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SURRENDERING AND TERMINATING SUBLEASES: HOW TO AVOID THE POTHOLES

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HOW TO AVOID THE POTHOLES

(a) The Effect of Surrender on a Sublease

(i) At Common Law

At common law, privity of estate was destroyed upon merger or surrender of a tenant's reversion and, as a result, covenants were thereby prevented from running with the reversion. As such, following the surrender of the head lease, a subtenant would be released from all its obligations under the sublease and, accordingly, the subtenant would be in a position to lawfully enjoy the property for the balance of the term of the sublease without payment of rent or observance of any covenants. It should be stressed, however, that the covenants may not be enforced against the subtenant by reason of there being no privity of estate as between the head landlord and the subtenant. If however, there is privity of contract, the subtenant will continue to remain liable.

Even more problematic for landlords is the fact that this common law rule remains unaltered in situations where the head landlord is unaware of the existence of the subtenancy.

Ontario Law Reform Commission, *Report on Landlord and Tenant Law* (1976), at 37.

C. Bentley, *Williams & Rhodes, Canadian Law of Landlord and Tenant*, Volume 1, 6th ed. (Toronto: Carswell, 1988) at 12-24 & 12-25; L. Blundell, *Woodfall's Law of Landlord and Tenant*, Volume 1, 27th ed. (London: Sweet and Maxwell, 1968) at 17/18; A.H. Oosterhoff and W.B. Rayner, *Anger and Honsberger Law of Real Property*, (Toronto: Canada Law Book, 1985) v. 1 at page 291; Ontario Law Reform Commission, *Report on Landlord and Tenant Law* (1976), at 37; *Royal Bank of Canada* v. *Loeb Inc.*, [1995] O.J. No. 1702 (Ontario Court (Gen. Div.), June 8, 1995, Feldman J.); *Webb* v. *Russell* (1789) 3 Term. Rep. 393.

A.H. Oosterhoff and W.B. Rayner, *Anger and Honsberger Law of Real Property*, (Toronto: Canada Law Book, 1985) v. 1 at page 291; *Parker* v. *Jones*, [1910] 2 K.B. 32.

(ii) Section 17 of the Ontario Commercial Tenancies Act

What if a tenant (sublandlord) surrenders the head lease prior to the expiration of the term of the head lease? Section 17 of the Ontario *Commercial Tenancies Act* (the "Act") provides that where a tenant surrenders the head lease, the landlord becomes an assignee of any reversion expectant on a valid sublease granted by the tenant to a third party and accordingly is bound as landlord by the terms of the sublease with the subtenant. Simply put, a subtenant's rights are not disturbed in instances where

the head lease is surrendered. The head landlord, as a result, acquires all rights, benefits and advantages as against the subtenant arising by virtue of the sublease and, in turn, the subtenant acquires all rights as against the head landlord which rights the subtenant held by virtue of the sublease. In effect, Section 17 preserves the rights and obligations of subtenants so that the subtenancy remains unaffected in instances where there is a surrender of the head lease. It also preserves the liability of the subtenant in respect of payment of rent and observance of its covenants (being those that are set out in the sublease).

It is important to note that this provision only applies with respect to a "surrender" of a lease and not to a termination of the lease by the landlord. In simpler terms, if the tenant and the landlord agree that the tenant's lease will come to an end before the expiry of the term, this will be viewed in law as a "surrender of the lease". If on the other hand if the landlord exercises its rights under the lease to terminate the lease as opposed to agreeing on an early termination of the lease, the lease will have been terminated and the rights of a subtenant under Section 17 of the Act will not apply.

The Canadian jurisdictions which have enacted an equivalent to Ontario's Section 17 are: **(i) Manitoba:** *Landlord and Tenant Act*, R.S.M. 1987, c. L70, s.16; **(ii) New Brunswick:** *Landlord and Tenant Act*, R.S.N.B. 1973, c. L-1, s. 5; **(iii) Northwest Territories:** *Commercial Tenancies Act*, R.S.N.W.T. 1974, c. L-2, s. 6; **(iv) Prince Edward Island:** *Landlord and Tenant Act*, R.S.P.E.I. 1988, c. L-4, s.6; **(v) Saskatchewan**: *Landlord and Tenant Act*, R.S.S. 1978, c. L-6, s. 8; and **(vi) Yukon Territory:** *Landlord and Tenant Act*, R.S.Y.T. 1986, c. 98, s. 5(1). Several Canadian jurisdictions have not enacted an equivalent to Ontario's Section 17 and thus remain subject to the common law position as to the effect of a surrender on a sublease. These jurisdictions are: (i) Alberta; (ii) British Columbia; (iii) Newfoundland; and (iv) Nova Scotia. It should be noted that, in the Province of Quebec, the Civil Code does not provide for any contractual privity ("lien de droit") as between the head landlord and subtenant. As a result, if the head lease is cancelled, terminated or resiliated, the subtenant must relinquish possession of the premises. This is true even in situations where the head landlord and tenant voluntarily agree to terminate the head lease.

