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# Shopping Center Legal Update

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# *In Re AB Liquidating Corp.*: Handling the Matter of a Bankrupt Tenant's Security Deposit

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In a recent case that may have sealed the fate of landlords trying to apply their security deposit to their damages claim, *In re AB Liquidating Corp.*, 416 F.3d 961 (9th Cir. 2005), the Ninth Circuit Court of Appeals, ruled that a landlord must deduct a bankrupt tenant's security deposit from its damages claim, after it is capped by § 502(b)(6) of the Bankruptcy Code, rather than from the actual total damages resulting from a tenant's rejection of the lease pursuant to § 365 of the Bankruptcy Code. (All references to the Bankruptcy Code refer to 11 U.S.C. § 101, *et seq.*, including, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act, which became effective Oct. 17, 2005.)

## The Facts

In April 2000, Adaptive Broadband Corp. ("Adaptive"), a Sunnyvale, Calif.-based telecommunications firm, entered into a five-year commercial lease at the annual rent of $2 million. As security for the lease, Adaptive provided a $1 million letter of credit to landlord AMB Property L.P. ("AMB"). In July 2001, Adaptive filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Northern District of California and immediately rejected the lease pursuant to § 365 of the Bankruptcy Code. AMB successfully mitigated its damages by re-letting the premises to another tenant and then filed a $2 million proof of claim in Bankruptcy Court for damages AMB claimed resulted from Adaptive's rejection of the lease. Actual damages totaled approximately $5 million; however, the damages were capped at $2 million by virtue of § 502(b)(6) of the Bankruptcy Code. The Official Committee of Unsecured Creditors contested AMB's claim against Adaptive's bankruptcy estate, arguing that AMB should apply the $1 million security deposit to offset AMB's claim of a full year's rent, thus leaving AMB with $1 million claim for rejection damages against Adaptive's bankruptcy estate.

## Section 502(b)(6) Lease Damages Cap

Section 502(b)(6) of the Bankruptcy Code provides that the Bankruptcy Court should disallow any claim "to the extent that—

"(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—

- **a)** the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
  - (i) the date of the filing of the petition; and
  - (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus
- **b)** any unpaid rent due under such lease, without acceleration, on the earlier of such dates. . . ." 11 U.S.C. § 502(b)(6)

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Of course, the lease damages cap set forth in § 502(b)(6) is somewhat arbitrary and is applied rather mechanically in the interest of efficiency. As landlords are well aware, there is a major distinction between a rejection damages claim and the capped amount. A claim represents the total value the landlord may assert under substantive non-bankruptcy law while the claim is limited by whatever damages are available under non-bankruptcy law. The term "damages" in § 502(b)(6) spans the full range of damages known to non-bankruptcy law that "result" from "termination of a lease of real property." *See Condor Systems*, 296 B.R. 5, 12-13 (B.A.P. Ninth Cir. 2003) (under analogous cap of 502(b)(7) on employees' breach claims).

In sharp contrast, the cap merely defines how much of the substantive claim will be "allowed" to be paid by the bankruptcy estate and requires "disallowance" of the remainder of the claim. Simply put, the cap establishes a limit on what will be allowed to be paid from the bankruptcy estate and is neither a substantive damages remedy nor a limit on substantive damages.

A landlord's mitigation of damages, by re-letting the premises, is relevant only to calculation of the landlord's actual damages under substantive non-bankruptcy and does not factor in to the § 502(b)(6) cap. Accordingly, "any resulting proceeds from that mitigation are properly deducted from the claim before the 502(b)(6)(A)'s damages cap is applied." *In re Handy Andy Home Imp. Centers, Inc.,* 222 B.R. 571, 575 (Bankr. N.D.Ill. 1998). It is, therefore, possible that a similar approach could be followed with respect to a debtor's security deposit that the landlord is holding when the debtor files bankruptcy—the security deposit would reduce the landlord's state law damages from the debtor's breach, and the full § 502(b)(6) cap would then be applied to those damages (as first reduced by the amount of the security deposit).

## The Decision

AMB, the landlord in *AB Liquidating*, argued that a security deposit simply mitigates the landlord's total damages claim and should therefore be deducted from the total—uncapped—rejection damages claim. AMB argued that the plain language of § 502 requires a court to: (1) determine the landlord's gross damages (net of any recovery obtained from re-letting of the premises); (2) subtract from those gross damages any mitigation from security deposits (including letters of credit); (3) compare this "mitigated damages" amount to the statutory cap of one year's rent; and (4) allow a claim for the lesser of either the "mitigated damages" or one year's rent. *AB Liquidating*, 416 F.3d at 964. The Bankruptcy Court disagreed and, on appeal, both the District Court and the Ninth Circuit affirmed the Bankruptcy Court's ruling.

In reaching its decision, the Ninth Circuit relied on the Second Circuit's decades-old ruling in *Oldden* v. *Tonto Realty Co.*, 143 F.2d 916 (1944), where the court held that the security deposit held by a landlord of a tenant in bankruptcy should be deducted from the allowable claim rather than the total damages. The Ninth Circuit noted that the holding in *Oldden* was endorsed by Congress in 1977 in a frequently cited House Judiciary Report amending the landlord cap provisions of § 502(b) of the Bankruptcy Code. (416 F.3d at 964). The congressional report stated that a landlord is not permitted to offset actual damages using the security deposit and then claim for the balance. *See* H.R. Rep. 95-595, at 353-54 (1977). Rather, the security deposit is to be applied in satisfaction of the claim that is allowed under § 502(b). Congress stated that the landlord damages cap

> "is intended to compensate the landlord for his loss while not permitting a claim so large . . . as to prevent other general unsecured creditors from recovering a dividend from the estate." *AB Liquidating*, 416 F.3d at 964 [quoting H.R.Rep. 95–595 at 353–54 (1977)].

AMB argued that the *Oldden* rule should not apply in the case of letters of credit that are provided as security deposits. The Ninth Circuit rejected that argument, stating that the proceeds of the letter of credit were subtracted properly from AMB's allowed claim based on both *Oldden* and other case law. In *AB Liquidating*, the issue on appeal to the Ninth Circuit was the construction of § 502(b)(6) of the Bankruptcy Code. Given the facts of the *AB Liquidating* case, the landlord's claim was capped at the lesser of its actual damages or one year's lease payments; the alternative cap of 15% was not at issue. The parties agreed that the landlord's "gross damages" totaled $5 million. Because that amount exceeded one year's rent—$2 million—the parties further agreed that the cap applied. The only issue on appeal was whether the $1 million security deposit should be applied against the $5 million "gross damages" number or the $2 million "capped" number. This narrow issue was an issue of first impression in the Ninth Circuit.

The Ninth Circuit rejected this plain meaning argument as misplaced. In its plain language, § 502(b)(6) makes no mention of how security deposits should be applied in the calculation of landlord rejection damages claims. The statute gives no clear guidance regarding whether such security deposits should be applied to the landlord's gross damages claim or its capped claim. Given the ambiguity, Congress's explicit endorsement of *Oldden* in the legislative history appears to have prevented the Ninth Circuit from adopting AMB's argument that *Oldden* should be rejected outright. The Ninth Circuit further rejected the argument that it should apply *Oldden* only in the context of cash security deposits and not letters of credit, and decided that extending *Oldden* to letters of credit would not unnecessarily interfere with third-party relationships, would not unduly penalize landlords while failing to advance the policy of the Bankruptcy Code, and would not greatly upset the commercial leasing industry. Thus, the proceeds of the letter of credit were subtracted from the landlord's capped claim properly.

In deciding *Oldden*, the Second Circuit reasoned that since "the statute [under a predecessor version of the Bankruptcy Code] sets a limit on damages for breach of lease by bankruptcy, then the landlord should be entitled only to that sum and not more; otherwise the security would be in the nature of a forfeiture in the event of bankruptcy, and forfeitures are not favored by the courts." *Oldden*, 143 F.2d at 921. "The contrary result would mean that a landlord with security would be able to exceed the statutory limit by as much as the security he holds, and that landlords would receive different treatment in bankruptcy proceedings, depending upon the existence and size of the security in their possession." *Id.* at 920. "In light of the history and purpose of the statutory provision and its clearly expressed intent, we should construe it so as to give it full force and effect, and not allow it to be nullified by crafty draftsmanship in particular leases." *Id*.

In *AB Liquidating*, the landlord argued that *Oldden* was decided wrongly and that the Ninth Circuit should adopt the argument of the dissent in *Oldden*, which wrote:

> "I see no reason to think that Congress intended that a landlord who, bargaining with a tenant of whose financial stability he is doubtful, and to whom he would not otherwise lease his property, demands and receives security, is, with respect to that security, to be treated differently from other secured creditors. An ordinary secured creditor . . . can retain his security only to the point where it makes him whole; he is allowed to share in the estate only so far as he is unsecured; the value of the security is deducted from his total claim, and, if there is a deficiency, he is, to that extent, an unsecured creditor and permitted to participate. That is to say, a secured creditor, as such, has no provable claim; he may share in the estate only so far as he is treated like every other unsecured creditor.
>
> Nothing in the wording or legislative history of the 1934 amendment enacting the statutory cap on lease damage claims shows any purpose to modify [then existing landlord damage cap provision] any plan to accord a peculiar status to a secured landlord. There is not a syllable on the subject of security in the amendment, nothing to suggest that Congress had that subject in mind. Under [then existing landlord damage cap provision] if a landlord is wholly secured, he, like any other secured creditor, has no provable claim. He has one only if he is partially unsecured. With respect to his unsecured balance, he is, I think, in precisely the same position as a landlord without any security. The one-year-rent maximum, I think, applies to his unsecured balance just as it does to the claim of a wholly unsecured landlord. Why the fixing of such a maximum should be regarded as amending [then existing landlord damage cap provision] I cannot understand." *Oldden*, 143 F.2d at 922 (Clark, J., dissenting) (citation omitted).

## Relation to Other Sections of the Bankruptcy Code

When it enacted the Bankruptcy Code,[1] Congress apparently intended to continue the guidance of *Oldden* and modified the treatment of secured claims as set forth in the *Oldden* dissent. Section 506 of the Bankruptcy Code allows a creditor to exercise a right of setoff and provides as follows:

**a)** "An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under § 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or of a plan affecting such creditor's interest.

**b)** To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

**c)** The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.

**d)** To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void unless

(1) such claim was disallowed only under § (502(b)(5) or 502(e) of this title; or
(2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under § 501 of this title."

11 U.S.C. § 506.

The structure of § 506 provides that a creditor's security—either a lien or a setoff right—secures the creditor's "allowed claim." 11 U.S.C. § 506. In the case of a commercial landlord of a rejected lease, the "allowed claim" is the "capped" claim after applying the mandates of § 502(b)(6). *See Cutler* v. *Lindsey*, 1997 WL 705435, at *3-4 (4th Cir. 1997). This analysis actually supports the notion that the landlord's security deposit should be applied to the "capped" claim. One court has described the intertwined relationship of the Bankruptcy Code provisions to landlords' security deposits, as follows:

> "The tenant provides the security deposit . . . required by the lease, which lease terms ordinarily . . . require it to be refunded after faithful performance of the lease. The tenant's right to a refund is property in the sense of 541 in the tenant's bankruptcy case and, hence, is property of the estate.
>
> As property of the estate, the security deposit is required to be turned over to the trustee under 542(b) once it becomes due (as when the lease is terminated or expires during bankruptcy), subject, per 542(b), to offset under 553.
>
> Section 553(a)(1) forbids setoff to the extent that claim is disallowed. Since any claim in excess of the 502(b)(6) cap is disallowed, offset is only permitted against the allowed portion of the claim. This is why the legislative history statement that the security deposit must be applied against the allowed claim is accurate.
>
> Under the terms of 502, the landlord's claim for rent is disallowed by 502(b)(6) to the extent it exceeds the cap stated in that section . . . . Thereby, the result in *Oldden* is preserved." *Redback Networks, Inc.* v. *Mayan Networks Corp*. (*In re Mayan Networks Corp*.), 306 B.R. 295, 304-05 (B.A.P. 2004).

The *AB Liquidating* court was a bit less stringent in analyzing the relationship among §§ 502(b)(6), 506(a), 506(d) and 553(a). In fact, the *AB Liquidating* court held simply that "[s]ection 502(b)(6) makes no mention of how security deposits should be applied in the calculation of allowable claims" than "the statute is ambiguous as to whether such deposits should be applied to a landlord's gross damages or its capped claim." 416 F.3d at 964. The court further held that "Congress's explicit endorsement of *Oldden* prevents us from accepting [the landlord's] invitation to reject the case outright." *Id.*

To make matters worse for a battered landlord, the treatment of security deposits as outlined above may subject the landlord to having to return a security deposit despite also having his or her rejection damages claim capped by § 502(b)(6). Such a scenario arises where the landlord finds itself in possession of a security deposit greater than the "capped" amount of the landlord's rejection damages. *See* 11 U.S.C. § 542(b).

The *Oldden* court commented about this possibility, as follows:

> "In the situation where the landlord, by virtue of obtaining an unusually large deposit in advance, has still a balance in his hands after deducting the claim for one year's rent allowable by the statute . . . it is clear that when the lease is at an end, and no damages can thereafter be due, the security must be returned. Hence, even before the 1934 amendment, the security could be retained only as against possible claims, and the cases assumed that upon complete termination of the lease upon bankruptcy, any surplus over damages allowable in bankruptcy was returnable to the trustee. The statute now makes the termination of the lease complete, and the damages fixed; and anything in excess should go to the trustee for the general creditors." *Oldden,* 143 F.2d at 921.

Congress specifically addressed this issue in the legislative history to § 502(b)(6), stating that "to the extent that a landlord has a security deposit in excess of the amount of his claim allowed under this paragraph, the excess comes into the estate." *See* S. Rep. No. 95-989, at 63; *see also* H.R. Rep. No. 95-595 at 353-54 (same); *Mayan Networks*, 306 B.R. at 305 [stating that "when the tenant provides a security deposit that exceeds the 502(b)(6) cap: offset may be taken with respect to the amount of the capped claim under 553(a), and the balance must be turned over to the estate under 542"]. Accordingly, *AB Liquidating* has made it abundantly clear that a cash security deposit held by a landlord of a commercial tenant does not allow the landlord to recover damages attributable to future rent in excess of the § 502(b)(6) cap.

## Other Forms of Security

Of course, if the landlord is able to obtain a personal guaranty during lease negotiations, it can recover to the full extent of its state law damages from the guarantor, regardless of the tenant's bankruptcy filing. *Kopolow* v. *P.M. Holding Corp*. (*In re Modern Textile, Inc*.), 900 F.2d 1184, 1191–92 (8th Cir. 1990); *Bel-Ken Associates Ltd. Partnership* v. *Clark*, 83 B.R. 357 (D. Md. 1988); *Things Remembered, Inc.* v. *BGTV, Inc.*, 151 B.R. 827, 831 (Bankr. N.D. Ohio 1993).

Is a standby letter of credit a better form of security deposit? Not necessarily. In *AB Liquidating*, the debtor-tenant had the option of posting *either* a cash security deposit of $1 million or a $1 million standby letter of credit. 416 F.3d at 962. In either instance, the lease provided that "Landlord shall, at the expiration or earlier termination hereof and after Tenant has vacated the Premises, return to Tenant that portion of the Security Deposit not used or applied by Landlord." *Id.; see also PPI Enterprises*, 324 F.3d 197, 210 ("it is clear that parties intended the letter of credit to operate as a security deposit," as the lease "expressly provided that the letter of credit was 'in lieu of' debtor-tenant's cash security obligation"); *Mayan Networks*, 306 B.R. 310–11 (Klein, B.J., concurring) ("the Landlord contractually agreed in the lease that letter-of-credit proceeds are part of the security deposit that must be refunded to the Debtor following faithful performance of the lease"); *Stonebridge Technologies*, 291 B.R. 63, 71 ("the proceeds of the Letter of Credit became a part of the Security Deposit pursuant to the express terms of the Lease"). Thus, where lease terms provide that a landlord's draw on a standby letter of credit is to be treated in precisely the same fashion as a cash security deposit, the courts (including the Ninth Circuit in *AB Liquidating*) have routinely concluded that letter-of-credit proceeds must be deducted from the landlord's "capped" claim in a manner mirroring the treatment of a cash deposit. *Mayan Networks*, 306 B.R. at 299; *see also Stonebridge Technologies*, 291 B.R., at 71 ("[a]lthough initially independent of the Lease, the proceeds of the Letter of Credit must be applied as the parties bargained for—as a security deposit for the Lease"). Similarly, where the landlord's post-petition draw under the standby letter of credit exceeds the applicable cap under § 502(b)(6), the landlord is obligated to pay the excess amount into the debtor-tenant's bankruptcy estate under § 542(b) of the Bankruptcy Code—just as it must with a cash security deposit in excess of the cap.

