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Rent Abatement in Commercial Leases

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EXECUTIVE SUMMARY

The word “abatement” when used in the context of “rent” ranks second among the seven deadly words a landlord does not want to hear in a lease negotiation. The others are “termination”, “set-off”, “allowance”, “reimbursement”, “self-help” and “the-landlord-shall”. Accordingly, the negotiation of express rights of abatement for tenants in commercial, industrial and retail leases can be a difficult task.²

This paper will canvas: five categories of circumstances in which rent abatement is relevant; drafting considerations for abatement clauses; availability of insurance; and the impact of insurance on the negotiation of abatement rights. We also review whether the circumstances give rise to common law or statutory rights of abatement.

This paper is written for lawyers and people engaged in drafting offers to lease and leases for retail, office, specialty and industrial premises in Ontario, Canada.³

INTRODUCTION

A recently negotiated lease of retail premises in a large regional shopping centre contained more than 45,000 words. That is about the same number of words as Ray Bradbury’s famous

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² This is the second article in the “Seven Deadly Words” series. The first was “Tenant Termination Rights,” presented by Dennis Tobin and Michael Gilbert of Blaney McMurtry LLP at the Six-Minute Commercial Leasing Lawyer seminar in 2015. The article is available at http://www.blaney.com/files/16085_Tenant_Termination_Rights.pdf.

³ This article is not intended to provide legal or insurance advice and no legal or business decisions should be based upon it. If you have questions about the content of this article please call Dennis Tobin or your regular Blaney McMurtry lawyer.

book *Fahrenheit 451*, a classic science fiction book obviously very different from a lease, if only because most leases are something of a mystery.

The following are some simple statistics derived from the above noted sample lease that illustrate the rarity of abatement rights. Leasing professionals will not be surprised to learn that buried in those 45,000 words were only 20 references to variations of the word “abate.” Of those 20 references, 18 appeared in the body of the lease and deal with 6 different scenarios.

Our conclusion is that the occurrences of abatement rights in commercial leases are rare even in the case where the landlord and the tenant have relatively equal negotiating power.

WHAT IS RENT ABATEMENT AND WHEN IS IT APPROPRIATE?

Let’s put the discussion of abatement in context.

“Abatement” of rent in a lease negotiation means the right or process of reducing the rent in certain circumstances. It is an agreed reduction not requiring the awarding and calculation of damages.

Abatement can be confused with “set-off”. Where abatement is a reduction of the agreed rental amount, set-off is where you seek to withhold specified amounts from an otherwise agreed rental amount, for example where the tenant has suffered damages for breach of the lease by the landlord.

Abatement is only one of many remedies. The fact that we discuss abatement as a remedy in the particular circumstances listed below does not mean it is the best remedy or the only remedy. From a tenant’s point of view, it is usually best to draft your remedies so that you can claim other remedies as well.

Abatement of rent is a way to reduce rental expense for a period of time in certain circumstances but often the better remedy is a claim for a loss of revenue or profit. Very often the tenant is interested in recovering the lost profits and the right to abate rent is “nice to

have". Since the rent paid by the tenant is the landlord's revenue, ensuring the rent continues to be paid is very important from the landlord's perspective.

If the tenant or the landlord has business interruption insurance then there are fewer circumstances requiring abatement of rent. Business interruption insurance insures against the possibility that a loss prevents the business from operating and earning income at its pre-loss level. This can be purchased by the tenant and the landlord for their own interests. A tenant's policy may provide for the payment of rent during a period of interruption, thereby protecting the landlord's interest, however the landlord should still have contingent coverage in the event the tenant's policy does not respond. It may take a while to repair the damage and if that time period is longer than the coverage period under the business interruption insurance then perhaps abatement of rent can be triggered by the expiry of the insurance.

If the risk is insurable then the parties are trying to cover off the exclusions and those elements of the risk which are not insurable. The best way to do that is to be informed as to what type of insurance is available and what exclusions apply. Speak to an insurance broker about these issues.

"Waiver of subrogation" is a common issue in commercial leases. Including a waiver of subrogation or a mutual waiver of subrogation is good for a number of reasons: the recovery from the insurance company is final; there is no delay in the payout by reason of the need to determine fault; and it avoids a subrogated claim. This means that no claim is commenced in the name of the landlord or the tenant, as the case may be, against the other which could involve unpleasant examinations and discoveries involving employees of both parties. An explicit contractual waiver or release included in the lease will bind the insurance companies in many cases.

In some circumstances both the landlord and the tenant arrange insurance. This is because the tenant may not be able to make the ultimate payment notwithstanding they received the payout from the insurance company, or the tenant may go out of business or become bankrupt.¹ The tenant will usually argue for a right of abatement and ask the landlord to

arrange business interruption insurance. If the tenant is required to arrange business interruption insurance it may not want to contribute to the cost of the landlord's business interruption insurance.