Shapiro v. Handleman, [1974] O.R. 223 (C.A.)

A.H. Oosterhoff and W.B. Rayner, *Anger and Honsberger Law of Real Property*, (Toronto: Canada Law Book, 1985) v. 1 at page 291

(iii) <u>Conduct Respecting the Acceptance of Surrenders</u>

In jurisdictions where there is no equivalent to Section 17 of Ontario's *Commercial Tenancies Act*, it is absolutely critical that a landlord does not accept the surrender of a head lease without first obtaining a written representation from its tenant that there are no subsisting subtenancies affecting the premises. If, on the other hand, the premises are the subject of a sublease in which there is no privity of contract between landlord and subtenant, the landlord should not accept the surrender until such time as it has entered into a tenancy agreement directly with the subtenant or obtained the

subtenant's release and surrender of its rights in the subleased premises. If the subtenant refuses to co-operate, the landlord should, if at all possible, consider terminating the head lease if has grounds to do so, as opposed to accepting the surrender.

(iv) Surrender Agreements

Standard form surrender agreements should provide that the tenant is required to provide the landlord with a representation and warranty that the premises, or any part thereof, are not the subject of a valid or subsisting subtenancy agreement. The surrender agreement should also provide that the landlord's acceptance of the surrender is conditional on there being no subtenancies. While the inclusion of these provisions is clearly critical in jurisdictions where there is no equivalent to Ontario's Section 17, it may also be beneficial to include these provisions in the other jurisdictions, to help avoid surprises on the part of the landlord.

(v) Subleases & Consents To Sublease

Most standard form sublease and consent to sublease agreements provide for the subtenant's waiver of any *statutory* rights that the subtenant may have to, *inter alia*, retain the unexpired term of the sublease or to remain in occupation of any portion of the subleased premises. Clearly, the intent here is to avoid having to deal with the continued occupation of an undesirable subtenant. However, in order to achieve this objective, these documents should provide for the subtenant's waiver of both its statutory and common law rights.

(b) **Subtenant's Ability to Retain the Leased Premises - Relief from Forfeiture**

Section 21 of the Act permits a subtenant or underlessee to apply to the court for relief from forfeiture. Simply put, the tenant can apply to Court for an order permitting it to retain its leased premises subject to court imposed lease terms as to payment of rents, expenses, compensation and giving of security amongst other things save for the term, which term would coincide with the term granted to the tenant under the sublease plus any options to renew but in any event not longer than the term of the original head lease. However, many sublease agreements specifically provide that the subtenant waives its rights under Section 21 of the Act. The rights of the subtenant on such an application will depend on many factors including whether the landlord has consented to the sublease. The Courts will be refrain from permitting the subtenant to continue under its sublease with the landlord where it would be unfairly prejudicial to the landlord if it were to be forced to be bound by the sublease which would have imposed obligations on the landlord which obligations were materially different and inconsistent with its obligations under the head lease. A tenant leasing only part of the premises that were the subject of the head lease could be forced to assume the whole head lease as it pertains to all of the premises subject to the head lease and not just the subleased premises, if it wants to continue in possession of the subleased premises. In most cases the tenant would not

be in a financial position to do so and would accordingly lose possession of its subleased premises unless it could make its own deal directly with the landlord. The underlying principle is that a Court must be satisfied that the granting of relief to a subtenant under Section 21 of the Ontario *Commercial Tenancies Act* will not unfairly prejudice or adversely affect the head-landlord.

Golden Griddle Corp. v. *Toronto (City)* 33 O.R. (3d) 545 (C.A.), leave to S.C.C. denied.

(c) **Effect of Bankruptcy or Winding-up Order on Subleases**

Section 39(2) of the Act allows a subtenant, occupying the premises *with the consent of the landlord*, a means of protecting its leasehold interest in the event of the bankruptcy or winding up of the head tenant, by electing within three months of the filing of the bankruptcy to take over the head lease on the same terms and conditions save and except as to rent. Rent payable by the subtenant to the landlord on the subtenant's assumption of the head lease is the greater of the amount payable under the sublease and the amount payable under the head lease. A subtenant is not required to pay any arrears owed to the landlord by the head tenant as a condition of electing to assume the head lease under Section 39(2).

Hammersmith Manor Enterprises Inc. v. *Frazzor Corp.* (1991), 4 O.R. (3d) 46, 19 R.P.R. (2d) 87 (Gen. Div.)

