How Not to Exercise an Option to Purchase Land

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The recent Court of Appeal decision in *1785192 Ontario Inc. and 1043303 Ontario Ltd. v. Ontario H Limited Partnership* provides useful guidance on the rules around the exercise of options to purchase land where the price to be paid is to be set in accordance with appraisal evidence.

In this case, a tenant under a pair of commercial leases wished to purchase the properties that it occupied. Each lease contained an option to purchase which provided that the purchase price would be the midpoint of appraisals to be obtained by each party.

The parties each obtained an appraisal. They were far apart. The tenant's appraiser suggested a value of $11,746,000. The landlord's appraiser put the value at $31,200,000. The midpoint, therefore, was $21,473,000.

Both parties used reputable appraisers. This gives rise to the question as to how two reputable appraisers could possibly be so far apart in valuing a commercial property. As is typically the case, the difference was caused mostly by a difference in assumptions. The landlord's appraiser assumed that the highest and best use of the properties would involve having them re-zoned for the development of a residential condominium complex. The tenant's appraiser assumed that its highest best use should reflect the current zoning, which was for commercial use.

Perhaps needless to say, both sides accused the other of putting forward appraisals which either artificially devalued or overvalued the properties for the advantage of their respective clients.

In any event, the option to purchase clause in each lease was clear in specifying that the price would be the average of the two appraisals.

The landlord took the position that its appraiser was correct. However, for closing, the landlord ultimately agreed to accept the average amount of about $21,000,000.

The tenant was more obstinate. After insisting that its appraisal was accurate, it tendered the amount specified by its appraiser but paid over to its lawyer in trust the difference between that amount and the mid-point amount, to be held in trust pending the outcome of future litigation.

The landlord refused to convey title on that basis and had the $11,746,000 that had been tendered by the tenant returned to the tenant's solicitor.

The tenant brought an application to the court for an Order requiring the landlord to close at a price of $11,746,000.

The judge hearing the application concluded that it would have been understood in the lease that each party can seek an appraisal using reasonable assumptions most favourable to that party and that this is what had happened. As both parties obtained a compliant appraisal, the purchase price was the midpoint between the two. However, as to whether the tenant had properly tendered at closing, the judge accepted the tenant's argument that given the dispute about the purchase price the tenant was justified in tendering the undisputed amount while placing the disputed balance with a reputable stakeholder pending a court decision. Accordingly, the judge required the landlord to convey the property in exchange for the midpoint amount, to be made up of the funds originally tendered by the tenant together with the additional amount held by the tenant's solicitor in trust.

Note that this would have meant that the landlord would be paid the total amount which it had been prepared to accept before the start of the litigation, namely the midpoint amount.

By this point, however, and for reasons not set out in the initial decision or the subsequent decision of the Court of Appeal, this was no longer satisfactory to the landlord. The landlord appealed the application judge's decision to the Court of Appeal on the basis that the tenant had defaulted by tendering only part of the purchase price while sending the balance over to its own lawyer to be held in trust. The tenant cross-appealed on the basis that the application judge had made a mistake in concluding that the landlord's appraisal was valid. The tenant argued that the dramatic difference between the two valuations was not within the realm of reasonable disagreement and one of them had to have been a product of a methodological error. As the landlord's appraiser had allegedly incorporated "speculative assumptions", it was not valid and therefore the only valid appraisal before the court was that of the tenant.

The Court of Appeal first concluded that there has been no error made by the application judge in dealing with the appraisals. Whether or not an appraisal is valid is a question of fact and, the judge having decided that they were valid without making any obvious error in the process, that decision had to be respected.

However, the Court of Appeal ruled that the judge had been wrong in finding the tenant's partial tender of funds to be adequate. On the contrary, the Court of Appeal decided that this had been a breach of the tenant's obligation to tender an amount equal to the midpoint of the two valuations. This was the methodology specified in the option clauses and the parties had a legal obligation to close the transaction on those terms.

There are cases in which a partial tender may be satisfactory but those are generally restricted to circumstances in which a purchaser wants to close the purchase of a property with an abatement. In some of those cases, it may be possible to tender the amount which the purchaser feels is appropriate while paying the amount of the claimed abatement into court or in escrow.

That approach is not appropriate in a case in which a closing is taking place pursuant to an option to purchase. Options must be exercised strictly and the tenant, not having tendered exactly as required by the option, was in default and therefore no longer entitled to close on any basis. As the court indicated, the tenant should have tendered the purchase price properly and litigated about it afterwards.

In my view, the entire issue goes back to the wording in the option clause. We now know without question that options are going to be enforced strictly in accordance with their wording. While the wording with this option might seem sensible on its face, this case illustrates how such wording can lead to an unexpected result given that appraisals by their very nature, can lead to very different results depending on assumptions made by the appraisers. Perhaps the best lesson to be learned from this case has to do with the importance of drafting option clauses of this nature in such a way as to try to limit the possible range of outcomes.