## The Bottom Line

Is there a drafting fix that could cause a bankruptcy court to treat a landlord's security deposit differently? Probably not without materially altering the terms of the up-front lease negotiation. It appears that the only effective method of ensuring that letter-of-credit proceeds are not treated as a cash security deposit for purposes of § 502(b)(6) of the Bankruptcy Code is for the lease to provide that the proceeds are not refunded upon expiration of the lease. In other words, the lease must provide that the landlord has no obligation to return the proceeds of the standby letter of credit to the tenant and that the landlord may retain the proceeds regardless of whether the tenant is in default and even if the tenant does not owe the landlord anything upon expiration. This type of provision would leave the tenant, now debtor, with no interest in the letter-of-credit proceeds and, thus, the proceeds will not constitute property of the debtor's bankruptcy estate pursuant to the Bankruptcy Code. Obviously, this concept may represent a radical shift in the substantive lease negotiations and likely will be resisted by a tenant.

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[1]The relevant sections of the Bankruptcy Code cited in this article remain unchanged by the Bankruptcy Abuse Prevention and Consumer Protection Act (Public Law 109-8), which took effect, in pertinent part, on Oct. 17, 2005.

# Enforcing Exclusive Use Clauses

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## Introduction

In today's competitive leasing environment, as a condition to entering into a lease, tenants often require landlords to give them protection against competition from other tenants in the shopping center in the form of so-called "exclusives." In order to induce tenants to come to their shopping center, and because the concept of giving a tenant protection against competition in its particular market niche seems to be a fairly straightforward proposition, landlords are often inclined to grant such exclusives. Although such provisions constitute restraints of trade and thereby implicate state and federal antitrust laws, courts have generally upheld them so long as they are reasonable in scope and effect. However, as a recent case illustrates, the administration and enforcement of such exclusives after the lease is executed can go well beyond simply the language of the exclusive itself, and may implicate concepts such as privity, third-party beneficiary, liquidated damages, estoppel and waiver. *Mark-It Place Foods, Inc.* v. *New Plan Excel Realty Trust, Inc.*, 156 Ohio App.3d 65, 804 N.E.2d 979 (Ohio 2004).

## Facts

The *Mark-It Place Foods* case presents a somewhat convoluted set of facts that can be summarized, in relevant part, as follows.

In July of 1989, the New Boston Development Company ("NBDC") entered into a lease with Scrivner, Inc. ("Scrivner") for the operation of a grocery store in a shopping center ("Shopping Center") being developed by NBDC. The lease between NBDC and Scrivner contained the following provision for exclusive use (the "Scrivner Exclusive"):

> "Neither Lessor nor any affiliate or related party shall, without Lessee's prior written consent, own, operate or grant any lease or permit any assignment or sublease for a store (or any portion of a store) in the Shopping Center or any of Lessor's real estate located within 1,500 yards of the Shopping Center which permits a tenant under such lease to sell or offer for sale groceries, meats, poultry, seafood, dairy products, fruits, vegetables or baked goods, provided these restrictions shall not be deemed to prohibit a restaurant from serving prepared food."

In November of 1989, NBDC leased a 112,238 square foot building in the Shopping Center to Wal-Mart. The Wal-Mart lease did not contain any provision prohibiting Wal-Mart from operating in violation of the Scrivner Exclusive; Wal-Mart, in fact, sold foodstuffs including chips, nuts, beverages, cereal, cookies, canned meats, pasta and other convenience food items in its premises.

Ultimately, Scrivner assigned its lease to S.M. Flickinger ("Flickinger"), which in turn subleased the Scrivner premises to Mark-It Place Foods, d/b/a Festival Foods ("Mark-It Place Foods"). Flickinger then assigned the lease to Fleming Companies, Inc. ("Fleming"). Accordingly, at the time of the lawsuit, the relevant parties were NBDC as landlord, Fleming as tenant and Mark-It Place Foods as sublessee.

In 1992, NBDC decided to sell the Shopping Center. New Plan Excel Realty Trust, Inc. ("New Plan") expressed interest in purchasing the Shopping Center, and began examining the Shopping Center leases. During such process, New Plan discovered the Scrivner Exclusive and the absence of any obligation to comply with the Exclusive in the Wal-Mart lease. Shortly after the discovery, New Plan sent an "estoppel letter" to NBDC and Fleming, requesting, among other things, the parties' assurances that there were no defaults under the terms of the Scrivner lease. NBDC and Fleming executed the letter, and Mark-It Place Foods assented to the execution and delivery of the letter to New Plan. Two months later, New Plan requested and received an updated "tenant estoppel certificate" affirming that there were no breaches of the Scrivner lease. Based upon the estoppel letter and tenant estoppel certificate, New Plan purchased the Shopping Center in early 1993.

In December of 1998, Fleming sent a letter to New Plan, notifying it that Wal-Mart was selling foodstuffs in the Shopping Center in violation of the Scrivner Exclusive and requesting that New Plan take immediate action to require Wal-Mart to cease such sales. New Plan took no action, and Fleming discontinued its rental payments as set forth in the Scrivner lease.

In November of 1999, Mark-It Place Foods filed suit, alleging that New Plan and Fleming had violated the provisions of the Scrivner lease by permitting Wal-Mart to sell foodstuffs in violation of the Scrivner Exclusive.

After a lengthy discovery process, all parties filed motions for summary judgment. In ruling on such motions, the trial court held as follows: (1) Mark-It Place Foods, as a sublessee under the Scrivner lease, could not bring suit directly against New Plan because no privity of contract (or estate) existed between them; (2) no breach of the Scrivner Exclusive occurred because the Exclusive was "overbroad" and should be construed only to prohibit other supermarkets in the Shopping Center and any other store primarily engaged in the sale of foodstuffs; (3) in light of the court's holding under clause (2) above, Mark-It Place Foods' claim against Fleming was held to be moot. Because of its holding under clause (1) above, the trial court did not consider the enforceability of Fleming's remedy for New Plan's violation of the Scrivner Exclusive (i.e., abatement of all rent payable under the Scrivner lease until cessation of such violation).

## Analysis

Prior to addressing the merits of the parties' respective assignments of error, the appellate court noted that the standard of review for summary judgments is *de novo* and that, under such standard of review, the appellate court would afford no deference to the trial court's summary judgment decision and would conduct its own independent review. In reciting such standard of review, the court noted that summary judgment is only appropriate when a movant can demonstrate that (1) no genuine issue of material fact exists; (2) the movant is entitled to judgment as a matter of law; and (3) reasonable minds can come to only one possible conclusion and that conclusion is adverse to the opposing party, with the evidence construed most strongly in favor of the non-moving party. *See* Ohio Civ. R. 56(C).

## Privity of Contract/Third-Party Beneficiary Status

The court first addressed whether Mark-It Place Foods, as a sublessee in the Shopping Center, could bring an action directly against the landlord under the Scrivner lease: New Plan. In reaching its conclusion that Mark-It Place Foods could not maintain such action, the court discussed concepts relating to privity and third-party beneficiary status.

Mark-It Place Foods first argued that, despite the well-settled rule cited by the court that no privity of contract exists between a sublessee and an original lessor [*see Crowe* v. *Riley*, 63 Ohio St. 1, 9, 57 N.E. 956 (Ohio 1900)], the parties to a lease could alter this principle by agreement. Mark-It Place Foods contended that it had privity of contract with New Plan because the Scrivner lease provided that the original landlord would be liable to any sublessee. In rejecting this argument, the court held that although an original landlord might agree to be liable to a sublessee pursuant to a lease agreement, a sublessee could never agree to be liable to an original landlord because such sublessee is not a party to the original lease. Ultimately, the court found that "[p]rivity of contract between parties, including lessors and lessees, is a fundamental prerequisite to bringing suit for the breach of a contract and we do not believe that the parties in the instant case could alter those principles in the lease agreement." *Mark-It Place Foods*, at p. 80.

The court next addressed whether Mark-It Place Foods could maintain an action against New Plan as a third-party beneficiary of the Scrivner lease. In addressing this argument, the court first noted that "[a]s a general proposition, a third party for whose benefit a contract has been entered may bring an action for a breach of that contract." *See Grant Thornton* v. *Windsor House, Inc.*, 57 Ohio St.3d, at 158, 161 (Ohio 1991). The court further stated, however, that only an *intended* third-party beneficiary may exert rights to a contract to which it is not a party. *Trinova Corp.* v. *Pilkington Bros., P.L.C.*, 70 Ohio St.3d 271, 277 (Ohio 1994) (italics in original). The court noted that there are three categories of intended third-party beneficiaries: (1) a creditor beneficiary, (2) a donee beneficiary and (3) an incidental beneficiary. Only the first two categories, however, may bring an action as a third-party beneficiary. An incidental beneficiary under a contract to which he or she is not a party cannot recover from the promissor in breach. *Mark-It Foods*, at p. 81.

Mark-It Place Foods did not argue that it was either a creditor or donee beneficiary, and thus its argument regarding third-party beneficiary status was rejected by the court. However, the court did engage in a brief discussion of the meanings of "creditor" and "donee" beneficiaries. The court found that a party is a "creditor" beneficiary if the performance of the promise satisfies a duty owed by the promissee to the beneficiary. The court noted that it found nothing in the record to suggest that Scrivner owed a debt or other such "duty" to Mark-It Foods when it entered the original lease. Indeed, the court found, the fact that the sublease provided for rental payments in exchange for subletting the premises tended to indicate that the sublease was intended purely as a business transaction and was not intended to discharge any obligation owed to the sublessee.

The court then found that a party is a "donee" beneficiary only if performance of the promise is meant to bestow some gratuitous benefit rather than to satisfy a legal obligation. Again, the court found that the provisions of the sublease relating to the payment of rent would belie any contention that a gift formed the basis of the Scrivner lease.

Accordingly, the court rejected Mark-It Foods' argument that it could maintain an action directly against New Plan on the basis that it either had privity of contract with New Plan or was an intended third-party beneficiary of the Scrivner lease.

## Exclusive

The court next addressed whether New Plan violated the Scrivner Exclusive by permitting Wal-Mart to sell certain food items as described above.

The court began its analysis with a recitation of the basic premise that leases are contracts and are subject to the traditional rules of contract interpretation. *Mark-It Place Foods*, at p. 83. The first such rule cited by the court is that "[t]he cardinal purpose in construing contracts is to ascertain and give effect to the parties' intention." *Mark-It Place Foods*, at p. 83. According to this rule, common words used in a written instrument will be given their ordinary meaning unless (1) manifest absurdity results or (2) some other meaning is clearly evidenced from the instrument. The court also noted that the interpretation of written contracts is a question of law which, unlike issues of fact that are afforded great deference, is reviewed on appeal *de novo*.

The court then addressed the language of the Scrivner Exclusive, which prohibited the landlord from permitting a tenant to sell, or offer to sell "groceries, meats, poultry, seafood, dairy products, fruits, vegetables or baked goods." The court found that, although the prohibited items were not specifically defined in the Scrivner Exclusive, "groceries" are the commodities sold by a "grocer," who is one who sells foodstuffs and various household supplies. The court found that "meats, poultry, seafood, dairy products, fruits and vegetables" were self-explanatory, and found that "baked goods" are "food items that are baked in an oven and placed for sale." *Mark-It Place Foods*, at p. 84. The trial court construed the Scrivner Exclusive to mean that the contracting parties meant to exclude only "supermarkets" or other "stores primarily engaged in the sale of foodstuffs." The appellate court disagreed with this conclusion.

First, the court found that neither the word "supermarket" nor the phrase "primarily engaged in the sale of foodstuffs" appears in the Scrivner Exclusive, and that "courts should refrain from reading terms into instruments when these terms do not otherwise exist." *Mark-It Place Foods*, at p. 84. Second, the court found that the trial court's interpretation of the language of the Scrivner Exclusive was too restrictive. In reaching this conclusion, the court stated that although the trial court's decision might have been valid if the Scrivner Exclusive had referred only to "groceries," the Exclusive in fact referred to much more specific items, suggesting that the parties intended to prohibit not just the sale of groceries by supermarkets, but also the sale of the other items specified in the Exclusive by any store. Third, the court found that the trial court had impermissibly based its decision on extrinsic evidence outside the four corners of the lease. The trial court considered: (1) the parties' actions or inactions with regard to subsequent estoppel letters and (2) deposition testimony by several individuals as to the original intent of the parties in entering into the lease. The court found the trial court's consideration of the above-described evidence impermissible based on the principle that when a contract is unambiguous, intentions not expressed by writing in the contract are deemed to have no existence and cannot be shown by parole evidence. This is the well-settled parol evidence rule. Thus, extrinsic evidence is admissible to ascertain intent only when the contract is unclear or ambiguous, or when the circumstances surrounding it give the plain language special meaning. The court held that the language of the lease regarding the Scrivner Exclusive was clear and unambiguous, and should have been afforded its plain and ordinary meaning.

Having concluded that the Scrivner Exclusive had a broader meaning than was afforded by the trial court, the court turned to the issue of whether the Scrivner Exclusive amounted to an illegal restraint of trade in violation of R.C. Chapter 1331. New Plan argued that if the Exclusive were given its literal meaning, then it would violate state restraint of trade laws. The trial court ruled that the Exclusive did not violate state antitrust laws based on that court's narrowed construction of the provision. However, the appellate court considered whether the Exclusive violated such laws based on its more expansive reading of the provision.

In reaching its conclusion that the Scrivner Exclusive did not violate state antitrust laws prohibiting any "trust," the court first discussed the scope and meaning of the word "trust." Pursuant to state law, a "trust" is defined, *inter alia*, as "a combination by two or more persons to carry out restriction in either trade or commerce or to prevent competition in the sale of produce or commodities." *R.C. 1331.01*, at (B) and (C). Based upon the foregoing, New Plan argued that NBDC and Scrivner combined to form an illegal "trust" in restraint of trade. The court disagreed.

In reaching its conclusion, the court first noted that the Ohio Supreme Court recognized years earlier that if anti-trust laws were construed literally or strictly, no partnership could be formed, no corporation could be organized, no vendor could agree to a reasonable limitation upon his or her future business and scores of other activities that have been permitted and approved of in this country for centuries would be banned. *See List* v. *Burley Tobacco Growers' Co-Operative Assn.*, 114 Ohio St. 361, 377 (Ohio 1926). Thus, the Ohio Supreme Court held that contracts in restraint of trade are not illegal unless they are unreasonable. The court then cited a case in which the Ohio Supreme Court held that "a provision in a shopping center lease granting a lessee the exclusive right to carry on a certain line of business in the shopping center does not constitute an illegal restraint of trade under R.C. Chapter 1331 as long as the scope and effect of the grant is not unreasonably broad." *S.K. & J.K., Inc.* v. *Fairview Shopping Center*, 63 Ohio St.2d 201, at paragraph 1 of the Syllabus (1980). The exclusive use provision in that case involved restricting the sale of liquor, alcoholic beverages, wines and beer by the glass but, because it did not affect the whole community and did not extend beyond the shopping center, the court found that the provision was not unreasonably broad.

The court found that similarly, in the instant case, the restrictive use provision only prohibits stores from selling groceries and other specified food items in the Shopping Center. It does not affect the rest of the New Boston community and, thus, appears to pass muster under the *S.K. & J.K., Inc.,* case. The court further found the Scrivner Exclusive to be reasonable under the test set forth in a federal case. *Child World, Inc.* v. *South Towne Centre, Ltd.*, 624 F.Supp. 1121, 1130-1121 (U.S. Dist. Ct. Ohio 1986). Under such test, the federal court cited the following factors to determine whether an exclusive use provision is overly broad: (1) the relevant product and geographic markets, together with the showing of unreasonable impact upon competition in these markets due to the restrictive covenant; (2) the availability of alternate sites for the entity excluded by the operation of such covenant; (3) the significance of competition eliminated by the exclusivity clause, and whether present or future competitors were the parties excluded; (4) the scope of the restrictive covenant and whether it varies depending on the circumstances; and (5) the economic justifications for including the restrictive covenant in the lease.