Tenants often complain that regardless of which party carries the insurance the tenant pays for it. The tenant pays directly for its own insurance and the tenant pays for the insurance arranged by the landlord through its contributions to its proportionate share of operating costs. If properly arranged, one policy can be excess coverage to the other policy with the goal that you can overlap coverage but not have to overlap premiums. In some circumstances, both the landlord and the tenant will carry insurance. This is prudent if you are concerned that throughout the term of the lease one or both parties may not maintain the insurance as required under the lease or if there is a chance the coverage limits are not sufficient.

Parties to a lease should assume that there is no natural "right of abatement" or right to reduce the rent. The right to abatement arises from what you negotiate and include in writing in the lease, from statute and possibly the common law (in the case of eviction and the breach of the landlord's covenant of quiet enjoyment).

DRAFTING ABATEMENT CLAUSES

Some of the considerations to keep in mind when drafting the abatement clause include the following:

- (a) The party who wants to enforce the right to abate the rent should draft the clause. You are more motivated to get it right.
- (b) Clearly define what triggers the abatement right.
- (c) The period of the abatement needs to have a clearly defined beginning and end. Specify when it is triggered and what constitutes the end of the abatement period.
- (d) Specify how the abatement it is to be calculated. Proportionate abatement is common and is based on the proportion of the leased premises rendered unusable

by the tenant. Refer to the definition of the leased premises and consider if it is appropriate. The use interrupted may relate to parking or common areas as well as space within an office, store or industrial plant.

- (e) Specify which elements of the rent abate and consider minimum rent, operating costs, taxes, insurance, and percentage rent. All elements of the rent may not be appropriately abated in the particular circumstance. For instance, if the tenant is still operating in some of the premises you would not want to abate utilities.
- (f) At some points of time during the lease term the tenant pays no rent or a reduced rent. Fixturing periods and free rent periods are examples. If the abatement period falls within one of these periods of time then abating a rent that is already reduced may not be what you want. Consider including the right to apply the period of the abatement to a later period of the term when the tenant would otherwise pay full rent.
- (g) Take into account the insurance that is available. The tenant may not want both an abatement right and have business interruption insurance. If the tenant or the landlord has business interruption insurance then there are fewer circumstances requiring abatement of rent. If the tenant is entitled to abatement of rent then the insurer will not want to reimburse the tenant for the rental expense, taking the position that the tenant must exercise its abatement rights as mitigation of the losses. It may take a while to repair the damage and if that time period is longer than the coverage period under the business interruption insurance then perhaps abatement of rent can be triggered by the expiry of the insurance. Also, abatement may be appropriate to cover a deductible or waiting period under the coverage.

What are the circumstances where a tenant and landlord may negotiate or expect an abatement of the rent?

1. **It's only fair.**

Here we are talking about circumstances where something has occurred and there is agreement contained in the lease.

One thing that cannot be avoided is people have a moral sense of right and wrong. If one party has caused damage to another party by their actions there is an expectation that the offending party will pay for that damage. This sense of fairness extends to all parts of the negotiation including how tenants feel about paying rent in circumstances where they are not getting the full use of the premises.

(a) **Changes to the site plan, the common areas, the parking or the loading dock.**

Leases are often explicit about the landlord's right to make whatever changes they like to the project. The lease often defines the project, shopping center or building as the buildings and facilities as they currently exist or might in the future be altered. As a result, the lease is silent as to any remedy in the event the landlord decides to or is required to make changes. The most obvious circumstance that comes to mind concerns separate standalone sites in shopping centers where there are drive-through businesses such as coffee shops and fast food restaurants. Visibility, access and driving patterns are key to the success of such locations and permanent changes to the physical layout of the site after the tenant has taken possession will often result in direct damages to the tenant's business. The appropriate remedy may be a general prohibition against making such changes but abatement of rent may be appropriate in the circumstance where the landlord must make the changes for some reason or is entitled to and elects to do so over the tenant's objection.

(b) **Maintenance, repair, replacements made by the landlord which may include the leased premises.**

This circumstance would include the erection by the landlord of scaffolding and other obstructions which may negatively impact the visibility of the premises or the signage as well as temporary restrictions on the use of parking and loading facilities. Consideration should also be given to the time of year that these

types of things might occur and the retail tenant will want to avoid not only the obligation to pay rent but also the loss of revenue over the busy holiday season. An example of where this may become an issue is where the Landlord reserves the right (or the lease is silent) to restrict access to some or all of the parking lot for any number of reasons including seasonal displays and garden centres operated in the common areas and parking lots by other tenants.

The standard language found in many leases provides the landlord with the right to make alterations to the “lands”, “shopping center”, “building” and the “project”, all of which definitions usually include the leased premises.

