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RealEstateBrief

Summer 2006

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In our first article, Celia Hitch considers how a number of recent and potential catastrophic events would be dealt with in a typical commercial lease. Celia recently joined the Toronto Real Estate Group as counsel after nearly 20 years of experience as senior in-house corporate counsel in the real estate industry.

Our second article by Damon Chisholm reminds landlords that the actions taken when a tenant defaults on its lease may have an impact on the extent of damages that may be claimed for that default. Specifically, if proper notices are not given the landlord may have its monetary claim severely limited.

For other articles and comments on leasing and other real estate issues please visit our blog at lawoftheland.blogs.com.

Hurricanes, Terrorists, Pandemics and *Force Majeure*: Have You Looked at Your Lease Lately?

Introduction

The damage and destruction provisions of a lease are often overlooked or lightly negotiated. There are exceptions – such as tenants who are leasing premises – which are unique, for instance, by virtue of their location or because there are no contiguous premises of the same size available for lease in the immediate area. For the most part, however, Canadian landlords decline to discuss this topic by noting that, except for one roof collapse in Newfoundland in the 1980s, there has never been an event of catastrophic damage in Canada.

The Changing Landscape

After 9/11, however, many property owners and tenants, especially in downtown office towers, started to think more critically about the "what if's" of a terrorism strike on their building. Damage from acts of terrorism – previously not excluded from most Canadian "all risks" insurance – was suddenly excluded. Coverage for terrorism could be purchased separately, for significant premiums.

Regardless of its initial cost, many building owners – especially in downtown properties – purchased terrorism coverage, charged the cost through to their tenants and moved on. Many tenants grumbled about the increase in their operating costs as a result of a sharp spike in insurance rates, which in Ontario happened to coincide with substantial increases in hydro rates, but became accustomed to this new reality and moved on.

Then, Hurricane Katrina hit the coast of the United States and even those parts of New Orleans which were spared by the hurricane were once more at risk a few days later when the levees broke.

Many Canadians, though, see these events as American issues, not something that they have yet incorporated into their business agendas. Alternatively, they see these as "one off" events, like the SARS outbreak in Toronto a few years ago or the Quebec ice storm; something that you soldier through but not something that needs to be incorporated into companies' long range planning. Those who have considered this have

probably created disaster recovery plans which deal with the elements required for them to carry on business elsewhere if their usual location is suddenly unavailable to them.

Impact on Leases

Canadian landlords and tenants who have not considered what this means in their lease context, though, may not yet have thoroughly assessed what lessons 9/11 and Katrina may have for us.

I recently participated as a panelist at a conference at Georgetown University in Washington D.C. where we had an open discussion about exactly these issues with about 80 senior U.S. attorneys, all of whom specialize in commercial leasing. It is clear that, for many American tenants and landlords, a thorough assessment is underway. It is also clear that many lawyers are finding a patchwork of provisions in leases which do not always add up to their desired outcome for these kinds of situations.

A Few "What If's"

Consider these possibilities:

- there is no event of damage or destruction; instead, there is a pandemic. The military has blocked access to the downtown core, so that no one can use their space or retrieve their possessions from it. If you are the landlord, can you still collect rent? If you are the tenant, do you still have to pay rent? Does it make any difference if the closure is because of a hurricane or a terrorist act, not a pandemic?
- the building is undamaged except for a few broken windows but there is no hydro or water service to the building, so it has been closed by health authorities until essential services can be restored. To enforce the closure, the access road has concrete barricades across it. Do the rent obligations continue, even though the tenants cannot get into their premises? What does "unusable" mean?
- the shopping centre is undamaged but there is no hydro service. Humidity, though, is a real concern, as there is no way that fans can run to circulate air without hydro. The owner has agreed in its standard lease to remove any mould which is found as soon as it is discovered. Mould is spreading down the length of the common areas but, even if the owner can find someone who can remove the mould, it will continue to grow in the absence of normal air circulation. Given the landlord's lease obligation, what should it realistically be doing? Given that the building owner is unlikely to be able to fix the mould problem in the short term, does the tenant have an unexpected "out" card?

