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FUNDAMENTAL BREACH AND FRUSTRATION IN COMMERCIAL TENANCIES

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The Commission offices are located on the 12th floor of the Woodsworth Building, 405 Broadway, Winnipeg, Manitoba R3C 3L6. TEL. (204) 945-2896, FAX (204) 948-2184.

TABLE OF CONTENTS

CHAPTER 1

INTRODUCTION

This is the third in a series of Reports on commercial tenancy law.[1] In this Report, we examine two topics: fundamental breach and frustration.

The conventional view of a lease has been that it is a conveyance of an interest in land from a landlord to a tenant. The result of this view is that, traditionally, the law which governs a landlord and tenant dispute has been the law of property rather than the law of contract. More recently, the contractual aspects of the relationship have been recognized in part, but this concept has been embraced slowly and incompletely. Two principles of the law of contracts which traditionally have not been applied to commercial tenancies are the principles of fundamental breach and frustration. In this Report, we consider fundamental breach and frustration in order to determine whether these principles should also govern commercial leases and whether legislation is necessary to ensure this result.

A. PRINCIPLES WHICH SHAPE THE REPORT

The principles which shaped our Report on *Covenants in Commercial Tenancies*[2] also shape this Report. They are:

1. The law should be rational, certain and simple.

2. Anachronisms should be abolished.

3. The law should be fair both to landlords and tenants.

4. The law should be changed only where a change is necessary; conversely, where there is no apparent need for reform, the present law should be retained.

B. ORGANIZATION OF THE REPORT

In the Chapters which follow, we examine the principles of fundamental breach and frustration with the goal of determining whether commercial tenancy law is in need of reform with respect to these matters. We begin in Chapter 2 with a discussion of the current law. This is followed in Chapters 3 and 4 with a discussion of the problems in the current law, how these problems might be reformed and our recommendations; Chapter 3 deals with fundamental breach and Chapter 4 deals with frustration. Chapter 5 sets out proposals for amendments to *The*

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[1]The other Reports in the series are Manitoba Law Reform Commission, *Distress for Rent in Commercial Tenancies* (Report #81, 1994) and Manitoba Law Reform Commission, *Covenants in Commercial Tenancies* (Report #86, 1995).

[2]Manitoba Law Reform Commission, *Covenants in Commercial Tenancies* (Report #86, 1995).

Landlord and Tenant Act,[3] together with explanatory notes, and Chapter 6 contains a summary of our recommendations. Finally, Appendix A contains the draft legislation without commentary.

[3]*The Landlord and Tenant Act*, C.C.S.M. c. L70.

CHAPTER 2

THE CURRENT LAW

When a party to a contract breaches the contract, in what circumstances will the innocent party be relieved of his or her obligation to do what he or she has promised to do but has not yet done? When a contract becomes impossible to perform without the fault of either party to the contract, what are the obligations of the parties and how should their positions be settled? As this Chapter will demonstrate, the answers to those questions depend upon whether or not the contract is a commercial lease.

A. FUNDAMENTAL BREACH OF CONTRACT

We begin with the first question. In the following sections, we consider the common law contract principle of fundamental breach, the extent to which the principle has been applied to leases, the methods by which landlords have circumvented the common law lease principles and recent changes in the approaches taken by the courts in jurisdictions outside Manitoba.

1. Contract Law Principle

Parties to a contract may expressly provide in their contract that a breach of a particular obligation will lead to certain consequences. For some obligations, the parties may specify that a breach will give the innocent party the right to choose whether to carry on with the contract and sue the wrongdoer for damages or to end the contract and be relieved of future obligations. When the parties specify for themselves the consequences of a breach of an obligation in their contract, the courts will usually respect the parties' freedom to contract.[1]

Because of the wide range of obligations found in many contracts, parties will seldom exhaustively specify the consequences of a breach of every obligation; indeed, some obligations simply cannot be categorized in this way.[2] Where the parties have not clearly specified their wishes and one of the parties breaches an obligation, the innocent party must ask a court to determine whether he or she is entitled to be relieved of his or her unperformed contractual obligations.

It used to be that when the courts made such a determination, they focused upon the nature of the contractual obligation which was breached. For example, in sale of goods contracts, the courts focused on whether the obligation which was breached was a "condition" or a "warranty". A breach of "condition" entitled the innocent party to end the contract and sue for damages. A breach of "warranty" entitled the innocent party only to sue for damages; he or she remained obligated to perform his or her own promises. In contracts which did not involve a sale of goods,

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[1]On occasion, a court will find that, although the parties have used words that are indicative of a particular intention, if interpreting the contract according to that intention leads to a highly unreasonable result, it can search for some other possible meaning of the contract in order to do justice between the parties: *Wickman Machine Tools Sales Ltd.* v. *L. Schuler A.G.*, [1974] A.C. 235 (H.L.).

[2]*Hongkong Fir Shipping Co. Ltd.* v. *Kawasaki Kisen Kaisha Ltd.*, [1962] 2 Q.B. 26 at 65-66 (C.A.) per Diplock L.J.

the courts took a similar approach. A breach of an "independent" covenant[3] did not relieve the innocent party of the obligation to perform his or her own promises. However, a breach of a "dependent" covenant[4] relieved the innocent party of the responsibility for fulfilling his or her unperformed obligations.

The courts gave some consideration to the effect of the breach in determining whether the innocent party should be relieved of his or her future obligations. However, it was not until the early 1960's that the courts clarified that, where parties to a contract have not expressly defined the consequences of a breach in their contract, the consequences should depend entirely upon the nature of the breach and the foreseeable events to which the breach gives rise.[5] England's Court of Appeal stated in *Hongkong Fir Shipping Co. Ltd.* v. *Kawaski Kisen Kaisha Ltd.*:

> The fact that the emphasis in the earlier cases was upon the breach by one party to the contract of his contractual undertakings, for this was the commonest circumstance in which the question arose, tended to obscure the fact that it was really the event resulting from the breach which relieved the other party of further performance of his obligations. . . .[6]

The Court of Appeal stated that a determination of the consequences of a breach of contract depends upon the answer to the question:

> [D]oes the occurrence of the event deprive the party who has further undertakings still to perform of substantially the whole benefit which it was the intention of the parties as expressed in the contract that he should obtain as the consideration for performing those undertakings?[7]

If the answer to this question is "yes", that is, if the breach is a "fundamental breach",[8] the innocent party is discharged from the contractual obligations which have not yet been performed; if the answer is "no", the innocent party remains obligated to perform his or her promises.

The Supreme Court of Canada adopted this test in 1989 in *Hunter Engineering Co., Inc.* v. *Syncrude Canada Ltd.* Wilson J. stated:

> A fundamental breach occurs "Where the event resulting from the failure by one party to perform a primary obligation has the effect of depriving the other party of *substantially the whole benefit* which it was the intention of the parties that he should obtain from the contract" . . . . This is a restrictive definition and rightly so, I believe. As Lord Diplock points out, the usual remedy for breach of a "primary" contractual obligation (the thing bargained for) is a concomitant "secondary" obligation to pay damages. The other primary obligations of both parties yet unperformed remain in place. Fundamental breach represents an exception to this rule for it gives to the innocent party an additional remedy, an election to "put an end to all primary obligations of both parties remaining unperformed". . . . It seems to me that this exceptional remedy should be available only in

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[3]Independent covenants are also referred to as "distinct" covenants or covenants "collateral to the main purpose of the parties as expressed in their contract".

[4]Dependent covenants are also referred to as "condition precedents", "material" covenants or "mutual" conditions.

[5]*Hongkong Fir Shipping Co. Ltd.* v. *Kawasaki Kisen Kaisha Ltd.*, *supra* n. 2.

[6]*Hongkong Fir Shipping Co. Ltd.* v. *Kawasaki Kisen Kaisha Ltd.*, *supra* n. 2, at 68 per Diplock L.J.

[7]*Hongkong Fir Shipping Co. Ltd.* v. *Kawasaki Kisen Kaisha Ltd.*, *supra* n. 2, at 66 per Diplock L.J.

[8]The phrase "fundamental breach" is associated with two distinct issues. The first concerns whether a breach of contract is more serious than one which would entitle the innocent party merely to damages and whether it entitles him or her to refuse any further performance under the contract (which is the meaning that is relevant to our discussion). The second concerns whether performance which is totally different from that which the contract contemplates prevents the wrongdoer from relying on any clause exempting liability: *Lalonde* v. *Coleman* (1990), 67 Man. R. 187 (Q.B.); *Suisse Atlantique Société D'Armement Maritime S.A.* v. *N.V. Rotterdamsche Kolen Centrale*, [1967] A.C. 361 (H.L.).

circumstances where the foundation of the contract has been undermined, where the very thing bargained for has not been provided.[9]

The Manitoba Court of Queen's Bench has also considered the issue of what constitutes a fundamental breach of contract. In *Lalonde* v. *Coleman*, Scott A.C.J. found that what occurred was "a total nonperformance or benefit to the plaintiff" and what resulted was "something totally different from that which the parties must have contemplated".[10] Scott A.C.J. concluded that the innocent plaintiff was entitled to walk away from the contract as he did not receive any of the benefit which he was to have obtained under the contract.

Thus, if it cannot be said that an innocent party is deprived of substantially the whole benefit of the contract (that is, if the breach is not a fundamental one), the innocent party will have to perform his or her obligations and will only be entitled to sue the wrongdoer for damages. However, if an innocent party is deprived of substantially the whole benefit which the parties intended him or her to obtain (that is, if the breach is a fundamental one), then the innocent party will have the option of continuing the contract and suing the wrongdoer for the breach or of ending the contract and not fulfilling his or her contractual obligations.

The rationale for this principle is that individuals who enter into a contract do so for their mutual benefit. For this reason, it is unfair to compel the innocent party to continue to fulfil his or her obligations when a breach by the other party prevents the innocent party from receiving any benefit.[11]

2. Application to Commercial Leases

Traditionally, the contract law principle just discussed has not been applied to leases. Thus, where the parties did not stipulate the consequences of a breach in their lease, the innocent landlord or tenant could not elect to end the lease for a breach by the other party and remained obligated to fulfil his or her yet to be performed promises, even if the breach was so serious as to deprive the innocent party of substantially the whole benefit of the lease.[12] The innocent party to

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[9]*Hunter Engineering Co., Inc.* v. *Syncrude Canada Ltd.* (1989), 57 D.L.R. (4th) 321 at 369 (S.C.C.) per Wilson J., quoting from *Photo Production Ltd.* v. *Securicor Transport Ltd.*, [1980] A.C. 827 (H.L.) (the *Hunter* case dealt with the issue of whether a contract clause that excluded liability for fundamental breach was enforceable). The test for whether a breach will permit an innocent party to treat the contract as at an end has also been described in the following ways: "[D]oes the breach of the stipulation go so much to the root of the contract that it makes further commercial performance of the contract impossible, or in other words is the whole contract frustrated?": *Hongkong Fir Shipping Co. Ltd.* v. *Kawasaki Kisen Kaisha Ltd.*, *supra* n. 2, at 64 per Upjohn L.J.; "[I]f it [the breach] is such as to go to the root of the contract, the other party is entitled to treat himself as discharged: but, otherwise, not.": *Cehave N.V.* v. *Bremer Handelsgesellschaft m.b.H. The Hansa Nord*, [1976] 1 Q.B. 44 at 60 (C.A.) per Lord Denning M.R.; "[O]ne must 'see wether [sic] the particular stipulation goes to the root of the matter so that a failure to perform it would render the performance of the rest of the contract by the plaintiff a thing different in substance from what the defendant has stipulated for'": *Pigott Construction Co. Ltd.* v. *W.J. Crowe Ltd.* (1961), 27 D.L.R. (2d) 258 at 269-270 (Ont.C.A.), quoting from *Bettini* v. *Gye* (1876), 1 Q.B.D. 183 at 188; "A breach of contract is a cause of discharge only if its effect is to render it purposeless for the innocent party to proceed further with performance.": *Pigott Construction Co. Ltd.* v. *W.J. Crowe Ltd.*, *supra* at 271, quoting *Cheshire & Fifoot's Law of Contract* (5th ed.) 488; "Does the failure of performance amount in effect to a renunciation on his part who makes default? Does it go so far to the root of the contract as to entitle the other to say, 'I have lost all that I cared to obtain under this contract; further performance cannot make good the prior default'?": *Alkok* v. *Grymek*, [1968] S.C.R. 452 at 456, quoting *Anson's Law of Contract* (21st ed.) 424.

