THE COMMERCIAL LEASE AND THE OPTION TO RENEW

In commercial leases, the option to renew plays an important role for the tenant by providing him with the flexibility necessary to his business operations. In cases where the rent was pre-established, certain formulations used had the effect of capping the rents at levels that were too low, for long periods of time. In some cases, this played greatly to the landlord's disadvantage. These renewal options have since been refined and the notion of market rates is now used more frequently.

However, a lease can still be renewed without the existence of a renewal option! Failure, by the landlord, to take action at the end of the lease term, can lead to surprises. If the tenant occupies the premises for more than ten days after the expiry of the lease without any opposition from the landlord, the tacit renewal will come into effect. Therefore, the lease would then automatically be renewed for a period of one year. This is what is stipulated in Section 1879 CCQ which, in our view, must be strictly construed.

A definition of the notion of renewal, as proposed by the Court of Appeal in the case of Cogefimo Inc. vs. Société Coinamatic Inc. (1998 R.D.I. 1993) – (JE98-855), and written by Judge Brossard, states as follows (Page 5):

« On doit donner aux termes utilisés par les parties leurs sens communs. On ne peut parler de terme et de renouvellement comme si les mots avaient la même signification, que ce soit en français ou en anglais. Le mot « terme » est en soi très clair et ne porte pas à confusion : il emporte l'extension du droit et la terminaison du contrat.

Le terme « renouvellement » est également clair et signifie la « remise » en vigueur d'un contrat, « à son expiration », plus souvent qu'autrement pour la même durée et aux mêmes obligations. La définition anglaise du mot « renewal » lui donne le sens de prolongation plutôt que de remise en vigueur.

Dans l'affaire Association des architectes c. Sarazin (1969) B.R. 321, interprétant une clause de renouvellement automatique comme en l'espèce, notre Cour disait :

« Le mot « renouvellement » appliqué à un contrat de louage de services signifie « la remise en vigueur dans les mêmes conditions » (Robert, Dictionnaire alphabétique et anologique de la langue française (1967) p. 1517); par lui-même, ce terme présuppose que le contrat qu'il remet en vigueur a cessé, ne fut-ce que momentanément, d'être en vigueur; il suggère donc une solution de continuité; la remise en vigueur même dite automatique ne peut donc présupposer que rien n'y fait légalement obstacle. (...) »

Some authors see an important distinction between the notion of "renewal" and that of "the extension of the term". This distinction is due to the fact that, on one hand, during the extension, the original lease remains in full effect even after the end of the original term, whereas on the other hand, in the case of a renewal, the original lease terminates for a short period of time, to allow the renewal to take effect. According to Harvey M. Haber, QC, the legal effect, resulting from this short period of time between the end of the original lease term and the beginning of the renewal, is such that no lease is effectively in place during that time and, therefore, all clauses relating to termination can, in principle, become applicable. It is not my intention to analyse this highly technical distinction which, in my opinion, has no practical value. However, it is relevant to emphasize the distinction between these two concepts.

We wish, therefore, to firstly discuss the mechanisms that serve to engage the option to renew and secondly, discuss certain principles dealing with the determination of the rent.

The Mechanism

The renewal clauses of the lease are such that generally, the tenant will be able to renew his lease as long as certain conditions have been fulfilled. The conditions most often found are:

* The tenant must not be in default relative to the lease;

* The tenant must provide written notice to the landlord; and

* The renewal can only be exercised by the tenant.

* In addition, it may also be preferable that certain clauses in the lease be excluded, and therefore not be applicable, during the renewal period.

The tenant found in default under the lease.

The tenant may be found in default by virtue of his obligations without this preventing him from exercising his right to renew under the lease, whether he be in default relative to payment of rent, rent in arrears, use clause, etc. A condition preventing the tenant from renewing his lease, if he is found in default, is generally found acceptable. In some cases, the tenant will request that this restriction apply only in cases of material default or any default not remedied at the time of exercising the option to renew. In any case, no matter the type of condition stipulated, it is essential that this notion be found in the renewal clause in order to protect the landlord from being legally bound to an undesirable tenant.