In many cases, the Landlord has no choice but to do the work as a result of its obligation to maintain, repair and replace the project. If the tenant does not include a restriction on the landlord’s alteration rights and obligations to maintain, repair and replace, the tenant could find itself with less than it bargained for and paying full rent in circumstances where the business revenue is disrupted. The fact that the landlord must do the work does not rule out the possibility of abatement. They are not mutually exclusive. In these circumstances, other remedies that might be considered would be the right to cease to carry on business and after a certain period of time to terminate the lease.

(c) **Other access issues.** In buildings with multiple levels, the inability to access the upper floors as a result of maintenance and repair, damage, destruction or the failure of elevators and escalators could cause quite a problem for the tenant. This is another circumstance where, if the tenant and their counsel think about it, their assumption would be that there is elevator service to all of the floors in the building at all times save and except on a temporary basis as a result of an emergency or regular maintenance. If you don’t put it in the lease, you don’t get it.

(d) **Failure of the landlord to maintain, repair and/or replace some or all of the premises, the common areas and facilities.** Abatement of rent could be negotiated in

this circumstance depending on the level of interference with the tenant's use of the leased premises. This is a difficult circumstance because, if the tenant does not have a self-help right, it has no effective remedy other than to sue the landlord. Even if the tenant has the right to remedy a circumstance created by the landlord's failure to maintain, repair or replace, the self-help right is usually limited to fixing defects exclusively in the leased premises.

(e) **Acts of the landlord amounting to an eviction.** Tenants are bound to pay rent for the entire term of the lease, without abatement, set-off or suspension, unless there is an agreement to the contrary, or acts of the landlord amounting to an eviction occur.² Acts amounting to an eviction are acts of a "grave and permanent character done by the landlord with the intention of depriving the tenant of the enjoyment of the demised premises".³

(f) **Breach of the covenant of quiet enjoyment.** Courts have previously awarded rent abatement where the tenant has established that the landlord has breached the covenant of quiet enjoyment. In order to establish a breach of the covenant of quiet enjoyment, the tenant must show that the ordinary and lawful enjoyment of the demised premises is substantially interfered with by the acts of the landlord. The interference must be of a grave and permanent nature, and must constitute a serious interference with the tenant's exercise of its right of possession.⁴

DMX Plastics Ltd v Misco Holdings Inc illustrates the factors taken into account by the Courts in such a situation.⁵ DMX leased a commercial property from Misco for a 10 year term to use for processing polyethylene products, producing drainage products and recycling plastics. The roof of the premises had recurring leaking problems, which the landlord had chosen to fix by patching, contrary to expert advice indicating that the roof had to be replaced in its entirety.⁶

At one point the roof started leaking so severely that it looked as if it was raining indoors. The tenant felt that it was not safe for his staff to continue work on the

premises and decided to shut down operations. The Ministry of Labour issued a stop work order.⁷

The Court found that the landlord breached the covenant of quiet enjoyment. The ongoing leaks in the roof caused a serious and substantial interference with the tenant's use and enjoyment of the premises, and had a significant impact on the tenant's ability to carry on its business. The landlord failed to remedy its breach, causing the tenant to move from one part of the building to another at great expense. The tenant was entitled to an abatement of rent of 50% for the relevant time period.⁸

In determining the actual abatement amount, the Court noted that "there is no magic formula." Relevant factors include the amount of rent, the age and general condition of the premises, the nature and degree of non-repair and its duration, efforts of the landlord to inspect, the co-operation or otherwise of the tenant in that regard, and the efforts made by the landlord to rectify the defect.⁹

Other decisions suggest that the landlord's covenant of quiet enjoyment may also be breached when a tenant's right to quiet enjoyment of the premises is substantially interfered with by another tenant. In *MNT Holdings Ltd v Bellano Ceramic Tile Co*,¹⁰ the tenant was entitled to rent abatement for two months because they were not able to enjoy the benefit they were entitled to expect in return for the payment of rent as a result of a neighbouring subletting tenant.¹¹ The neighbouring tenant used the premises as a construction site for movie sets and caused constant noise, dust and odour.¹² The Court held that the landlord was obliged to consider whether the proposed new tenants would represent a substantial interference with the tenant's right of quiet enjoyment of the premises. The landlord gave little or no consideration to the issue when they agreed to sublease the premises.¹³

2. **If we had thought about it, it would have been part of the deal.**

It is always a challenge to limit the detail in a commercial lease. The parties rarely have the patience or the money to negotiate every possible situation. We have to consider how parties

to a lease think about the negotiation. After they have dealt with location, the next thing they direct their minds to is the rent. As you work your way through the lease everything relates back to the rent. After all, the amount of rent that is paid is based upon the suitability of the location for the particular purpose. Abatement is a bit of a misnomer. It is not really a reduction in rent so much as a determination as to what the appropriate rent is in the circumstances. This is an important distinction when you are negotiating or interpreting the lease. Landlords will often resort to the claim that an abatement of rent is in fact a penalty and should not be enforced as a matter of law. However, if it is expressly stated not to be a penalty or is stated as an alternative rent then the interpretation of the lease should give rise to the true intent of the parties which is to have the tenant pay different rental amounts in different circumstances.¹⁴

(a) **Co-tenancy requirements.** Co-tenancy provisions in a lease provide that if the occupancy levels in the project fall below certain levels, then there should be a reduction in rent. This is a situation which calls for the determination of the *appropriate* amount of rent payable by the tenant when the co-tenancy requirement is not met. This is usually drafted as a form of abatement of rent during the period of the co-tenancy requirements failure. In truth, it is alternative rental rates for different occupancy levels in the project.