Based upon the foregoing factors, the court found that the Scrivner Exclusive related only to the Shopping Center and did not affect the rest of the community; nor did it create a barrier to entry, or prohibit competition, by any grocer outside of the Shopping Center and in the larger New Boston community. The court then emphasized, "anti-trust laws exist for the protection of *competition*, not *competitors*, and that the essence of competition is not within a shopping center, but between shopping centers." *Mark-It Place Foods*, at p. 87 (italics added). Accordingly, the court found that the Scrivner Exclusive did not violate state anti-trust laws.

Next, the court addressed the issue of whether the sale by Wal-Mart of the foodstuffs described above violated the Scrivner Exclusive. In determining that such operation by Wal-Mart did, in fact, violate the Scrivner Exclusive, the court found in fairly summary fashion that (1) the Wal-Mart lease did not prohibit the sale of food items in violation of the Scrivner Exclusive and (2), in fact, Wal-Mart sold such items (based upon photographs and other evidence entered as part of the record pursuant to Fleming's motion for summary judgment and apparently unchallenged by New Plan).

## Estoppel/Waiver

The court next addressed New Plan's contention that, even if there was a violation of the Scrivner Exclusive, Mark-It Place Foods and/or Fleming were estopped from asserting, or had waived, such violation as a result of executing the estoppel letter and tenant estoppel certificate referred to above. New Plan also asserted an estoppel theory independent of the letter and certificate.

In its discussion, the court first noted that "estoppel"in its general sense is a bar, which precludes a person from denying a fact that has become settled by an act of the person himself. The court cited three broad categories of estoppel: (1) estoppel by record, (2) estoppel by deed, and (3) estoppel *in pais* ("equitable estoppel"). The court found that although New Plan did not specify which type of estoppel it was asserting, based on the pleadings, it appeared as though it was raising equitable estoppel.

The purpose of equitable estoppel is to prevent fraud and to promote the interest of justice. *Ohio State Bd. of Pharmacy* v. *Frantz*, 51 Ohio St.3d 143, 145 (Ohio 1990). Equitable estoppel arises when one party induces another party to believe that certain facts exist and the other party changes its position to its detriment in reasonable reliance on those facts. To invoke the doctrine of equitable estoppel, a party must show that (1) there is a factual misrepresentation; (2) the factual misrepresentation is misleading; (3) it induced actual reliance, which is both reasonable and in good faith; and (4) the factual misrepresentation is a detriment to the relying party.

The court found that (1) New Plan presented evidence of equitable estoppel, raising a genuine issue of material fact, and (2) Fleming could argue that New Plan did not reasonably rely on the facts as stated in the estoppel letter and tenant estoppel certificate. Accordingly, the court revised the trial court's granting of summary judgment on the issue of equitable estoppel and remanded to the trial court for further proceedings on the issue. Interestingly, and perhaps instructively for practitioners, the court found that the estoppel letter and tenant estoppel certificate were not dispositive of the issue, but merely evidence of New Plan's claim of equitable estoppel.

The court next addressed New Plan's claim that Fleming waived any violation of the Scrivner Exclusive. The court first noted that "waiver" is the voluntary relinquishment of a known right and can be found in a great variety of circumstances. For example, "waiver by estoppel" exists when the acts and conduct of a party are inconsistent with an intent to claim a right, and have been such as to mislead the other party to its prejudice and thereby estop the party having the right from insisting upon it. Again, based on the facts presented in the motions for summary judgment, the court held that there were genuine issues of material fact relating to whether Fleming waived any violation of the Scrivner Exclusive by New Plan.

## Liquidated Damages

The final issue addressed by the court was whether the provision in the Scrivner lease allowing Fleming to discontinue the payment of all rent in the event of a violation of the Scrivner Exclusive, until cessation of such violation, constituted an enforceable provision for liquidated damages or an unenforceable penalty.

The court started its analysis from the premises that Ohio law generally respects the freedom of contract. However, as the court noted, complete freedom of contract is not permitted where it would violate some public policy. One such policy is that the law generally disfavors penalty provisions for breach of contract. Thus, while parties may insert into their contract a clause that apportions damages in the event of a default (a "liquidated damages" clause), they may not agree to a provision that operates as a penalty and punishes a party for breach. The Ohio Supreme Court has stated the following test to determine whether a provision is an enforceable provision for liquidated damages or an unenforceable penalty:

> Where the parties have agreed on the amount of damages, ascertained by estimation and judgment, and have expressed this agreement in clean and unambiguous terms, the amount so fixed should be treated as liquidated damages and not as a penalty, if the damages would be: (1) uncertain as to amount and difficult of proof, and if (2) the contract as a whole is not so manifestly unconscionable, unreasonable, and disproportionate in amount as to justify the conclusion that it does not express the true intention of the parties, and if (3) the contract is consistent with the conclusion that it was the intention of the parties that damages in the amount stated should follow the breach thereof.

The court did not consider the first and third prongs of the above test, and instead found that the rent abatement provision in the Scrivner lease was an unenforceable penalty based on the fact that the Scrivner lease provided for an abatement of rent that could have lasted for up to 40 or more years. The court found that the rent abatement clause thus rendered the entire contract so unreasonable that it could not possibly have been within the contemplation of the parties. Accordingly, the court held the abatement provision unenforceable, leaving Fleming to prove its damages resulting from New Plan's violation of the Scrivner Exclusive.

## Conclusion

The *Mark-It Place Foods* case presents a variety of issues that can arise in connection with the administration and enforcement of a provision for exclusive use set forth in a lease.

First, if you are, or represent, a sublessee under a lease that contains a provision for exclusive use, it is imperative to specify in the sublease which party has the responsibility to enforce the provisions of the exclusive and at whose cost. Further, it is imperative to specify what remedies the sublessee has against its sublessor because it will not have the right, absent a written agreement, to maintain an action directly against the original landlord.

Second, as a landlord that has granted an exclusive. it is obviously of the utmost importance not only to subject future tenants to such exclusive, but also to require such tenants to indemnify the landlord in the event of any violation of such exclusive. Given that the tenant that benefited by such exclusive may have the right to abate rent or perhaps terminate its lease, it is imperative to specify exactly what types of damages the violating tenant may be required to pay because some may constitute special or consequential damages not otherwise recoverable for such breach. Further, the party benefited by any exclusive must ensure that the remedy for any breach thereof, if in the form of a liquidated damages provision, is a true provision for liquidated damages and not an unenforceable penalty.

Finally, as a landlord or a lender, it is imperative to require extensive documentation of an estoppel or waiver of an alleged or potential violation of any clause in a lease, including an exclusive. As the court in *Mark-It Place Foods* held, estoppel certificates may or may not be dispositive, so it is imperative that they be clear and unambiguous; or, they may not achieve their intended purposes.

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# Can You Handle Rejection?

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In a case that arose from the bursting of the Internet bubble, the court was faced with the issue of whether to approve a retroactive rejection of the dot-com debtor's lease. *Pacific Shores Development* v. *At Home Corporation (In re: At Home Corporation),* 9th Circuit, Dec. 28, 2004, 392 F3rd 1064. The Ninth Circuit approved a retroactive rejection of the lease and related it back to the date of the debtor's motion, even though that date was *before* the landlord re-took possession of the premises. The panel relied heavily on *Thinking Machines* v. *Mellon Fin. Servs. Corp.* (*In re Thinking Machines*), 67 F. 3rd 1021 (1st Cir. 1995).

The debtor had leased two buildings from the landlord and deposited $20,000,000 in escrow for finish-out. Although the renovations were substantially completed, the debtor sought relief under Chapter 11 and did not occupy the buildings. On the date of the bankruptcy filing, the landlord held $1,000,000 in escrow. The tenant did not "surrender" the space to the landlord prior to filing because, for some reason, it was fearful that the landlord would convert the escrowed funds to "rent." On the date of filing, the debtor sought, among the usual "first day motions," to reject the lease *nunc pro tunc* to the date of filing of the motion. While the landlord did not object to the rejection, it did object to the retroactive nature of the request; if the relief were granted, it could not "retain" the $1,000,000 escrow monies as post-petition rent.

The landlord argued that it was improper to allow a retroactive rejection to be effective as of a date that was prior to the landlord's re-taking possession of the premises. It also argued that the court's reliance on the following factors was in error: (i) the debtor moved to reject the lease immediately upon filing the bankruptcy; (ii) the debtor immediately sought a hearing; (iii) the debtor was not in possession of the premises; and (iv) the landlord's sole interest was in "running the administrative rent."

The court went into a lengthy discussion of the "Shopping Center Amendments" to § 365 of the Bankruptcy Code and concluded that such amendments to § 365(d) cured the two significant problems faced by commercial landlords in a bankruptcy proceeding. The court recited that the amendments ensured a landlord that (1) it would receive its contractual rent until the lease was rejected and (2) the debtor could not tie up the space for the entire bankruptcy proceeding. The court then addressed the litigation that followed the passage of the amendments relating to the effective date of a rejection. It discussed the "majority view" that the rejection does not become effective until such time as an order is entered. This view regards court approval as a condition precedent to the rejection of a lease. *See Paul Harris Stores, Inc* v. *Salter Realty Trust* 148 B.R. 808, 815 (S.D. Ohio 1991). Under the "minority view," a rejection is effective upon the filing of the motion. Under this view, the court order is merely a stamp of approval of the business judgment exercised by the debtor or trustee. *See Joseph C. Spiess* 145 B. R. 597, 601 (Bankr. N.D. Ill. 1992).

In reviewing the ability of the bankruptcy court to order a retroactive rejection, the court noted that § 365 is silent on this issue. It then went on to find that a bankruptcy court had the equitable power to order a retroactive rejection when such an order was necessary or appropriate to carry out the provisions of § 365(d). This power flows from § 105(a), which is the equivalent of the "all writs" act for bankruptcy courts.

After finding that the court had the power to issue the retroactive order, the court explored whether the landlord's possession of the premises was required before such an order could be entered. The panel believed that possession was not necessary.

Finally, after deciding the bankruptcy judge had the statutory power to order retroactive rejection and that a surrender of possession by the tenant (or possession by the landlord) was not required, the court addressed whether the bankruptcy court's action was an abuse of discretion. It noted that retroactive rejection should be ordered only in exceptional cases, citing *O'Neil Theatres,* 257 B.R. 806, 808 (Bankr. E. D. La. 2000). The court would not limit the factors that a bankruptcy court could consider in determining whether to order a retroactive rejection. The landlord pointed out that in virtually every case where retroactive rejection was approved, the debtor was not occupying the premises. It argued that the automatic stay under § 362 in effect created a *de facto* occupancy. In finding that the bankruptcy court did not abuse its discretion, the panel commented on the fact that the court focused on the practical effect, rather than the legal significance of the lack of occupancy. It found that the lack of actual occupancy made it easier for the landlord to re-let the premises.

It appears that this panel of the Ninth Circuit was motivated to affirm in some part by the landlord's seemingly greedy motives to retain the $1,000,000 in rent. It made a point of reiterating the language from the bankruptcy court that the landlord's sole interest was in "running the administrative rent." In that regard, this may be a case of bad facts making bad law. In short, debtors will be seeking retroactive rejection whenever they can allege any facts that would enable them to argue that it would be "inequitable" for the landlord to be paid administrative rent for the period subsequent to the relation-back date. Acceptance of this argument would make it almost impossible for a landlord to obtain compensation for the period when it was barred by the automatic stay from taking possession of the premises.

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# Supreme Court to Hear Important Wetlands Cases

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On Tuesday, Oct. 12, 2005, the Supreme Court agreed to hear two wetlands cases (both from Michigan) that could help clarify the extent of federal jurisdiction under the Clean Water Act and to address the issues that were not reached in the Court's 2001 decision of *Solid Waste Agency of Northern Cook County* v. *Corps*, 531 U.S. 159 (2001) (*SWANC*). By taking these cases, the Court signaled that it will clarify whether the Clean Water Act jurisdiction extends to wetlands that are a distance from and only tenuously connected to traditionally navigable waters. The Court may also reach the issue of whether an isolated wetland hydrologically separated from a ditch that indirectly connects to a traditionally navigable water is regulated under the Clean Water Act.

The two cases, *Rapanos* v. *United States*, 376 F. 3d 629 (6th Cir. 2004), and *Carabell* v. *Corps*, 391 F. 3d. 704 (6th Cir. 2004), involved largely overlapping but also somewhat different issues. *Rapanos* involved a federal enforcement action against a developer for filling wetlands in Saginaw Bay and Midland Counties in Michigan. The wetlands were connected to the nearest navigable water (20 miles away) only by means of a man-made ditch, a non-navigable creek and a river that ultimately flowed into Saginaw Bay. The Sixth Circuit narrowly interpreted *SWANCC* and held that such a tenuous connection was sufficient under the Clean Water Act.

The *Carabell* case involved an appeal of a Corps permit denial to fill wetlands that were separated from a ditch by an upland berm that blocked surface drainage of water out of the parcel. The ditch then flowed indirectly into several other ditches that ultimately discharged into Lake St. Clair, Michigan. The Sixth Circuit held that the wetlands were "adjacent" to navigable waters that provided the significant nexus to establish Clean Water Act jurisdiction.

Thus, while both cases deal with the issue of hydrologic connection, the *Carabell* case also addresses the issue of whether an isolated wetland separated by an upland berm is "adjacent" to a water of the United States and can be regulated under the Clean Water Act.

In granting the petitions, the Court accepted two questions:

1) Does the Clean Water Act prohibition on unpermitted discharges to "navigable waters" extend to non-navigable wetlands that do not even abut a navigable water?
2) Does extension of the Clean Water Act jurisdiction to every intrastate wetland with any sort of hydrological connection to navigable waters, no matter how tenuous or remote the connection, exceed the constitutional power of Congress to regulate commerce among the states?

Supreme Court resolutions of these issues could also provide guidance in two pending Ninth Circuit cases and potentially reopen a third that was decided only days after the Supreme Court granted *certiorari* on the two wetlands cases.

The recently decided Ninth Circuit case, *Baccarat Fremont Developers, LLC* v. *Army Corps of Engineers*, Case No. CV-02-03317-CW (N.D. Cal., Oct. 14, 2005), reached both issues currently in front of the Supreme Court. In *Baccarat*, the commercial developer in Fremont, California, argued that the Corps did not have Clean Water Act jurisdiction over approximately 7 acres of wetlands on the site as those wetlands, which were separated by 65–70 feet across a man-made berm from a flood control channel that led to San Francisco Bay, had no current hydrological connection to waters of the U.S. and, therefore, were not "adjacent wetlands." The Ninth Circuit held that even though there was likely an ecological connection between the wetlands and the flood control channel, the Corps could regulate "adjacent wetlands" based on proximity alone, even if there was no significant hydrological or ecological connection.

The two pending cases, *Northern California River Watch* v. *City of Healdsburg* (9th Cir., No. 04-15442), and *San Francisco Baykeeper et al.* v. *Cargill et al.* (9th Cir., No. 04-17554), also revolve around the adjacency issues. In *Healdsburg*, the District Court found that (1) the City's wastewater treatment pond, a former gravel mining pit that was located near the Russian River (separated by a levee) but had no surface hydrological connection with the River, was jurisdictional since it was "adjacent" by virtue of proximity and an underground hydrologic connection and (2) the City's discharge into the pond required a National Pollution Discharge System (NPDES) permit, since the pond received only partially treated wastewater, which could discharge to the Russian River through a shared underground aquifer. Case No. CV-01-04686-WHA (N.D. Cal., Jan. 23, 2004). In addition to raising the "adjacency" question, the case on appeal also addresses whether the wastewater treatment pond and gravel mining exemptions apply, whether the pond is a "tributary" to the Russian River by virtue of a groundwater hydrologic connection and whether the pond is a "point source" of pollution for purposes of the NPDES requirements.

