Daoust Vukovich LLP
BARRISTERS & SOLICITORS

PDF 5-12

"LIMITING TENANT RIGHTS"

Prepared By: Natalie Vukovich and Jamie Paquin
Shopping Centre Legal Update, Vol. 26, Issue 1
Spring 2006

From Canada

In Depth

Limiting Tenant Rights

Natalie Vukovich
Jamie Paquin
Daoust Vukovich LLP
Toronto, Canada

Tenant rights in commercial leases are often limited by a provision that states the right is personal to the particular tenant and only available if the named tenant satisfies certain conditions. These provisions are usually identifiable, as they most often contain the phrase "so long as the Tenant is." The phrase is then qualified with certain conditions of which the following are the most universal:

So long as the tenant is:

- The original named tenant in possession of the premises/has not assigned or sublet;
- In occupation of the whole premises; and
- Not in/has never been in, material default under the lease.

Not only do the above conditions seem to be the most widely used to limit tenant rights under commercial leases, but there is a certain repetitiveness to the types of rights that they constrain:

- Option to extend the term;
- Right of first refusal/purchase option;
- Co-tenancy;
- Right to cease operating a retail business ("go dark");
- Signage and pylons;
- Exclusive use rights;
- Reduced removal/restoration obligations on term expiry;
- Parking; and
- Right to assign or sublet without landlord's consent.

These special personal rights and options raise several issues that have been dealt with in the courts over the last decade. This article will address some of these issues and how they have been handled in the courts.

A. *Personal Nature of Right*

A landlord may agree to grant a tenant certain rights or options only if that specific tenant with whom the landlord originally contracted is the party in possession of the premises and the one to exercise the option (or benefit from the right). It follows then that if the lease is assigned or the premises sublet, the option or right is not exercisable. Landlords argue that the purpose for such limitation is that they entered into the original tenancy agreement with a "known quantity" and are only prepared to provide a "known quantity" with the substantial benefit of a particular right or option. Tenants argue that the personal nature of the right affects the marketability of the lease and, in circumstances where a tenant justifiably needs to sell its business (and, therefore, the lease that attaches to that business), the right or option must be transferable as well. This concern of tenants is certainly valid as "personal" conditions constrain important tenant benefits under a lease (including option to renew provisions, provisions for tenant purchase rights, tenant pylon and signage rights and/or the right to assign or sublet without consent in certain circumstances, e.g., inter-family transfers, chain sales, sublets to franchisee). In response to this concern, landlords could take the alternative route of imposing a requirement for the landlord's prior written consent to all transfers as opposed to personalizing rights or options. The requirement of consent in most circumstances would achieve the same result of ensuring the existence of circumstances beneficial to the landlord. Where a landlord is faced with a tenant request to assign the lease, the landlord presumably investigates the transferee to decide whether or not to consent to the transaction. If consent is given, approval of the transferee is implied and there would, therefore, be no reason to deny that approved transferee the same rights and options of the original tenant. If there is a valid business reason to deny the transferee a particular right or option, the landlord's consent could be given on a conditional basis (i.e., subject to the removal of the right at issue). Given the law on reasonableness in the context of granting/withholding consent, it may be necessary to write the transfer clause as allowing the landlord to arbitrarily/unreasonably withhold consent. This is a tough sell.

In situations where a landlord's consent is not required for an assignment/transfer and where the original tenant is released, the personalizing of the right or option is very much an issue.

Ultimately, each right or option should be considered on its own merit as to the reason for it being limited in availability. The outcome of the issue will invariably be a function of bargaining strength. It remains an open question for the courts to decide at a future date, as to whether the law will enforce such limiting contractual terms, or if it might reject them as unduly restricting alienation.

B. *Meaning of "In Occupancy"*

Certain special rights of a tenant, such as a right of first refusal, extension option or covenant for exclusivity (to name a few), are often expressed to be only available when the tenant is in occupancy of the premises. Therefore, the question of what constitutes "in occupancy" is very important in landlord and tenant law.

This issue was dealt with in *Nortel Networks Ltd.* v. *Kanata Research Park Corp.* [Ont. Sup. Crt.] 73 O.R. (3d) 594. The court acknowledged that it is possible for a tenant to be in "legal" possession or control of property even if not in physical control of it. In this case, the tenant held a right to terminate the lease, but it was contingent on the tenant's being in occupancy of the premises. The court noted that no legitimate commercial purpose was served by restricting the meaning of occupancy to include only physical occupation. This case is especially problematic to many landlords of retail spaces who have, for years, routinely connected pylon sign rights, exclusives, options to renew and a myriad of other rights to occupancy. The interpretation of the phrase "in occupancy" in the *Nortel* case may not be in keeping with what the parties to those leases had intended.