[10]*Lalonde* v. *Coleman*, *supra* n. 8, at 195.

[11]Law Reform Commission of British Columbia, *Commercial Tenancy Act* (Report #108, 1989) 21.

[12]*Goldhar* v. *Universal Sections and Mouldings Ltd.* (1962), 36 D.L.R. (2d) 450 at 453 (Ont.C.A.):

> While the modern lease contains numerous contractual provisions it operates primarily to convey a possessory title. As a consequence the effect given by the law to promises by way of covenants in a lease has always received different treatment from that given to similar promises in an ordinary bilateral contract. In the latter where the covenants may be considered to be mutually dependent a substantial breach by one party will excuse the other party from further performance and permit recovery in damages for the breach. In leases, however, the covenants are assumed to be independent.

a lease was only entitled to sue the other party for damages for the breach.[13] The rationale for this approach is that the lease promises of landlords and tenants are "independent" of one another, that is, not influenced by the performance or non-performance by the other party of his or her promises.

For example, if a landlord did not provide heat to the lease premises as promised, the tenant could sue the landlord for damages but could not withhold the rent,[14] even if the lack of heat prevented the tenant from using the property as he or she had intended. The tenant's obligation to pay the rent could be suspended only when the landlord's breach amounted to an eviction.[15] Similarly, if a tenant breached a covenant (for example, the covenant to pay rent), the landlord could sue the tenant for damages but remained obliged to fulfil his or her own covenants.

However, for several reasons, landlords have not been affected by the inapplicability of the fundamental breach principle to commercial tenancies. Legislation permits landlords to terminate a lease for certain breaches by the tenant. Subsection 17(1) of *The Landlord and Tenant Act* provides that a landlord can re-enter the lease property when a tenant does not pay the rent[16] and subsection 17(2) provides that a landlord can re-enter when a tenant uses the lease premises as a bawdy house.[17]

In addition, landlords, who are usually in the superior bargaining position when a lease is being drafted, avoid the inapplicability of the fundamental breach principle to leases by insisting that the lease stipulate that breaches committed by the tenant constitute breaches of *conditions* rather than breaches of *covenants*. Categorizing a tenant's obligations in this way allows a landlord to terminate the lease for a breach by the tenant, rather than only to sue the tenant for damages.[18] For example, a landlord might specify that a *condition* of a lease is that the tenant insure the premises. If the tenant does not insure, the tenant would forfeit his or her lease interest and the landlord would be entitled to repossess the property.

More commonly now, landlords do not label the tenants' obligations as conditions; instead, they simply describe the breaches by the tenant as entitling the landlord to terminate the lease

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[13]In addition, an innocent party could seek an injunction or specific performance to enforce or restrain the breach of the other party's covenant. However, these are equitable remedies and, therefore, they are discretionary. For a discussion on the availability of these remedies, see, The Law Commission (Eng.), *Forfeiture of Tenancies* (Report #142, 1985) 138-139.

[14]*Johnston* v. *Givens*, [1941] 4 D.L.R. 634 (Ont. C.A.) (a residential tenancy case); *Goldhar* v. *Universal Sections and Mouldings Ltd.*, *supra* n. 12.

[15]*Winfield Developments Ltd.* v. *J.E.R. Associates Inc.* (1985), 36 Man. R. (2d) 301 (Q.B.).

[16]*The Landlord and Tenant Act*, C.C.S.M. c. L70, s. 17(1). Other Canadian provinces have similar legislation: *The Landlord and Tenant Act*, R.S.O. 1990, c. L.7, s. 18(1); *The Landlord and Tenant Act*, R.S.S. 1978, c. L-6, s. 9(1); *Landlord and Tenant Act*, R.S.N.B. 1973, c. L-1, s. 8; *Landlord and Tenant Act*, R.S.P.E.I. 1988, c. L-4, s. 9; *Landlord and Tenant Act*, R.S.Y.T. 1986, c. 98, s. 8(b); *Commercial Tenancies Act*, R.S.N.W.T. 1988, c. C-10, s. 8(b). Landlords can use a summary procedure to regain possession of lease premises when tenants fail to pay the rent: *The Landlord and Tenant Act*, C.C.S.M. c. L70, s. 73(1). Other Canadian provinces have similar legislation: *Commercial Tenancy Act*, R.S.B.C. 1979, c. 54, s. 28; *Landlord and Tenant Act*, R.S.N.B. 1973, c. L-1, s. 61; *Commercial Tenancies Act*, R.S.N.W.T. 1988, c. C-10, s. 41, as am. by S.N.W.T. 1993, c. 2, s. 1.

[17]*The Landlord and Tenant Act*, C.C.S.M. c. L70, s. 17(2). Other Canadian provinces have similar legislation: *The Landlord and Tenant Act*, R.S.O. 1990, c. L.7, s. 18(2); *The Landlord and Tenant Act*, R.S.S. 1978, c. L-6, s. 9(2); *Landlord and Tenant Act*, R.S.N.B. 1973, c. L-1, s. 9; *Landlord and Tenant Act*, R.S.P.E.I. 1988, c. L-4, s. 10; *Landlord and Tenant Act*, R.S.Y.T. 1986, c.98, s. 9; *Commercial Tenancies Act*, R.S.N.W.T. 1988, c. C-10, s. 9. Manitoba's *Residential Tenancies Act* changes the common law for both landlords and tenants. The Act explicitly lists the breaches of covenant which enable an innocent landlord or tenant to terminate a lease: *The Residential Tenancies Act*, C.C.S.M. c. R119, ss. 89 (1), 95 (1) and 96 (1). It also provides that a tenant can apply to the Director of Residential Tenancies for an order terminating the tenancy if the landlord reduces or withdraws services which are "so fundamental to the tenant that termination is justified": *The Residential Tenancies Act*, C.C.S.M. c. R119, s. 93.1.

[18]Law Reform Commission of British Columbia, *supra* n. 11, at 113.

and re-enter the premises.[19] For example, a lease may specify that, if the tenant does not keep the premises in good repair, the landlord can re-enter and repossess the lease property (without labelling this as a "condition").[20]

Finally, more and more frequently the courts are using contract law principles to determine the issues in cases involving leases. This change in approach began more than 20 years ago (in a case that did not deal with the issue of fundamental breach), when the Supreme Court of Canada indicated that some landlord and tenant problems should be resolved according to contract law principles.[21] Recently, courts in British Columbia, Alberta and Nova Scotia have applied the fundamental breach principle to cases involving commercial leases; these courts have determined that an innocent landlord or tenant can elect to terminate the lease without having to fulfil his or her remaining promises when the other party commits a fundamental breach of a lease covenant.[22]

However, this approach has not yet been taken by the Manitoba courts. In the most recent Manitoba case which considered the issue of fundamental breach in the context of a commercial

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[19]These provisions are called "provisos for re-entry". A proviso for re-entry by the landlord on non-payment of rent or non-performance of covenants by the tenant is included in *The Short Forms Act*, C.C.S.M. c. S120, Third Schedule, Deed of Lease, item 9.

[20]Many examples of provisos which a landlord may insist upon including in a lease can be found in H.M. Haber, *The Commercial Lease: A Practical Guide* (2nd ed., 1994) 457 and 459. Some examples of provisos for re-entry which are typically included in a commercial lease are:

> Despite anything contained in any present or future laws, statutory or otherwise, to the contrary, if and whenever during the Term hereof:
> (a) Tenant fails to pay any Rent on the date or dates appointed for the payment thereof . . . ; or
> (b) Tenant fails to observe or perform any other of the terms, covenants or conditions of this Lease to be observed or performed by Tenant . . . ;
> . . . .
> then and in every such case . . . Landlord, in addition to any other rights or remedies it has pursuant to this Lease or at law, shall have the immediate right of re-entry upon the Premises and it may repossess the Premises and enjoy them as of its former estate. . . .

[21]In *Highway Properties Ltd.* v. *Kelly, Douglas & Co. Ltd.* (1971), 17 D.L.R. (3d) 710 (S.C.C.), Laskin J. stated at 715:

> I approach the legal issue involved in this appeal by acknowledging the continuity of the common law principle that a lease of land for a term of years under which possession is taken creates an estate in the land, and also the relation of landlord and tenant, to which the common law attaches various incidents despite the silence of the document thereon. . . .
>
> There has, however, been some questioning of this persistent ascendancy of a concept that antedated the development of the law of contracts in English law and has been transformed in its social and economic aspects by urban living conditions and by commercial practice. . . .
>
> In the various common law Provinces, standard contractual terms (reflected, for example, in Short Forms of Leases Acts) and, to a degree, legislation, have superseded the common law of landlord and tenant; for example, in prescribing for payment of rent in advance; in providing for re-entry for non-payment of rent or breaches of other covenants exacted from the tenant; in modifying the absoluteness of covenants not to assign or sublet without leave; and in blunting peremptory rights of termination or forfeiture.

He continued at 721:

> It is no longer sensible to pretend that a commercial lease . . . is simply a conveyance and not also a contract. It is equally untenable to persist in denying resort to the full armoury of remedies ordinarily available to redress repudiation of covenants, merely because the covenants may be associated with an estate in land.

The Court in the *Highway Propreties* case decided that damages for the breach of land lease should be assessed on general contract principles. More recently, the Supreme Court of Canada has expanded this principle to chattel leases. In *Langille* v. *Keneric Tractor Sales Ltd.* (1987), 79 N.R. 241 at 255 (S.C.C.), the Court said: "The damages flowing from the breach of a chattel lease, like the damages flowing from the breach of a land lease, should be calculated in accordance with general contract principles."

[22]*Wesbild Enterprises Ltd.* v. *Pacific Stationers Ltd.* (1990), 52 B.C.L.R. (2d) 317 (C.A.); *Firth* v. *B.D. Management Ltd.* (1990), 73 D.L.R. (4th) 375 (B.C.C.A.); *Lehndorff Canadian Pension Properties Ltd.* v. *Davis Management Ltd.* (1989), 59 D.L.R. (4th) 1 (B.C.C.A.); *Krenzel* v. *Interprovincial Security Patrol (Red Deer) Ltd.* (1982), 38 A.R. 153 (Q.B.); *B.G. Preeco 3 Ltd.* v. *Universal Explorations Ltd.*, [1987] 6 W.W.R. 127 (Alta. Q.B.); *Willow Tree Holdings Ltd.* v. *Sims* (1991), 15 R.P.R. (2d) 277 (N.S.S.C.T.D.) (in this case, the Court found that, although there was a fundamental breach, the plaintiff could not repudiate the contract because she affirmed the contract by failing to rescind much earlier). In an earlier Nova Scotia case, *E. Parker Enterprises Ltd.* v. *Dud Hut Ltd.* (1979), 8 R.P.R. 322 (N.S.S.C.T.D.), the Supreme Court refused to apply the fundamental breach principle to a commercial lease; this case was not referred to in the *Willow Tree Holdings* case.

lease, the Court of Queen's Bench held that the tenant was not justified in withholding the rent when the landlord's breach did not amount to a wrongful eviction.[23] The courts in Ontario similarly have refused to apply the contract law principle concerning fundamental breach to leases.[24]

We will return to the issue of fundamental breach in the next Chapter and consider the need for reform. However, we now turn to the issue of frustration. We will review the common law principles, legislation which pertains to frustrated contracts and the application of the common law and legislation to commercial leases.

