Summary

Where does this leave us? Consider that, on first principles, relief from forfeiture is an award reinstating a tenancy that was lost (forfeited) due to default. If an option to renew depends on the fulfillment of a set of conditions precedent, including a condition relating to default, then if the condition is not met, the option does not arise (i.e. it cannot be lost or forfeited, it merely never comes to exist). The Courts have not, however, consistently applied this logic. Only *Clark Auto Body* applies this reasoning. In the other cases noted above (*Ross, Beltsos, Bogart, Firkin, Ole Miss*, for example), there is no such clear statement. On the contrary, sometimes relief has been granted and other times not, but

[22] *Supra* note 11.

not for the reason that the remedy is unavailable. Ultimately, failing a definitive ruling from a higher court, it may very well be that in certain circumstances, equitable relief is available to a tenant whose option to renew was lost to default. This is not an easy matter to predict.

CONCLUSION

Landlords and tenants should take pains to clearly and precisely express any elements of default that will deprive the tenant of an option to renew. Tenants should also carefully observe the pre-requisites to exercising a renewal right, as failure to achieve those pre-requisites MAY be fatal. Pursuing relief from forfeiture may be an alternative, but not a reliable one.