The issue of "in occupancy" is usually subject to intense negotiations. The discussion centers on whether physical occupancy is or should be a prerequisite to the enjoyment of, for example, protection from competition, the right to renew the lease, the right to be represented on signs, etc. For example, from the landlord's point of view, if a tenant is no longer physically occupying the premises, then the tenant should not continue to take up valuable signage space. On the contrary, tenants argue that despite no longer being in physical possession of the premises, they are still paying the same rent. Therefore, they should have the benefit of the entire bundle of rights negotiated for in the lease. The matter of whether there is or is not a legitimate commercial purpose in limiting certain rights to times when the tenant is actually carrying on business in its premises remains to be decided in the courts. From a negotiating perspective, once again, each right or option should be considered on its own merits as to the appropriateness of limiting its availability to times when the tenant is physically occupying the premises.

In any instance where the limitation is agreed to, the phrase "in occupancy" should not be used in such a simplified manner. Rather, when tying rights to "physical" occupation, the wording should be expanded. Some landlords are already using the wording such as, "Actual, physical occupancy" and another effective phrase is, "in occupancy and actively carrying on the business permitted by this lease in the whole of the premises."

C. When Is Default a Default?

If a tenant's right or option is dependent on the tenant not being in default, then, unless the provision states otherwise, the tenant is entitled to exercise the right or option even though at the time it exercises the right or option it is in default, provided it manages to cure the default before the point when the landlord is required to grant the right or option.[1] Accordingly, where a tenant has an option to renew, though at the time it exercises such option it is in default, if the tenant cures the default prior to the expiry of the term, the landlord is required to grant the renewal of the lease. However, a right or option may be dependent on a tenant never having defaulted under the lease. If this is the case, then the fact that the tenant's default has been cured does not reinstate the tenant's right or option.[2] Another possible scenario could be where a tenant validly exercises a right (while not in default) but prior to the benefit of the right becomes in default under the lease. This was the case in *Loveless* v. *Fitzgerald* (1909), 42 S.C.R. 254, where the lessee exercised an option to renew but, prior to the end of the original term, fell into default. The court held that "the tenant's right to extend was dependent upon the tenant fulfilling the covenants until the expiration of the original lease term, and therefore, since a covenant had been breached prior to the expiration of the term, despite the fact the tenant had already exercised its option to renew, the landlord was justified in refusing the extension."

The issue is further clouded by the question of what is meant by default. Does the nature of the default make a difference? Is the landlord required to give the tenant notice of default and allow the tenant an opportunity to cure? Typically, if it was prepared in a detailed fashion, the lease can be consulted to determine such questions. However, the situation may arise where a tenant is not aware it is—or ever was—in default until the time comes to exercise a particular right or option. Should the landlord or tenant bear the consequences in such circumstances? Such circumstances arose in *1383421 Ontario Inc.* v. *Ole Miss Place Inc.* [Ont. C.A.] 67 O.R. (3d) 161, where the tenant was in breach of several provisions of the lease and the landlord denied the tenant's request to renew on those grounds. The tenant argued that the landlord never notified it of the breach and continued to accept rent. The court found that the tenant's argument, that the landlord's acceptance of rent precluded it from refusing to renew the lease, was not sound. Although the acceptance of rent after known breaches is relevant to the landlord's right of termination of the lease, it is not relevant to the option to create a

new lease term. The court also determined that there was nothing in the renewal clause that required the landlord to give notice of default and that "a landlord need not give notice of a breach in order to refuse renewal."

The issues of default discussed above illustrate the importance of being as clear as possible when crafting rights and options that are contingent on some element of tenant default.

D. *Personal Rights and Automatic Renewal*

Rights personal to a specific tenant can be described as individual separate agreements within a lease in certain circumstances. For instance, where a lease provides for automatic renewal, the courts have determined on several occasions that certain personal rights did not continue into the new term without an express agreement between the landlord and tenant.[3] This was the case in *Budget Car Rentals Toronto Ltd.* v. *Petro-Canada Inc.* (Ont. C.A.) 69 O.R. (2d) 289, where the lease contained a right of first refusal in favor of the tenant, requiring the landlord to give the tenant the opportunity to match any *bona fide* offer to purchase the property. The lease also provided for automatic renewal unless terminated by either party. The court held that the original lease containing the option expired and "the automatic renewal was not effective to keep the option alive" beyond the expiration of the original term.