B. FRUSTRATION

1. Common Law Principle

It sometimes happens that an event occurs without the fault of either party to the contract which results in the contract becoming impossible to perform and a party to the contract experiencing hardship, inconvenience or material loss. Such an event is said to "frustrate" the contract. The Supreme Court of Canada has stated that an event frustrates a contract if it makes the performance of the contractual obligations "radically different from that which was undertaken by the contract".[25]

On the occurrence of a frustrating event, the parties to the contract are relieved of the obligations which they have not yet performed.[26] If one party receives absolutely no benefit from the contract prior to the frustrating event, he or she can recover a payment made to the other party in pursuance of the contract.[27] However, at common law, such a payment could not be recovered if the payor could be said to have received a benefit from the contract, however small.[28] Nor could a payment be recovered in respect of a benefit conferred on the other party when the party seeking the recovery had performed only part of his or her obligations.[29] In addition, it was immaterial that the party who had to repay the money had incurred expenses in performing his or her contractual obligations prior to the frustrating event.[30]

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[23] *Primeridian Farms Ltd.* v. *Guyot* (1986), 42 Man. R. (2d) 206 (Q.B.). In that case, at 210, Kroft J. quoted the judgment of Mathers C.J. in *Cross* v. *Piggott* (1922), 32 Man. R. 362 at 365 (Q.B.) as follows:

> . . . after the tenant has gone into possession his obligation to pay rent does not depend upon the performance by the lessor of any collateral obligations assumed by him and . . . nothing short of something done by the landlord which amounts to an eviction of the tenant will discharge the latter from his obligation to pay rent.

Also see *Winfield Developments Ltd.* v. *J.E.R. Associates Inc.*, *supra* n. 15, at 306: "[A] breach of a landlord's covenant does not give rise to any right of abatement or suspension of rent unless the breach amounts to a complete eviction."

[24] See *MSM Construction Ltd.* v. *Deiuliis* (1985), 49 O.R. (2d) 633 at 636 (H.C.):

> [T]he mere fact that the demised premises become unfit for whatever use the tenant was putting them to, due to a nuisance, does not exempt a tenant from the payment of rent. Rather the nuisance, if in breach of a covenant of the lease, gives a tenant the right to claim for damages.
>
> As to the application of the doctrines of frustration and fundamental breach to the facts of this case, it is my opinion that the learned trial judge was in error and did not direct herself in accordance with the law as enunciated in the cases to which I have made reference.

[25] *Peter Kiewit Sons' Co. of Canada Ltd.* v. *Eakins Construction Ltd.*, [1960] S.C.R. 361 at 368, quoting *Davis Contractors Ltd.* v. *Fareham Urban District Council*, [1956] A.C. 696 at 729 (H.L.).

[26] *Taylor* v. *Caldwell* (1863), 3 B. & S. 826; 122 E.R. 309 (Q.B.).

[27] *Fibrosa Spolka Akcyjna* v. *Fairbairn Lawson Combe Barbour, Ltd.*, [1943] A.C. 32 (H.L.).

[28] *Whincup* v. *Hughes* (1871), L.R. 6 C.P. 78; *Fibrosa Spolka Akcyjna* v. *Fairbairn Lawson Combe Barbour, Ltd.*, *supra* n. 27.

[29] *Appleby* v. *Myers* (1867), L.R. 2 C.P. 651.

[30] *Fibrosa Spolka Akcyjna* v. *Fairbairn Lawson Combe Barbour, Ltd.*, *supra* n. 27.

2. *The Frustrated Contracts Act*

As just mentioned, the common law did not address the unfairness to a party who had made payments to the other party in pursuance of the contract prior to a frustrating event, where the party who made the payments or conferred a benefit upon the other party received a small benefit from the contract or only partly performed his or her obligations. Nor did it address the unfairness to a party who, having incurred expenses, nevertheless had to repay the monies received prior to the frustrating event. This prompted legislators to enact legislation to provide a fairer system for settling the positions of parties to contracts that are frustrated.

The Frustrated Contracts Act provides for the adjustment of rights and obligations of parties to a contract that "has become impossible of performance or been otherwise frustrated."[31] The Act applies to most contracts, whenever made, which are governed by the law of Manitoba, provided that the common law requirements of frustration are met.[32]

The Act provides that, where money is paid pursuant to a contract before a frustrating event, the money can be recovered by the person who made the payment; money not yet paid does not have to be paid.[33] It further provides that, if a party to whom money has been paid or is yet to be paid incurred expenses in connection with the performance of the contract, that party may be allowed to retain or recover the money paid or payable, up to the amount of the expenses.[34] In addition, if a party received a benefit (other than money) before the frustrating event, a court may allow the other party to recover the whole or a part of the value of the benefit from the recipient.[35] The Act also provides that, if a party assumed an obligation under the contract in consideration of the conferring of a benefit by another party to the contract upon someone else, for the purpose of determining whether a party is entitled to receive the value of a benefit, a court may treat the benefit as if it were obtained by the party who assumed the obligation.[36]

In determining whether money should be recovered or retained, the Act provides that a court cannot consider an amount that is payable to a party due to the circumstances giving rise to the frustration of the contract under a contract of insurance, unless an express term of the frustrated contract or an enactment imposed an obligation to insure.[37] The Act also allows the parties to provide in their contract for a different apportionment of the parties' rights and obligations on frustration.[38]

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[31] *The Frustrated Contracts Act*, C.C.S.M. c. F190, s. 2(1).

[32] *The Frustrated Contracts Act*, C.C.S.M. c. F190, s. 2(1). The Act does not apply:
(a) to a charterparty or a contract for the carriage of goods by sea, except a time charterparty or a charterparty by way of demise;
(b) to a contract of insurance; or
(c) to a contract for the sale of specific goods where the goods, without the knowledge of the seller, have perished at the time when the contract is made, or where the goods, without any fault on the part of the seller or buyer, perish before the risk passes to the buyer" (s. 2(2)).

[33] *The Frustrated Contracts Act*, C.C.S.M. c. F190, s. 3(1).

[34] *The Frustrated Contracts Act*, C.C.S.M. c. F190, s. 3(2).

[35] *The Frustrated Contracts Act*, C.C.S.M. c. F190, s. 3(3).

[36] *The Frustrated Contracts Act*, C.C.S.M. c. F190, s. 3(4).

[37] *The Frustrated Contracts Act*, C.C.S.M. c. F190, s. 3(5).

[38] *The Frustrated Contracts Act*, C.C.S.M. c. F190, s. 3(6).

3. Application to Commercial Leases

Until recently, the common law doctrine of frustration was considered to be inapplicable to leases of real property.[39] As the Law Reform Commission of British Columbia stated:

> Whether or not the doctrine extends to leases has caused considerable controversy. . . . The problem turns on the nature of a lease which has both contractual and property aspects. Under the common law, a lease confers an interest in land. A tenant acquires what is called a nonfreehold estate. If he has rented a house for a year at a monthly rent and after a month the house burns down, the lease would not be regarded as frustrated and he would be responsible for the remaining rent in the absence of any agreement to the contrary. Although the house has been destroyed, the subject-matter of the contract, which is the interest in land, is said to be still in existence. If, however, the land disappeared (say, as a result of an earthquake or flood), it is thought that the lease would be frustrated.[40]

In an Ontario case, the Court found that *an agreement to lease* was frustrated by expropriation of the site but suggested that even expropriation would not frustrate a lease after the tenant is in possession of the lease property.[41]

However, recently, England's House of Lords stated that the doctrine of frustration can apply to leases in an appropriate case.[42] The Ontario Court of Appeal has supported this view in an *obiter* comment in a sale of land case:

> The doctrine of frustration has been applied to commercial contracts since *Taylor et al. v. Caldwell et al., supra*. In *Cricklewood v. Leighton's, supra*, Viscount Simon, L.C., and Lord Wright held against the accepted view that leases were outside the doctrine since a lease in addition to being a contract creates an estate in the land demised for the period of the agreed term. I adopt the reasoning of Viscount Simon, L.C., and his conclusion that there is no binding authority precluding the application of the doctrine of frustration to contracts involving the lease of lands. I am also in accord with his observations that the doctrine is flexible and ought not to be restricted by any arbitrary formula. I see no reason why the doctrine cannot be logically extended to contracts involving the purchase and sale of land.[43]

The courts in Manitoba have not yet had an opportunity to consider the issue of whether a commercial lease of real property can be frustrated.

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[39]G.H. Treitel, *The Law of Contract* (9th ed., 1995) 806. Also see *MSM Construction Ltd.* v. *Deiuliis*, *supra* n. 24.

[40]Law Reform Commission of British Columbia, *Frustrated Contracts Legislation* (Report #3, 1971) 16.

[41]*Re Dennis Commercial Properties Ltd. and Westmount Life Insurance Co.* (1969), 7 D.L.R. (3d) 214 (Ont. H.C.).

[42]*National Carriers Ltd.* v. *Panalpina (Northern) Ltd.*, [1981] A.C. 675 (H.L.). What constitutes an appropriate case has been discussed in Treitel, *supra* n. 39, at 806-808.

[43]*Capital Quality Homes Ltd.* v. *Colwyn Construction Ltd.* (1975), 61 D.L.R. (3d) 385 at 394-395 (Ont.C.A.) per Evans J.A.

CHAPTER 3

REFORM: FUNDAMENTAL BREACH

A. PROBLEMS IN THE LAW

As discussed in the preceding Chapter, commercial landlords usually have the power to end their leases for breaches of covenants committed by their tenants. This power derives in part from several provisions in *The Landlord and Tenant Act*.[1] In addition, landlords are often able to insist that provisions giving them the power to re-enter are included in leases due to the superior bargaining position which owners of the land usually hold when leases are negotiated.

Most tenants of commercial leases, however, do not have comparable powers. Tenants who are in an inferior bargaining position cannot negotiate terms in their leases which would allow them to terminate their leases for serious breaches by their landlords. As a result, when a landlord breaches a lease obligation, his or her tenant continues to be responsible for performing the lease obligations and is not entitled to end the lease, no matter how serious the breach committed by the landlord.

A tenant can sue his or her landlord for damages when the landlord breaches the lease. However, this remedy is considered to have an inadequate effect on the compliance of landlords with their lease promises.[2] On the other hand, the threat of termination is considered to be a remedy which will secure the performance of the other party's lease promises.[3] The remedy of damages is particularly inadequate in

> . . . the kind of case in which a landlord's breaches of covenant are frequent. None of the existing remedies provides a permanent solution in such cases. The tenant can of course respond to repeated breaches of covenant by the repeated exercise of remedies - but this is not good enough for him, any more than it would be good enough for a landlord faced with a consistently bad tenant. It is certainly no substitute for a right to end the tenancy and find a better landlord elsewhere.[4]

Damages are also inadequate where a landlord's financial position is weak. As the editor of a law report noted:

> This case also shows that if a tenant is dealing with a landlord whose financial position may be weak, it would be advisable to include an *express* condition in the lease to the effect that the tenant may, at its option, declare the lease null and void if the landlord is substantially in breach of its covenant to repair. Otherwise, the tenant may be forced to

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[1] *The Landlord and Tenant Act*, C.C.S.M. c. L70, s. 17(1) and (2).

[2] The Law Commission (Eng.), *Forfeiture of Tenancies* (Report #142, 1985) 138 and 140.

[3] See *Re Rexdale Investments Ltd. and Gibson* (1966), 60 D.L.R. (2d) 193 at 197 (Ont.C.A.), where Laskin J.A. stated that, when a landlord's power to terminate is subject to relief, this power is, in effect, merely security for the payment of the rent.

[4] The Law Commission (Eng.), *supra* n. 2, at 139-140.

> pay rent to an irresponsible landlord and have nothing in return except a good cause of action against a landlord who cannot respond to a judgment.[5]

The lack of equality for tenants in this respect has been criticized by several law reform agencies. England's Law Commission stated:

> [I]n relation to breaches of obligation, "both landlord and tenant should be exposed to the same consequences."
> . . . .
> The fact that such a scheme is available to landlords is in itself a reason a scheme should be available to tenants.[6]

The Law Reform Commission of British Columbia summarized the problem this way:

> The common law doctrine concerning the independence of mutual covenants in tenancy agreements is, therefore, very much a one-way street which overwhelmingly reinforces the legal position of the landlord and does little or nothing for the tenant.[7]

Finally, Ontario's Law Reform Commission stated:

> There is little excuse for requiring a tenant to be bound to pay rent where the landlord's covenants for making repairs, heating, and for quiet enjoyment have been broken.[8]

We also hold the view that the inability of commercial tenants to end their leases for a serious breach is an issue which calls out for reform.

We recognize that the courts in British Columbia, Alberta and Nova Scotia now apply the fundamental breach principle to commercial tenancies. However, in Manitoba, in the most recent cases which have considered the common law concept of fundamental breach in the context of commercial leases, the courts have not adopted the principle of fundamental breach for leases.