Like all questions where a lease is in effect, the starting point is to look to the lease itself.

Does "Force Majeure" Help?

Most leases contain a provision which says that, in the event of "force majeure" (acts of God, strikes, etc.), the time period for performing obligations under the lease will be extended by the number of days during which the event of force majeure is in existence. Most leases carve out an exception for rent, though, and clearly state that the obligation to pay rent will be unaffected by any event of force majeure.

Will Insurance Respond?

For tenants and owners with damaged premises and properties, the answer is probably most clear. The lease probably requires the tenant and the landlord to carry various types of insurance which will fund the reconstruction of the building and leasehold improvements and ensure that the rent is paid and the owner's income stream remains intact. In the Hurricane Katrina example, though, some insurers are examining the cause of the damage itself very closely. Their position is that since insurance exists to compensate people for damage that occurs due to unforeseeable events – and a hurricane is unforeseeable – they will compensate an insured party for hurricane damage to the extent that the policy requires the insurer to compensate the insured for damage from unforeseen risk. Damage caused by flooding when the levees broke, however, according to many American insurers, is foreseeable damage and they are declining to pay out those claims. In some cases, the total damage may result from a combination of both causes and lengthy periods of time will pass while the parties dispute how much relates to one cause and how much to the other.

The first significant court decision dealing with insurance claims made in the aftermath of 9/11 was released only in the last year. It will be a long time before any Katrina claims which are to be litigated find their way through the court system.

What If There's No Damage?

The more subtle scenario, though, of a tenant unable to access its premises to carry on its business in its virtually undamaged premises, may not be something that the tenant's insurance is required to respond to. There is no relief for the tenant in the damage and destruction sections of the lease, because there has been no significant damage to either the premises or

the building. Many leases simply do not contemplate an event which would leave the tenant dispossessed for an extended period of time.

On the flip side, almost all retail leases in regional shopping centres require tenants to be open and conducting their business in their premises on a continuous basis. The wording of the force majeure clause will be meaningful, as it may be relevant to whether the tenant's obligation to operate is suspended.

And what if the tenant, which knows it will be out of possession for 12 to 18 months, wants to open up another store while this one is being restored in a location which is within the radius restriction imposed in its existing lease? Will that radius restriction stand?

Conclusion

What does all this mean to prudent Canadian landlords and tenants? If you have not already seen these events as a wake-up call to reassess your master lease and policies in an effort to avoid some of these quagmires, perhaps the best takeaway is to make sure that all the jigsaw pieces of the lease fit before it is necessary to confirm your rights for real!

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Actions to Avoid When a Tenant Defaults Upon a Lease

Introduction

In situations where a tenant has breached its lease for failure to pay rent, the natural reaction of many landlords is to change the locks or erect hoarding across the property in order to preserve the remaining assets and prevent the tenant from causing any damage. However, this action can lead to limitations in what options the landlord can then take in order to recover its damages.

Breach by Tenant

When a tenant breaches a lease a landlord has four mutually exclusive options at its disposal, as set out in the leading case of *Highway Properties Ltd.* v. *Kelly Douglas & Co. Ltd.* (1971), 71 DLR (3d) 710:

1. Do nothing to alter the relationship with the tenant but insist on performance with the terms of the lease and sue for rent or damages on the grounds that the lease is still in force;
2. Terminate the lease and retain the right to sue for rent accrued due or for damages to the date of termination for previous breaches of the lease;
3. Advise the tenant that the property will be re-leased on the tenant's account and enter into possession as agent of the tenant for that purpose; or
4. Terminate the lease but notify the defaulting tenant that damages will be claimed for the present value of the unpaid future rent for the unexpired period of the lease less the actual rental value for that period.