The *Cargill* case has bounced for many years between the District Court and the Ninth Circuit. Prior to the *SWANCC* decision, the District Court had granted summary judgment to the citizen plaintiffs, finding that the water body in question, a man-made bermed salt-processing pond located next to Mowry Slough, which leads to San Francisco Bay, was jurisdictional. Case No. CV-96-2161 (N.D. Cal, Apr. 13, 1998). On appeal following the *SWANCC* decision, the Ninth Circuit ruled that the lower court decision had been based on the Migratory Bird Rule and, therefore, must be vacated and remanded to determine whether another valid basis for jurisdiction existed. 263 F. 2d 963 (9th Cir., Aug. 30, 2001). On remand, the District Court held that the pond was jurisdictional because it is an "adjacent water body." Case No. CV-96-2161 (N.D. Cal., Apr. 30, 2003). On appeal now, in addition to the adjacency issues in front of the Supreme Court, the Ninth Circuit will address whether a "water body" can be found jurisdictional under the adjacency test where the regulations and the case law all refer to adjacent "wetlands," not "water bodies."

Both the *Healdsburg* and *Cargill* cases are briefed and awaiting oral argument. It is likely that such argument will be delayed until the outcome of the Supreme Court cases is known. The Supreme Court is expected to hold oral argument in the *Rapanos* and *Carabell* cases soon, with a decision expected in June 2006.

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# Not 'One Inch'—A Vestige of Feudal Law Erodes in New York State

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It has been the law of New York State for more than 150 years that a landlord's encroachment on the tenant's space, regardless of how minimal, justifies a complete abatement of all rent[1] —until recently. On September 15, 2005, the Appellate Division First Department overruled that longstanding precedent.

Some commentators consider this a blockbuster ruling,[2] while others disagree. Regardless of how one characterizes it, whenever the bench changes precedent so dramatically, the bar is compelled to take a close look.

The facts in *Eastside Exhibition Corp.* v. *210 East 86th St. Corp*., 801 NYS2d 568 (1st Dept. 2005) are not in dispute. The tenant leased between 15,000 and 19,000 square feet (sf) of space[3] for a quad movie theatre in Manhattan for a term of almost 20 years. The lease permitted the landlord to enter the tenant's premises at reasonable times to make repairs and improvements, but it did not permit the landlord to permanently encroach on the tenant's floor area.

Approximately five years into the term, the landlord, without prior notice or permission, entered the tenant's premises and installed floor-to-ceiling steel cross-bracing between columns in the tenant's premises in preparation for the landlord's construction of two additional floors on the building.[4] The tenant withheld all rent and brought an action to both enjoin the landlord from doing any future work in the premises and to compel the removal of the cross-bracing that had been installed. The tenant also asked for compensatory and punitive damages.

The landlord served a series of default notices on the tenant and counterclaimed for rent and legal fees in excess of $630,000. The case was heard in a non-jury trial.

The trial court found that the encroachment occupied approximately 12 sf of floor area (between 0.06% and 0.08% of the tenant's total space) "that is not in an area essential to the operation of plaintiff's [tenant's] business and occupies so small a percentage of the total area as to be *de minimus*." *Id*. at 570. The trial court held that "the taking of a non-essential minute area of space" was an exception to the rule that a partial eviction warrants a total rent abatement, Id. at 570, and the landlord is permitted to leave the encroachment without foregoing any of the agreed rent. *Id*. at 571. In effect, the trial court held that a *de minimus* invasion of the tenant's space was not an illegal eviction by the landlord.[5]

The Appellate Division affirmed the verdict, but modified the holding on the law. Rather than declaring that a *de minimus* invasion of the tenant's space was not an eviction, the Appellate Division said ". . . we are constrained to hold that the instant defendant's alteration of plaintiff's premises, without authorization and without consent, was, however small, a taking . . . ." *Id.* at 571. The Appellate Division further held that the encroachment could remain without molestation by the tenant, but the tenant was entitled to be compensated for all its present and future damages. Instead of simply reducing the tenant's rent by the *pro rata* square foot cost of the area taken by the landlord, the court remanded the case for a hearing on the extent of the tenant's damages.

The court's holding seems very natural and logical when viewed from the perspective of contract law, *viz*., the landlord's breach entitles the tenant to compensatory damages. When viewed under the lens of real property law, however, the holding is surprising because of its abandonment of hundreds of years of history and legal precedent.

## Where One-Inch Began

The story began in 1066 when William the Conqueror captured England from the Saxons and became the owner of all lands by force of arms. The country was too large for him to manage alone, so he divided it up among approximately 1,500 of his closest friends in exchange for their money and obeisance.[6] Rather than give his lords full ownership of the land, he made them "tenants" holding of him. In this way, they owned the land for the duration of their lives (which he could end at whim) but they could not transfer the land or devise it to their heirs. The land always reverted to the king. This interest in the property they were given became known as a "leasehold" estate.

By 1650, the transformation from sovereign ownership of land to our allodial system of private ownership was complete and the common law was fully entrenched. The characteristics of leasehold estate continued to develop solely under principles of real estate law. The common law did not consider a leasehold a contract.

In feudal times and under common law, a leasehold estate was considered an ownership interest in land and the lease was the instrument by which such estate was conveyed. It was far more than the "contractual right to possess another's land" that we generally assume a leasehold is today. It is no coincidence that the ancient leases that grace the walls of law libraries and conference rooms begin with the recital "This Indenture of Lease" and closely resemble a deed—for, in fact, they were both considered conveyances, distinguishable only by the duration of the grantee's ownership.

In consideration for this ownership right, tenants paid rent. The right to possession of the land was essential to the landlord's right to receive payment. From this basic concept, courts found that rents were issued to landlords "out of the land"

and that "the whole rent is charged on every part of the land."[7] A common law landlord was entitled to collect the rents only so long as the tenant had peaceful possession of the land, undisturbed by the landlord or by anyone claiming through the landlord.

This inexorable link between rent and possession is a core principle. At a time when most covenants in a lease were independent,[8] the tenant's covenant to pay rent and the landlord's duty to give possession were interdependent—meaning that a landlord could not collect any rent if the landlord interfered with the tenant's estate in any way. This is the origin of the "one inch" rule— that the tenant is relieved from all responsibility for rent if the landlord takes even one inch of the tenant's space. As enunciated by Judge Cardozo in New York State's leading case, *Fifth Ave. Bldg. Co.* v. *Kernochan*, 221 NY 370, 117 N.E. 579 (1917), a partial eviction by the landlord suspends the rent because "it involves failure of the consideration for which rent is paid." *Id.* at 372. It cannot be apportioned, said Judge Cardozo, because the "the landlord is not permitted to apportion his own wrong." *Id.* at 373.

Students and clients find this concept difficult to understand because the geographic and economic conditions that characterized feudal times no longer exist. They have been entirely transformed in the modern urban landscape. We are no longer the agrarian society of the Middle Ages (certainly not the readers of this publication) where the primary value of a lease lay in the land itself. The tenant is no longer the "jack-of-all-trades" farmer. Shopping center and retail tenants today generally do not occupy the land. Rather, they purchase for their monthly rent a service from the landlord that not only includes the walls that enclose the space they occupy, but also encompasses light, water, power, communications, air-conditioning, vertical transportation, parking and even joint marketing programs. Commercial leases are viewed by the parties primarily as contracts and not as estates in land. The New York State Court of Appeals was even prompted to say in 1979, in a statement that remains almost unnoticed: "the obsolete doctrine of the lease as a conveyance of land was discarded."[9] The same sentiment inspired one trial court judge to declare: "Hornbook law to the contrary . . . there is no longer good reason—if there ever was—why leases should be governed by rules different from those applying to contracts in general."[10]

## Back to the Present

In the context of this changed reality, the Appellate Division's decision is entirely correct. The rule enunciated by the *Eastside* Court has been percolating for awhile. It is surprising that it took this long for it fully to emerge. In fact, the trial court did not think it was making new law. It cited four prior Appellate Division cases going back to 1979 in support of its holding.

The First Department took a much bolder position than the trial court. It did not cloak its overruling of the one-inch rule in the *dicta* of prior decisions. Rather, it clearly announced its departure from older law.

To begin, it rejected the trial court's determination that a *de minimus* invasion is not an eviction. The court stated, to the contrary, that even a *de minimus* invasion of the tenant's space is a wrongful partial eviction. Then the court said it would not follow established precedent and declare a complete abatement of rent. Instead, it adopted a more proportionate remedy than a total abatement. The court stated:

> "In light of current landlord/tenant realities and policies, it appears particularly untoward automatically to apply harsh and oppressive strictures derived from feudal law that mirror the policies and concerns of that earlier society. Instead, we conclude that a more realistic remedy than total rent abatement should be imposed for a partial eviction of the minimal proportions here present . . . . While plaintiff certainly has a grievance, it is one that can and should be compensated by money damages proportionate to the injury involved. Thus, we hold that plaintiff has been partially evicted and is entitled to compensation by way of a partial rent abatement for the injury it has suffered and will continue to suffer as a consequence . . . ." *Id.* at 572.

The *Eastside* Court also referred to the one-inch rule as a "draconian sanction of total abatement of rent for the actual partial eviction of the tenant." *Id.* at 572. This criticism of the one-inch rule is not new. The Restatement of Property supports a rent abatement as a more just result. In the words of the Restatement:

> "The majority rule has permitted the tenant to refuse to pay any rent when he suffers partial actual eviction. E.g. *Royce* v. *Guggenheim*, 106 Mass. 201, 8Am.R. 322 (1870); *Kuschinsky* v. *Flanigan*, 170 Mich. 245, 136 N.W. 362 (1912); *Morris* v. *Kettle*, 57 N.J.L. 218, 30 A. 879 (1895). This view is the product of the old learning that the rent derives as from the entire leasehold; e.g. *Smith* v. *McEnany*, 170 Mass. 26, 48 N.E. 781 (1897), and perhaps an element of judicial outrage at the faithless landlord. See, e.g. *Royce* v. *Guggenheim*, *supra*. A small number of jurisdictions permit the landlord to collect an abated rent. E.g., *Warren* v. *Wagner*, 75 Ala. 188, 51 Am.R. 466 (1883). This seems the more just result and is consistent both with remedies for defects in the condition of the premises as set out in Chapter Five and with remedies for interference by a paramount titleholder. *See* § 4.2. An analogous point of contract law, the doctrine that defaulting party could not get restitution, has been rejected by the Restatement of the Law of Contracts, § 357 (1932)."[11]

It is interesting that the Appellate Division failed to cite two of its prior decisions upholding partial rent abatements for partial actual evictions. In *Wilfred Laboratories, Inc.* v. *Fifty-Second Street Hotel Associates, et al.*, 519 NYS2d 220 (1st Dept. 1987), the landlord invaded 8 sf of the tenant's 18,000 sf space to construct a 26-story addition to its building. The Appellate Division affirmed the trial court's grant of a 15% rent abatement for the invasion, albeit on waiver grounds. Similarly, in *81 Franklin Co.* v. *Giancinni*, 554 NYS2d 207 (1st Dept. 1990), the court found that the tenant had been deprived of about 1% of its total leased space. The tenant sued to recover rent it had paid for the period it was displaced by the landlord's renovation work. The one-inch rule was not applied, and the court granted only a partial abatement, stating: "The tenant may recover in damages *the proportionate part of the rent of that portion of the premises from which he was evicted*. . . ." (emphasis added).

*Eastside* is also consistent with other changes that have occurred in landlord-tenant law. For example, common law cases involving constructive eviction required the landlord's wrongful conduct to deprive the tenant of the beneficial enjoyment or actual possession of the entire premises before rent would abate.[12] A partial constructive eviction was not possible, and the tenant had to vacate the entire space—not just a part of it. More recently, courts have sanctioned abatements for partial constructive evictions in derogation of common law principles.[13]

Another example is the implied warranty of habitability in residential leases. This rule was first judicially decreed in New York State in 1971,[14] and was subsequently codified by the legislature in August 1975 in RPL § 235-b. At common law, the landlord had no duty to maintain or repair the tenant's premises. The doctrine of *caveat emptor* caused the tenant to assume full responsibility for the condition and fitness of the premises. Even where the landlord covenanted to make repairs, the landlord's breach did not justify the tenant's withholding of rent[15] because the covenant to pay rent was independent of the landlord's covenant to repair. The obsolescence of this common law rule became apparent, and courts concluded that the urban tenant leasing an apartment contracted for a place to live and not an estate in land.[16] As such, the landlord's contractual duty is to ensure that it remains habitable.[17]

The court's holding in *Eastside* is not necessarily grounds for celebration by landlords. Although clearly intended to protect the landlord from the inequitable loss of its entire rent, it may be the first step on a slippery slope of leasing law reforms that will eventually benefit tenants. It is not far-fetched to imagine how this leniency could backfire. Will a landlord no longer be entitled to reject the tenant's $19,000 check because it is only $12 short?[18] Does this holding suggest the possibility that a lease will not terminate upon the occurrence of a conditional limitation where the rent is only late by a *de minimus* amount of time?[19] Will all jurisdictions now require landlords to mitigate damages?[20] What if the tenant invades a portion of the common area or another tenant's space? Will the landlord lose the right to require the removal of the tenant?[21] Under principles of contract law, these results are possible if not probable. One could argue that unbridled speculation of this type is unwarranted, but surely one needs to know where the line will be drawn. Otherwise, the parties may try to anticipate solutions for such contingencies. This will surely make the drafting and negotiation of leases more time consuming and may even result in claims against counsel if they do not attempt to cover every remote contingency.

As with all matters involving transactional real estate, one should not rely solely on precedent. Practitioners should be careful to address this issue specifically in the lease. Landlords' counsel should provide that intrusions in the floor area of the tenant's premises for columns, risers, wires, pipes, stairwells, elevators, shafts and other building systems neither violate the covenant of quiet enjoyment nor constitute a partial eviction, provided they do not materially interfere with the tenant's occupancy and business. Likewise, tenants' lawyers must be wary that where the lease is silent, a landlord may intentionally invade its client's premises in derogation of the one-inch rule. Therefore, they should seek to limit this newfound right of landlords and relegate when, where and to what extent such invasion is permitted. In addition, tenants should try to limit such invasions to specific purposes, such as the enlargement of the shopping center or for permanent structural repairs. A back door to recapture part of a tenant's space for the purpose of leasing it to others does not belong in the alteration or maintenance sections of a lease. It should be addressed directly, if at all, in a separate provision.

The ultimate result of *Eastside* is not a comforting sense of closure. To the contrary, it casts a pall of foreboding over what will come next. Professor Randolph (*see fn 2 supra*) warns tenants: "The court here would sanction the landlord's simply moving in for its own convenience and redoing the lease on a 'no harm, no fault' rationale."[22] We will have to wait to find out if he is right.

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1 *Cristopher* v. *Austin*, 11 NY 216 (1854), *Peck* v. *Hiler*, 24 Barb. 178 (1850), *Johnson* v. *Oppenheim*, 2 Jones & S. 416 (1872), WL 9166.

2 Professor Patrick Randolph of the University of Missouri—Kansas City School of Law and moderator of the American Bar Association's Daily DIRT discussion board is irritated by the New York State Bar's apathy toward this decision. He writes in one posting: "The editor urges the New York leasing bar to seek an amicus appearance and encourage an appeal to reestablish the very important principle that landlords cannot invade leased space with impunity any more than anyone else can – de minimus consequences or not . . . New York Bar – get busy This is wrong." Posting of Patrick Randolph, DIRT@umkc.edu to DIRT@listserv.umkc.edu (September 20, 2005, EST) [hereinafter, *DD Listserv*] copy on file with author.

Professor Randolph is right about the apathy. The author was able to find only one article discussing this case. It is a short summary of the facts and holding in the *N.Y. Real Property Law Journal. See Nicholas Malito*, 33 *N.Y. Real Property Law Journal,* No. 4, 192 (Fall 2005).

In the course of this case analysis, the author will endeavor to show that this holding is neither shocking nor unexpected. To the contrary, the author believes that it is overdue and much needed to prevent giving tenants a windfall by allowing them to occupy the premises rent-free when they have been deprived of only the tiniest fraction of their space.