(b) **Landlord does not complete its work.** If asked, the tenant would probably conclude that it should not pay rent until all of the covenants of the landlord respecting renovation and the landlord's work in the premises and the project are completed. Often there is a discussion about whether to use "substantial completion" rather than "complete in all respects" before the abatement right is triggered. However, there are probably certain absolutely necessary elements of the landlord's work which, if they are not completed, will have a substantial negative impact on the tenant's ability to commence its own work or use the leased premises to its full advantage. Examples could include where the landlord is installing an elevator but the elevator installation is not complete when the tenant is supposed to begin its work. In that circumstance, the

tenant's contractors may not be able to access the premises. Sometimes negotiations for landlord's work extend beyond the leased premises and include renovations of common areas such as the building lobby, the parking, the elevators and the hallways in accordance with agreed plans. If this additional work to the common area is not also completed by an agreed date then an abatement may be appropriate and later a claim for damages can be added.

(c) **Damage and destruction.** Absent an agreement to the contrary, damage or destruction of the premises does not give rise to the right to an abatement of rent unless the lease is created under the *Short Form of Leases Act* (discussed below). Leases often contain a clause that stipulates that in the event of destruction or significant damage to the premises, rent will abate for the time period for which the premises are not usable by the tenant.

Damage and destruction is the one circumstance where the parties would expect to have insurance. The insurance considerations elsewhere in this article impact whether or not you also negotiate abatement of rent.

(d) **Environmental contamination.** Abatement of rent may not be a sufficient remedy in circumstances where there is environmental contamination. Very often leases will be drafted to provide that there shall be no remedy in the case of contamination so long as the contaminant is contained in accordance with environmental laws and does not exceed limits allowable for the particular use. However, it may be that by virtue of the nature of the tenant's business, the tenant would not continue to carry on business from some or all of the premises in the particular circumstances. Abatement of rent may be appropriate for the duration of any temporary remediation work. In some cases, it may be that abatement is not the appropriate or sole remedy and that after certain period of time the tenant should be permitted to terminate.

It is not possible to purchase insurance to respond to a loss due to known, pre-existing, environmental conditions. Pollution and contamination exclusions are common in commercial general liability insurance policies and commercial property policies. If pollution or contamination are potential risks on the property, it is prudent to investigate purchasing extensions of coverage for pollution related losses, although it is noted such coverage is often subject to lower limits and significant premiums.

3. **Circumstances created by third parties.**

Certain circumstances in which abatement of rent may be considered are created by third parties. These circumstances include:

(a) **Access restrictions to the project.** If the city adjusts the street access to a retail shopping center or if the loading access from an alley is closed off, the traffic flow and cost of making deliveries for the tenant may be affected rather dramatically. In that context, the value of the premises to the tenant is less. If you anticipate this possibility in the lease, you can negotiate the right to a proportionate abatement.

(b) **Ability to carry on the proposed use or some part of the proposed use.** This is one that comes up more often than you think, especially in industrial commercial settings where the tenant determines that the premises is ideal for all sorts of reasons but it turns out that the premises cannot be used for the proposed use due to by-law and zoning restrictions. In most negotiations, it is buyer beware. However, if the premises are being marketed for the use, it is not unusual or unreasonable for the tenant to ask the landlord to represent that the proposed uses are permitted. It is also prudent for the tenant to make inquiries or instruct their legal counsel to review the permitted uses under the local bylaws. Anticipating future changes, the tenant may negotiate an abatement of rent in the event that some aspect of its use may at a future date be prohibited or restricted.¹⁵

(c) **Expropriation:** This is a clause that most parties do not pay much attention to. However, it is possible that some or all of the shopping center or building is

expropriated. Depending upon the extent of the expropriation and whether or not the leased premises are included, it could have a significant direct or indirect impact on the use of the leased premises.¹⁶ Most expropriation clauses will provide for a proportionate reduction in rent to the extent that the leased premises or a portion of it is included in the expropriation. Consider the case where a tenant was leasing an entire building consisting of approximately 15,000 square feet of office space as well as a rather large parking lot which surrounded the building. The tenant was a trucking company and needed the parking lot for their trucks. How do you determine the proportionate reduction in the circumstance where part of the parking lot is expropriated but the building is left untouched? The tenant may be of the view that the parking lot was just as important, or more important, than the offices because it needed a place to park its trucks. The lease in that case referred only to the impact on area of the office premises for the purposes of determining the proportionate share reduction in rent and it had to be renegotiated.

