THE IMPLEMENTATION OF A CO-TENANCY RIGHT – ENFORCEABILITY AND DUTIES OF GOOD FAITH AND REASONABLENESS YOU NEED TO KNOW

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1. Is a co-tenancy right unconscionable or an unenforceable penalty?

To date, I am not aware of any Canadian cases that suggest that a co-tenancy right can be attacked on the basis of it being unconscionable or an unenforceable penalty. Unconscionability is a tough case to make. It depends on the landlord being able to show that it was forced to sign a lease with a co-tenancy clause under time and/or economic pressures that were so unfair that the court ought not to enforce the contract or the particular provision in the contract. We are talking about an inequality in bargaining power that is so egregious that a court will not enforce the provision – perhaps if the contract was non-negotiable and there were some extraordinary time pressures. But, generally speaking, I think it is fair to say that the circumstances in which a landlord could successfully argue that a co-tenancy right was unconscionable are remote. That is a pretty hard bar to meet, with most landlords being sufficiently sophisticated that they likely could not claim that enforcement of the co-tenancy was unconscionable. One party may have more leverage than another, but the circumstances in which a disparity of leverage amounts to genuine unconscionability are likely remote.

On the issue of a penalty, the question is whether or not the consequences of the breach of the co-tenancy right in monetary terms is so excessive as to not constitute a genuine pre-estimate of the damages that the tenant would suffer, but rather constitutes an unenforceable penalty.[1] Invariably, the principles relating to whether or not the amount is or is not a penalty is tied to the notions of unconscionability and fairness. The oft cited case of *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.*, Cal 4th 2015 DJDAR 409, a California Court of Appeal case, suggests that in that jurisdiction the court may reach the conclusion that the rent abatement component of a co-tenancy provision is an unlawful penalty in circumstances in which the value of the money or property given up under it is not reasonably related to the harm that is anticipated to be caused. In that case, where Ross Dress for Less terminated its lease because the Mervyn's department store closed, the court found that such closure was unlikely to have any reasonable impact on the Dress for Less store and that the co-tenancy result constituted a penalty. The application of that court's decision to Canadian courts is not totally improbable – as in California, penalty clauses are generally not enforceable, so in that regard the position of the courts is similar. Nonetheless, again, I am not aware of any Canadian cases that have determined that a co-tenancy right is not enforceable on account of it being a penalty. Having said that, it is important that if there is a co-tenancy amount payable or a reduction in rent, the amount to be paid generally needs to be a reasonable and genuine pre-estimate of damages. So – in circumstances in which a co-tenancy clause provides for a rent abatement, it likely should be reasonably limited, with respect to both the duration of the abatement and in relation to the expected damages suffered by the Tenant.

[1] For a general review of this area of the law, see "A Review of Liquidated Damages vs. Penalty (Health Quest v. Arizona Heat). Melodie Eng, The Six-Minute Commercial Leasing Lawyer 2020.

In most circumstances, the rent abatement is followed by a termination. That may, in and of itself, make the co-tenancy enforceable.

Determining the relationship between the rent abatement and the amount of damages might be more problematic – how, if you are a tenant, do you determine what your damages are, if for instance, you can't show a decline in sales? Perhaps because you have not yet opened. Or if you have opened and there is not yet a decline, a decline over time based on a loss of prestige to the shopping centre might also be difficult to prove. Stipulating that the amount of the rent abatement is a genuine pre-estimate of damages and not a penalty may go some way towards bridging those issues. Suffice to say, if you want to avoid any issues relating to your co-tenancy being an unreasonable penalty, consideration should be given to providing a mechanism for the provision to be cured, establishing that there is actual harm that will occur when and if you decide to exercise your co-tenancy right and then documenting that harm to justify the abatement.

Finally, it is interesting to note that in the case of *Old Navy (Canada) Inc. v. The Eglinton Town Centre Inc.*, [2019] O.J. No. 3506 (the "Old Navy" case, dismissed on appeal 2020 ONCA 679), the court specifically declined to rule on whether or not the co-tenancy provision was a penalty clause and therefore unenforceable. The court considered cases on this but declined to rule. So the opportunity to allege a penalty is not off the table by any means.