[3] The author assumes the differential is the variance between usable and rentable square footage, but the decision does not explain why the stipulated square footage of the demised premises is not exact.
[4] The decision does not explain why permanent cross-bracing was needed in the tenant's premises on the 1st and 2nd floors of the landlord's 7-story building, other than to say it was intended to support the addition of an 8th and a 9th floor to the building.
[5] This point sounds very much like the principle of "*de minimus non curat lex*"— the law does not concern itself with trifles. The notion that not every trivial wrong is worthy of legal redress and judicial attention, however, is precisely contrary to the "one inch" rule.
[6] Lords had to take an oath of fealty to the king. Hence, the name "feudal" system.
[7] Christopher, 11 NY at 218; *Armstrong* v. *Cummings*, 58 How Pr 331 (1880).
[8] Real estate principles crystallized before the development of mutually dependent covenants as a principle of contract law. This is no longer the case and in addition to the interdependency of rent and possession, courts have found that the tenant's obligation to pay rent is likewise suspended when the landlord breaches his contractual duty to maintain and repair the premises, maintain its habitability or provide other contractual services. These cases are more in line with contemporary social conditions and modern legal values. *Green* v. *Superior Court*, 517 P.2d 1168 (Cal. 1974).
[9] *Park West Management Corp.* v. *Mitchell*, 418 NYS2d 310 (1979). This declaration is consistent with the position advocated by some scholars. Even scholars who criticize the court's holding acknowledge the changed reality. For example, Professor Randolph chides the *Eastside* decision, saying, "New York leases have been removed from their status as property and have been reduced to mere contracts." *DD Listserv*. Further support for the notion that leases are contracts and not property is found in New York RPL § 235-c, which states that if a court finds any lease clause unconscionable as a matter of law, the court may refuse to enforce the lease or may "blue pencil" the clause and enforce the balance of the lease. Surely, this reformation is only possible because a lease is viewed as a contract rather than a property right.
[10] *Parkwood Realty Company* v. *Marcano*, 353 NYS2d 623, 624 (Civ.Ct. 1974).
[11] Restatement (Second) of Property, Landlord and Tenant § 6.1 (Reporter's Note 6 1977).
[12] *Fifth Ave. Bldg. Co.,* v. *Kernochan*, 221 NY 370, 117 N.E. 579 (1917).
[13] *Manhattan Mansions* v. *Moe's Pizza*, 561 NYS2d 331 (Civ. Ct. 1990). *Arbern Realty Co.* v. *Clay Craft Planters, Inc.*, 727 NYS2d 236 (2nd Dept. 2001). In *Manhattan Mansions*, the landlord permitted a persistent water leak in a portion of the tenant's store to remain unrepaired for almost one year, causing the tenant to close its pizza shop periodically to clean up the mess. The court extended the constructive eviction rule, which theretofore required the tenant to vacate the entire premises, to a partial constructive eviction where only a portion of the premises was vacated. Rather than abating all rent, the tenant received only a partial abatement commensurate with the period its occupancy was disturbed. Likewise, in *Arbern Realty*, the tenant was constructively evicted from several loading docks, a small part of the leased premises, when the landlord permitted a reduction in the number of parking spaces (not part of the leased premises) adjacent to the building. The Appellate Term upheld a 25% rent reduction. *See also Kipsborough Realty Corp.* v. *Goldbetter*, 367 NYS2d 916 (Civ.Ct. 1975) and *Meinken* v. *Levinson*, 267 NYS 612 (1st Dept. 1933).
[14] *Jackson* v. *Rivera*, 318 N.Y.S.2d 7 (Civ.Ct. 1971).
[15] *Green*, 517 P.2d at 1172.
[16] *Park West Management Corp.* v. *Mitchell*, *supra*. at 323.
[17] *Green* v. *Superior Court, supra.* at 1172.
[18] *Ferris* v. *Rashbaum*, 42 N.Y.S.2d 363 (1943).
[19] "Upon the occurrence of a conditional limitation, the lease has come to an end. There is nothing the tenant can do to revive it. He cannot recoup any rights by curing the default, because the landlord is not proceeding on a default. Nor can equity relieve the tenant from the default; for, the lease is at an end." 2 *New York Real Property Practice, Rasch's Landlord & Tenant* § 23.25 (Patrick A. Randolph, Jr. ed.) [4th ed. 1998].
[20] A limited number of jurisdictions including, notably, New York, Massachusetts and Pennsylvania do not require a landlord to mitigate damages in commercial leases or prevent a landlord from accelerating rents when a tenant breaches the lease *Holy Properties Ltd., L.P.* v. *Kenneth Cole Productions, Inc.*, 637 N.Y.S.2d 964 (1995); *Fifty States Management Corp.* v. *Pioneer Auto Parks*, 415 NYS2d 800 (1979). A thorough state-by-state analysis regarding mitigation of damages is found in 2 Milton Friedman, *Friedman on Leases*, app. 16A [5th ed. 2005].
[21] The author was unable to find a case that adjudicates the rights and remedies of a landlord in this situation. However, in cases involving minor encroachments by adjacent landowners, the general rule states that where the encroachment is minor and unintentional, or where the expense of removing the encroachment exceeds the benefit that would accrue from its removal, the appropriate remedy is monetary damages. *See Christopher et al.* v. *Rosse et al.*, 458 N.Y.S.2d 8 (3d Dept. 1982); *Lawrence et al.* v. *Mullen*, 338 NYS2d 15 (2nd Dept. 1972); *Goldbacher* v. *Eggers*, 76 N.Y.S. 881 (Sup Ct 1902); 6 Warrens Weed New York Real Property, Injunctions § 67.34 [5th ed.]. In other words, if, after weighing the equities, the court determines that the injunction (the type of relief typically sought in these circumstances) would unfairly prejudice the encroacher, the court will grant money damages in lieu of the injunction.

By analogy, this suggests that, under the appropriate circumstances, a court would reach the same result involving landlords and tenants. Where the tenant's occupation of space belonging to the landlord is minor and unintentional, or where the cost to the tenant for removal exceeds the benefit to the landlord from its removal, the landlord would be unable to force the tenant to remove the encroachment. The sole remedy available to the landlord would be damages for the encroachment in the form of rent for that space.
[22] *DD Listserv.*

# Green, Red or Blue Light? New Mexico Sends Mixed Signals With *Kmart* Decision

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On the eve of the New Year, the New Mexico Supreme Court handed down its long-awaited decision in the *Kmart* case involving the state's power to subject an out-of-state intangible holding company to gross receipts and income tax on royalties from licensing trademarks and trade names to a related in-state licensee. *Kmart Corp.* v. *Taxation and Revenue Department*, No. 27,269, N.M. Sup. Ct., Dec. 29, 2005. From a taxpayer's perspective, there is good news and bad news in the decision.

The good news is that the taxpayer prevailed on the gross receipts tax issue, although on narrow statutory grounds. The court held the tax did not apply to receipts from the out-of-state grant of a license to use property in the state because the statute had been amended to make it clear that the transaction should be treated as a nontaxable out-of-state "sale" of the license to use intangible property, rather than the taxable in-state "lease" of intangible property used by the licensee within the state.

The bad news is that the court did not reach the income tax issues raised by the case, but instead quashed the *certiorari* it had previously granted on the income tax issue and, more importantly, ordered that the New Mexico Court of Appeals decision sustaining the tax over constitutional objections to "be filed concurrent with the filing of this opinion." In short, for the moment at least, the law in New Mexico, as in South Carolina [*Geoffrey, Inc.* v. *South Carolina Tax Commission*, No. 23886, July 6, 1993, *cert. denied*, 114 S.Ct. 550 (Nov. 29,1993)], North Carolina [*A&F Trademark, Inc.* v. *Tolson*, 605 S.E.2d 187 (N.C. Ct. App. (2004)] and New Jersey [*Lanco, Inc.* v. *Director, Div. of Taxation*, 21 NJ Tax 200, 203 (Tax 2003)], is that economic nexus—rather than *Quill*'s physical-presence standard [*Quill Corp.* v. *North. Dakota*, 504 US 298 (1992)]—is the Commerce Clause jurisdictional standard for income tax purposes.

## Background: Court of Appeals Decision

To appreciate the significance of the *Kmart* decision and "nondecision," it is important to understand the background of the case and the posture in which it has been languishing for the past five years. The underlying facts of the case should be familiar reading to anyone with even a passing acquaintance with *Geoffrey*, *A&F, Lanco* and other intangible holding company cases. Kmart created a subsidiary [Kmart Properties, Inc. ("KPI")] to own and manage its trademarks, trade names and service marks, such as "Blue Light Special," "At Home With Martha Stewart" and "Kmart" (collectively, the "marks"). After Kmart transferred the marks to KPI, KPI licensed them back to Kmart in return for a royalty of 1.1 % of Kmart's gross sales in the United States. Because Kmart was able to deduct the royalty payments to KPI, it significantly reduced, and in some cases eliminated, Kmart's income tax liability in New Mexico. KPI, on the other hand, paid state taxes only in Michigan, where all its employees and tangible property were located, and Michigan does not tax income from royalty payments.

In addressing the question of whether New Mexico had sufficient nexus to subject KPI to income tax on the more than $2 million of royalties that it received as a result of Kmart's New Mexico sales, the New Mexico Court of Appeals had little difficulty concluding that due process strictures were satisfied. *Kmart Properties, Inc.* v. *Taxation and Revenue Dep't*, _ NM _, _ P2d _ (Ct. App. 2001), *petition for cert. granted*, 131 NM 564, 40 P3d 1008 (2002), *petition for cert. quashed and opinion ordered to be filed,* __ NM ___, ___ P3d ___ (2005) [hereinafter cited as *Kmart Properties, Inc.* (Court of Appeals)]. Because KPI purposefully directed its efforts toward New Mexico and purposefully availed itself of the benefits of the New Mexico market by allowing its marks to be exploited in the state, KPI met the "minimum contacts" standard of the Due Process Clause, which does not require that the taxpayer be physically present in the state.

The more controversial question was whether KPI had the "substantial nexus" with New Mexico that the Commerce Clause demands. The Court recognized that "[t]here has been a split among state courts regarding whether *Quill*'s [physical] presence requirement was intended as a broad, Commerce Clause principle applicable to all state taxes, or whether physical presence was limited to sales and use taxes." *Kmart Properties, Inc.* (Court of Appeals). Squarely confronting this conflict, the court concluded that *Quill*'s physical-presence requirement does not apply to income taxes. In reaching this conclusion, the court pointed to the text of the Court's opinion in *Quill*, which "repeatedly emphasized a narrow focus upon sales and use taxes" and left the "clear impression that it was not applying the . . . physical-presence requirement to any other taxes." *Kmart Properties, Inc.* (Court of Appeals). The court further observed that sales and use taxes can impose special burdens on interstate commerce (beyond the payment of money) that distinguish them from income taxes:

> "Unlike an income tax, a sales and use tax can make the taxpayer an agent of the state, obligated to collect the tax from the consumer at the point of sale and then pay it over to the taxing entity. Whereas, a state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates." *Kmart Properties, Inc.* (Court of Appeals)

Once having concluded that the Commerce Clause analysis of the New Mexico income tax was "controlled, not by *Quill*'s physical presence [test], but by the overarching substantial nexus test announced in *Complete Auto Transit*," the court found that "the use of KPI's marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishes a sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax." *Kmart Properties, Inc.* (Court of Appeals).

## *Gross Receipts Tax* v. *Income Tax Nexus*

The creation of nexus over intangible holding companies through the operations of their licensees in the state generally arises in the context of income taxation rather than sales and use taxation, because sales and use taxes generally do not apply to the sale or license of intangibles. However, New Mexico—a state with one of the broadest sales taxes in the country—does apply its gross receipts (sales) tax to receipts from the license to use certain intangible property in the state.[1] Consequently, in *Kmart*, there were gross receipts tax issues as well as income tax issues raised by the intangible holding company arrangement. Although the precise factual context in which the related-party nexus issue arose is atypical from a sales and use tax perspective, the general principles that the court articulated are clearly relevant to cases involving the more typical sales and use tax controversy involving sales of tangible personal property.

## Court of Appeals Commerce Clause Nexus Finding

In addressing the question of whether New Mexico had sufficient nexus to subject KPI to gross receipts tax on the more than $2 million of royalties it received as a result of Kmart's New Mexico sales, the court had no difficulty concluding that due process strictures were satisfied for the reasons already described above in connection with our discussion of the income tax issues raised by the case. The more controversial question was whether KPI had the "substantial nexus" with New Mexico that the Commerce Clause demands. Since KPI admittedly had no physical presence of its own in the state, the court recognized that "[i]f the Department is to satisfy the *Quill* standard, it must demonstrate something special about the nature of trademarks and KPI's relationship with Kmart Corporation within New Mexico that constitutes physical presence or its functional equivalent." *Kmart Properties, Inc.* (Court of Appeals). The court found that both these factors justified the conclusion that KPI had "physical presence or its functional equivalent" in New Mexico.

After briefly describing the legal nature of a trademark, whose ownership is inseparably connected to the business with which it is associated, the court observed that [w]hen Kmart Corporation created KPI and transferred ownership of the "Kmart" name, it legally separated the trademark and goodwill from the actual business upon which that goodwill depends. As a practical matter, KPI and Kmart Corporation became . . . corporate "Siamese Twins" inextricably bound to each other.

*Kmart Properties, Inc.* (Court of Appeals). In substance, then, Kmart—though not the "agent" of KPI—nevertheless was a "representative" of KPI in New Mexico, acting through its employees "to represent and promote the goodwill of KPI's marks to the New Mexico consuming public." *Kmart Properties, Inc.* (Court of Appeals). Consequently, Kmart's physical presence in the state could be attributed to KPI in much the same way as the physical presence of the in-state "independent contractors" was attributed to the out-of-state vendors in *Scripto* v. *Carson*, 362 US 207 (1960), and *Tyler Pipe Ind.* v. *Dept. of Revenue*, 483 US 232 (1987). What mattered was not "the label or technical legal status of the representative within the taxing state," but rather "a physical presence, within the taxing state, of someone acting on the company's behalf." *Kmart Properties, Inc.* (Court of Appeals).

Based on the *Scripto*/*Tyler Pipe* standard, the court found ample justification for concluding that *Quill*'s physical presence standard was satisfied. In its view, the record supported the conclusion that Kmart used its stores and employees in New Mexico as "local representatives" of KPI and its goodwill: "An extensive apparatus of Kmart stores, signs, and employees are . . . physically present in New Mexico to work on behalf of KPI's goodwill and associated interests." *Kmart Properties, Inc.* (Court of Appeals). The court, therefore, held that "the combination of Kmart Corporation's activities in New Mexico, together with the tangible presence of KPI's marks, constitutes the functional equivalent of physical presence as afforded by the independent representatives in *Scripto* and *Tyler Pipe*." *Kmart Properties, Inc.* (Court of Appeals).

Prior to the New Mexico Supreme Court's decision, it was clear that the court of appeals' determination that *Quill*'s physical-presence requirement did not apply to income taxes was unnecessary to its decision, because in that portion of its opinion dealing with KPI's gross receipts tax liability, the court concluded that KPI had physical presence in New Mexico by virtue of Kmart's activities on its behalf in the state. With the New Mexico Supreme Court's reversal of the court of appeals' decision on the gross receipts tax issue, albeit on statutory grounds, the status of its discussion of the gross receipts tax nexus issues is not altogether clear. There is no longer any "holding" on this point, because of the reversal on substantive grounds.

However, one may nevertheless argue that the court of appeals decision, on its facts, does not run counter to *Quill* because of the existence of physical presence, as explicated by the court in its gross receipts tax analysis. This narrow reading, however, appears to be undermined by the fact that the New Mexico Court of Appeals squarely concluded that *Quill*'s physical-presence test is inapplicable in the income tax context.

## New Mexico Supreme Court's Decision

The reasoning of the court of appeals is needed to assess the effect of the supreme court's decision. From a gross receipts tax standpoint, the New Mexico Supreme Court plainly resolves the issue of the taxability of royalties paid by in-state licensees to out-of-state intangible holding companies in favor of the taxpayer. However, it does so on the narrowest of statutory grounds—namely, that an amendment to a statute excluding from the definition of a lease the "granting of a license to use property" and characterizing it as a sale effectively removes royalty agreements consummated outside of New Mexico from the scope of the gross receipts tax. While this is good news for New Mexico taxpayers (and potential taxpayers), particularly out-of-state licensors of software and other intangibles, it has little impact on taxpayers elsewhere, because most state sales and use taxes do not apply to license royalties.

On the income tax side, however, the decision of the New Mexico Court of Appeals has been removed from the limbo in which it has been resting for the past five years and it is now good law in New Mexico, with arguable implication for the emerging law regarding income tax nexus over intangible holding companies in other states. Although there is still a remote possibility that the New Mexico Court of Appeals could change its mind about quashing the *certiorari* it had granted on the income tax issue (assuming that Kmart were to seek a reconsideration of that issue), we are not holding our breaths for that eventuality.