Notice to Landlord

This notion is equally as important to the Landlord. If the ultimate date by which the tenant must provide written notice is not specified in the lease, the landlord may find himself in a situation where he is unaware of the tenant's intentions. It is not enough to merely specify the latest date by which written notice must be provided, but it is equally important to specify the earliest date by which the tenant is permitted to send the written notice to the Landlord. For example, to specify that notice must be sent to landlord at least twelve months prior to the expiration of the term but no earlier than eighteen months prior to the expiration of the term, is a formulation commonly used. In fact, there may be instances, where the tenant, wishing to take advantage of favourable market conditions, could send his notice to

renew, forty-eight months prior to the expiration of the lease term. This situation, although rare, could generate other problems of which one should be aware. If the rent is to be determined relative to fair market value, should the date used to establish the rent be the date at which the notice must be sent or the commencement date of the renewal term? A conflicting situation, such as this one, can easily be resolved by imposing a precise window during which the renewal option must be exercised.

Rather than referring to a number of months, some prefer to use the notion of days in order to avoid any misunderstanding as to the time frame within which the option to renew is to be exercised. For instance, if the term ends the fifteenth day of a particular month and the renewal clause provides that the notice must be sent six months prior to the end of the term, how should the six months be counted? Should we count six full calendar months or six one-month periods prior to the end of the term? This question has at times been a source of conflict.

Another point to consider is what the notice should pertain to. In the decision rendered in the case of Les Entreprises Gilles Leblanc Ltée vs. Claude Lachance et als (2000) R.D.I. 199 (Cour d'Appel), the court had to determine if the tenant, occupying two premises by virtue of his lease, could consider these two premises as separate and renew the lease for only one of the two. One of the parties affirmed that the notice was invalid, as it did not apply to the totality of the leased premises. The Court of Appeal, confirming the decision of the Superior Court, concluded that it was possible, under certain circumstances, to separate the renewal into parts and that, in this particular case, the landlord had not been the victim of any prejudice.

Personal Rights

The renewal is generally granted upon the consideration of various factors, including the evaluation of the tenant himself. By specifying that this clause is not transferable or assignable by the tenant (or that the tenant must himself occupy the leased premises in order to exercise the renewal), the landlord will adequately protect himself from having to deal with a third party with whom he does not wish to do business. However, the tenant will attempt to eliminate such a restriction in order to capitalize on the added value such a clause could have in the case of a transfer.

Exclusions

The renewal clause should include an exhaustive list of the clauses that are found in the lease but whose application should be excluded during the renewal period. For example, clauses pertaining to payment of capital allowance, free rent, as well as the option to renew itself, should definitely be excluded in order to prevent the tenant from taking advantage of these clauses a second time during the renewal period. Certain jurisprudence has concluded that the wording found in the lease amendment resulting from an option to renew (or an extension) can in some cases preserve the existence (and therefore the legal effects) of certain clauses. In fact, it has been ruled, that an amendment to lease, which was in fact an extension of the term, had the effect of maintaining the option to renew found in the lease. As a result, this situation allowed the tenant, at the end of the extension of the term, to exercise his option to renew, which was still in

effect. Quite a surprise for the landlord who may have had other plans for the premises in question!

List of points to be considered

The following list constitutes a non-exhaustive list of points for consideration by the landlord, that can be incorporated in a renewal clause, according to the type of transaction contemplated or the type of tenant involved:

* Insist on the option to have a credit check done at the time of the renewal, and include it as a condition;

* Do not allow the tenant, having already vacated the leased premises, to renew the lease;

* If the original lease is outdated, acquire the flexibility to sign a new lease, which is more up-to-date with current practices, rather than signing an amendment to lease;

* If a surety exists, ensure that the surety is part of the renewal document;

* With regards to commercial leases, if the tenant is to pay a percentage rent, ensure that the payment of said rent is made during a predetermined period in order that he may exercise his option to renew;

* Never consent to any clause that requires the landlord to send a notice to the tenant, as a reminder notice, which will trigger the process of the option to renew;

* In commercial leases, require that the franchisee respects his obligation when the lease is signed with the franchisor;

* When the rent is determined by establishing the market value: (i) specify a clear method by which to establish the rate of the rent to be paid during the renewal; and, (ii) provide for the option to become null and void, should the parties be unable to reach an agreement as to the market rate.s

Establishing the rent

The renewal clause must clearly provide the parameters by which the rent will be established. In some cases the rent will already be determined, making things simple. However, as things are rarely simple, the parties will tend to avoid speculating on the rent that would normally be payable in five, ten or fifteen years. For this reason, the formulation most equitable to all parties concerned is usually to establish the rent based on fair market value.