No doubt, the Manitoba courts will have another opportunity to address this issue in the future. At that time, they may be persuaded to apply the principle of fundamental breach of contract to commercial leases; that is, the courts may allow an innocent party to terminate a commercial lease for a breach of covenant which deprives him or her of substantially the whole benefit of the lease. However, such a result is far from a certainty and it is impossible to know when such a case will come before the Manitoba courts.

Reform by the common law in this area has been very slow. As British Columbia's Law Reform Commission stated in a Report which preceded the common law reforms in that province:

> Almost 20 years have passed since the decision in *Highway Properties*. The law is still far from settled on many of the issues which arise from the case with no prospect of early improvement. Uncertainty of this kind cannot be desirable when important commercial interests are at stake. Legislative intervention, in some degree, is clearly required.
>
> We believe that a new *Commercial Tenancy Act* should recognize and reinforce the recent tendency in the case law to emphasize the contractual elements of a tenancy

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[5]*E. Parker Enterprises Ltd.* v. *Dud Hut Ltd.* (1979), 8 R.P.R. 322 at 323 (N.S.S.C.T.D.) (editor's note).

[6]The Law Commission (Eng.), *supra* n. 2, at 138 and 140, quoting from The Law Commission (Eng.), *Provisional Proposals Relating to Termination of Tenancies* (Working Paper #16, 1968) 27.

[7]Law Reform Commission of British Columbia, *Commercial Tenancy Act* (Report #108, 1989) 22. This Report preceded the common law advances in British Columbia discussed in Chapter 2.

[8]Ontario Law Reform Commission, *Landlord and Tenant Law Applicable to Residential Tenancies* (Interim Report, 1968) 57.

agreement and to rely more heavily on the concepts of contract law in resolving differences between the parties.[9]

We concur with this view.

Although landlords usually hold the superior bargaining position, there are occasions when tenants hold an equal or superior bargaining position. An example might be a shopping centre lease which involves a national chain store or so-called "anchor tenant". Fairness to all parties in these cases would be achieved by the enactment of equivalent legislation for both landlords and tenants.

RECOMMENDATION 1

Legislation should provide that an innocent party to a commercial lease has the right to terminate the lease when the other party commits a fundamental breach of the lease.

It remains to give meaning to the phrase "fundamental breach of the lease". We envision two possible approaches. Covenants could be categorized as "fundamental" or "non-fundamental"; the category into which a particular covenant fell would determine the consequences of a breach of that covenant. In the alternative, legislation could focus on the effect of the breach of a covenant. In the following section, we will discuss these options.

B. APPROACH TO REFORM

Categorization of covenants could be accomplished by setting out in legislation a list of those obligations which, if breached, would entitle an innocent landlord or tenant to terminate their lease. In other words, the law in this area could be codified.

This approach can be found in *The Residential Tenancies Act*.[10] That Act provides that a tenant may notify the landlord of termination if the landlord does not provide doors and locks or vital services, does not repair the premises or interferes with the tenant's enjoyment of the property.[11] A landlord may notify a tenant of termination if the tenant does not pay the rent, does not keep the rental unit clean, disturbs other tenants or assigns or sublets without consent.[12]

Specificity regarding the obligations which, upon breach, entitle an innocent party to terminate introduces certainty to the law. Greater certainty, in turn, might reduce the number of landlord and tenant disputes.[13]

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[9]Law Reform Commission of British Columbia, *supra* n. 7, at 19.

[10]*The Residential Tenancies Act*, C.C.S.M. c. R119, ss. 89 and 95. In addition to this list of "fundamental" obligations, the Act contains a more general provision which allows a tenant to apply to court for an order terminating the tenancy if the landlord reduces or withdraws services which are "so fundamental to the tenancy that termination is justified" (s. 93.1). Part IV of *The Landlord and Tenant Act*, C.C.S.M. c. L70, which was repealed effective September 1, 1992 by *The Residential Tenancies Act*, S.M. 1990-91, c. 11, s. 198, C.C.S.M. c. R119, also contained a general provision which made applicable to residential tenancies the common law rule respecting fundamental breach of a contract (s. 88).

[11]*The Residential Tenancies Act*, C.C.S.M. c. R119, s. 89(2). The landlord must be given an opportunity to remedy the breach within a reasonable time after receiving written notice from the tenant.

[12]*The Residential Tenancies Act*, C.C.S.M. c. R119, ss. 95(1) and 96(1).

[13]This was the goal of the committee made up of civil servants, landlord and tenant representatives and a representative of the Rent Appeals Panelists which recommended the codification of the "fundamental" obligations of residential landlords and tenants in *The Residential Tenancies Act*: Landlord and Tenant Review Committee, *Report to the Honourable Maureen Hemphill, Minister of Housing* (February 1987) I-2.

However, commercial leases tend to be far more complex, involve more variables and include a greater variety of covenants than their residential counterparts. Covenants which are of great importance to one commercial landlord or tenant can be of little importance to another. For example, the availability of parking spaces would be critical to a tenant with a retail business but would be of much less importance to a tenant with a mail-order business. This complexity may make impractical, if not impossible, the codification of covenants in commercial tenancy legislation.

In addition, categorizing particular covenants as fundamental or not does not allow for any flexibility; that is, this approach does not recognize that breaches of the same covenant can produce different effects: a single breach or frequent occurrence of a breach may result in intolerable consequences while another breach of the same covenant may result in a less significant and tolerable effect. For example, a single breach of a repair covenant may be tolerable while the repeated breach of the same covenant may produce an effect which is intolerable to the innocent party. Furthermore, a breach of the same covenant may have a different significance not only for different landlords and tenants but also for the same landlord or tenant.

For these reasons, we believe that codification of covenants in commercial tenancy legislation is inappropriate. In our view, using the effect of a breach of covenant is a far better criterion to determine whether an innocent party should be obliged to perform his or her unperformed obligations after the other party breaches his or her lease obligations. This approach would achieve fairness for the parties and would achieve simplicity through uniformity between contract law and landlord and tenant law.

The adoption for leases of the common law rule of contract respecting the effect of a breach of covenant by one party on the innocent party's obligation to perform was recommended by the Ontario[14] and British Columbia Law Reform Commissions.[15] A similar criterion for termination was recommended by the English Law Commission. It proposed that a court should make an absolute order of termination of a tenancy where it is satisfied

> . . . by reason of the serious character of any . . . events occurring while the present landlord has been the landlord, or by reason of their frequency, or by a combination of both factors, that he is so unsatisfactory a landlord that the tenant ought not in all the circumstances to remain bound by the tenancy.[16]

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[14]Ontario Law Reform Commission, *Landlord and Tenant Law* (Report, 1976) 127-128. The Commission recommended that legislation provide: "(1)(a) except where otherwise provided in the Act, the common law rules of contract respecting the effect of a breach of a condition or a covenant by one party to a contract on the right to damages or injunctive relief, or on the obligation to perform by the other party, should apply to tenancy agreements; . . . ."

[15]Law Reform Commission of British Columbia, *supra* n. 7, at 24.

[16]The Law Commission (Eng.), *supra* n. 2, at 150. The Commission also recommended that a court should be able to make the termination order on terms to apply during the period after the hearing and, in particular, to specify that a sum less than the rent be payable. In addition, the Commission recommended that the court make an absolute order in the following cases (at 150):

- Case (2) Where the court is satisfied that a transfer of the reversion has been made in order to forestall the making of an absolute order under Case (1) above, that there is a substantial risk of the continuance or recurrence of the state of affairs giving rise to a termination order event on which the proceedings are founded, and that the tenant ought not in all the circumstances to remain bound by the tenancy.
- Case (3) Where the court, though it would wish to make a remedial order, is not satisfied that the landlord is willing, and is likely to be able, to carry out the remedial action which would be required of him.

Conditions (that is, events the occurrence of which automatically give rise to the termination of a tenancy) and the landlord's insolvency would not be events for which a tenant would be able to seek a termination order, although a tenant and landlord could freely negotiate for the inclusion of such a provision in their lease.

The Commission further recommended that, to overcome the greater bargaining strength of landlords, tenants should be able to seek termination orders for breaches by their landlords regardless of any provision or agreement which may have been made between the parties to the contrary. The Commission proposed that, if a landlord's breach did not meet the criteria necessary for an absolute termination order, a court should be able to order the landlord to perform a remedial action. For example, a court could order a landlord to pay the tenant or some other person, discontinue the breach, or take some other action to rectify the consequences of his or her breach. If remedial action had already been taken by the landlord, was impossible, unnecessary, or ought not in the circumstances to be required, the Commission recommended that a court should not make a remedial order (at 149-151).

RECOMMENDATION 2

Legislation should provide that the common law rule concerning fundamental breach of contract applies to commercial leases.

The result of this recommendation will be that, when a fundamental breach of a lease occurs, the innocent party to the lease can choose to ignore the breach and continue to perform his or her lease obligations or he or she can choose to end the lease. However, we recognize that there is a practical risk inherent in the latter choice. The effect of a given breach or breaches of a lease is a subjective matter and an innocent landlord or tenant may be uncertain about whether a judge will agree that the effect of a particular breach is sufficiently serious so as to entitle him or her to terminate the lease; he or she may fear the losses which could result from an incorrect conclusion on his or her part. A tenant who believes that the landlord has committed a fundamental breach of his or her lease obligations may nonetheless be hesitant to enter into a new lease with a different landlord and to relocate his or her business for fear that the landlord will dispute the allegation. If a court should later determine that the landlord did not commit a fundamental breach of the lease, the tenant would be liable for the obligations contained in both.

In our opinion, an innocent landlord or tenant should not have to risk the losses which could result from acting upon an honestly held but mistaken belief that the effect of a particular breach or series of breaches is sufficiently serious so as to entitle him or her to terminate the lease. The Ontario Law Reform Commission recommended that the innocent party should be able to ask a court to make an order terminating the lease for a fundamental breach of the lease.[17] We agree that, although an innocent party should not be obliged to seek a court order before ending a lease on the basis of fundamental breach, that option should be available where the party desires that certainty.

RECOMMENDATION 3

Legislation should provide that a landlord or tenant may, prior to terminating the lease for a fundamental breach, seek a declaration from a court that the other party has committed a fundamental breach of the lease.

The chief obligation from which a tenant will want to be relieved after a fundamental breach by the landlord is the obligation to pay the rent. Obviously, where a tenant declares the lease to be at an end because of a fundamental breach, he or she will stop paying rent. However, should a tenant who chooses to seek a declaration of fundamental breach from a court and who therefore remains in possession of the premises in the interim be allowed to withhold the rent and, if so, is a specific legislative provision necessary?

In our view, a tenant who wishes to obtain confirmation from a court regarding his or her entitlement to terminate the lease for a fundamental breach should not be put in the position of later having to recover rent paid to the landlord for the period after the breach and prior to a court's declaration of a fundamental breach. In other words, we believe that it is important that a tenant be able to withhold the rent while the court makes its determination about fundamental breach.

In its Report on landlord and tenant law, the Ontario Law Reform Commission examined the interpretation given by the courts to the provision in Ontario's residential tenancy legislation which adopts the common law rule respecting the effect of a fundamental breach of covenant. It

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[17]Ontario Law Reform Commission, *supra* n. 14, at 127.

found that this general provision has been interpreted not to allow a residential tenant to withhold rent in response to a breach of a material covenant by the landlord.[18] For this reason, the Ontario Commission concluded that a specific provision allowing an innocent tenant to withhold the rent after a fundamental breach was necessary. The Commission recommended that a tenant who wished to withhold rent should have to apply to a judge for an order abating the rent or pay the rent into court and then apply to court for an order respecting the disposition of the money. In addition, the recommendations of the Commission suggest that, in an "appropriate case", a tenant should be allowed to withhold rent on a self-help basis.[19]

However, we feel that a landlord's entitlement to be paid the rent deserves greater protection. We concur with the view of the Law Reform Commission of British Columbia that a self-help remedy could invite "abuse by the unscrupulous (or desperate) tenant who might seize on any trivial default (real or imagined) by the landlord as an excuse to avoid paying rent when it is due."[20] To "eliminate any frivolous use of rent withholding",[21] the British Columbia Commission recommended that a court application be necessary for the withholding of rent.[22]

RECOMMENDATION 4

Legislation should expressly provide that a tenant should be able to withhold the payment of rent for a fundamental breach by the landlord when he or she seeks a declaration from a court that the landlord has committed a fundamental breach and when, upon motion, the court orders that rent due under the lease be paid into court pending its determination as to a fundamental breach.