(d) **The President moves in next door.** Some things are unacceptable, uninsurable, unbelievable and not negotiable. Consider the case of the tenants occupying prime street front locations on Fifth Avenue in New York City in 2016 and 2017 when the candidate for President of the United States decided to set up shop next door. The combination of crowds and security exclusion zones seriously damaged their businesses. If they had thought about it ahead of time, they would have negotiated abatements. This is the type of scenario that takes into account all of the different types of considerations that we are discussing in this paper but is so rare it would not come up.¹⁷

In some cases where there are actions of civil authorities that interfere with the business of the tenant, the tenant can obtain insurance coverage as an extension of its property insurance. However, it usually requires that the order barring access to the property be a direct result of damage to the insured property or neighbouring properties. This coverage usually has a waiting period (3 days is typical) and lasts only for short periods (2 weeks is typical).

4. **Acts of God.**

As they say, we may plan but God has plans of his own. Again, one thing that cannot be avoided is people having a moral sense of right and wrong so that if one party has caused damage to another party by their actions there is an expectation that the offending party will pay for that damage. However, a truly benevolent God treats everybody the same and Acts of God impact the landlord as much as they do the tenant. That is why God-fearing people invented insurance. Therefore, perhaps neither the landlord nor the tenant should be responsible to the other for acts of God and abatement of rent without insurance coverage is not going to be acceptable.

(a) **Fire and other casualties.** This is the most obvious risk and is usually contemplated in all leases. The lease terms will address circumstances where the leased premises or the project are damaged by fire, water, and the weather. In more extreme cases, it may go on to deal with earthquake and other more extreme circumstances which are often excluded in standard commercial property insurance policies and must be purchased separately.

(b) **The failure of utilities.** Do you wonder what would happen to our technological world if the electricity goes out? Without electricity, gas or water many businesses could not carry on. Modern-day definitions of utilities often include fiber-optic cable and access to the Internet. However, very few leases require the landlord to provide utilities as a service as opposed to making utilities supplied by third parties available at the premises. Also, in our experience few leases provide for an abatement of rent in these circumstances. Part of the solution is to arrange property and business interruption insurance against these risks.

(c) **Riots, emergency and civil unrest.** In Toronto we remember the G20 Summit in 2010 and the impact it had on downtown businesses. Not only was a large portion of the downtown fenced off but large crowds did some damage to a number of businesses. For several days retailers' customers were unable to easily access the stores. At a certain point, stores had to be closed for fear of damage being done. SARS had an

impact on tourism in 2004 and coffee shops and other businesses contained within hospitals were closed to everyone except staff and patients. These are all circumstances where the tenant would not want to pay full rent unless insurance covered the expense.

5. **Statutory rights of abatement under the *Short Form of Leases Act*¹⁸**

Some leases are stated to be pursuant to the *Short Form of Leases Act*. If that is the case and the appropriate proviso is included in the lease, then pursuant to Schedule B of the legislation, the following provisions are incorporated into the lease:

Provided, and it is hereby expressly agreed, that in case the premises hereby demised or any part thereof shall, at any time during the said term, be burned down or damaged by fire, lightning or tempest so as to render the same unfit for the purposes of the said lessee, then and so often as the same shall happen, the rent hereby reserved, or a proportionate part thereof, according to the nature and extent of the injuries sustained shall abate, and all or any remedies for recovery of said rent or such proportionate part thereof shall be suspended until the said premises shall have been rebuilt or made fit for the purposes of the said lessee.¹⁹

This provision was addressed in an old Ontario case, *Noble Scott Ltd v Murray*.²⁰ The case is interesting from a couple of perspectives including the reference to the *Short Forms of Leases Act*. The plaintiffs (landlord) demised the third storey of a building, “together with the reasonable use in common with others entitled thereto of the elevator leading to said premises for the purpose of carrying freight only”.

A fire destroyed the elevator and damaged part of the premises and the building generally. The plaintiffs promptly restored the building, but the replacement of the elevator took some time. The plaintiffs entered a contract to replace the elevator without delay, and the work started shortly after and was carried out diligently. The plaintiffs sued for rent arrears, as the defendants had stopped paying rent.

The Court addressed the issue of abatement with reference to the provisions of the *Short Forms of Leases Act* noted above. The lease contained the ordinary short form proviso that in case of fire, rent shall cease until the premises are rebuilt. The Court held that the elevator was not part of the premises demised by the lease. There was no right to abatement of rent on account of the interruption of the service. The defendants were liable for the rent for which the plaintiffs sued.