2. How does the doctrine of good faith impact the enforceability of a co-tenancy clause?

Generally speaking, the case of *Bhasin v. Hyrnew*, 2014 SCC 71 (the "Bhasin case") stands for the principle that parties to a contract must perform their contractual obligations "in good faith". What does that mean? Again, generally speaking, it has been interpreted to mean that they can't act in bad faith – they can't intentionally mislead the other contracting party to that party's detriment. They shouldn't lie. So while we know that lying to another party constitutes bad faith we are not as certain that failure to disclose a material fact is also bad faith. Generally speaking, there needs to be some active intention to mislead or deceive. Which is to say, we are not absolutely certain at what point conduct rises to the level of "bad faith". What we do know is that the doctrine of good faith confers on the court a broad and flexible power to create law.[2] It may be the basis for the court to intervene and impose an obligation on a party to a contract based on the notion of good faith and fairness. It was alluded to in the discussion by the Court in the Old Navy case, more comprehensively discussed elsewhere. It is definitely something that parties should always consider whenever there might be a potential dispute with respect to a contract and its interpretation – if one party does not act in good faith, perhaps in the exercise of its co-tenancy rights, then a court may decline to enforce those rights. As has been noted by the courts, it would indeed be ironic if the Bhasin case had the effect of creating uncertainty in contractual interpretation rather than predictability. It would be a problem if the courts use Bhasin to rewrite contracts under the rubric of being "fair". But what is of even greater concern is the possibility that when a party does exercise its rights under a contract, the doctrine of good faith will limit its freedom to do so solely in its own best interests. That a party will be restrained from exercising its discretionary rights in such a way as to damage the other parties' contractual expectations. There are indeed cases that suggest otherwise (see for instance *Zenex Enterprises Limited v. Promenade Limited Partnership*, 2019 ONSC 3262) and *1548 Richmond Manor Inc. v. Fido Solutions Inc.*, 2019 ONSC 3833). I am generally of the view, based on recent case law, that a party is entitled to exercise its bargained for contractual rights pursuant to the express terms of its contract, and that it may do so without reference to whether or not acting in its own self-interest breaches a good faith principle.

[2] For a recent discussion of the principles in Bhasin see "Five Years On: The Effect (So far) of Bhasin v. Hrynew and the Duty of Good Faith in Commercial Leasing" Karsten Lee and Dian Thompson, ICSC Law Conference 2019.

3. Commercial Reasonableness/Sunset

The enforceability of a co-tenancy clause may be affected generally by different principles of contract interpretation. Those principles include tests of what was the objective intention of the parties when the provision was entered into, a common sense approach to contract interpretation, review of the provision in the context of the lease as a whole and the contra proferentum rule. All of the principles of contract interpretation may affect the enforceability of a co-tenancy provision.[3] And in particular, if the provision contains a sunset clause - that may well impact how such a clause is to be applied. A sunset clause limits the amount of time a tenant can enjoy a remedy, in this case, for a co-tenancy default. At the end of the sunset period, the tenant is required to choose – usually whether to cancel the lease or revert to full base rent. It can also be said that a sunset clause in a co-tenancy is one where the landlord fulfills a condition that prevents the tenant from exercising its rights, for instance, curing the co-tenancy default. There may also be included other provisions that restrict the operation of the co-tenancy - tenant default, tenant not in operation, tenant requirement to show an actual drop in sales, etc.

The most recent case dealing with the issue of whether or not a co-tenancy was enforceable as a result of circumstances other than a bankruptcy is the Old Navy case. In that case, the court found that upholding the Tenant's interpretation of the clause would result in a commercial absurdity, that the provision would run indefinitely and therefore, having identified an ambiguity in the drafting, it determined to interpret the provision in a way that made sense from a business perspective. The court was of the view that the interpretation of this particular co-tenancy clause needed to be considered through the lens of its commercial purpose, evidence related to the importance and identity of the "Key Stores", the parties' understanding and intent at the time the lease was entered into and then as reflected by their subsequent conduct.

The Tenant, Old Navy, leased premises from the Landlord before the shopping centre was fully constructed. Old Navy was not required to operate unless certain "Key Stores" were operating – namely Cineplex, Roots, Globo Shoes and Danier Leather plus 80% of the remaining gross leaseable area of the Shopping Centre. About 16 years into the term of the Lease, Danier Leather made an assignment in bankruptcy although at that time about 90% of the remaining centre was leased. Despite the Landlord having failed to notify the Tenant of this event (as was its obligation under the Lease), the Tenant learned of the bankruptcy and purported to invoke its rights under the lease to pay alternate rent, pursuant to its co-tenancy clause. The court found for the Landlord, at trial and dismissed the case on appeal.