In summary, *Kmart* must now be added to *Geoffrey*, *A&F* and *Lanco* as decisions, squarely holding that economic rather than physical presence is the test for substantial nexus under the Commerce Clause for income tax purposes. Finally, there is the question of *Kmart*'s implications for sales and use tax nexus. As noted above, the New Mexico Supreme Court's reversal on the merits of the gross receipts tax issue leaves the status of the Court of Appeals nexus analysis somewhat unclear. At a minimum, however, it stands as a template for state taxing authorities (and their counsel) in arguing for "attributional nexus," even though any citation to that opinion as "authority" must note that it has been "reversed on other grounds."

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[1] New Mexico's Gross Receipts and Compensating Use Tax applies to "the total amount of money or the value of other consideration received from selling property in New Mexico, from leasing property employed in New Mexico, from selling services performed outside New Mexico, the product of which is initially used in New Mexico, or from performing services in New Mexico, received from selling property in New Mexico." N.M. Stat. Ann. § 7-9-3.1(A)(1). The statute further provides that property is "real property, tangible personal property, licenses, franchises, patents, trademarks and copyrights," N.M. Stat. § 7-9-3(J), and that "the granting of a license to use property is the sale of a license and not a lease." N.M. Stat § 7-9-3(E). *Kmart Properties, Inc.* (Court of Appeals).

## Of Interest

*Articles*

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*Cases*

### Assignment

The provisions in a New York State commercial lease restricting the assignment of a lease are to be construed strictly because New York law disfavors restrictions on assigning or subletting. *Ring* v. *Mpath Interactive Inc., Gamespy Industries, Inc., and Hearme,* 04-3170-cv(L), United States Court of Appeals for the Second Circuit, 130 Fed. Appx. 501, May 6, 2005.

### Bankruptcy

The assumption of leases by a debtor under its confirmed Chapter 11 plan, before the debtor files a second Chapter 11 case and rejects its leases and its first case was converted to one under Chapter 7, does not limit the lessors from pursuing claims only against the reorganized debtor in the Chapter 7 case. *In re Braude Jewelry Corp.*, 333 B.R. 156 (Bkrtcy.N.D. Ill. 2005).

Calculated under the statutory cap, and based on the debtor's post-rejection lease payments, a debtor/tenant is not entitled to a credit against the landlord's damages for the debtor's post-petition rejection of the lease. *In re Community Health Net,* 333 B.R.308 (Bkrtcy. W.D.Pa. 2005).

A staffing agency that supplied employees for a Chapter 7 debtor's restaurant, and to which the debtor made unauthorized post-petition wire transfers in order to reimburse the staffing agency for wage payments made earlier to the same employees, was not a "mere conduit" but an "initial transferee," which the trustee could hold liable for the amount of those unauthorized post-petition transfers. *In re Cypress Restaurants of Georgia, Inc.,* 332 B.R. 60 (Bkrtcy.M.D.Fla. 2005).

All stages of a cause of action initially filed in state court against a Chapter 11 debtor, including the debtor's appeal from the state court judgment entered against it, were stayed by the automatic stay. A debtor-in-possession could waive the protection of the automatic stay by filing a notice of appeal and could not be liable to a creditor for expenses that the creditor incurred as a result of the debtor's failure to obtain a stay of relief before filing the appeal. *In re Mid-City Parking, Inc.,* 332 B.R. 798 (Bkrtcy.N.D.Ill. 2005).

A Chapter 11 debtor moved to reject its executory lease-sales agreement with the lessee for a portion of a pier owned by the debtor to operate a water park; the Bankruptcy Code pre-empted the remedy of specific performance available to the lessee under state law. *In re Nickels Midway Pier, LLC,* 332 B.R. 262 (Bkrtcy. D.N.J. 2005).

The cap on a lessor's damages for breach of a debtor-lessee's rejected lease applied only to claims the lessor filed for payment from the estate and did not limit the amount that the lessor could recover under a letter of credit issued to secure the debtor's performance under the lease. *In re Stonebridge Technologies, Inc.,* 430 F. 3d. 260 (5th Cir. 2005).

Even though the landlord mailed the invoice for payment of monies owed after the filing date of the bankruptcy petition, the charges were not post-petition lease obligations that qualified for an administrative expense and the trustee was not obligated to timely perform these obligations under the unexpired lease. *In re Winn-Dixie Stores, Inc.,* 333 B.R. 870 (Bkrtcy.M.D. Fla. 2005).

A debtor's claimed reliance on the permanence of the landlord's post-petition rent concessions was unreasonable and the landlord was not estopped from subsequently claiming full post-petition rent. *Savoy IBPP 8, Ltd.* v. *Nucentrix Broadband Networks,* 333 B.R. 114 (N.D. Tex. 2005).

As a matter of first impression, the U.S. district court held that damages for emotional injuries are not "actual damages" within the meaning of the Bankruptcy Code section permitting recovery of actual damages for willful violation of an automatic stay. *U.S.* v. *Harchar,* 331 B.R. 720 (N.D. Ohio 2205).

## Condemnation/Eminent Domain

Federal cease and desist orders under the *Clean Water Act* for draining wetlands, which lasted over nine years, may constitute a temporary regulatory taking under the *Penn Central* Doctrine, where a prior court found no current wetlands. *Sartori* v. *U.S.,* 67 Fed. Cl. 263 (Ct. Fed.Claims 2005).

## Contracts

Under Michigan law, parties can enter into an enforceable contract that requires them to execute another contract at a later date; specific performance may not be granted where continuing judicial supervision would be required. *Lowe's Home Centers, Inc*. v. *LL&127, LLC*; *Eastwood LLC*, 147 Fed. Appx. 516 (6th Cir. 2005).

In a dispute involving the exercise of an option to purchase under a lease, the court will avoid construction of a contract that renders one or more of the provisions of the contract meaningless. *Mooradian Company* v. *Mednikow Properties, Inc.*, 284 Wis. 2d 569, 699 N.W.2d 252 (Ct. App. Dist. 3, 2005).

## Covenants

No implied covenant of continuous operations may be found between a ground lessor and the owner of the property because a ground lease is a financing device for developing unimproved land where the lessee is paying most of what is necessary to develop the land and protect the owner's role as a passive investor. Long-term commercial leases, by their nature, are risky and the lessees are not guarantors of future market conditions. *Patton* v. *Simon Property Group, Inc., et al.,* 370 F. Supp. 2d 846 (E.D.Ark. W. Div. 2005)

An exclusive covenant may be severed from the lease once the tenant subleases and voluntarily relinquishes the original use of the site; moreover, it cannot be used to protect a leaseholder's interest at other locations. *Tippecanoe Associate, Inc.* v. *Kimco Lafayette 671, Inc.*, 829 N.E.2d (Ind. 2005).

## Environment

An environmental impact report was supported by substantial evidence that a Wal-Mart Supercenter would not cause urban decay; a proposal for an outlying gas station must be analyzed separately. *Anderson First Coalition* v. *City of Anderson*, 30 Cal.Rptr.3d 738, 130 Cal. App. 4th 1173 (Cal.App.Ct. 2005).

## Fees

School impact fees do not constitute a taking, even though they are spent on schools throughout the district rather than on the school directly impacted by the development. *Herron* v. *Mayor and City Council of Annapolis*, 388 F. Supp.2d 565 (D. Md. 2005).

Where the landlord had a right of access to make building improvements, the tenant's failure to allow access was a default that permitted the landlord to recover attorney fees. Under the terms of the lease, the landlord was entitled to recover attorney fees upon any default of the lease. The court noted that it was not because the landlord prevailed in the litigation that it was entitled to the award of attorney fees; attorney fees were an agreed-upon consequence of failure to comply with the terms of the lease. *Huron Associates* v. *210 East 86th Street Corp.*, 18 A.D.3d 231, 794 N.Y.S.2d 360 (App. Div. 1st Dept. 2005).

### Guarantors

Under the plain language of a guaranty, the guarantor was liable only for rent unpaid by the tenant during the first three years of the lease. After the tenant failed to pay rent, the landlord sued and obtained a confession of judgment. The guarantor sought to strike the confessed judgment, and the district court denied the request. The appellate court reversed and held that a landlord may not confess judgment against a guarantor for rent previously paid by the tenant. *Liberty Place Retail Assocs.* v. *Famiglia Int'l, Inc.*, Civil Action No. 05-1463, United States District Court for the Eastern District of Pennsylvania, Aug. 11, 2005.

### Landlord & Tenant

A tenant remained liable under the lease and its subtenant vacated the premises, which were vandalized. The landlord had to take possession and operate the business, making a profit after a few months. The landlord sued the tenant for damages, and the tenant argued there were none. The court held that although a landlord is required to mitigate damages, the landlord is not required to take measures that are unreasonable or impractical; nor is a tenant entitled to profit when the landlord assumes the tenant's business after the tenant improperly vacates the premises. *Ai Ping Lu* v. *Grewal et al.*, 130 Cal. App. 4th 841, 30 Cal. Rptr. 3d 623 (Cal. App. 2d Dist. 2005) *Petition for Review Denied*, S136565, Supreme Court of California, Sept. 28, 2005.

A landlord is not required to send specific notice to the tenant of the landlord's right to terminate possession without terminating the lease where the tenant has been "chronically late" with rent payments and each notice of default delivered by the landlord advised the tenant of the landlord's right to terminate. *West Side Limited Partnership* v. *W.B.Y. Ventures, L.L.C. d/b/a W.B. Yeats*, 616 S.E.2d 30 (N.C. Ct. App. 2005).

### Leases

The landlord and tenant entered into a lease for commercial space. The tenant never occupied the space, and the landlord relet the premises to another commercial tenant. The tenant then commenced an action against the landlord; the landlord made a pre-answer motion to dismiss the complaint based upon the recapture clause in the parties' lease. The trial court granted the landlord's pre-answer motion. The tenant appealed, and the appellate court reversed. The appellate court held that the landlord incorrectly relied upon the recapture clause because the tenant had never occupied the premises. The appellate court reinstated the complaint. *Blinds To Go., Inc.* v. *Times Plaza Development, L.P.*, 19 A.D.3d 524,797 N.Y.S.2d 529 (App. Div. 2d Dept. 2005).

The debtor had to assume or reject a lease of a portable storage building because it was a true lease under state law. It was not a disguised security agreement, even though the lessor was in the business of selling such a portable storage building and the debtor-lessee had the option of acquiring the building at the end of the term at no additional cost. *In re Shores*, 332 B.R. 31 (M.D. Fla. 2005).

In a case involving an option to purchase contained in an addendum, the court held that the language of the addendum unambiguously allowed the purchase of the property and thus avoided construction of the contract in such a way that would render one or more of the provisions of the contract meaningless. *Mooradian Company* v. *Mednikow Properties, Inc.*, 284 Wis. 2d 569, 699 N.W.2d 252 (Wis. Ct. App. Dist. 3, 2005).

Where the landlord drafted the lease and used alternative wording in the lease and the default notice he sent the tenant for nonpayment of rent, the court construed the ambiguous language in favor of the tenant and against the landlord as the drafter. *Walters d/b/a Lake Geneva Centre* v. *National Properties, LLC*, 282 Wis. 2d 176; 699 N.W.2d 71 (Wis. 2005).

### Signs & Billboards

In a dispute involving a sign along an Interstate, the appellate court properly deferred to the Department of Transportation's findings that the elimination of lighting brought the display into conformance with the law, in determining whether the sign constituted a nuisance. *Pallco Enterprises, Inc.* v. *Beam*, 132 Cal. App. 4th 1482; 34 Cal. Rptr. 3d 490 (Cal. Ct. App. 3d Dist. 2005).

### Taxation

In a case contesting the tax assessments of several retail chain locations, the court held that even if income, expense and rental information are not privileged, the government may not be required to release the information where the burden on the government outweighs the benefit to the property owner. *Kmart Corporation* v. *County of Lyon*, File Nos. C0-01-252, C0-03-370, C2-04-199, C4-00-289, CX-02-284, Minnesota Tax Court, Aug. 2, 2005.

## Zoning

Judicial review of a zoning board's decision to deny a building permit application to expand a liquor store requires the court to interpret the zoning code as a question of law, reflecting legislative intent. *Northside Corp.* v. *City of Atlanta*, 275 Ga. App. 30; 619 S.E.2d 691 (Ga. Ct App. 2005); *cert. denied,* Case No. S06C0001 (Ga. 2006).

A refusal to grant variances for a hotel that was 38,000 square feet larger than the approved plan called for did not constitute a taking. *Wilmington Hospitality LLC* v. *New Castle County*, Delaware Superior Court, C.A. No. 03C-07-213 MMJ May 24, 2005.

*Legislation*

**Ohio**—2005 New Laws, S.B. No. 167, enacts a one-year moratorium on eminent domain and creates a new legislative task force to study eminent domain.

## In Depth

# Limiting Tenant Rights

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Tenant rights in commercial leases are often limited by a provision that states the right is personal to the particular tenant and only available if the named tenant satisfies certain conditions. These provisions are usually identifiable, as they most often contain the phrase "so long as the Tenant is." The phrase is then qualified with certain conditions of which the following are the most universal:

So long as the tenant is:

- The original named tenant in possession of the premises/has not assigned or sublet;
- In occupation of the whole premises; and
- Not in/has never been in, material default under the lease.

Not only do the above conditions seem to be the most widely used to limit tenant rights under commercial leases, but there is a certain repetitiveness to the types of rights that they constrain:

- Option to extend the term;
- Right of first refusal/purchase option;
- Co-tenancy;
- Right to cease operating a retail business ("go dark");
- Signage and pylons;
- Exclusive use rights;
- Reduced removal/restoration obligations on term expiry;
- Parking; and
- Right to assign or sublet without landlord's consent.

These special personal rights and options raise several issues that have been dealt with in the courts over the last decade. This article will address some of these issues and how they have been handled in the courts.

### A. *Personal Nature of Right*

A landlord may agree to grant a tenant certain rights or options only if that specific tenant with whom the landlord originally contracted is the party in possession of the premises and the one to exercise the option (or benefit from the right). It follows then that if the lease is assigned or the premises sublet, the option or right is not exercisable. Landlords argue that the purpose for such limitation is that they entered into the original tenancy agreement with a "known quantity" and are only prepared to provide a "known quantity" with the substantial benefit of a particular right or option. Tenants argue that the personal nature of the right affects the marketability of the lease and, in circumstances where a tenant justifiably needs to sell its business (and, therefore, the lease that attaches to that business), the right or option must be transferable as well. This concern of tenants is certainly valid as "personal" conditions constrain important tenant benefits under a lease (including option to renew provisions, provisions for tenant purchase rights, tenant pylon and signage rights and/or the right to assign or sublet <u>without consent</u> in certain circumstances, e.g., inter-family transfers, chain sales, sublets to franchisee). In response to this concern, landlords could take the alternative route of imposing a requirement for the landlord's prior written consent to all transfers as opposed to personalizing rights or options. The requirement of consent in most circumstances would achieve the same result of ensuring the existence of circumstances beneficial to the landlord. Where a landlord is faced with a tenant request to assign the lease, the landlord presumably investigates the transferee to decide whether or not to consent to the transaction. If consent is given, approval of the transferee is implied and there would, therefore, be no reason to deny that approved transferee the same rights and options of the original tenant. If there is a valid business reason to deny the transferee a particular right or option, the landlord's consent could be given on a conditional basis (i.e., subject to the removal of the right at issue). Given the law on reasonableness in the context of granting/withholding consent, it may be necessary to write the transfer clause as allowing the landlord to arbitrarily/unreasonably withhold consent. This is a tough sell.

In situations where a landlord's consent is not required for an assignment/transfer and where the original tenant is released, the personalizing of the right or option is very much an issue.

Ultimately, each right or option should be considered on its own merit as to the reason for it being limited in availability. The outcome of the issue will invariably be a function of bargaining strength. It remains an open question for the courts to decide at a future date, as to whether the law will enforce such limiting contractual terms, or if it might reject them as unduly restricting alienation.

### B. *Meaning of "In Occupancy"*

Certain special rights of a tenant, such as a right of first refusal, extension option or covenant for exclusivity (to name a few), are often expressed to be only available when the tenant is in occupancy of the premises. Therefore, the question of what constitutes "in occupancy" is very important in landlord and tenant law.