THE THINGS THAT CAN BE INSURED

Obtaining proper insurance will offset or mitigate many of the losses that might be sustained by landlord or tenant after unanticipated damages to the premises or interruptions to business activities. It may also render unnecessary the need for abatement of rent. The most significant types of insurance:

(a) **Property Insurance** - typically you expect a landlord to insure the building and its improvements; while the tenant insures its own personal property and tenant's improvements. This is a "first party" policy, meaning the insurance company pays the loss directly to the named insured, or to those designated as loss payees. Even where a lease provides that the tenant is to secure whole building insurance the landlord is well-advised to purchase contingent or excess insurance. If a tenant goes bankrupt or fails to pay the premiums, the landlord could be left uninsured. A contingent policy protects against that risk.

(b) **Boiler and Machinery Insurance** – this is a specialized form of property insurance, to address issues like mechanical breakdown in heating or electrical systems. The coverage can be purchased by either tenant or landlord, depending on the circumstances.

(c) **Liability Insurance** - modern terminology is "commercial general liability" or "CGL" insurance, but older precedents still use the terms public liability insurance or comprehensive general liability insurance. The terminology of the CGL is nearly universal in the insurance industry and is the preferred term in lease agreements.

This insurance covers the risk of harm to other people caused by the policyholder's negligence.

(d) **Business Interruption Insurance** - this insures against the possibility that a loss prevents the business from operating and earning income at its pre-loss level. This can (and probably should) be purchased by the tenant and the landlord for their own interests. A tenant's policy may provide for the payment of rent during a period of interruption, thereby protecting the landlord's interest, but the landlord should still have contingent coverage in the event the tenant's policy does not respond.

FEATURES OF BUSINESS INTERRUPTION INSURANCE

Business interruption insurance should form a part of the insurance package for both landlord and tenant. A proper combination of insurance and lease provisions can help ensure the continuation of rent payments in the event of an unexpected loss causing the suspension of the business operations or causing additional expenses to be incurred.

Like first party property insurance, business interruption policies require a connection to a direct physical loss to the described premises. For a tenant, this means some care has to be taken in defining the described premises, in order to avoid arguments that damage to the remainder of the building does not trigger this coverage. A landlord's insurance will typically be net of any recoveries from other sources, such as the tenant actually paying the rent.

The requirement of physical and direct loss to property limits the business interruption coverage. Some things cannot be insured against. For example, neighbouring construction blocking access to the building is not an insurable risk. However, if that construction damages the building, any interruption may be covered.

The importance of both the landlord and tenant having business interruption insurance is demonstrated in a recent Ontario Court of Appeal decision: *2224981 Ontario Inc v Intact Insurance Company*.²¹ In that case a fire largely destroyed the premises. The lease did not provide for an abatement of rent in the circumstances and the tenant simply stopped paying

the rent. The landlord's business interruption insurer was ultimately required to cover the claim for lost rent, rather than the tenant's insurance or the tenant itself, even though the tenant remained under a legal obligation to pay (and actually had some business interruption insurance of its own). The landlord's insurer was required to bear the risk of seeking recovery of the rent from the tenant in a subsequent action. The landlord may not have been made whole had it not purchased its own business interruption insurance.

Common features of business interruption insurance include:

- (a) As noted, there is a requirement for "direct physical loss" at the premises. If the premises cannot be accessed because of a direct, physical loss to a neighbouring property, this coverage may not be triggered (there are optional coverages available to offset this risk).
- (b) The losses can be calculated using various methods: loss of profits; loss of gross revenue; or extra expenses of continuing operations (e.g. payment of standing charges). Loss of profits is typically the most expensive and inclusive coverage.
- (c) Payment is usually subject to a monetary limit as well as a period of indemnity. There may be a waiting period (72 hours is common) and the loss period is usually capped (12 months is common). If the business is of a nature that more than 12 months may be required to restore it after a catastrophic loss, other periods of indemnity can be purchased.

It is possible to purchase contingent business interruption insurance, which protects against the risks of physical damage to neighbouring properties causing harm to the business, even if your own property is not damaged. If a supplier's premises are damaged and this interrupts the flow of critical parts to your manufacturing facility, that risk can be insured. Hurricane Katrina provided many examples of the benefits of this type of insurance.

It is possible to purchase coverage for interruptions caused by civil authorities, arising from physical damage to a neighbouring property. After 9/11, for example, some companies were able to seek insurance recovery for losses sustained when bridges and tunnels were closed and

access to the business was blocked. Since 9/11 this type of coverage has become rarer in the United States. There does not appear to be the same market-driven reduction in this coverage in Canada. Note, however, the requirement for physical damage blocking an access route would not qualify however long the disruption.

SUBROGATION - AN UGLY WORD THAT IS HARD TO SPELL

Put simply, subrogation is the right of an insurance company to sue someone else in your name, seeking to recover the damages the insurance company has had to pay to you. It is the attempt by the insurance company to recover its payments from the at-fault party. In the leasing context, subrogation rights add complexity and confusion. Ideally, the lease should contain contractual indemnities and insurance requirements that extinguish subrogation rights and thereby maximize the efficiency of the insurance policies and reduce premiums for both parties.