Westhill One Ltd. v. *Taylor* (1989), 70 O.R.. (2d) 93 (H.C.)

(d) **Subleases Under a Yearly Tenancy (a là Goodyear/Burnhamthorpe)**

When a subtenancy exists under a yearly tenancy (for instance, if the long-term head lease has been converted to a yearly tenancy through the attornment by the head tenant to the landlord's mortgagee under a mortgage enforcement proceeding), and subsequently the head tenant terminates its yearly tenancy, there is a question as to the effect, if any, on the subtenancy.

Section 17 of the Act essentially provides that the head tenant cannot defeat the interests of a third party subtenant by surrendering the lease. However, in the circumstances described, an intervening act has caused the original lease to be terminated and a new year to year head tenancy put in place. Does Section 17 answer the question? The original head lease was not surrendered, or even terminated. According to *Goodyear Canada Inc. v. Burnamthorpe Square Inc.* (1997), 32 O.R. (3d) 657 (Ont. Ct. (General Division)); (1998), 41 O.R. (3d) 321 (C.A.); leave to appeal to S.C.C. denied, [1998] S.C.C.A. No. 629, , it was suspended in some less-than-permanent fashion due to the action of the mortgagee in taking possession. As the original lease is suspended, it might flow logically that the original sublease is also suspended and that the subtenant is on a year to year subtenancy. To date, however, this issue has not been directly addressed by any Canadian or English court of law. It would not seem logical that Section 17 has any application.

Several issues emerge:

(i) If the head tenant terminates its yearly tenancy, what is the effect on the subleases? Will they be terminated also?

Yes - This issue was conclusively decided by the English Court of Appeal in the case of *Pennell v. Payne*, [1995] 2 All E.R 592, wherein the Court had to decide whether a head tenant's unilateral notice to quit was effective in terminating a sub-tenancy. Prior to this case, the law in England provided that (along the lines of Section 17 of the Act pertaining to surrenders) whenever the head tenant by its own voluntary act terminated the head tenancy, a sub-tenancy remained binding on the landlord. The Court of Appeal overruled the previous case law and held that a sub-tenancy is automatically terminated in instances where the head tenant terminates the head lease by serving a notice to quit on the landlord.

Pennell has not been judicially considered in Canada.

(ii) Is the head tenant under an obligation not to terminate its yearly tenancy without the sub-tenant's consent?

Potentially, no - with respect to a sublease entered into prior to the "creation" of the yearly tenancy only. (See note (iii), below, with respect to a sublease entered into after the yearly tenancy took effect).

To date, this issue has not been directly addressed by any Canadian or English court of law. However, in *Pennell*, Simon Brown L.J. of the English Court of Appeal seems to have indirectly addressed the issue when he made the following *obiter* comment:

> It must be remembered that....service of a [notice to quit on the landlord] would in all cases (*unless only the tenant can lawfully terminate the subtenancy*) expose the tenant to a liability to his subtenant in damages from breach of his express or implied covenant of quiet enjoyment. [the emphasis is mine.]

Implicitly, and recognizing that this statement was merely *obiter dicta*, a head tenant is not obligated to obtain a sub-tenant's consent prior to terminating the head lease provided the head tenant terminates the sub-tenancy 'lawfully'. Accordingly, if a yearly sub-tenancy can be lawfully terminated by the sublandlord/head tenant on six months' notice to the subtenant effective on the last day of the year on which the yearly tenancy is based, then it would appear that the head tenant is not obligated to obtain the sub-tenant's consent to terminate the head lease so long as the head tenant provides proper notice of termination of the sublease to the subtenant.

(iii) If the head tenant is already a yearly tenant when it enters into a sublease for a term extending past the anniversary of the yearly tenancy, how is the situation any different? Is it even possible for a head tenant to enter into a sublease for a period longer than its own term?

The common law principle of *nemo dat qui non habet* (he who hath not cannot give) would seem to prohibit the granting of a sub-lease for a period that extends beyond the head lease. The principle is invoked in instances where a party seeks to convey, unto another, a greater estate in land than the party holds itself. Based on this principle, one would logically conclude that a yearly tenant could not grant a sublease for a term that extends beyond the annual expiration date of the head tenancy.

There is case law that supports this conclusion (admittedly, however, these cases do not invoke the principle of *nemo dat qui non habet*). In *Mount Citadel Ltd. v. Ibar Devs. Ltd.* (1976), 14. O.R. (2d) 318 (H.C.), the landlord leased a multi-unit apartment building to the tenant, who granted several subleases which extended beyond the term of the head lease. It was pointed out by the Court that the purported subleases were neither assignments, because they did not relate to the entire leasehold interest of the defendant, nor subleases in the technical sense of that term, because no reversionary interest was retained by the tenant.