This issue was dealt with in *Nortel Networks Ltd.* v. *Kanata Research Park Corp.* [Ont. Sup. Crt.] 73 O.R. (3d) 594. The court acknowledged that it is possible for a tenant to be in "legal" possession or control of property even if not in physical control of it. In this case, the tenant held a right to terminate the lease, but it was contingent on the tenant's being in occupancy of the premises. The court noted that no legitimate commercial purpose was served by restricting the meaning of occupancy to include only physical occupation. This case is especially problematic to many landlords of retail spaces who have, for years, routinely connected pylon sign rights, exclusives, options to renew and a myriad of other rights to occupancy. The interpretation of the phrase "in occupancy" in the *Nortel* case may not be in keeping with what the parties to those leases had intended.

The issue of "in occupancy" is usually subject to intense negotiations. The discussion centers on whether physical occupancy is or should be a prerequisite to the enjoyment of, for example, protection from competition, the right to renew the lease, the right to be represented on signs, etc. For example, from the landlord's point of view, if a tenant is no longer physically occupying the premises, then the tenant should not continue to take up valuable signage space. On the contrary, tenants argue that despite no longer being in physical possession of the premises, they are still paying the same rent. Therefore, they should have the benefit of the entire bundle of rights negotiated for in the lease. The matter of whether there is or is not a legitimate commercial purpose in limiting certain rights to times when the tenant is actually carrying on business in its premises remains to be decided in the courts. From a negotiating perspective, once again, each right or option should be considered on its own merits as to the appropriateness of limiting its availability to times when the tenant is physically occupying the premises.

In any instance where the limitation is agreed to, the phrase "in occupancy" should not be used in such a simplified manner. Rather, when tying rights to "physical" occupation, the wording should be expanded. Some landlords are already using the wording such as, "Actual, physical occupancy" and another effective phrase is, "in occupancy and actively carrying on the business permitted by this lease in the whole of the premises."

### C. When Is Default a Default?

If a tenant's right or option is dependent on the tenant not being in default, then, unless the provision states otherwise, the tenant is entitled to exercise the right or option even though at the time it exercises the right or option it is in default, provided it manages to cure the default before the point when the landlord is required to grant the right or option.[1] Accordingly, where a tenant has an option to renew, though at the time it exercises such option it is in default, if the tenant cures the default prior to the expiry of the term, the landlord is required to grant the renewal of the lease. However, a right or option may be dependent on a tenant never having defaulted under the lease. If this is the case, then the fact that the tenant's default has been cured does not reinstate the tenant's right or option.[2] Another possible scenario could be where a tenant validly exercises a right (while not in default) but prior to the benefit of the right becomes in default under the lease. This was the case in *Loveless* v. *Fitzgerald* (1909), 42 S.C.R. 254, where the lessee exercised an option to renew but, prior to the end of the original term, fell into default. The court held that "the tenant's right to extend was dependent upon the tenant fulfilling the covenants until the expiration of the original lease term, and therefore, since a covenant had been breached prior to the expiration of the term, despite the fact the tenant had already exercised its option to renew, the landlord was justified in refusing the extension."

The issue is further clouded by the question of what is meant by default. Does the nature of the default make a difference? Is the landlord required to give the tenant notice of default and allow the tenant an opportunity to cure? Typically, if it was prepared in a detailed fashion, the lease can be consulted to determine such questions. However, the situation may arise where a tenant is not aware it is—or ever was—in default until the time comes to exercise a particular right or option. Should the landlord or tenant bear the consequences in such circumstances? Such circumstances arose in *1383421 Ontario Inc.* v. *Ole Miss Place Inc.* [Ont. C.A.] 67 O.R. (3d) 161, where the tenant was in breach of several provisions of the lease and the landlord denied the tenant's request to renew on those grounds. The tenant argued that the landlord never notified it of the breach and continued to accept rent. The court found that the tenant's argument, that the landlord's acceptance of rent precluded it from refusing to renew the lease, was not sound. Although the acceptance of rent after known breaches is relevant to the landlord's right of termination of the lease, it is not relevant to the option to create a new lease term. The court also determined that there was nothing in the renewal clause that required the landlord to give notice of default and that "a landlord need not give notice of a breach in order to refuse renewal."

The issues of default discussed above illustrate the importance of being as clear as possible when crafting rights and options that are contingent on some element of tenant default.

### D. *Personal Rights and Automatic Renewal*

Rights personal to a specific tenant can be described as individual separate agreements within a lease in certain circumstances. For instance, where a lease provides for automatic renewal, the courts have determined on several occasions that certain personal rights did not continue into the new term without an express agreement between the landlord and tenant.[3] This was the case in *Budget Car Rentals Toronto Ltd.* v. *Petro-Canada Inc.* (Ont. C.A.) 69 O.R. (2d) 289, where the lease contained a right of first refusal in favor of the tenant, requiring the landlord to give the tenant the opportunity to match any *bona fide* offer to purchase the property. The lease also provided for automatic renewal unless terminated by either party. The court held that the original lease containing the option expired and "the automatic renewal was not effective to keep the option alive" beyond the expiration of the original term.

The decision most often referred to in Canada on this point is that of the Court of Appeal in *England in Sherwood* v. *Tucker* [1924] 2 Ch. 440, in which the tenant had an option to purchase the property for a stated price during a three-year lease term. The court determined that "there is a clear distinction between the two things" (referring to the lease of the premises vs. an option to purchase). "The first is the demise of the premises by the landlord to the tenant, and although it is to be found in an agreement, or in a lease signed and executed by the parties, still the option is a separate and independent contract whereby a chance is given to the tenant, under the conditions imposed, to purchase the freehold of the premises which are demised to him." This point with respect to a tenant's option to purchase was also clearly made in Halsbury (4th ed.) 1983, p. 87, para. 109:

> Such an option is collateral to, independent of, and not incident to the relation of landlord and tenant. It is not therefore one of the terms which will be incorporated in the terms of a yearly tenancy created by the tenant holding over after the expiration of the original lease; and when the parties agree that a lease is to be extended, unless it is clearly shown that it was their intention that the option to purchase should continue throughout the extended period, it will not be deemed to be one of the terms of the extended tenancy.

Therefore, when drafting personal rights (as opposed to rights *in rem*), the parties must be careful to ensure that their intentions are clearly expressed. The parties may intend to draft a right or option that runs with the land, such as a restrictive covenant. A restrictive covenant must "touch or concern the land," which means it must "affect the nature, quality or value of the demised land or its mode of use."[4] Restrictive covenants may benefit either the landlord or tenant and since restrictive covenants "run with the land," they continue to be effective beyond the original term of the lease when renewed. As was discussed above, this is not the case with certain rights *in personam,* which do not themselves create an interest in land. Some examples of rights *in personam* are the option to purchase, the option to renew and the right to any Right of First Offer (ROFO) Space. The classic example of a right *in rem* is a restrictive covenant, which may include a restriction on the carrying on of a particular trade or business on a certain property.

## DRAFTING CONSIDERATIONS

A recent trend that has developed in limiting tenant rights along the lines discussed in this article is to include a provision in the lease that defines all of the limiting conditions. The defined term is then used wherever required. This style is a matter of convenience, not substance, and is more typically found in office or industrial leases than retail leases.

Following is a provision that may be included in a lease:

"Required Conditions" means:

(a) The Tenant has paid all Rent as and when due and punctually observed and performed the covenants and obligations of the Tenant under the Lease; and

(b) No Transfer has occurred; and

(c) The Tenant is in occupation of and conducting business in the whole of the Premises.

Having defined the limiting conditions in such a manner, to limit any right or option in the lease, the following phrase need only be included in each instance: "<u>So long as the Required Conditions are satisfied</u>...."

However, this style may not always be that convenient, as the limiting conditions may vary from one right or option to the other, which could present a drafting nightmare. For example, an option to renew may be contingent on the required conditions being met but, in the same lease, the tenant's right of first refusal may only be contingent on the tenant being in occupancy and not in default, while the co-tenancy right may depend only on occupancy.

The paramount consideration in drafting limitations on tenant rights is that the parties' intentions are well expressed. It takes time to get it right.

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[1] *Loveless* v. *Fitzgerald* (1909), 42 S.C.R. 254 and *Advanced Car Specialities Ltd.* v. *Jakobsons*, 131 D.L.R. (3d) 48.
[2] *5000 Kingsway Ltd.* v. *F & A Enterprises Ltd. (c.o.b.) Peachy Keen Restaurants* [1994] B.C.S. No. 60.
[3] *Budget Car Rentals Ltd.* v. *Petro-Canada Inc.* (Ont. C.A.) 69 O.R. (2d) 289.
[4] *Nylar Foods Ltd.* v. *Roman Catholic Episcopal Corp. of Prince Rupert* (1988), 48 D.L.R. (4th) 175.

# Canadian Division Report on Legislative and Judicial Developments

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## I. GOVERNMENT RELATIONS GENERALLY

### A. *Parking Tax*

1. **Quebec**

   During the fall of 2005, the Quebec Parking Tax coalition met as a group to plan strategy, and certain members met with senior cabinet member officials to discuss the situation. The story has not changed: the City of Montreal is still pushing for the Parking Tax, although the general reaction in both provincial government circles and municipalities other than the City of Montreal is that they are not particularly hot on the idea. Our sources have confirmed that it is Mayor Gérald Tremblay of the City of Montreal who continues to press the Minister of Municipal Affairs to permit the Parking Tax legislation.

   Not taking any chances, a series of meetings are being arranged with key cabinet ministers, being Treasury Board, Municipal Affairs and the Ministry of Finance as well as Premier Charest's office to once again discourage the tax. Also, the coalition sent the attached letter to Mayor Tremblay in December 2005, once again denouncing the tax for the same reasons as previously denounced and advising that we would continue to vigorously oppose any such taxation efforts. As in 2004, the decision will be one tied to the spring 2006 provincial budget, and our efforts will be directed toward discouraging the provincial government from supporting the enactment of the enabling legislation.

   Our Alberta legislative contributor reports that Calgary's recently filed transportation and tax plan for 2007 does not include plans for a tax on parking spaces.

2. **British Columbia**

   Randy Klarenbach, of Richards Buell Sutton, reports:

   On September 21, 2005, the B.C. provincial government introduced to the provincial legislature Bill 9, being the greater *Vancouver Transportation Amendment (GVTA) Act*.

   Bill 9 gave Translink, the transport authority for the vast metropolitan area in B.C.'s lower main land (22 municipalities in total), the requisite taxation power to level the parking stall tax on retailers and businesses. It was passed into law within a week, with minimum debate and without any substantive public consultation. In legislative terms it was a slam dunk, despite a broad-based opposition that formed to argue against it, supported vigorously by many members of ICSC, in coalition with other industry groups. Regrettably, the provincial government chose to push this legislation through without any substantive debate or usual committee consultation and has opened the door to Translink to create significant increases in commercial property taxation.

   Property owners such as Ivanhoe Cambridge, Cadillac Fairview and Oxford Development were up in arms over its implementation and convened a teleconference in January in order to ascertain what, if anything the industry can do to apply pressure to the provincial government and/or Translink to overturn this tax. Steven Dover, of The Capital Hill Group, who submitted a status report, participated on this teleconference call and briefed the Canadian Division Committee on a suggested course of action.

3. **Income trust legislation**

   Efforts are being made both on the federal and provincial levels to enact legislation that will regulate income trusts in a manner similar to regulation of publicity traded corporations. It appears that the Canadian Bar Association's Uniform Law Conference of Canada has assembled a small team of lawyers to prepare a coordinated national initiative to legislate income trusts across the country.

   As many of the larger Canadian ICSC members are income trusts of one form or another, this process and any draft legislation that surfaces should be monitored carefully.

4. **Nova Scotia Sunday Shopping**
   ICSC has been active in the debate concerning Sunday shopping in the province of Nova Scotia. Below is a report from Peter McKenzie of CB Richard Ellis that explains the situation. With Premier John Hamm, a long-time opponent of Sunday shopping, announcing that he plans to retire from office early in 2006, ICSC has identified this as an opportunity to re-open debate on this issue— particularly, since the results of a survey conducted for ICSC show that the majority of Nova Scotians favour Sunday shopping.

## II. PROVINCIAL REPORTS

**1. British Columbia**

**a) Legislative Developments**
See discussion on the Parking Tax.

**b) Case Law**
Randy Klarenbach, of Richards Buell Sutton LLP, reports on four recent decisions of the British Columbian courts:

- *Royal City Shopping Centre Ltd.* v. *Canadian Direct Insurance Inc.* [2005] B.C.J. No. 2478 (S.C.)

  This case examined whether a Notice Letter from the tenant constitutes a valid renewal. The letter read, in part, as follows: "In terms of Rider No.1, Article 3.1 of the Lease Agreement dated October 19, 1995 we hereby tender notice of our intention to exercise the option to renew subject to satisfactory negotiation of the lease terms."

  Stating that the principles applicable to the acceptance of an offer also apply to the exercise of an option, the Court looked for "clear and unambiguous" language. It determined that a renewal conditional upon "satisfactory negotiation of the lease terms" did not amount to clear and unambiguous language, and, therefore, did not constitute a valid exercise of the option to renew the lease. Also considered by the Court were the surrounding circumstances and the subsequent conduct of the parties. In this respect, the fact that the tenant had decided to look for alternative leasing before sending the Notice Letter to the landlord constituted further evidence of the absence of a clear intention to actually renew the existing lease.

- *Fire Productions Ltd.* v. *Lauro* [2005] B.C.J. No. 2278 (S.C.)
  The lease for an unimproved space provided that any improvements to the premises would become the property of the landlord. The parties failed to agree on the rent, and the matter was referred to an arbitrator, who concluded that the value of the tenant's improvements to the premises was to be included in determining the renewal rent. The B.C. Supreme Court reversed this decision, holding that the value of tenant improvements should not be taken into account upon renewal unless the renewal clause stated otherwise. The Court added that having the tenant pay an increased rent on the basis of non-removable improvements would be equivalent to making the tenant pay interest upon an expenditure it made by itself.

- *Evergreen Building Ltd.* v. *IBI Leaseholds Ltd.* [2005] B.C.J. No. 2552 (C.A.)
  The landlord owned a 10-story office building in downtown Vancouver, which it wished to demolish and replace with a residential tower. The lease contained no demolition clause, nor any right of the landlord to re-enter as long as the tenant was not in breach of the lease, which it was not. Upon application by the tenant, a Chambers Judge granted a permanent injunction restraining the landlord from breaching its covenant of quiet enjoyment. On appeal, the B.C. Court of Appeal found that the judge had simply rejected an award for damages and imposed an injunction which it saw as tantamount to an award of specific performance. The Court of Appeal held that the Chambers Judge should have considered the equities between the parties, including any factors relating to the uniqueness of the property demised and the relative hardship, if any, of holding the landlord to the strict terms of the lease. The case was remitted back to the Supreme Court, with a note that "the judge who ultimately hears this matter will be in a better position to determine whether the nature of this lease in the particular circumstances of this case is such that the demise aspects of the lease should be given more, or less, significance than the contractual aspects."

- *Makhija Holdings Ltd.* v. *Boulevard Prescriptions Ltd.* [2005] B.C.J. No. 2687
  The tenant, a pharmacist, under a three-year lease, vacated the premises after having been in possession for one year. The tenant had negotiated a number of lease provisions related to the "prescription performance" of the landlord, a physician. These provisions were intended to ensure a certain level of business for the pharmacy. Finding that none of these conditions were fulfilled, the tenant gave the landlord 30 days' notice of the closure of the pharmacy. Subsequently, the tenant gave the landlord a cheque for the May rent after being reassured by the landlord that the damage deposit would be refunded to him. The tenant was sued by the landlord two years later, and only then did he learn what remedy the landlord was pursuing. The Court dismissed the landlord's application, holding that the landlord did not give the tenant timely notice of its election of remedies. The Court

further found that the landlord, in assuring the tenant that he would return the damage deposit, led the tenant to believe that he would not be pursuing any other remedies.

**2. Alberta**

**a) Legislative Developments**

Howard J. Sniderman, of Witten LLP, reports that the City of Calgary has now filed its transportation and tax plan for the coming year, and it does not have any plans for the introduction of a tax on parking spaces.