C. ANCILLARY ISSUES

1. Relief from Forfeiture for Tenant and Others Claiming Under Tenant

At common law, the interests of subtenants and mortgagees of a tenant (known as "derivative interests") end when the landlord re-enters or forfeits the lease for a breach by the

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[18]Ontario Law Reform Commission, *supra* n. 14, at 126-127. In one case, the court determined that a tenant who alleged that the landlord breached a material covenant could not refuse to pay rent and also remain in possession of the property: *Brahmsgate Investments Ltd.* v. *Finn*, [1973] 3 O.R. 188 (Co. Ct.). In another case, a tenant who alleged that the landlord had breached his covenant to keep the premises in good repair paid his rent into a private trust fund in an attempt to withhold the rent. The landlord applied for an order for payment of arrears of rent and the tenant, in response, claimed for the abatement of rent due to the landlord's breach. The court ruled that the tenant's claim for the abatement of rent could not be raised as a defence; the tenant had to make a separate application to enforce the landlord's obligation to repair: *Re Pajelle Investments Ltd. and Booth (No.2)* (1975), 7 O.R. (2d) 229 (Co. Ct.). In a third case, a court held that the covenant to repair was a material covenant, the breach of which entitled the tenant to withhold rent; the issue of non-repair could be adjudicated upon paying the withheld rent into court: *Re Quann and Pajelle Investments Ltd.* (1975), 7 O.R. (2d) 769 (Co. Ct.).

[19]Ontario Law Reform Commission, *supra* n. 14, at 127-128:

(a) except where otherwise provided in the Act, the common law rules of contract respecting the effect of a breach of a condition or a covenant by one party to a contract on the right to damages or injunctive relief, or on the obligation to perform by the other party, should apply to tenancy agreements;

(b) where one party commits a breach of a fundamental term of the tenancy agreement, the other party should have the right to apply by summary application to a judge for a declaration that the tenancy is terminated;

(c) where the landlord commits a breach of a fundamental term of the tenancy agreement, the tenant should have the additional right to apply by summary application to a judge for an abatement of rent; in the meanwhile, upon such a breach the tenant should have the right to withhold rent from the landlord, while remaining in possession of the rented premises, but should then be required to pay this money into court. The disposition of the money paid into court should be subject to any further order of the judge; and

(d) the exercise of the rights accorded to the parties under (b) and (c) should not preclude in appropriate cases the exercise of the rights accorded to them under (a).

[20]Law Reform Commission of British Columbia, *supra* n. 7, at 25.

[21]Law Reform Commission of British Columbia, *supra* n. 7, at 25.

[22]Law Reform Commission of British Columbia, *supra* n. 7, at 24-25.

tenant. The rationale for this rule is that the landlord is the lord of the land and inherently entitled to recover it if the tenant defaults. The termination of derivative interests is not so much unfair as a natural consequence of the fact that they are subsidiary interests which derive from an interest which is itself subsidiary to the landlord's interest. A practical reason for this rule is that, if a derivative interest (for example, a subtenancy) were to continue when the tenancy from which it derives is forfeited, landlords would be tempted to eliminate the risk of ending up with tenants with whom they are not happy by limiting a tenant's ability to sublet or mortgage his or her interest.[23]

The Landlord and Tenant Act contains provisions which vary the common law rule. Subsection 19(1) provides that, when a landlord has a right of re-entry or forfeiture for a breach of covenant or condition by a tenant, the tenant or a person whose lease interest derives from the tenant's interest (a subtenant or mortgagee) may apply to court for relief against forfeiture.[24] Section 20 provides that when a landlord proceeds by action or otherwise to enforce a right of re-entry or forfeiture, a person who derives a lease interest from the tenant may apply to court for an order making him or her the tenant for the remainder of the term of the lease or a lesser term up to the length of the sublease, on whatever terms the courts considers fit.[25]

These provisions apply only when a landlord exercises a right to re-enter or claim forfeiture for a breach by the tenant. We believe that the same relief should be available when a landlord is entitled to terminate the lease for a fundamental breach.

RECOMMENDATION 5

The relief that is available to tenants and persons who derive an interest from a tenant pursuant to subsection 19(1) and section 20 of The Landlord and Tenant Act should be available to the same persons when a landlord seeks to terminate a tenancy for a fundamental breach of the lease by the tenant.

2. Preservation of Derivative Interests by Landlord

A landlord who is entitled to terminate a tenancy for a fundamental breach by the tenant may not want to end the interests of the tenant's subtenants. He or she may have no quarrel with them and it will probably be in his or her interest that they remain in possession, paying rent.

At present, a landlord who ends the tenant's lease interest can retain the interest of a party who derives his or her interest from the tenant by subtenancy only by entering into a new lease with the subtenant or by persuading the subtenant to ask a court (pursuant to section 20 of *The Landlord and Tenant Act*) for permission to step into the position of the former head tenant. This

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[23]The Law Commission (Eng.), *supra* n. 2, at 98-99.

[24]*The Landlord and Tenant Act*, C.C.S.M. c. L70, s. 19(1). Subsection 19(1) provides for relief against forfeiture to "lessees" where the landlord is proceeding to enforce a right of re-entry or forfeiture for non-payment of rent or some other cause. "Lessee" is defined to include "an original or derivative under-lessee and the heirs, executors, administrators and assigns of a lessee and a grantee under such a grant and his heirs and assigns" (s. 18 (1)). Included among those who can claim relief from forfeiture pursuant to section 19(1) are subtenants: *Re Vanek and Bomza* (1976), 74 D.L.R. (3d) 175 (Ont. H.C.J.); *Canada Trust Co.* v. *Brunswick of Canada Ltd.* (1990), 9 R.P.R. (2d) 213 (Ont. S.C.); assignees whose assignment is security for a loan: *Re Hurontario Management Services Ltd. and Menechella Brothers Ltd.* (1983), 146 D.L.R. (3d) 110 (Ont. C.A.); and mortgagees by sublease: *Re Toronto-Dominion Bank and Dufferin-Lawrence Developments Ltd.* (1981), 122 D.L.R. (3rd) 272 (Ont. C.A.). The law is the same in England, where relief from forfeiture can be claimed pursuant to a provision similar to subsection 19(1) of *The Landlord and Tenant Act* by mortgagees by sub-demise: *In Re Good's Lease*, [1954] 1 W.L.R. 309 (Ch. D.); mortgagees by way of legal charge: *Grand Junction Co. Ld.* v. *Bates*, [1954] 2 Q.B. 160 (Q.B.D.); and mortgagees who have taken a purported assignment of the tenancy by way of sub-demise: *Grangeside Properties Ltd.* v. *Collingwoods Securities Ltd.*, [1964] 1 W.L.R. 139 (C.A.).

[25]*The Landlord and Tenant Act*, C.C.S.M. c. L70, s. 20.

situation poses unnecessary hardship for landlords and subtenants who wish to retain their interests. In order to continue in a lease relationship, the parties must spend time and money to prepare, execute and register new lease documents or to apply to court.

We see no reason why landlords who wish to end only the head tenancy because of a fundamental breach by the tenant should not be able to preserve the derivative interests of that tenant. So long as no additional obligations are thereby imposed on the derivative interest holders, we approve of this solution for its practical benefit of saving the parties time and money.

The surrender of a lease by a tenant to a landlord provides a useful model.[26] When a tenant surrenders his or her lease interest to the landlord, the surrender takes place subject to the rights of any derivative interests. In other words, on a surrender by a tenant, every derivative interest in the surrendered property is preserved. Thus, preservation of derivative interests in the case of a fundamental breach by the tenant could be achieved by allowing landlords to cause a deemed surrender of the lease interest. We adopt this approach because it achieves our objective and because, by utilizing the established legal concept of surrender, it avoids adding greater complexity to tenancy law.[27]

Furthermore, no harm would ensue for derivative interest holders. A person who enters into a sublease or mortgage does so with the expectation of having the lease interest for the agreed duration. A subtenant or mortgagee can hardly complain when his or her same interest continues for the period that he or she agreed upon in the sublease or mortgage after the head tenancy is terminated.[28]

The only interest holder who would have some change to his or her position would be one who derives an interest directly from the head tenant (an original derivative under-lessee), as he or she would obtain a new landlord. However, this does not differ from what occurs on a surrender by a head tenant of his or her tenancy to the landlord; a subtenant who derives his or her interest directly from the former head tenant automatically experiences a change of landlord from the former tenant to the tenant's landlord, without his or her consent.[29]

RECOMMENDATION 6

A landlord who terminates a lease for a fundamental breach by the tenant should be able to preserve derivative interests by causing all of the interest of the tenant to be deemed to be surrendered to the landlord.

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[26]A tenant may surrender his or her lease interest to the landlord with the consent of the landlord. The landlord then takes over the lease and, for the purposes of third parties such as subtenants, steps into the tenant's shoes.

[27]Although the issue is beyond the scope of this Report, consistency within *The Landlord and Tenant Act* would be achieved by allowing landlords to cause a deemed surrender in circumstances in which they are presently entitled to re-enter or forfeit a tenancy. Such amendments are worthy of consideration.

[28]Although a subtenant who derives his or her interest directly from the tenant would be in privity of estate with the landlord, after the surrender he or she would not be in privity of contract with the landlord and would not assume the original tenant's obligation of continuing liability.

[29]Section 16 of *The Landlord and Tenant Act*, C.C.S.M. c. L70 provides:

> Where the reversion expectant on a lease of land merges or is surrendered, the estate which for the time being confers, as against the tenant under the lease, the next vested right to the land shall, to the extent of and for preserving such incidence to, and obligations on, the reversion as, but for the surrender or merger thereof, would have subsisted, be deemed the reversion expectant on the lease.

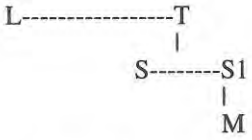
Also see, *Shapiro* v. *Handelman*, [1947] 2 D.L.R. 492 (Ont.C.A.), in which the Court held that the rights of a subtenant are not affected by a surrender, even if his rights are unknown to the landlord at the time of the surrender and the granting of the sublease rendered the head lease liable to forfeiture.

RECOMMENDATION 7

The consent of a person who derives a lease interest from the tenant should not be required for a deemed surrender caused by the landlord.

A tenant may divide his or her lease interest into more than one part and may retain one part and sublet the other part or may sublet both parts to different individuals. Each subtenant may, in turn, further sublet his or her respective interest. The following example illustrates.

> Example. L leases a building to T who, in turn, grants a subtenancy in the first floor of the building to S and in the second floor to S1. S1 then mortgages his interest to M.



In such a case, should a landlord be able to preserve some derivative interests and not others?

Landlords could be given an unrestricted right to preserve any derivative interests. In the above example, L would be able to preserve the interest of S1 without also preserving the interest of M or the interest of S without the interests of S1 and M.

In the alternative, the ability of landlords to preserve derivative interests could be restricted to the preservation of interests of immediate derivative interest holders, that is, persons who derive an interest directly from the tenant and those who derive an interest in the same property. Applying this approach to our example, L would be free to preserve the interests of S, S1 or both. However, if L decided to preserve S1's interest, the interest of M would automatically also be preserved.

Restricting the preservation by landlords in this way would prevent any arbitrary disruption to existing contractual relationships. In addition, this approach would be in keeping with the general principle that derivative interests should only end if a superior interest in the property on which they depend is brought to an end. If a landlord wishes to have the tenant's immediate subtenant retain his or her interest, he or she would have to accept the fact that that person previously entered into agreements with others that he or she cannot disrupt.

England's Law Commission recommended that landlords should be able to preserve the derivative interests of a tenant on the termination of a tenancy.[30] It also recommended that, when a tenant's interest is divided between more than one derivative interest holder, each of whom holds his or her interest separately, a landlord should be able to preserve some or all of the separate derivative interests, but he or she must be required to preserve the whole interest in the derivative interest which is preserved. The Commission felt that this restriction was necessary in order to avoid unfairness to the derivative interest holders. We agree with this conclusion.