Some renewal options expressly stipulate that if, within a predetermined period of time, the parties, acting reasonably, have not been able to reach an agreement, the option to renew will become null and void. This formulation of the renewal option, generally favourable to the landlord, requires that the parties not deliberately act in bad faith. What is the validity of these clauses? In the decision rendered by the Superior Court in the case of Pétrole Farand Inc. vs. Ultramar Canada Inc. (JE96-454), it was a question of determining the extent of the parties' obligations in the case of a lease renewal clause which stipulated that the parties were to renegotiate the rent and that « … à défaut d'entente sur le montant du loyer, il n'a pas de prolongement. ». The Court concluded that such a clause « …amène à considérer pareille convention comme étant vide d'application ou d'exercice parce qu'il y a absence d'une obligation d'exécuter. » (p.7). Also, Judge Nolin, using the fundamental principal of the liberty to contract, specified that «… l'élément de la bonne foi n'a pas à être considéré parce que le bail ne comporte pas qu'il doit être prolongé, et que les parties sont tenues de négocier entre elles un nouveau bail »(p.7). This type of clause is common and although, on one hand, it forces the parties to make certain efforts in order to reach an agreement, it does not have, on the other hand, a compelling force.

In the decision rendered in the case of Marie-France Renault et Émile Suissa vs. Société du Parc des Îles et Ville de Montréal (JE98-2190), the Court had to determine the validity of a renewal clause that, once again, stipulated that the parties were to negotiate new lease conditions for the additional

five-year terms and that, should an agreement not be reached, the lease would be automatically terminated. The Court had the following comments with regards to such a clause (Page 8):

« (…) que l'intimée est, de mauvaise foi ou non, en contravention ou non avec l'article 4 du contrat, indûment refusée de se plier au parcours prévu à cet article, le Tribunal a-t-il le pouvoir en droit d'imposer aux parties les « conditions » et/ou « les nouvelles obligations » d'un second bail autre que la durée de ce nouveau bail? La Cour ne le croit pas. Notre droit reconnaît la plus grande liberté de convenir de contrats licites aux parties contractantes et il ne permet pas aux tribunaux, dans une matière comme en l'instance, de brimer cette liberté et de leur imposer sa volonté contractuelle. L'entente de s'entendre ne peut par notre droit agendrer une nouvelle entente exécutoire. »

However, other clauses relative to establishing the rent at fair market value, stipulate that if the parties are unable to agree on the rent to be paid, the dispute will be submitted to arbitration. Such a mechanism clearly has the advantage of creating a real option to renew that can be exercised and enforced by the tenant. The drafting of such a clause relative to establishing fair market value is, however, a critical element. In fact, a good number of cases of litigation or arbitration pertain to determining the fair market value.

A relatively recent decision rendered by Judge Nicole Duval Hesler (National Trust Company vs. 2000 McGill College Avenue Building Inc. (1998) Q.J. No 609 - REJB 1998-05535), suggested an interesting definition of a renewal clause to the effect that the rent would be: "an annual rental equal to the fair market value […] to be determined by a reference to the renewal rental rate, which Tenants are accepting to pay for comparable space in the building". In effect, the judge was to determine if the rent payable during the renewal period was a "net effective rent" or a "face rate". One of the witnesses, who testified during the proceedings, explained to the Court that the notion of net effective rent did not exist at the time of the signing of the lease in the early 90s. The judge concluded that, "put another way, the parties could not have meant to use the net effective rate because the concept was unknown at the time. What they meant was the face rental rate, being nothing else available then." Therefore, the definition given to the notion of fair market value in the lease is a critical factor for the parties, when determining the rent payable during the renewal period.

In conclusion, the option to renew is an excellent mechanism that provides flexibility for the tenant. The landlord, however, will legitimately attempt to limit its application to ensure that the option is used in a precise manner respecting the rights of all parties. However, this clause, for obvious reasons, is definitely one of the most important clauses found in a commercial lease. Each party must take care when drafting this clause to ensure that his intentions are clearly stated in order to avoid conflicting situations in the future.

Note: the following works were used to write this article: Best Commercial Lease Clauses, Brownstone Publishers, Inc., 2000, New-York; Jobin, P.-G, Le louage, Les éditions Yvon Blais, 1996; H.M. Haber, The Commercial Lease, a Practical Guide, Canada Law Book, 1999.