The Tenant had argued that the clause was perfectly clear and required that if any two of the requirements were met it was entitled to pay alternate rent – that Danier was in bankruptcy met one of those two requirements. The Landlord, on the other hand, maintained that the "Key Store" requirement was an opening requirement and that the 80% requirement was the only continuing requirement. The court found that the clause being considered was ambiguous on account of each of the Landlord and the Tenant having two different interpretations of it and hence should be construed against the Tenant under the contra proferentum rule because the lease was the Tenant's standard form. That rule, I might add, opened up the court to look at a wide variety of provisions to interpret a clause, in circumstances in which the "Entire Agreement" clause might otherwise have militated against its doing so. Having said that, it then proposed to interpret the clause in an objective and reasonable manner as so as to void absurd results (the "business efficacy rule" of interpretation). It found that the Tenant's interpretation of the co-tenancy clause would cause a result that was not commercially reasonable and therefore offended the business efficacy rule. It said that absent clarity in the clause, it would not agree to a result which would

[3] See for instance, "A Review of Recent Cases and the Principles of Contractual Review" Yael Bogler, The Six-Minute Commercial Leasing Lawyer 2020.

entitle the Tenant to occupy the premises for the balance of the term as it might be extended paying an alternate rent (which barely covered common area costs) in circumstances in which the complained of event was of a trivial nature (none of the "Key Tenants" except perhaps Cineplex were really anchor tenants at all) and had no impact on its business operations. In this particular case, there was no evidence before the court that the Tenant had suffered any financial loss as a result of the Danier bankruptcy. It also found that it was the Landlord's understanding that the co-tenancy provision was only intended to apply in a catastrophic situation (like for instance a Cineplex default) and not in this situation, where the default was of a minor rather inconsequential nature. It also agreed to rectify the Lease to include a mutual termination clause that had been included in the letter of intent but which for no explained reason was not included in the lease, which would have allowed either of the Landlord or the Tenant to terminate the lease if the co-tenancy provision took hold thereby making sense of a provision that might otherwise have allowed the tenant to pay virtually no rent for the rest of the term. Likely it didn't help the Tenant that none of the people who negotiated the lease were there to discuss it, whereas the Landlord was available to give evidence as to what it thought the language of the clause meant.

At the end of the day, the court refused to uphold a result that it thought did not make any sense in the business world. What is clear from the case is that, an ambiguity having been found, the court was willing to do a deep dive into what the parties intended, as evidenced by their conduct at the time the lease was entered into and by their conduct after the pivotal event occurred. And it was not prepared to accept an interpretation that was not objectively commercially reasonable. In contractual interpretation, one of the overarching principles is the rule of business efficacy – contracts must be interpreted with good business sense to give effect to the intention of the parties, and an interpretation that would give effect to a commercial absurdity will likely not be accepted despite the literal meaning of the words.

The task of lawyers drafting a co-tenancy provision is made clearer but nonetheless more daunting – the words must be drafted in a common-sense fashion to reflect the intention of the parties (as reflected by the contract as a whole) at the time it was entered into. Absent that – you can't be certain whether or not a right for which you have bargained will be enforceable. And as a lawyer, it is important to clarify to the extent you are able exactly what the parties intend, and if possible to keep documentation relating to that intent should a subsequent dispute arise. The court may look at a wide swath of evidence of past conduct to determine the issue of intention and despite the parol evidence rule, that review might include successive drafts of the document (or any predecessor document) to determine the objective intention of the parties.

4. Maybe the Co-Tenancy isn't broken at all?

As many co-tenancy clauses provide a mechanism for the Landlord to introduce a replacement tenant, it is interesting to consider the circumstances in which that obligation might be satisfied. The California case, *Radioshack Corp. V. Azusa Pacific Univ.*, 2016 WL 3640370 is an interesting case in point. In that case the court ruled that a fitness centre was "similar" to a discounter, Big Lots, because of the amount of foot traffic that was driven to the centre. Also they compared the quality of the goods sold by the fitness centre to those sold by Big Lots and decided that the co-tenancy replacement tenant requirement had been met.

It may also be that the requirement is ambiguous – for instance, the obligation to replace a retailer with a similar major retailer – may open the door to the Landlord fulfilling the co-tenancy obligation with a retailer entirely dissimilar to the operator that has departed and there may be little that the tenant with the co-tenancy right can do to complain about it.

5. Co-Tenancy and Force Majeure

During the pandemic, when there were government restrictions on opening or remaining open for business, some tenants took a closer look at their existing co-tenancy clauses to determine whether or not the failure of tenants to open would be a trigger, or whether (on the other side of the table) a landlord might use the government restrictions to prevent a tenant from getting the benefit of a co-tenancy provision. In my view, it is likely fundamental to the rights of a tenant that is getting the benefit of co-tenancy provision, that it be in operation. So – if a government restriction prevents all but essential businesses from operating, then it is likely that a tenant also prevented from operating, could not rely on its co-tenancy provision to abate rent or terminate its lease. As centers reopen, but with fewer tenants, it may be that a co-tenancy provision is legitimately triggered. I am not aware of any "post-pandemic" cases dealing with a co-tenancy provision. It is likely to early to say whether or not, as the retail landscape shifts yet again, co-tenancy will be an important legal issue for determination by the courts.

The concepts addressed in this paper are for information purposes only and should not be relied upon as legal advice. Legal counsel should always be obtained before addressing any of the issues referred to in this paper.