RECOMMENDATION 8

Where a person who derives an interest directly from a tenant holds an interest in only part of the lease property, the landlord should be able to preserve the derivative interests in that part only of the lease property by causing the interest of the tenant in that part of the lease property to be surrendered to the landlord.

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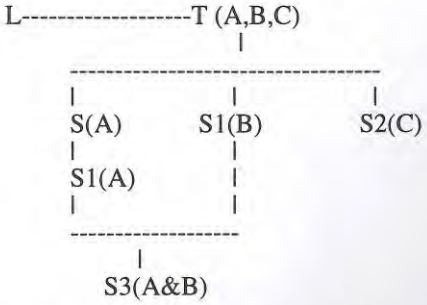
[30]The Law Commission (Eng.), *supra* n. 2, at 99.

In some instances, derivative interests in one part of a lease property are related to derivative interests in another part. The following example illustrates.

> Example. L leases a strip mall which consists of three areas, A, B and C, to T who, in turn, grants a subtenancy of area A to S, area B to S1 and area C to S2. S then sublets area A to S1 and S1 sublets areas A and B together as a single tenancy to S3.



> Area A is related to area B because they have been sublet together as a single tenancy.

This example raises the question of whether a landlord who wishes to retain S as a tenant must also preserve the interest of S1 in area B.

In our view, if a landlord wishes to preserve a derivative interest which is related to another derivative interest, he or she also must preserve the related interest. In our example, if L wishes to preserve the interest of S in area A, he or she would have to preserve the interests of S1 and S3 in area A as well as the related interests of S1 and S3 in area B. Any other solution could create unfairness to S3 and would also create an unjustifiably complicated situation.

RECOMMENDATION 9

Where a landlord causes a deemed surrender of a derivative interest in one part of the lease property that is related to a derivative interest in another part of the lease property, he or she must also cause a deemed surrender of all the related derivative interests in the other part of the lease property.

As discussed earlier, a derivative interest holder who derives his or her interest directly from the tenant will have a new landlord after the deemed surrender. To this extent, his or her position is changed and it is necessary that he or she should be informed. However, although the rights and obligations of other derivative interest holders remain unchanged, we believe that they too should be informed of the legal change that is taking place.

RECOMMENDATION 10

A deemed surrender should be accomplished by written notice being served of the deemed surrender on the tenant and every derivative interest holder.

3. Liability of Landlord for Tenant's Mortgage

After an actual surrender (as opposed to the deemed surrender we are suggesting in the context of a fundamental breach), a head tenant who had previously mortgaged his or her lease interest remains liable to the mortgagee for the payments because of the tenant's covenant in the mortgage to repay the mortgage proceeds.[31] As such, on default, a mortgagee can sue the former tenant for the debt owing.

However, as mentioned earlier, a surrender operates subject to the rights of derivative interest holders whose interests are preserved. This means that a mortgagee of a leasehold interest retains the rights of mortgagee of that interest after surrender. This entitles a mortgagee to sell the former tenant's leasehold interest on default by the tenant and retain the proceeds up to the amount of the mortgage debt. A landlord can avoid a sale of the former tenant's lease interest by discharging the debt out of his or her own money.[32] However, a landlord is not entitled to reimbursement from the former tenant for an amount paid to the mortgagee[33] unless the landlord made it a condition of accepting the surrender that the former tenant promise to indemnify him or her if the landlord is required to cover a future default on the former tenant's mortgage.

In general, we believe that the rights and obligations of a landlord and mortgagee on a deemed surrender caused by a landlord should parallel what happens on an actual surrender by the head tenant. In our view, the tenant's mortgagee should be entitled to sue the landlord for the mortgage debt when the former tenant defaults. However, it seems unfair to us that a landlord who preserves a derivative interest on the termination of the lease for a breach by the tenant should be required to cover the former tenant's default on the mortgage without being entitled to indemnification from the former tenant to the extent of the amount paid to the mortgagee.[34]

RECOMMENDATION 11

A landlord who covers a former tenant's mortgage default which occurs after he or she causes a deemed surrender should be entitled automatically to indemnification from the former tenant for the amount paid to the mortgagee.

4. Relief to Landlords on Termination by Tenant

At present, a tenant or person who derives a lease interest from a tenant can ask a court for relief from forfeiture when a landlord seeks to forfeit the tenancy for a breach by the tenant.[35]

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[31]A landlord who accepts the surrender of the tenant's interest which has been mortgaged may expressly undertake to indemnify the former tenant should he or she be sued by the mortgagee. Alternatively, if the amount secured by the mortgage forms part of the consideration for the surrender then, absent any express provisions, there will be an implied obligation on the part of the landlord to indemnify the tenant for the mortgage debt: *Waring* v. *Ward* (1802), 7 Ves. Jun. 332 at 336-337, 32 E.R. 136 (Ch.) (which stands for this principle in regard to transfers of property which are subject to encumbrances generally, as opposed to surrenders of leasehold interests). Thus, if this covenant of indemnification can be implied, a former tenant who is called upon by the mortgagee to pay the mortgage debt could seek indemnification from the landlord. For registered leases, *The Real Property Act*, C.C.S.M. c. R30, s. 77, codifies this covenant which has been implied by the courts for transfers of land which are registered and, in addition, creates privity between the mortgagee and transferee of the mortgagor: *Guaranty Trust Company of Canada* v. *Bailey* (1985), 59 A.R. 297 (C.A.). In the context of surrender, this means that, where the covenant of indemnification can be implied between the landlord and former tenant and where the lease is registered, a mortgagor can sue the landlord directly upon default of the mortgage obligations entered into originally by the former tenant for the money due on the mortgage.

[32]The Law Commission (Eng,), *supra* n. 2, at 102-103.

[33]The Law Commission (Eng.), *supra* n. 2, at 103.

[34]England's law reform body also took this position: The Law Commission (Eng.), *supra* n. 2, at 103.

[35]*The Landlord and Tenant Act*, C.C.S.M. c. L70, s. 19(1).

No equivalent right exists for landlords where a tenant seeks to end the lease by reason of a fundamental breach.

We recognize that landlords would likely seek such relief infrequently. While a tenant may lose a great deal on termination, as a property may be the tenant's place of business and the tenant may have spent a great deal of money on upgrading the premises, a landlord may not care about retaining a particular tenant provided that he or she can relet the lease property without a financial loss. A landlord probably has an attachment to a particular tenant only when he or she believes that the tenant (for example, an anchor tenant in a shopping mall) cannot be replaced by another of a similar economic value. Nonetheless, there may be circumstances where a particular tenant is of great importance to a landlord; in the interests of fairness and uniformity between the rights of tenants and landlords, we believe that landlords should also be able to seek relief.

RECOMMENDATION 12

Landlords should be entitled to seek relief from termination in the same way that a tenant can seek relief from forfeiture.

5. Rights of Holders of Derivative Interests of Tenant on Termination by Tenant

At common law, when a landlord is entitled to terminate the lease for a breach by the tenant, unless some effort is made by a holder of a derivative interest, all derivative interests also end. This is fair to the landlord since he or she is not then saddled after termination with an unwanted derivative interest of the tenant. However, *The Landlord and Tenant Act* has changed the common law so that a person who derives a lease interest from the tenant may apply to court for relief from forfeiture or to be put into the position of head tenant. Thus, a person with a derivative interest, who may have had no part in the breach which resulted in the landlord enforcing his or her right to forfeiture or re-entry, can try to protect his or her own interest.

In our view, a person who derives a lease interest from a tenant should have the same right to protect his or her interest when a tenant seeks to terminate the lease for a breach by the landlord.

RECOMMENDATION 13

After a fundamental breach by a landlord, a person who derives his or her lease interest from the tenant should be entitled to apply to court for an order vesting him or her with the tenant's lease interest, or preventing termination by the tenant for the landlord's breach.

CHAPTER 4

REFORM: FRUSTRATION

A. PROBLEMS IN THE LAW

Commercial leases that are prepared by lawyers usually specify the consequences of an unexpected event that occurs without either party's fault and that makes performance of the lease impossible. However, not every commercial lease is prepared by a lawyer; those who are not are unlikely to address the issue of what should happen when the lease becomes impossible to perform.

Individuals who do not address the possibility of frustration in their leases cannot be certain of what their rights and obligations will be if an event occurs that meets the common law requirements of frustration. As discussed in Chapter 2, this uncertainty results from the fact that, although in other jurisdictions some courts have recently considered leases to be capable of frustration, Manitoba courts have not yet had an opportunity to consider whether a commercial real property lease can be frustrated. Legislative reform would bring greater certainty to Manitoba law immediately.

In our view, legislative reform in this area should, as its cornerstone, adopt the common law principle of frustration which applies to other contracts. In addition to the certainty which would result for commercial landlords and tenants whose leases do not address the issue of frustration, this approach would achieve uniformity between contract and commercial tenancy law. Conformity between these two areas of law has been supported by the Supreme Court of Canada; as Laskin J. stated in the *Highway Properties* case (which did not involve frustration), commercial leases are not simply conveyances but are also contracts.[1] Adoption of the common law principle of frustration also would make similar the law of Manitoba and Ontario, given the adoption of the principle of frustration of contracts for commercial tenancies by the Ontario Court of Appeal.[2] It would also achieve consistency within tenancy law in Manitoba, as *The Residential Tenancies Act* currently provides that a tenancy is deemed to terminate when a rental unit or residential complex is made uninhabitable by fire, flood or other occurrence or is otherwise frustrated[3] and *The Expropriation Act* provides that an expropriation of a tenant's lease interest is deemed to frustrate the lease.[4] The Law Reform Commission of British Columbia has also recommended this approach.[5]

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[1] *Highway Properties Ltd.* v. *Kelly, Douglas & Co. Ltd.* (1971), 17 D.L.R. (3d) 710 at 721 (S.C.C.) per Laskin J.

[2] *Capital Quality Homes Ltd.* v. *Colwyn Construction Ltd.* (1975), 61 D.L.R. (3d) 385 at 394 (Ont. C.A.).

[3] *The Residential Tenancies Act*, C.C.S.M. c. R119, s. 105(1).

[4] *The Expropriation Act*, C.C.S.M. c. E190, s. 46 (2):
> Where all the interest of a lessee in land is expropriated or where part of the lessee's interest is expropriated and the expropriation renders the remaining part of the lessee's interest unfit for the purposes of the lease, as determined by the court, the lease shall be deemed to be frustrated from the date the lessee went out of possession.

[5] Law Reform Commission of British Columbia, *Commercial Tenancy Act* (Report #108, 1989) 26. A government Bill which adopted this recommendation was introduced for First Reading into the British Columbia Legislature on May 11, 1993, but it did not proceed any further: Bill 10, *Commercial Tenancy Act*, 2nd Sess., 35th Parl. B.C., 1993.

However, simply importing the law of frustration to commercial tenancies may not be enough. Although the adoption of this principle is important, we recognize that, as for other contracts, leases will only rarely become impossible to perform due to a frustrating event. In fact, the unique characteristic of land - its permanence - may make frustration even less likely for leases than it is for contracts. Certainly, there will be an occasional case in which, for example, the buildings on a strip of land and the land itself are washed away in a devastating flood or access to lease premises is eliminated for most or all of the term, making it impossible for the tenant to utilize it for his or her lease purposes. However, in our opinion, when an unexpected event such as a flood, tornado or fire occurs, lease premises often will be only partly destroyed and will be capable of being rebuilt within a period of time that makes the continuation of the lease feasible, albeit with some temporary concessions being made by both the landlord and tenant. In other words, even many devastating events cannot be said to truly render a commercial lease "impossible" of performance. Thus, the adoption for leases of the law of frustration which applies to other contracts will result in only a minimal change to the present situation.

Moreover, we believe that, even where buildings on the lease premises are totally destroyed by an unexpected event and the time required to rebuild is lengthy, perhaps extending beyond the term of the lease, many commercial tenants would prefer that their lease not end but, instead, that it continue and that any building that is destroyed be rebuilt so that they can continue their business in the same location rather than relocate.[6] In addition, we feel that, in the same circumstances, commercial landlords who have reliable tenants would probably prefer to rebuild and continue in the lease rather than to commence uncertain lease relationships with new tenants.

