June 2014

mcmillan Real Estate Bulletin

Limiting Your Indemnity – When the Words are Important

Tsain-Ko Village Shopping Centre Limited Partnership v Watts ("*Tsain-Ko*")[1] is the story of how the best laid plans of a father trying to help his son get started down his chosen career path can go awry.

In the case the father, Ronald Watts ("Watts"), agreed to provide to a landlord a limited indemnity of the lease obligations of a shell company being used by Spencer Watts, his son, to lease premises for his fledging restaurant business. The indemnity agreement contained typical provisions, essentially putting the father, as indemnifier, into the shoes of the tenant under the lease. However, it also contained the following limitation in section 8:

> "**8. Limitation.** Notwithstanding anything to the contrary contained herein, the liability of the Indemnitor under this Indemnity Agreement shall be limited so long as the Indemnitor is not in default hereunder, to:
>
> (a) the sum of $68,500 in respect of any claim for which demand is made by the Landlord

[1] Tsain-Ko Village Shopping Centre Limited Partnership v Watts, 2013 BCSC 85.

during the first Term Year of the Term of the Lease;

(b) the sum of $45,666.66 in respect of any claim for which demand is made by the Landlord during the second Term Year of the Term of the Lease;

(c) the sum of $22,833.33 in respect of any claim for which demand is made by the Landlord during the third Term Year of the Term of the Lease; and

The liability of the Indemnitor under this Indemnity Agreement shall cease and be at an end after the third Term Year."

The Court concluded that the evidence satisfactorily established that the declining amount of the defendant's obligations under the indemnity agreement over the first three years of the term of the lease related to a recovery by the landlord of a tenant improvement allowance provided by the landlord to the tenant under the lease.

The restaurant commenced operations in July 2007. By August 11, 2009, in the third year of the term, the tenant was in arrears of rent in the amount of $52,315.75. On that day the landlord made written demand on both the tenant and the indemnifier for payment of the outstanding amount.

By November 1, 2009, neither the tenant nor the indemnifier had made any payments in response to the landlord's demand letter. On November 12, 2009, the landlord's lawyer wrote to Watts' lawyer, taking the position that because Watts was in default under the indemnity agreement, the limitations of liability did not apply, and requiring Watts to satisfy all of the tenant's liabilities under the lease. A few days later Watts' lawyer tendered a trust cheque in the amount of $22,833.33, which purported to be in full satisfaction of Watts' obligations under the indemnity agreement. The cheque was returned by the landlord's lawyer to Watts' lawyer. Watts' lawyer then took the position that Watts' liability was discharged. Shortly thereafter the litigation with respect to Watts' liability under the indemnity agreement was commenced, with the landlord taking the position that the indemnifier was liable for the entire liability of the tenant under the lease (by then in excess of $200,000) and Watts taking the position that its liability was limited to $22,833.33.

The Court accepted the defendant's proposition that the obligations of indemnifiers should be strictly examined and enforced, but also stated that such obligations must be interpreted in the context of the entire transaction. The Court then proceeded to accept the arguments of the plaintiff to find that the defendant was unable to rely on the limitation in Section 8(c) of the indemnity agreement, based on the following:

- The Court cited *Vancouver City Savings Credit Union v Vancouver Mechanical Contractors USA Inc.* for the proposition that "[the] starting point in analysing the parties' position is the wording of the guarantee itself. The objective intention of the parties, as set out in the

terms of their agreement is what is determinative, not their subjective intentions or beliefs."[2]

- There was no issue that the tenant was in continuing default under the lease.

- Section 1(b) of the indemnity agreement provided that the indemnifier "will, upon demand, effect prompt and complete performance of all the terms and conditions in the Lease to be observed and performed by the Tenant." Section 7 of the indemnity agreement provided that the indemnifier would "be bound by the terms of the Lease in the same manner as though the Indemnifier were the tenant named in the Lease and as if the Indemnifier had executed the Lease and had a primary obligation under the Lease."

- By the operation of sections 1(b) and 7 of the indemnity agreement, Watts was in default of his obligations under the indemnity agreement when demand was made.

