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Fundamental Breach of Commercial Leases

Introduction

A typical commercial lease is not a balanced document in terms of rights and remedies for a breach of the lease. There will be long list of tenant defaults that will give the landlord a full range of remedies. This will include a right to enter the premises and terminate the lease for any default not cured within the required notice and cure period. On the other hand, there will typically be no listing of landlord defaults or tenant rights and remedies.

A tenant does have rights at common law. A tenant can, of course, bring an action for any damages suffered as a result of a breach by its landlord. Another right is to treat the lease as at an end where that is justified by a fundamental breach of the lease by the landlord. The recent decision of *Kenny Alwyn Whent Inc. v J. Mao Dentistry Professional Corp.* is an example of a situation where the tenant attempted to use this remedy.

The plaintiff landlord in the *Mao Dentistry* case sought damages for breach of contract stemming from a lease entered into with the tenant, Mao Dentistry Professional Corp. The tenant had vacated the premises and had ceased paying rent. In response to the landlord's action to recover rent, the tenant argued that the landlord was in fundamental breach of the lease due to an infestation of mice and spiders, the presence of litter in the parking lot, incorrect back charges and an unreasonable refusal to provide a consent to sublet. As a result, the tenant argued, it was relieved of its obligations under

the lease. The court did not agree and in coming to its decision reviewed the law of fundamental breach.

Fundamental Breach: An Overview

A fundamental breach has been described in various ways. For instance, it has been defined as a breach "that deprives the innocent party of substantially the whole benefit of the contract", or alternatively as "a breach that goes to the root of the contract". These definitions share similar principles. A fundamental breach is not simply a breach of a contractual term. In addition, the relative importance or significance of the breached term in the context of the entire agreement is crucial. The very "nature and purpose" of the contract must be considered. If fundamental breach is found, the party to whom the fundamental breach was committed against is entitled to treat the contract as at its end.

The court in the *Mao Dentistry* case reviewed the case law and noted that the Ontario Court of Appeal set out five factors to be considered in *Spirent Communications of Ottawa Ltd. v Quake Technologies (Canada) Inc.* They are the following:

1. The ratio of the party's obligations not performed to that party's obligations as a whole;

2. The seriousness of the breach to the innocent party;

3. The likelihood of repetition of such breach;

4. The seriousness of the consequences of the breach; and

5. The relationship of the part of the obligation performed to the whole obligation.

Some Examples

Failed Claims for Fundamental Breach

In the *Mao Dentistry* case, the tenant's counter claim for fundamental breach on the part of the landlord was dismissed. It was

found by the court that the problems with mice and spiders, although an obvious annoyance, did not go to the heart of the commercial lease agreement. Specifically, it is important to note that several of the tenant's own actions prevented the court from being able to find a fundamental breach. For example, the court highlighted the tenant's passive action in response to the pest issues. Although complaints were made about the problem, the tenant proceeded to continue with his business as normal, did not make arrangements to relocate, renewed the lease twice during the period he was a tenant and did not seek abatement of rent. Clearly, the court felt that the tenant's actions did not correspond with having been deprived of the substantial benefit of the contract.

The *Spirent* case was itself a failed attempt to establish that a fundamental breach had occurred. Spirent Communications of Ottawa Limited entered into a sublease with Quake Technologies (Canada) Inc. for a portion of its space. Due to weather and construction issues, the occupancy date was delayed by six weeks, after which time Quake decided not to proceed with the sublease. Quake claimed that the six week delay in occupancy amounted to a fundamental breach of the sublease agreement. However, the court disagreed. The court stated that the delay of six weeks, when compared with Quake's obligation to occupy the office space for a period of three years under the sublease, did not represent a breach that deprived Quake of substantially the whole benefit of the contract, despite having material consequences.

Successful Claims for Fundamental Breach

In contrast, *1723718 Ontario Corp. v MacLeod* is a case where a fundamental breach of a lease was found. The landlord's failure to repair a boiler, which had caused the premises to drop to a temperature beyond what was feasible for the tenant to continue his medical practice, was determined to be fundamental to the agreement. The key distinction with the *Mao Dentistry* case is that here the tenant's business was made impossible due to the temperature. It was not a case of lesser impacts that while certainly an annoyance and potentially a breach, did not deprive the tenant of the full benefit of its premises.

In *Lehndorff Canadian Pension Properties Ltd. v. Davis Management Ltd.* the landlord refused to permit the tenant to assign the lease. It was held that such refusal was an unreasonable withholding of consent in breach of the lease. The tenant was not in possession of the premises and was attempting to recover some amounts from the assignment to offset its continuing rental obligation. The court held that the unreasonable refusal was a breach that amounted to effective frustration of the tenant's right to mitigate its loss and amounted to a breach of a fundamental term of the lease. This risk to landlords has been responded to in many landlord forms of leases. Landlords will provide in their form of lease that the tenant's sole remedy where a landlord withholds consent is to seek an order requiring the landlord to grant that consent. The risk of being held to having fundamentally breach is contracted out of.

In *Ad Hoc Management Inc. v Prudential Assurance Co.*, the breach committed by the landlord was also found to be a fundamental breach. This case in particular is a clear example of a certain breach "going to the heart of the contract". The lease in this case included a right of first refusal which gave the tenant the right to lease an adjoining space for the purposes of expansion. The landlord proceeded to lease the adjoining space without providing the tenant with the first refusal opportunity. As such, the court found that the tenant's contractual ability to expand to the adjoining property was fundamental to the agreement between the parties, and the agreement would not have been entered into without this option. In addition, with seven years remaining on the tenant's lease, it was found by the court that being unable to expand for this period of time was severely prejudicial.

Conclusion

Given the fact specific and contextual analysis of fundamental breaches conducted by the courts, and the nature of the factors discussed in *Spirent*, it is imperative that a tenant in a commercial lease proceed cautiously when faced with a potential breach. The threshold for a fundamental breach by the landlord is high. As a result, a party who believes they are in the right to treat the contract

as at its end may themselves be found to have breached the agreement by failing to continue with their contractual obligations, as was the situation in the *Mao Dentistry* case. A fundamental breach, which allows a contract to be terminated early "is an exceptional remedy that is available only in circumstances where the entire foundation of the contract has been undermined."

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a cautionary note