These considerations have led us to the conclusion that merely to adopt the common law of frustration and the consequences set out in *The Frustrated Contracts Act* would be a step forward but would not provide an adequate solution for many commercial landlords and tenants. For these reasons, we propose that the legislation that addresses frustration should go beyond the adoption of the common law and statute law of frustration to address the needs of landlords and tenants who wish to restore the buildings on the lease premises and continue their lease relationship.

RECOMMENDATION 14

Legislation should provide that the common law principle of frustration of contracts and the consequences of The Frustrated Contracts Act should apply to commercial leases.

RECOMMENDATION 15

Legislation should also provide a scheme to meet the needs of landlords and tenants who wish to restore the lease premises and continue their leases.

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[6]See M.J. Ross, *Drafting and Negotiating Commercial Leases* (3rd ed., 1989) at para. 10.22:

> . . . [A] compromise might be for the landlord to be relieved from his covenant to reinstate during the last few years of the term, but in any event the tenant should require a clause to be inserted by which the tenant will receive from the landlord, in such circumstances, a share of the insurance money payable equal to the value of the tenant's interest. *This, however, may not compensate the tenant for the loss that his business may suffer as a result of having to vacate that particular location.* [emphasis added]

A preference to remain in the same location is sometimes also held by residential tenants. To accommodate this preference, *The Residential Tenancies Act*, C.C.S.M. c. R119, s. 105(2), gives a tenant whose premises have been made uninhabitable by fire, flood or other occurrence a right of first refusal to rent the premises if they are made habitable within one year of the frustrating event.

B. LEGISLATIVE SCHEME

It remains for us to consider the scope and details of the legislative scheme which will address the needs of landlords and tenants who wish to rebuild and continue their lease. In our view, the scheme should attempt to mirror the anticipated intentions of most landlords and tenants.[7] Furthermore, we believe that a scheme which applies to a very wide range of situations most likely to occur, yet not necessarily entailing frustration, would be of greatest use to commercial landlords and tenants; we believe this would encompass the destruction of buildings that renders the lease premises totally or partly unfit for the tenant's purposes. We are convinced of the usefulness of this broad approach by the fact that the same approach is taken by those commercial landlords and tenants who address the issue of destruction of lease premises in their leases. As the Ontario Law Reform Commission stated:

> Almost all commercial and industrial tenancy agreements deal explicitly with the consequences of a total, or partial, destruction of the rented premises; the clauses concerning frustration often involve complex rent abatement provisions, further complicated by existing provisions respecting payments based on a percentage of sales.[8]

Although application to a wide range of situations is desirable, we also recognize that a legislative scheme cannot address every situation, nor do we believe that it should. In our view, the scheme should not pertain to the destruction of buildings on lease premises that are not crucial to the tenant's lease purposes; destruction of this scale should not affect the continuation of a lease and should be left to the parties to be resolved. In addition, in our view, the legislation should not deal with destruction which occurs with the intentional fault or negligence of a landlord or tenant.[9] Limiting the scheme to destruction which occurs without fault would achieve greater simplicity in the law as this criterion would be shared by this scheme and the common law doctrine of frustration.

RECOMMENDATION 16

A legislative scheme which provides for the rebuilding of buildings on leased premises should be limited in its application to destruction which occurs without the intentional fault or negligence of the landlord or tenant of those buildings that are crucial to the tenant's purposes.

Although a landlord and tenant may want to continue in their lease relationship after a building that is crucial to the tenant's purposes is destroyed, there are obvious limits to what is practically possible. Where destruction of a building is accompanied by significant destruction of the land which comprises the lease premises, rebuilding would probably not serve a useful purpose and, in some cases, may not even be feasible. Destruction of this magnitude would probably frustrate the lease, in which case the lease would end, the landlord and tenant would be excused from the performance of their unperformed obligations and the rights and obligations of the landlord and tenant in respect to money paid or payable, expenses incurred and benefits obtained prior to the frustrating event would be governed by *The Frustrated Contracts Act*.[10] A landlord and tenant who wished to have other consequences apply on the occurrence of a frustrating event could negotiate such terms in their lease.

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[7]We have been assisted in devising a scheme which mirrors the anticipated intentions of most landlords and tenants by the recommendations for clauses in a commercial lease made by H.M. Haber, *The Commercial Lease: A Practical Guide* (2nd ed., 1994) 208-219 and 442-447.

[8]Ontario Law Reform Commission, *Landlord and Tenant Law* (Report, 1976) 209.

[9]Where lease premises are destroyed by a negligent or intentional act of one of the parties, the innocent party would be able to sue the wrongdoer for damages and may be excused from further obligation by reason of a fundamental breach.

[10]*The Frustrated Contracts Act*, C.C.S.M. c. F190.

RECOMMENDATION 17

The legislative scheme should not apply to the destruction of buildings on lease premises that are crucial to the tenant's purposes where the land which comprises the lease premises is also significantly destroyed.

The essence of our proposed scheme is that the parties should have an opportunity to continue the lease where that is feasible. In recognition of the likely intentions of most parties to a commercial lease, a lease should only be cancellable in the most extreme circumstances. For this reason, the legislative scheme should make a distinction between total and partial destruction of buildings on lease premises. In our opinion, a landlord or tenant should not be able to set aside a lease for destruction that is less than the total destruction of a building located on the lease premises that is crucial to the tenant's purposes; where the damage is less significant, the building should be rebuilt and the lease continued.

RECOMMENDATION 18

Legislation should provide that, when a building on lease premises that is crucial to the tenant's lease purposes is totally destroyed without the intentional fault or negligence of the parties, either party may elect to terminate the lease.

RECOMMENDATION 19

Legislation should provide that, when a building on lease premises that is crucial to the tenant's lease purposes is only partly destroyed without the intentional fault or negligence of the parties, neither party may elect to terminate the lease because of the destruction.

RECOMMENDATION 20

Legislation should provide that, where neither party terminates a lease for the total destruction of a building that is crucial to the tenant's lease purposes or where a building that is crucial to the tenant's lease purposes is partly destroyed, the landlord shall be obliged to rebuild the building to make it fit again for the tenant's purposes.

In order to provide certainty to the parties to the lease, a decision to terminate should be communicated within a defined period of time sufficient to allow the parties to assess the damage. Sixty days should usually be sufficient for this purpose. Where further time is required, we would allow a court to grant more on application from one of the parties.

RECOMMENDATION 21

Legislation should provide that a party who wishes to terminate a lease must serve the other party with notice within 60 days of the destruction of a building that is crucial to the tenant's lease purposes and that a court, on application, may grant an extension of this period.

When one of the parties to a lease elects to terminate the lease, the lease will end and the parties will be released from their future lease obligations. Fairness between the landlord and tenant and simplicity in the law would be achieved by having *The Frustrated Contracts Act* govern the rights and obligations of the parties in respect to monies paid or due prior to the destruction of the building.

RECOMMENDATION 22

Legislation should provide that, where one of the parties to a lease terminates the lease for the total destruction of a building that is crucial to the tenant's lease purposes, The Frustrated Contracts Act govern the rights and obligations of those parties.

The time required to restore damaged buildings or structures to a usable state may be considerable. We believe that fairness to the parties would be achieved by the suspension or abatement of the rights and obligations of the parties to receive or pay rent during the rebuilding process. We would distinguish between situations in which destruction to a building renders the lease premises totally unfit as opposed to only partly unfit for the tenant's purposes. In the former case, we think that fairness to the parties can be achieved only by the suspension of the right to receive and the obligation to pay rent during the rebuilding period. In addition to recognizing the temporary absence of consideration between the parties, the full abatement of rent would also encourage a landlord to rebuild in a timely fashion.

However, when destruction renders lease premises partly fit for the purpose for which they are leased, we believe that the tenant's rent obligation should be abated, rather than suspended. The amount of rent that is abated could be equal to the rent multiplied by the proportion of the lease premises that remains usable bears to the entire premises. This means, for example, that if one-third of the lease premises remains usable for the tenant's purposes, the tenant would remain obliged to pay one-third of the rent.[11] In order to keep the law as simple as possible, we would not consider placing on the tenant the obligation of paying a greater amount of rent as the rebuilding occurs and the premises become more fit for his or her purposes.

We recognize that there will be some hard cases in which rent abatement or suspension will not be sufficient to compensate a tenant for business losses which are incurred during the rebuilding period. However, on balance, we consider that, in most situations, fairness to landlords and tenants, as well as the likely intentions of most landlords and tenants, would be achieved by the abatement or suspension.

RECOMMENDATION 23

Legislation should provide that, if a building or structure on the lease premises that is crucial to the tenant's lease purposes is rendered totally unfit and neither party has elected to terminate the lease, the parties should remain obligated to perform their lease obligations except that the tenant should not have to pay any rent from the date of the destruction until the rebuilding is completed.

RECOMMENDATION 24

Legislation should provide that, if a building on the lease premises that is crucial to the tenant's purposes is rendered partly unfit for the tenant's lease purposes, the parties should remain obligated to perform their lease obligations but the tenant's obligation to pay the rent should be abated until the rebuilding is completed, in an amount which the portion of the premises that is rendered unfit bears to the entire premises on the date of the destruction.

When destruction of a building renders lease premises completely unusable to a tenant, there is little or no benefit to be gained by the tenant if the rebuilding process takes most or all of

[11]Subsection 46(1) of *The Expropriations Act*, C.C.S.M. c. E190, provides that, when only part of the interest of a tenant is expropriated, the tenant's obligation to pay rent is abated in an amount that is determined by a court.

the time that remains of the term of the lease. In our view, rebuilding is only an attractive option if the term of a lease will be extended for a period equivalent to the time that the premises are rendered unusable; rights in the lease which must be exercised within a particular time frame should be similarly extended. We do not consider a provision concerning an extension of the term to be necessary where destruction renders the lease premises only partly unusable to the tenant.

RECOMMENDATION 25

Legislation should provide that, when a building on the lease premises is totally or partly destroyed, rendering the premises completely unfit for the tenant's purposes and the parties have not terminated the lease, the term of a lease should be extended for a period equivalent to the period from the date of the destruction to the date the premises are fully restored to their useful state.

RECOMMENDATION 26

Legislation should provide that any specified date for the exercise of a right or the performance of an obligation under the lease should be adjusted to correlate with the extended term.

As we have said earlier, we believe that leases will only rarely be frustrated. For this reason, we envision that this scheme of allowing for the continuation of leases will usually operate in respect of leases in which the unforeseen event does not amount to frustration. However, we recognize that sometimes this may not be so. For example, when the time that is required to rebuild is a very significant part of the term of the lease or equal to or greater than the term of the lease, a court might, if asked, determine that the lease has been frustrated in accordance with the common law doctrine of frustration and that *The Frustrated Contracts Act* governs the rights and obligations of the parties.

However, as we stated earlier, we believe that, in these circumstances, many commercial landlords and tenants would not want their lease to be frustrated and *The Frustrated Contracts Act* to apply but would instead prefer to rebuild and continue with their lease. We propose, therefore, that the application to leases of the scheme we have set out should have precedence over the application of the common law doctrine of frustration and *The Frustrated Contracts Act*.

RECOMMENDATION 27

The application to leases of the common law doctrine of frustration and The Frustrated Contracts Act should be made subject to the application of the foregoing scheme.

The legislative scheme would, of course, apply only where the lease in question does not cover the particular circumstance; in other words, parties would be free to negotiate their own intended consequences of future events which damage or destroy the lease premises and set them out in their lease.

CHAPTER 5

THE LANDLORD AND TENANT AMENDMENT ACT (ANNOTATED)

In this Chapter, we attempt to show how our proposals would work in practice. We set out a draft of an Act to amend *The Landlord and Tenant Act* with annotations explaining the intent and effect of each provision. The provisions of the Act are restated without annotations in Appendix A.