The purpose of insurance is to compensate parties for unexpected loss. The purpose of subrogation is to transfer loss from an insurer to another party. That loss transfer component is of no real interest to a landlord or a tenant. The most efficient outcome after a large loss is for each party's insurer to pay their respective losses as quickly as possible, without the need to determine fault. Allocating fault will lead to delays in recovery and future litigation that will harm the landlord and tenant relationship. The provisions of the lease should complement the existence of the insurance coverage, to avoid future claims that will benefit only the insurance companies.

Mutual releases to the extent of insurance proceeds, combined with an explicit waiver of subrogation, will ensure that the insurers are on notice that they are expected to pay the claims promptly and not to devote inappropriate time and attention on seeking to blame the other party to the lease. Obviously, it is important to evaluate the potential size of the risks to make sure adequate limits of insurance are purchased, because any loss that is not covered by insurance would properly be the subject of an action between the parties, unless those are also released.

It is critical to ensure that the lease contains an explicit waiver of subrogation clause. It may not be sufficient to include only a request that the insurance policy contain a waiver of subrogation clause since many insurers will not issue a policy containing such a clause. An explicit contractual waiver will, however, bind the insurance companies.

BUYING THE INSURANCE

Negotiating the insurance provisions in leases is often acrimonious, as each side seeks to rely on its own well-established precedents. Making sure all the parties know who is in the best position to minimize risk, who is expected to bear the risk of loss and what activities are being carried on will smooth the process. The lawyers need to understand and discuss the nature of the businesses involved.

The most economically efficient lease from an insurance perspective is one that designates the insurance responsibility to the party most at risk or most in control of a risk. A stand-alone building may be more appropriately insured by the tenant. In a mall property it is much more important for the landlord to control the property insurance as its interest in the whole is much greater.

As a general rule, it is prudent to keep insurance clauses to what is capable of being achieved in the market. It is better practice to include provisions requiring the parties to demonstrate the existence, and renewal, of the various policies. It is even more important that the parties obtain proof of that insurance every single year.

The acquisition of the insurance is the obligation of the client. In this regard, the client's use of a knowledgeable broker is critical. A broker is in the best position to discuss the risks unique to the company and to find insurance options to best mitigate against those risks. The broker should be made to earn its commission. The lease provisions should be provided to the broker with instructions to acquire coverage that matches or exceeds the requirements.

The common practice is to obtain a Certificate of Insurance as the required proof of insurance under the lease. These are typically prepared by the broker. It is very common for these

certificates to contain errors. Often they will reference only one of the policies. There are different types of certificates for property policies and liability policies. Most importantly, there is case law demonstrating that a Certificate of Insurance is not necessarily evidence the policy has been issued. Most standard form Certificates contain warnings that the certificate is issued for information purposes only and only the actual policy wordings will bind the insurer. An error or omission in a Certificate can result in loss of coverage. It is strongly recommended that copies of actual Declarations pages and policy wordings be acquired prior to the lease effective date.

OTHER CONSIDERATIONS: MORTGAGEES AND PURCHASERS

You must always consider the impact of what is negotiated in the lease from the perspective of mortgagees and future purchasers of the project. Mortgagees are very concerned with any provisions of a lease which could result in the amount of rent being reduced. The revenue generated from the lease will have an impact on the amount of a mortgage. If there is a chance (like the circumstance where you may negotiate an abatement clause) the rent will be reduced at some time in the future, the mortgagee may discount the value of the rent which can be collected. Similarly, a proposed purchaser of the project will seek a discount to market price if there are terms permitting an abatement or reduction of the rent.

The risk of abatement clauses impacting the mortgage or the sale price of the project can be mitigated with the appropriate insurance coverage and the requirement in the lease that any abatement or reduction in rent is subject to the landlord receiving the insurance proceeds.

WHAT IS A COMMERCIAL LEASING LAWYER'S RESPONSIBILITY REGARDING INSURANCE?

Commercial leasing lawyers should ask their clients to have the lease provisions that have been negotiated between the landlord and tenant reviewed by the client's insurance broker. Particular emphasis should be placed on (but not limited to) provisions dealing with insurance, damage and destruction, abatement, and mutual releases and indemnities. The insurance broker is going to be familiar with the business of the landlord or tenant, as the case may be, where the risk to their business is and which of the risks can be reasonably insured for. The

landlord or tenant can then be offered the range of insurance options that meet both their business needs and their obligations under the lease.

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Appendix - Endnotes

¹ This is what happened in *2224981 Ontario Inc v Intact Insurance Company*, 2016 ONCA 870.

² Rose H McConnell, *Ontario Real Estate Law Guide*, vol 3 (Toronto: LexisNexis Canada, 2015) at 53,735.