The decision most often referred to in Canada on this point is that of the Court of Appeal in *England in Sherwood* v. *Tucker* [1924] 2 Ch. 440, in which the tenant had an option to purchase the property for a stated price during a three-year lease term. The court determined that "there is a clear distinction between the two things" (referring to the lease of the premises vs. an option to purchase). "The first is the demise of the premises by the landlord to the tenant, and although it is to be found in an agreement, or in a lease signed and executed by the parties, still the option is a separate and independent contract whereby a chance is given to the tenant, under the conditions imposed, to purchase the freehold of the premises which are demised to him." This point with respect to a tenant's option to purchase was also clearly made in Halsbury (4th ed.) 1983, p. 87, para. 109:

> Such an option is collateral to, independent of, and not incident to the relation of landlord and tenant. It is not therefore one of the terms which will be incorporated in the terms of a yearly tenancy created by the tenant holding over after the expiration of the original lease; and when the parties agree that a lease is to be extended, unless it is clearly shown that it was their intention that the option to purchase should continue throughout the extended period, it will not be deemed to be one of the terms of the extended tenancy.

Therefore, when drafting personal rights (as opposed to rights *in rem*), the parties must be careful to ensure that their intentions are clearly expressed. The parties may intend to draft a right or option that runs with the land, such as a restrictive covenant. A restrictive covenant must "touch or concern the land," which means it must "affect the nature, quality or value of the demised land or its mode of use."[4] Restrictive covenants may benefit either the landlord or tenant and since restrictive covenants "run with the land," they continue to be effective beyond the original term of the lease when renewed. As was discussed above, this is not the case with certain rights *in personam*, which do not themselves create an interest in land. Some examples of rights *in personam* are the option to purchase, the option to renew and the right to any Right of First Offer (ROFO) Space. The classic example of a right *in rem* is a restrictive covenant, which may include a restriction on the carrying on of a particular trade or business on a certain property.

DRAFTING CONSIDERATIONS

A recent trend that has developed in limiting tenant rights along the lines discussed in this article is to include a provision in the lease that defines all of the limiting conditions. The defined term is then used wherever required. This style is a matter of convenience, not substance, and is more typically found in office or industrial leases than retail leases.

Following is a provision that may be included in a lease:

"Required Conditions" means:

(a) The Tenant has paid all Rent as and when due and punctually observed and performed the covenants and obligations of the Tenant under the Lease; and

(b) No Transfer has occurred; and

(c) The Tenant is in occupation of and conducting business in the whole of the Premises.

Having defined the limiting conditions in such a manner, to limit any right or option in the lease, the following phrase need only be included in each instance: "So long as the Required Conditions are satisfied...."

However, this style may not always be that convenient, as the limiting conditions may vary from one right or option to the other, which could present a drafting nightmare. For example, an option to renew may be contingent on the required conditions being met but, in the same lease, the tenant's right of first refusal may only be contingent on the tenant being in occupancy and not in default, while the co-tenancy right may depend only on occupancy.

The paramount consideration in drafting limitations on tenant rights is that the parties' intentions are well expressed. It takes time to get it right.

NATALIE VUKOVICH is a partner in Canada's only commercial leasing boutique firm, Daoust Vukovich Baker-Sigal Banka LLP, in Toronto.
JAMIE PAQUIN is an associate with the firm and practices commercial leasing and real estate law with an emphasis on landlord and tenant matters.

[1]*Loveless* v. *Fitzgerald* (1909), 42 S.C.R. 254 and *Advanced Car Specialities Ltd.* v. *Jakobsons*, 131 D.L.R. (3d) 48.
[2]*5000 Kingsway Ltd.* v. *F & A Enterprises Ltd. (c.o.b.) Peachy Keen Restaurants* [1994] B.C.S. No. 60.
[3]*Budget Car Rentals Ltd.* v. *Petro-Canada Inc.* (Ont. C.A.) 69 O.R. (2d) 289.
[4]*Nylar Foods Ltd.* v. *Roman Catholic Episcopal Corp. of Prince Rupert* (1988), 48 D.L.R. (4th) 175.