- Neither the original lease proposal nor the indemnity agreement explicitly or impliedly limited the defendant's obligations only to the repayment of the unpaid portion of the tenant improvement allowance.

In the end result, the Court was satisfied that, based on the terms of the indemnity agreement and given the involvement of legal

[2] Vancouver City Savings Credit Union v Vancouver Mechanical Contractors USA Inc,2008 BCSC 404 at para 20, affd 2010 BCCA 397, leave to appeal dismissed 2010 SCC 410.

counsel on behalf of the defendant from the beginning in negotiating the lease and the indemnity agreement, acceptance by the Court of the defendant's interpretation of "not in default" in Section 8 of the indemnity Agreement would not constitute strict construction of the limitation provision. Rather, "it would amount to a rewriting of a clear and unambiguous contractual provision that would undermine or make meaningless other provisions of a clearly constructed debtor/creditor relationship".[3] Further, the Court stated that "[s]uch a result, based upon extrinsic evidence, prior negotiations and subjective belief would constitute the creation of a new agreement" contrary to previous principles enunciated by the B.C. Court of Appeal.[4] Accordingly, the Court found that the ongoing defaults by the tenant under the lease also constituted continuing defaults by Watts under the terms of the indemnity agreement, for which his liability was not limited.

Hindsight is a wonderful thing and so, when you read the Court's decision in this case and can focus on the provisions in the indemnity that resulted in Watts' liability not being limited as Watts appears to have intended, it almost seems unfair to be suggesting how the indemnity agreement could have been drafted to provide for the desired limitation. Nevertheless, here are a few suggestions:

- Not uncommonly, Watts tried to limit his indemnity both by capping the amount and limiting it in time. If other provisions of the indemnity agreement had recognized those limitations on liability that Watts

[3] *Supra,* note 1 at 44.

[4] *Ibid*.

intended, the placement of the proviso "so long as the Indemnitor is not in default hereunder" in Section 8 would probably have been fine, as it was the Court's determination that, based on various other provisions contained in the indemnity agreement, Watts was, in fact, in default under the agreement.

- Alternatively, if Watts' intention was that only the limitation in time, not the limitation on the amount, was to be dependent on the tenant not being in default at the end of the first three years of the term, then perhaps the proviso would have been more properly placed at the end of the provision. In either event, care should always be taken as to where and how specific limitations are incorporated into an indemnity agreement.

- Much was made by Watts and his lawyer about the fact that the well-understood intention of the landlord and the indemnifier was that the indemnity by Watts was intended to ensure repayment by the tenant to the landlord of the tenant improvement allowance over the first three years of the term of the lease. The Court acknowledged this to have been the intention. However, that fact was nowhere stated in either the agreement to lease or the lease itself. If that had been the mutual intention of the parties, there is no reason why it could not have been set out in some form in the lease or, better, in Section 8 of the indemnity agreement. Instead, both were silent on the matter and that was fatal.

- It is not uncommon in legal drafting to use "Notwithstanding the foregoing", or some similar formulation, to negate what might otherwise be provided in a document in favour of what is then about to be stated. Although not specifically commented on by the Court in *Tsain-Ko*, focussing on the broad language of some of the other provisions of the indemnity agreement rather than relying solely on that phrase in the preamble to the limitation provision in the agreement, may have led to a different result.

- For example, what if Section 1(b) had been amended to delete the original provision and provide in its place that the indemnifier "will, upon demand, *pay to the Landlord the then appropriate sum provided for in Section 8, if the Tenant fails to* effect prompt and complete performance of all the terms and conditions in the Lease to be observed and performed by the Tenant."

- Or what if Section 7 of the indemnity agreement had been amended to provide that the indemnifier would "be bound *to repay the amount of the Tenant Improvement Allowance* in the same manner as though the Indemnifier were the tenant named in the Lease and has a primary obligation *to so repay the Tenant Improvement Allowance* under the Least

Mr. Watts' story may have had a happier ending if some or all of the foregoing amendments had been made to the indemnity agreement.

by David Ross

For more information on this topic please contact:

Toronto David N. Ross 416.865.7015 david.ross@mcmillan.ca

a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.