³ See *Winfield Developments Ltd v JER Associates Inc*, 36 Man R (2d) 301, 36 ACWS (2d) 310 (QB) (where the landlord's failure to provide adequate air conditioning did not justify unilateral withholding of rent, paras 25, 28); *Cross v Piggott* (1922), 69 DLR 107 (Man KB) (where, in the context of a residential tenancy, heating issues did not constitute an eviction, as on each occasion when complaint was made of insufficient heat the default was promptly remedied, paras 11 and 13); *Marvin Investments Ltd v Manitoba*, 2001 MBCA 133.

⁴ *Firth v B.D. Management Ltd* (1990), 73 DLR (4th) 375, 23 ACWS (3d) 208 (BCCA) at para 16.

⁵ *DMX Plastics Ltd v Misco Holdings Inc*, (2008) 172 ACWS (3d) 212, 76 RPR (4th) 300 (Ont Sup Ct J) [*DMX Plastics*]. For a similar fact scenario also resulting in rent abatement, see *A Woessner Construction Co v Pacific Group Displays Ltd*, 2014 ABPC 13, 239 ACWS (3d) 759.

⁶ *DMX Plastics*, *supra* note 5 at paras 13-18, 73.

⁷ *Ibid* at para 18.

⁸ *Ibid* at paras 75, 82.

⁹ *Ibid* at para 82.

¹⁰ 2002 BCPC 81 [*MNT Holdings*]; See also *Albamor Construction & Engineering Inc v Simone* (1995), 56 ACWS (3d) 759 (Ont Ct J (Gen Div)).

¹¹ *MNT Holdings*, *supra* note 10 at para 21.

¹² *Ibid* at para 6.

¹³ *Ibid* at para 17.

¹⁴ See, for example, *Calloway REIT (Westgate) Inc v Michaels of Canada ULC* (2009), 175 ACWS (3d) 553 (Ont Sup Ct J). One of the issues in the case was the enforceability of two articles in the lease. One of the articles provided for liquidated damages in case the actual completion date of buildings in the shopping centre was after the contemplated completion date. The other article provided for liquidated damages in the form of an abatement of rent. At paras 84-89, the Court outlined the common law and equitable principles on whether a provision in an agreement constitutes a penalty. At common law, if the stipulated remedy represents a genuine attempt to estimate the damages that the innocent party would suffer in the event of a breach, it will be enforced. If it is extravagant and unconscionable in amount in comparison with the greatest loss that could be proved to have followed from the breach, it is a penalty. Equity also requires that the sum forfeited be out of all proportion to the damage. However, equity focuses on the time of the breach rather than the time the contract was entered into and considers whether it is unconscionable for the innocent party to retain the money forfeited. The Court held that the two articles were not penalties.

¹⁵ Although not abatement cases, a number of decisions illustrate the importance of considering the ability to carry out the proposed use. *Canadian Medical Laboratories Ltd v Stabile* (1997), 69 ACWS (3d) 367 (Ont CA) is one such case. The tenant brought an action for rescission of the 10-year lease it had entered. The use clause in the lease provided for use of the premises as a laboratory. The action failed. The lease did not make any stipulations concerning zoning. Although specific uses were referred to in the lease, no representations were made regarding the zoning required to support those uses. There was a specific clause stipulating against collateral warranties or representations. See also *Milne v Delta Foods* (1996), 1 RPR (3d) 150, 61 ACWS (3d) 587 (PEI Sup Ct) for the proposition that the duty to ensure the fitness of the premises for the intended purpose lies with the tenant (para 23). See also *0707448 BC Ltd v Cascades Recovery Inc*, 2011 BCSC 1065, where the British Columbia Supreme Court affirmed the principle that there is no implied warranty in a lease that the premises are fit for the lessee's purpose, even where known to the landlord (para 93).

¹⁶ Section 34 (1) of the *Expropriations Act*, RSO 1990, c E.26 provides that subject to s 34(2), where only part of the interest of a lessee is expropriated, the lessee's obligation to pay rent under the lease shall be abated proportionately, as determined by the Ontario Municipal Board. Subsection 34(2) provides that where all the interest of a lessee in land is expropriated or where part of the lessee's interest is expropriated and the expropriation renders the remaining part of the lessee's interest unfit for the purposes of the lease, as determined by the Board, the lease shall be deemed to be frustrated from the date of the expropriation.

¹⁷ Matthew Schneier, “How Fifth Avenue Is Coping”, *The New York Times* (23 Nov 2016) online: The New York Times <<http://www.nytimes.com>>.

¹⁸ RSO 1990, c S.11.

¹⁹ *Short Form of Leases Act*, RSO 1990, c S.11, Schedule B, s 11.

²⁰ *Noble Scott Ltd v Murray*, 1925 OLR 595 aff’d ONCA.

²¹ 2016 ONCA 870.