NEWS Release

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Why Offset Causes Upset

Landlords' Powerful Hammers

In the common law provinces, if a tenant fails to pay rent when due under its lease, the landlord has multiple remedies, including termination and distraint. These remedies serve as powerful "hammers", since most commercial tenants would prefer to avoid the business disruption resulting from their use. Their self-help nature makes them cost-efficient; no Court order is generally required. While a landlord could seek a Court remedy by suing for the amount owed, most prefer to avoid the expense in a strong economy where demand is constant. Much better to wield the hammer.

Tenants' Weak Hammer

By contrast, if a landlord fails to pay its tenant an amount due under a lease, the tenant has little recourse. As a general statement of common law, when a landlord fails to pay an amount it owes to the tenant, the tenant cannot terminate and it cannot disrupt the landlord's business without Court intervention. The tenant can sue for the amount, but litigation is expensive and unpredictable. Some tenants have the foresight and strength to successfully negotiate a specific right of offset into their lease. Without that right, however, there is a hidden gem lying in section 35 of the Commercial Tenancies Act. That section allows the tenant to set off against rent any "debt due" by its landlord. Unfortunately, the meaning of "debt due" generally requires the judicial support of a Court order (that is, the tenant cannot just make a claim and advance into offset mode). Yet the right remains valuable to tenants, even as a weak hammer, because some tenants take the risky position that a debt is due even without a Court judgment. They offset rent on their mere allegation of a debt due and, in the right circumstances, they find that their landlord is reluctant to counter their position.

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Many tenants successfully negotiate "boilerplate" rent abatement terms in their leases, which apply if certain events occur (for example, damage and destruction, cessation of utilities, interference with access). Most of these do not arise in the context of a default by the landlord; they presume that the landlord will cover the rent abatement through insurance proceeds.

The Mortgagee's Influence

Landlords and their lenders despise all tenants' rights of abatement and set-off. Most commercial lease forms require the tenant to pay rent "without deduction, abatement or set-off" *and* expressly state that the tenant waives its statutory or legal rights to abatement or set-off (including the right under section 35). Commercial property lenders will typically stipulate in their loan documents that all leases must contain these terms. In Canada, the vast majority of tenants concede these terms of their leases during lease negotiations. It is noteworthy that foreign tenants are far less accepting of it. Why so? There seems to be a widespread acceptance in the Canadian business community that commercial property lenders simply will not finance properties where there is any risk of set-off. This is less commonly the case on American soil, where lenders' status is not as exalted as in Canada. By and large, Canadian tenants seem to accept that a lender needs the right to seize the property and collect the rents, so a landlord is a boxed-in borrower who must extract a waiver of set-off from its tenants or risk lack of financeability.

Exercising the Set-off Right

Lawyers are routinely consulted with the question, "Can I withhold my rent?". Most tenants think better of it when reminded that they agreed not to in their lease and that they might face termination or distraint for failure to pay rent if they do. Then they consider litigating and are irked to be reminded that even if they obtain judgment, they are bound by their lease not to exercise the right of set-off.

473807 Ontario Ltd. V. TDL Group Ltd.

Recently, a decision of the Ontario Superior Court of Justice brought the issue of set-off into sharp focus. A strong tenant, The TDL Group Ltd. (o/a "Tim Hortons"), successfully sued its unsophisticated landlord over site plan infractions and was awarded damages of almost $700,000. The damages consisted of substantial legal costs, as the case was appealed to the Court of Appeal. The lease clearly required the landlord to indemnify the tenant for expenses arising from a breach of the landlord's covenants, but the scale of the costs was a remarkable $644,000. The Court stipulated that the tenant could set-off the entire damage award against rent due to the landlord (who was acknowledged in the judgment as "the landlord from hell"). The tenant would have been happier with a payment from the landlord but at least it obtained the right to set-off. The ability to recover legal expenses was especially sweet.

Unfortunately, the matter did not end there. Trouble brewed when the landlord defaulted under its mortgage. The mortgagee instituted power of sale proceedings and asked the tenant to pay (attorn) rents to it as landlord. The tenant and mortgagee had previously executed a postponement and non-disturbance agreement ("PNDA") in which the tenant had committed to attorning in these very circumstances. The tenant attorned, but in doing so sought to continue offsetting rent, on the basis that the mortgagee was bound to honour the state of the rental account as it existed when the rents were attorned.

Unfortunately, the PNDA did not contain a term addressing whether the tenant could avail itself of the set-off. The mortgagee went to Court to obtain a declaration that the tenant owed the full rent to the mortgagee without any set-off. The Court held in favour of the mortgagee. It found that the tenant's Court-ordered right of set-off against the landlord did not extend to the mortgagee as the PNDA did not so provide, and the tenant's attornment to the mortgagee created a fresh tenancy between parties without regard to the state of receivables as between the tenant and the landlord. The decision is being appealed.

Allowances/Inducements

Commercial leases often include payment by the landlord to the tenant of an allowance or inducement, as consideration for entering into the lease. If the payment is not secured (by a letter of credit or monies in trust, for instance), a strong tenant will obtain the landlord's agreement to allow a right of offset. The Tim Hortons case highlights the importance of taking this a step further. The tenant should extract a promise from the landlord's mortgagee that in consideration for the agreement to attorn, the mortgagee will respect any right of set-off available to the tenant under the lease or at law. While this may seem blasphemous to those who hold lenders in such high esteem as to believe they should never be expected to bear a risk, the question devolves to a simple one of who, as between two "innocents" (the unpaid tenant vs. the unpaid lender), should bear the risk of the landlord's failure to perform. The lender holds security. Typically, the tenant does not, nor do many tenants have the clout to obtain it from their landlords.

Moral of the Story

The right of offset can be very valuable. If the right is obtained, depending on the integrity of the landlord, it may also become important to have ensured that the mortgagee will honour it. Tenants, "CYA" – cover your allowances!

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