In *Wright-Williams Mgmt. v. Wilson* (1982), 40 O.R. (Co. Ct.), the tenant was a month-to-month tenant. After having taken possession of the premises, the tenant advised the landlord that he intended to sublease the premises for a period of five months. The subtenant undertook to vacate the premises on 60 days notice should the tenant require them earlier. The landlord refused to consent to the sublease and instituted proceedings seeking a declaration that the purported sublease was void. The Court held that the transaction could not be a proper sublease, for the tenant had purported to sublet for a period longer than its own term of one month. Nor could the transaction constitute a valid assignment, because the tenant had purported to retain a right of re-entry against the subtenant. The declaration sought by the landlord was granted.

There is, however, a flaw in the conclusion reached in the foregoing cases. A tenancy from year to year is considered as one continuous term, dating from its inception, and not a recurrence of yearly tenancies commencing anew each year (see *Sherlock v. Milloy* (1893), 13 C.L.T. 370 (Ont.)). Accordingly, because a yearly tenant is viewed as having a continuous or unbroken estate in the land, it should be possible for a yearly tenant to grant a sublease for a period beyond the annual expiration of the yearly tenancy. In fact, the holding in *Sherlock* is consistent with an obiter statement of Simon Brown L.J. in *Pennell* wherein he implies (reiterating a comment of Hoffman L.J.) that a yearly tenant may grant a 99-year sublease:

> Finally, and perhaps most tellingly of all, is this consideration [as to why a subtenancy should automatically terminate in instances where the head tenant terminates that head

> lease.] If Mr. Gore is right, a tenant from year to year can perfectly lawfully exploit his position in the most remarkable way. Take this example, suggested by Hoffman L.J. in the course of argument: he can grant a 99-year subtenancy for a large premium at a peppercorn rent and immediately then exercise his right to give an upwards notice to quit. This will leave his landlord subject to that subtenancy, entitled to no redress against his own tenant...

Based on this statement though, one would conclude that with respect to premises subleased to a long-term subtenant by a yearly head tenant, the head tenant has no lawful right to terminate the subtenancy and therefore in the case of a long term subtenancy granted after the yearly tenancy arose, the head tenant owes a duty to the subtenant not to terminate its own yearly tenancy.

(iv) Is the head tenant entitled to "carve up" the premises with respect to which it enjoys a yearly tenancy, terminating the yearly tenancy with respect to only the portion that is not subleased?

Possibly. There is no case law on this point. However, it is not uncommon to find situations where a tenant assigns its interest in a lease with respect to a portion of the leased premises only, so by logical extension it would seem possible that the head tenant could terminate its yearly tenancy with respect to a portion of the premises only.

(e) **Liability of Head Tenant for failing to provide Landlord with vacant possession free and clear of all Subtenancies**

If a head tenant terminates the head lease and then on the termination date fails to deliver vacant possession of the leased premises free and clear of all subtenancies, the head landlord is entitled to damages for (i) the value of the whole premises for the time the landlord is kept out of possession and, (ii) the costs of ejecting the sub-tenant.

This issue was considered in *Henderson v. Squire* (1869), L.R. 4 Q.B. 170. In that case, Cockburn J., quoting from *Harding v. Crethron* (1793), 1 Esp. 57, held:

> when a lease is expired the tenant's responsibility is not at an end; for if the premises are in possession of an under-tenant, the landlord may refuse to accept the possession, and hold the original lessee liable; for the lessor is entitled to receive the absolute possession at the end of the term.

Cockburn J. continued:

> [t]he landlord is entitled to recover all the loss he has sustained by not being put in possession of the entire premises at the end of the term; he is entitled to a sum equivalent to the rent which he has lost, and to the expenses he has been put to in taking legal proceedings to oust the sub-tenant from wrongful possession.

The principles enunciated in *Henderson* were followed, in Ontario, in the case of *Lindsay v. Robertson* (1899), 30 O.R. 229 (Div. Ct.). The *Henderson* principles were also cited as law in the later case of *Miles v. Marshall* (1975), 7 O.R. (2d) 544.

A review of *Williams & Rhodes* reveals that the foregoing accurately describes the present state of the law.

It is also appropriate to consider whether a head tenant's failure provide its landlord with absolute possession (i.e. free and clear of all subtenancies) amounts to a waiver of its notice to quit. While this specific issue has yet to be considered by a Canadian court of law, it is clear that a notice to quit can be waived, and a new tenancy created, only by the express or implied *consent of both parties* (Cole, *Ejectment*, as cited in *Williams & Rhodes*).

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