All but the first alternative involve entering into possession of the premises. The landlord must be careful in how it does this. Generally, when a landlord changes the locks or erects hoarding across the property after the tenant has breached the terms of the lease, this action will be viewed by the courts as terminating the lease. The landlord would be deemed to have elected the second *Highway Properties* option and only be able to claim for damages up to the date of termination. The landlord will have unknowingly given up its right to claim damages for the unpaid future rent.

In *Fuda et al.* v. *DiAngelo et al.* (1974) 43 DLR (3d) 645 the Ontario courts held that:

> Where, upon the default of a tenant, a landlord takes possession of the premises, changes the lock and attempts to sell the business of the tenant as a going concern, the landlord will be deemed to have elected to terminate the lease.

Some Examples

In *Langley Crossing Shopping Centre* v. *North-West Produce Ltd.* [2000] BCJ No. 258, the British Columbia Court of Appeal held that the mutually exclusive nature of the *Highway Properties* options means that if a landlord fails to clearly notify a tenant of their election, it may be barred from clarifying its choice or making a re-election at a later date.

In the *Langley Crossing* case, the landlord changed the locks of the premises and subsequently sent notices (within one to two months after changing the locks) that it intended to hold the tenant responsible for all damages for the balance of the term of the lease. The trial decision held that the subsequent notices were sufficient under *Highway Properties* to

allow the landlord to collect future losses. In allowing the appeal, the Court of Appeal held that the changing of the locks amounted to an election to terminate the lease and that the landlord was limited to damages up to the date of termination. The Court of Appeal stated that notice of its election should be given either before or "contemporaneously with the termination." The Court of Appeal did, however, state that notice can be given after termination, but that this usually must be on the basis that the tenant "walked out" on the lease so that it was not possible for the landlord to give notice of the election before termination.

In *Commercial Credit Corp. Ltd.* v. *Harry D. Shield Ltd. et al.* (1980) 29 OR (2d) 106, an Ontario decision, the court held that where a tenant disclaims the lease and the landlord accepts the keys to the premises as they are concerned about the security of the property, there will be no forfeiture and no surrender of the lease if the landlord notifies the tenant that the lease remains in full force. It was stated that such notice must be given in a timely matter.

In *North Bay T.V. Audio Ltd.* v. *Nova Electronics Ltd.* (1983), 44 OR (2d) 342, affirmed 47 OR (2d) 588 (ON CA) the court found that the tenant had repudiated the lease and that the landlord had elected to terminate the lease by changing the locks, thereby preventing the tenants from having access to the premises. The court went on to state:

> Although such notice [of its intention to proceed against the tenant for prospective damages] must be given, I do not read the decision in Highway Properties (and the subsequent cases which consider it) as requiring that such notice be given contemporaneously with the taking of possession by the landlord…

On the endorsement dismissing the appeal, the Ontario Court of Appeal held:

> We agree with the disposition of this case by Rutherford J. and more particularly with his conclusion that notice of intention to claim damages for prospective loss of rent need not be given contemporaneously with the termination of tenancy and that the notice given by the commencement of proceedings was sufficient to found the claim for damages in this case. [the Writ in this case was issued one month after the termination of the lease by changing the locks.]

This decision differs in its view of when notice must be given from *Langley Crossing Shopping*. In order to succeed in arguing that a landlord is entitled to future damages under the lease if the keys were taken or hoarding erected, a landlord must be able to distinguish *Langley Crossing Shopping* on the basis that the tenant "walked out" on the lease so that it was not possible for the landlord to give notice of the election before termination, and, as such, the reasoning in *North Bay T.V. Audio* should apply.

Conclusion

In order to preserve its ability to pursue a defaulting tenant for prospective damages under a lease, a landlord should immediately advise the tenant, in writing, that it has accepted the tenant's repudiation of the lease and that it intends to hold the tenant liable for prospective damages under the lease. This notice should be given prior to taking any action to enter or secure the premises.

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Publication Mail Agreement Number 40007871

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