**b) Case Law**

Murray F. Tait, Vice-President and Corporate Counsel of T&T Properties, reports on three recent decisions of the Alberta Courts:

- *Chroniaris Enterprises Ltd.* v. *MKRS Pub Inc.*, 2005 ABQB 867, Alberta Court of Appeal
  The tenant, without the landlord's consent, changed the use of the premises from a full-service, sit-down, licensed restaurant and lounge to a lounge with a full bar. It also removed partition walls, with the result that the premises could no longer be operated as a restaurant and a separate lounge. The landlord subsequently refused to allow the tenant to exercise its option to renew as a result of what it perceived as a continuing subsisting default of the tenant under the lease. The Court granted the tenant's application for a writ of possession on the following grounds:

  1) The use of the premises had not fundamentally changed, in that the menu had remained almost the same and the liquor-to-food ratio remained steady. Moreover, the facility remained one of full service with a full kitchen, with the patrons seated and served by staff.
  2) The landlord had assisted in the renovations, had not issued a written notice of breach and continued to accept rental payments from the tenant—all leading the Court to believe that the landlord had deliberately omitted to notify the tenant of any alleged default. The landlord is therefore estopped from relying on that default to defeat the tenant's renewal attempt.
  3) Acknowledging that the tenant had increased the sales by 660% and invested approximately $90,000.00 in improvements, the Court exercised its discretion to relieve against forfeiture.

  The Court finally concluded that the tenant had substantially complied with the lease and that any breaches alleged were relatively trivial in nature. Allowing the landlord not to renew the lease would, therefore, result in a windfall for the landlord.

- *CriticalControl Solutions Corp.* v. *954470 Alberta Ltd.*, 2005 ABQB 753, Alberta Court of Queen's Bench
  This case discusses the application of the *Statute of George*, 11 Geo.11, ch. 19, and the ability of the landlord to distrain the tenant's property at a location other then the leased premises. The landlord must establish: (i) there was rent in arrears; (ii) the property that was removed was the property of the tenant; (iii) the property was removed fraudulently or clandestinely; and (iv) the property was removed with the intent to prevent the landlord from distraining for the arrears in rent.

  As to the first condition, there was a dispute as to whether there were actually arrears in existence, since a third party had tendered an uncertified cheque to the landlord for payment of such arrears. The Court held that the landlord is under no obligation to accept an uncertified cheque from an unknown third party for rent when the landlord knows the tenant cannot pay the rent and plans to remove its assets.

  As to the second condition for the enforceability of the *Act*, the Court determined that the third party was occupying the leased premises and enjoying the benefits of its occupancy, in a capacity that was more than that of a mere licensee. Therefore, it was a party liable for rent and its goods could properly be subject to a landlord's distress, under Section 104(b) of the *Civil Enforcement Act* of (Alberta).

  As to the third condition, the Court held that although the computer assets were not removed clandestinely, they were nevertheless removed in a fraudulent and dishonest manner, as they were part of the secured party's plan to pay the rent and then allow the secured party to seize the assets and remove them, something with which the landlord would not cooperate.

  Finally, the fourth requirement had been met in that the property was removed with the intent to prevent the landlord from distraining for arrears of rent.

  The Court therefore concluded that the landlord's seizure of the computer equipment on the secured party's premises was valid and that the landlord was entitled to proceed to sell the computer equipment insofar as there was a balance for outstanding rental arrears and costs.

- *National Courier Services Ltd.* v. *RHK Hydraulic Cylinder Services Inc.*, 2005 ABQB 856 (Q.B.)
  In a counterclaim against the landlord's action claiming overholding rent (during an environmental remediation), the tenant alleged it is a duty of its commercial landlord to warn a tenant that the tenant is polluting the

environment. This claim arose out of the landlord's failure to warn the tenant immediately that, according to an environmental study provided to the landlord, the tenant's business activity was polluting the environment at unacceptable levels. Consequently, the tenant pleaded guilty under the Alberta Environmental Legislation and paid in excess of $300,000 as a result of the environmental damage. The Court held that the relationship between the landlord and the tenant was governed by the lease, and that the lease placed all obligations for environmental concerns and regulatory compliance squarely on the tenant and not on the landlord. As such, there could be no expectation that the landlord would look out for the tenant's interests. The Court also rejected the tenant's allegation that the landlord owed a contractual duty of good faith to the tenant, which would have been breached by the landlord's failure to warn, as Alberta law does not recognize a general duty of good faith between contracting parties nor does it recognize a general duty of good faith in the performance of a contact. As to damages, the Court concluded that the landlord was entitled to overholding rent as stipulated in the lease.

**3. Saskatchewan**

**a) Legislative Developments**

Neil MacKay of MacPherson Leslie & Tyerman LLP, reports as follows:

- *Electrical Inspection Act*, S.S. 1993, c. E-36

  Section 17 of the *Act* was proclaimed into force on September 9, 2005. This section grants the chief inspector discretion to cancel an existing permit or refuse issuance of a new permit.

**b) Case Law**

*Her Majesty the Queen* v. *101051287 Saskatchewan Ltd.* and *J.J. Kahmo Holdings Ltd.*, 2005 SKCA 137

In this case, the tenant and operator of a nightclub changed the use it made of part of the premises. Before the Court of Appeal, the issue was whether this new use constituted a "non-conforming use" under *The Planning and Development Act* (Saskatchewan), in which case the owner would be entitled to the benefit of Sections 113 and 115(1) of the *Act*, which permit the owner to maintain a non-conforming use and to extend such use throughout the building.

Section 2(s) of the *Act* provides the following definition:

*(s)* ***"non-conforming use"*** *means the following specific use:*

*i)* *being made of land or a building or intended to be made of a land or a building lawfully under construction, or in respect of which all required permits have been issued, at the date a zoning bylaw or any amendment to a zoning bylaw affecting the land or building becomes effective; and*

*ii)* *that on the date a zoning bylaw or any amendment to a zoning bylaw becomes effective does not, or in the case of a building under construction or in respect of which all required permits have been issued will not, comply with the zoning bylaw.*

The Court held that the statutory definition of non-conforming use is not confined to a use that is prohibited by a zoning by-law, but also includes all uses that are rendered non-compliant whether they are specifically prohibited or not. Accordingly, a municipality cannot abrogate a property owner's statutory right by adopting a new zoning by-law, and, in the present case, the property owner had the rights afforded to him under Sections 113 and 115(1) of the *Act*.

- *Subway Franchise Restaurants of Canada, Ltd.* v. *Mattison*, 2005 SKQB 339

  The sublessor applied for an immediate writ of possession against the sublessee, which was also a franchisee of the sublessor, on the basis that the sublessee had a history of late payment and had been issued notices of default on previous occasions, and also on the basis of provisions of the franchise agreement, which provided that:

  *"… the Company may include a notice that because of repeated cause for termination, a subsequent repeat of a given default in the next twelve (12) month period shall be good cause for a final termination without allowing the Franchisee the opportunity to remedy or even if the default is remedied"*.

  The Court found that such provision was contrary to the relief provisions of *The Landlord and Tenant Act* (Saskatchewan), out of which the landlord could not contract. The Court, therefore, granted relief from forfeiture subject to the tenant's paying the rent arrears (which it had already done after being served with the sublessor's application) and a fixed amount of costs into Court.

**4. Manitoba**

Glen R. Peters, of Fillmore Riley LLP, reports as follows:

**a) Legislative Developments**

*Manitoba Building Code, amendment*—Regulations 149/2005 and 177/2005

The Manitoba Building Code is amended by requiring plans, drawings and related documents submitted with an application to build a building or to substantially alter an existing building (as more fully detailed in the Code), to be prepared, signed and sealed by an architect or professional engineer, or both.

**b) Case Law**

- *Winnipeg City Assessor et al.* v. *Licharson et al.*, 2005 MBCA 95 (CanIII)
  The *Kushnier* and *Rene Management and Holdings Ltd*. appeals are part of four appeals that were consolidated and heard by the Manitoba Court of Appeal. Both are concerned with the circumstances permitting the Municipal Board to defer the application of an assessment reduction as a penalty for failure to fully comply with a municipal assessor's requests for information related the value of a property.

- *Tollak Plac (Canada) Ltd.* v. *Selkirk and District Planning Area Board*, 2005 MBQB 229
  Issue #1: Where a construction permit applicant demonstrates compliance with provisions of the development plan zoning by-law or the *Planning Act* (Manitoba), the duty of the Planning Area Board to issue a building permit is absolute, and no extraneous matters may be considered in the exercise of the Board's function. Moreover, the legislation does not, to use the Court's expression, "fetter further development of the property" and, where the existing use of land conforms to a zoning by-law, an owner may intensify its use provided that it otherwise complies with current zoning regulations.

  Issue #2: A decision of the Planning Board was tabled 120 days after the application for the permit had been filed. The Court decided that the language of Section 58 of the *Planning Act* (which states that "the permit applied for shall not be further withheld") is mandatory, and that property owners are entitled to finality within 60 days. It is not for the Board to assess the quality of an application and consequently delay the point at which the 60-day period starts to run; if the application is not sufficient, it should simply be rejected; if not, the 60-day delay should be adhered to.

**5. Ontario**

**a) Legislative Developments**

Stephen J. Messinger, of Minden Gross Grafstein & Greenstein LLP, reports as follows:

- *Bill 20—Frederick Banting Homestead Preservation Act*, 2005
  The Bill imposes a restrictive covenant on the property in the town of New Tecumseh, preventing a person from erecting any new building or structure, or altering or demolishing any building or structure on the property, except to erect an educational and interpretative centre and to do other things authorized by regulations. The Bill has passed the second reading.

- *Bill 21—Energy Conservation Responsibility Act*, 2005
  The government may, by regulation, require persons who are selling, leasing or otherwise transferring an interest in real or personal property to provide such information as may be prescribed in the circumstances that are prescribed. The Bill has undergone a first reading.

- *Bill 24—Environmental Protection Amendment Act*, 2005
  The Bill proposes that a person obtain a certificate of approval from the Director of Environmental Protection before spreading or storing sewage sludge, other bio solids and derived products. The bill has undergone the first reading.

- *Bill 31—Liquor License Amendment Act*, 2005
  The Bill proposes that beer sold in public premises (such as a restaurant, a bar or a stadium) under a liquor license must be poured into unbreakable containers before being served to the public. The Bill has undergone the first reading.

- *Bill 40—Disclosure of Crimes on Property Act*, 2005
  The Bill proposes that a vendor in a PSA, and a landlord in a tenancy agreement, must disclose to the purchaser or tenant whether the property that is the subject of the agreement has been used to commit a crime during the time that the vendor or landlord had a legal interest in the property. The Bill has undergone the first reading.

- *Bill 51—Planning and Conservation Land Statute Law Amendment Act*, 2005
  The bill proposes to modify aspects of the land use planning process, provide additional tools for implementation of provincial policies, and give further support to sustainable development intensification and Brownfield redevelopment. The bill has undergone the first reading.

- *Bill 211—Ending Mandatory Retirement Statute Law Amendment Act*, 2005
  This bill amends the Human Rights Code and various other acts to end mandatory retirement. The bill received Royal Assent on December 12, 2005.

**b) Case Law**

Joseph Grignano, of Daoust Vukovich LLP, reports as follows:

- *Deem Realty Investments Ltd.* v. *Evergrand Properties Ltd.* [2004] O.J. No. 6238

  The tenant sought to recover rent which it alleged it had overpaid because the actual floor area of its premises was less then the square footage included in the lease. The lease contained a measurement provision, but the landlord had failed to perform such measurement until shortly before the end of the lease term. The Court held that by failing to measure, as it was required to do under the lease, the landlord had breached its agreement with the tenant, thereby causing the latter to suffer damages in the form of overpaid rent. The Court also noted that the tenant's overpayments resulted in the landlord being unjustly enriched.

- *Cartareal Corporation N.V.* v. *Her Majesty the Queen in Right of Canada, represented by the Minister of Public Works and Government Services* [2005] O.J. 4371

  This case involves the interpretation of the following early termination provision in a lease: "The lessee shall have the right to terminate the lease *effective* May 31, 2004, upon delivering to the landlord at least 6 months prior written notice together with a penalty equal to 3 months rent."

- The landlord asserted that such language meant that if the tenant exercised the option, the date of termination could only occur on May 31, 2004. The Court sided with the tenant and determined that in a contractual context, "effective" most commonly means "coming into operation." As a result, the provision in question provided the tenant with a right to terminate anytime after May 30, 2004 (but not before), with such right continuing until the end of the lease.

- *Beaver Fuels Management Ltd.* v. *Baker's Dozen Holdings Corp.* [2005] O.J. No. 4739

  The landlord initiated termination proceedings against the tenant due to the tenant's failure to pay rent and in connection with *other lease defaults* on the part of the tenant. The tenant sought the benefit of Section 20(4) of the *Commercial Tenancies Act* (Ontario) (and thereby to stay the proceedings) by paying its rental arrears into Court. The Court registrar refused to accept the tenant's funds. The Court found that Section 20(4) applied to proceedings that related *solely* to rent in arrears. Accordingly, the tenant could not have the proceedings stayed.

- *1258816 Ontario Inc. (c.o.b. Ottawa train Yards)* v. *Business Depot Inc.* [2005] O.J. No. 3948

  In this case, the Court held that the specific provision of an offer to lease requiring a mutual agreement of both the landlord and the tenant to extend conditions should override the more generic *proviso* applicable to such conditions, whereby the conditions are for the benefit of the tenant and the dates for waiver or satisfaction could be extended by tenant. Accordingly, as mutual agreement had not been reached, the offer to lease was null and void.

**6. Quebec**

Philippe de Grandmont, of De Grandpré Chait LLP, reports as follows:

**a) Legislative Developments**

- *Protection Policy for Lake Shores, River Banks, Littoral Zones and Flood Planes*

  This new Environment Québec policy is designed to more adequately protect high velocity flood plane zones, to expand the scope of application of flood plane management plans and to restate the measures in the Agreement respecting flood risk mapping applied to flood plane preservation entered into on September 19, 1994, with the Government of Canada.

  The municipalities are required to adopt and enforce this new policy, which will no doubt impact future development of affected lands and must be factored heavily into a development project decision.

**b) Case Law**

*Industries NRS Ltée* c. *Pham*, C.Q. Longueuil (Oct. 14, 2005), AZ-50339797

A tenant may not invoke his inability to understand the language in which the lease was drafted, nor can the landlord cut off electricity as a way of doing justice to itself.

**7. Nova Scotia**

James Rossiter, of Wickwire Holm, reports as follows:

**a) Legislative Developments**

Nova Scotia has amended its *Small Claims Court Act* to increase that Court's monetary jurisdiction to $25,000 from $15,000.

The province has also passed a *Commercial Mediation Act* to facilitate the use of mediation to resolve commercial disputes.

**b) Case Law**

No report.

**8. New Brunswick**

Serena Newman, of Barry Spalding, reports as follows:

**a) Legislative Developments**

- Minimum wage

Effective January 1, 2006, the minimum wage was increased to $6.40 per hour, and will further be increased to $6.60 per hour on January 1, 2007.

- *Franchise Act*

Bill 6, introduced into the legislature, would impose disclosure and fair dealing requirements with respect to the franchisor-franchisee relationship. It has undergone the first reading.

- *Limitation of Actions Act*

The government is considering whether to amend the *Act* by creating two interconnected limitation periods that would apply to all claims to remedy an injury, loss or damage that occurred as a result of an act or omission: (i) The basic period which is two years from the discovery of the wrong; and (ii) an ultimate period of 15 years, running from the date of the wrongful act.

**b) Case Law**

- *R*. v. *Love* [2005] N.B.J. No. 361 (Q.B.)

After failing to comply with a shopping center owner's notice not to enter the property, the accused was convicted of trespass and ordered to stay away from the mall. The Court held that the notice did not constitute discrimination under the *Human Rights Act* (N.B.). It confirmed that while owners of private property cannot use the *Trespass Act* as a means of denying peaceful public demonstrations or denying people the right to be there if the law permitted them to be there, they can otherwise decide who they will permit on their property.

**9. Prince Edward Island**

Donald K. MacKenzie, of Foster Hennessey MacKenzie, advises of no legislative developments in Prince Edward Island (P.E.I.).

With respect to case law, the only development came on December 15, 2005, when the P.E.I. Regulatory Appeals Commission denied an application by Loblaw Properties Ltd. relating to retail petroleum licenses at Atlantic Superstore outlets in various P.E.I. localities.