THE LANDLORD AND TENANT AMENDMENT ACT	COMMENTARY
HER MAJESTY, by and with the advice and consent of the Legislative Assembly of Manitoba, enacts as follows:	
C.C.S.M. c. L70 amended *1 The Landlord and Tenant Act is amended by this Act.*	
2 Section 1 is amended by adding the following definitions in alphabetical order:	*This section defines several new terms which are used later in the draft Act.*
"declaration of fundamental breach" means a declaration under section 17.6;	*An innocent landlord or tenant may wish to know for certain before he or she terminates a lease for a fundamental breach that the breach by the other party is indeed a fundamental breach. A declaration of fundamental breach made by a court provides this certainty. It indicates whether or not a fundamental breach of the lease has occurred; it does not terminate the lease. Once a court declares that a fundamental breach has occurred, the innocent party is entitled to terminate the lease; an innocent landlord also has the option of causing a deemed surrender of the lease. If the court declares that a fundamental breach has not occurred, the innocent party is not entitled to terminate the lease or to cause a deemed surrender.*

"deemed surrender" means the deemed surrender of a lease under subsection 17.5(2);

When a tenant commits a fundamental breach of the lease, the landlord usually will want to end his or her relationship with the tenant. However, he or she may have no quarrel with a subtenant of the tenant and may wish to have the subtenant retain his or her interest. A landlord may accomplish this objective by causing a deemed surrender of the tenant's lease interest. The result of a deemed surrender is the same as the result of an actual surrender made by a tenant to the landlord: the tenant is stripped of the interest in the property that is deemed to be surrendered and that interest is then held by the landlord; the interests of persons who derive their interest from the tenant in the surrendered property are preserved and continue, unaffected by the displacement of the tenant.

"notice of deemed surrender" means a notice of deemed surrender under subsection 17.5(4);

A landlord who wishes to end the interest of a tenant for a fundamental breach but retain the interest of a subtenant of a tenant must serve the tenant and every person who holds an interest under the tenant with a notice of deemed surrender. Service of the notice causes a deemed surrender of that part of the tenant's lease interest identified by the landlord in the notice.

"notice of termination" means a notice of termination under subsection 17.5(4);

A landlord or tenant who wishes to end the interest of the other party for a fundamental breach must serve the other party and every person who holds an interest under him or her with a notice of termination. The service of the notice causes the lease to terminate.

3 The following is added after section 17:

FRUSTRATION

Frustration

17.1 The common law regarding frustration of contract, as amended or supplemented by statute, applies to every lease.

This section adopts for leases the common law principle of frustration as modified by statute. This means that when the lease obligations of a landlord or tenant become impossible to perform due to the occurrence of an event without the intentional fault or negligence of either party, that is, when the common law requirements for frustration

are met, then specific consequences follow: provided that section 17.2 of The Landlord and Tenant Act does not apply, the lease is frustrated, the landlord and tenant are discharged from their yet to be performed lease obligations and their rights and obligations are determined in accordance with the provisions of The Frustrated Contracts Act.

Examples of circumstances where the common law requirement of frustration might be met and The Frustrated Contracts Act apply are: a building that is central to the tenant's purposes is destroyed, along with a significant part of the land comprising the lease premises; the land component of the lease premises is destroyed; most of the shopping centre where the lease premises are located is destroyed, without any damage to the lease premises; property that is adjacent to the lease premises is destroyed, cutting off access to the lease premises.

Section 17.2 applies when an event occurs without the intentional fault or negligence of the landlord or tenant which partly or totally destroys a building, structure or site on the lease premises that is central to the tenant's lease purposes and the land that forms a part of the lease premises is not significantly destroyed.

"Commercial unit"
17.2(1) In this section, "commercial unit" means a building, structure or site on leased premises, the use or occupancy of which is central to the purpose for which those premises are rented.

The definition of commercial unit encompasses structures of any description that are located on the lease premises and that are central to the tenant's lease purposes; it does not encompass the land that forms a part of the lease premises. As a result, section 17.2, which governs the rights and obligations of landlords and tenants where a commercial unit on the lease premises is destroyed by an event that occurs without the intentional fault or negligence of either party, does not apply to the destruction of buildings, structures or sites on the lease premises, the use or occupancy of which is not central to the tenant's purposes, to the destruction of buildings, structures or sites that are not located on the lease premises, nor to the destruction of the land that forms a part of

the lease premises. This means, for example, that section 17.2 does not apply when part of a shopping centre is destroyed, but the lease premises, which are located in the shopping centre, are not destroyed. It also means that section 17.2 does apply when part or all of a shopping centre, including the lease premises located in the centre, are destroyed (unless, of course, the shopping centre lease addressed the issues of frustration, destruction and rebuilding of the lease premises, which is usually the case).

Non-application of section
17.2(2) This section does not apply when destruction of a commercial unit is accompanied by significant or total destruction of the land comprising the leased premises.

In general, section 17.2 governs the rights and obligations of landlords and tenants when an event occurs without the negligence or intentional fault of either party which partly or totally destroys a commercial unit on lease premises. However, section 17.2 does not apply when, in addition to the destruction of a commercial unit on the lease premises, the portion of the lease premises that is land is significantly or totally destroyed. Excluding cases with this extent of damage recognizes that, when the land that comprises the lease premises is totally or significantly destroyed, rebuilding and continuation of a lease is probably not feasible. In such a case, a lease would probably be frustrated and the landlord and tenant would be discharged from their yet-to-be-performed obligations and their rights and obligations would be governed by The Frustrated Contracts Act.

When parties may choose to terminate
17.2(3) A landlord or tenant may terminate a lease when total destruction of a commercial unit occurs without fault or negligence by any party to the lease.

This provision empowers a landlord or tenant to terminate a lease where a commercial unit is totally destroyed.

Time for termination
17.2(4) Subject to subsection (5), a party who terminates a lease under subsection (3) shall serve on the other party written notice of termination within 60 days of the date of destruction of the commercial unit.

When a commercial unit is totally destroyed, the landlord or tenant is entitled, if he or she wishes, to terminate the lease. Some definitive action must be taken by the landlord or tenant to convey his or her decision to terminate to the other interested parties. This subsection requires a landlord or tenant who wishes to terminate the lease

to notify the other interested parties of his or her intention by a notice which must be served within 60 days of the destruction of the commercial unit. This period of time gives the parties ample opportunity to evaluate the destruction, without being so long as to be unfair to the other party. If neither the landlord nor tenant sends a notice of termination to the other party within the 60 days, the lease will continue.

Extension of time
17.2(5) The Court of Queen's Bench may, upon application by a party to a lease, extend the time for service under subsection (4) for such period as it considers just.

Sometimes, 60 days will not be a sufficient period of time for a landlord or tenant to determine whether to terminate the lease. If a party does not serve a notice of termination within 60 days, but later decides to terminate the lease, he or she may apply to the Court of Queen's Bench for an extension of the 60 day deadline. If the Court does not grant an extension, a landlord or tenant who did not serve a notice of termination within the 60 day period cannot terminate the lease pursuant to subsection 17.2(3).

When no termination allowed
17.2(6) A landlord or tenant may not terminate a lease by reason only of partial destruction of a commercial unit which occurs without fault or negligence by any party to the lease.

When a commercial unit is only partly destroyed, it may be rendered wholly unusable but the damage may be easily and quickly repaired. For example, severe flooding might make a commercial unit completely unusable due to damage to the carpets, which can be replaced within a few days of the damage. The requirement that a commercial unit be totally destroyed in order for a landlord or tenant to terminate the lease prevents a landlord or tenant from terminating a lease where the damage to a commercial unit is not significant enough to warrant termination.

Effect of termination
17.2(7) Where a party terminates a lease under subsection (3), The Frustrated Contracts Act shall apply and determine the rights and liabilities of the parties.

Subsection 17.2(3) contemplates that a landlord or tenant may terminate a lease when total destruction of a structure located on the lease premises that is central to the tenant's lease purposes occurs without the intentional fault or negligence of either party. If one of the parties decides to terminate the lease then, whether or not the common law requirements for frustration are met, the provisions of The Frustrated Contracts Act govern the rights and

obligations of the landlord and tenant.

Rebuilding when wholly unfit

17.2(8) Where neither party terminates a lease under subsection (3) or where partial destruction in accordance with subsection (6) renders a commercial unit wholly unfit for the purpose for which the premises are rented,

(a) the landlord shall rebuild the commercial unit with all reasonable speed and render it wholly fit for the purpose for which the premises are rented;

(b) the tenant is not obliged to pay rent to the landlord for the premises during the period between the date of destruction and the date the commercial unit is again wholly fit;

(c) the term of the lease shall be extended for a period equivalent to the amount of time between the date of destruction and the date the commercial unit is again wholly fit; and

(d) any specified date for the exercise of a right or the performance of an obligation under the lease shall be adjusted to correlate with the extended term.

When a commercial unit is rendered wholly unusable by the tenant and the lease is continuing, the tenant cannot be expected to pay any part of the rent for the use of the premises. This provision recognizes this by providing for the complete abatement of the rent which would otherwise be due, from the date of the destruction until the commercial unit is wholly fit again for the tenant's purposes. The tenant is not required to pay even a portion of the rent that would otherwise be due as the commercial unit is restored and becomes partly usable. The full abatement of rent may also encourage the landlord to rebuild without delay. As for other obligations owed by the landlord or tenant to third parties, such as the payment of the mortgage, taxes and insurance, these cannot be abated; they must be performed by the person who owes the obligation.

There would be little, if any, reason for a tenant to continue his or her lease until the end of the term where destruction of a commercial unit makes it wholly unusable to the tenant and where rebuilding of the commercial unit is expected to consume most or all of the time that remains in the term of the lease. To ensure that continuation of a lease is a beneficial solution in these circumstances, the term of the lease is extended by the same period of time that it takes for the commercial unit to be made fit again for the tenant's purposes.

It seems inappropriate that a landlord or tenant should be excused from having to perform an obligation or should lose the benefit of the performance of an obligation by the other party when the time required to rebuild the commercial unit extends beyond the date before which the obligation has to be performed or the right has to be exercised. This subsection addresses this problem by providing that, where a landlord or tenant is entitled to exercise a right or obligated to perform a task by a certain date, that person will be entitled to exercise that right or obligated to perform that task before a later date which corresponds with the extended term of the lease. For

example, where a tenant is entitled to renew the lease prior to one year from the end of the term of the lease, he or she will be able to exercise the same right prior to one year from the end of the extended term.

Rebuilding when partly unfit

17.2(9) Where partial destruction in accordance with subsection (6) renders a commercial unit partly unfit for the purpose for which the premises are rented,

(a) the landlord shall rebuild the commercial unit with all reasonable speed and render it wholly fit for the purpose for which the premises are rented; and

(b) during the period between the date of destruction and the date the commercial unit is again wholly fit, the tenant is obliged to pay to the landlord for those premises a rent reduced according to the proportion which the part of the premises rendered unfit on the date of destruction bears to the entire premises.

A landlord has the same obligation where a commercial unit is partly destroyed and remains partly usable by the tenant for his or her lease purposes as he or she has when a commercial unit is rendered wholly unusable by the tenant: the landlord is required to rebuild the commercial unit in a timely fashion so that the tenant will have the full use of the lease premises as soon as possible.

When a commercial unit is rendered partly unfit for the tenant's purposes, the tenant continues to be benefited by the use of the premises to whatever extent the commercial unit is usable. In recognition of this, this subsection provides that, when a commercial unit is rendered only partly unfit, the tenant's obligation to pay rent is not abated entirely but is reduced by the amount that the part of the premises that is unfit bears to the entire premises. This reduced amount of rent remains payable throughout the rebuilding period even though, over the course of the rebuilding period, the commercial unit may become more fit for use by the tenant.

TERMINATION BY FUNDAMENTAL BREACH

Common law applies

17.3 The common law of fundamental breach of contract applies to every lease.

The same law of fundamental breach that applies to contracts also applies to leases. The result is that, when a landlord or tenant of a commercial lease commits a breach which goes to the root of the lease and makes further performance of the lease by the other party fundamentally different than what was contemplated by parties when the lease was entered, the innocent party to the lease is entitled to terminate the lease.

The term "fundamental breach" is also used in the context of exclusion clauses in contracts. However, this use of the term has

no relevance in the context of this legislation.

"Under-lessee"
17.4 In sections 17.5 and 17.10, "under-lessee" means under-lessee as defined in subsection 18(1).

The interest of a person who derives his or her interest from a tenant will be affected when the landlord or tenant commits a fundamental breach of the lease and the landlord or tenant terminates the lease or the landlord causes a deemed surrender of the tenant's interest. It is reasonable, therefore, that every person who derives an interest from a tenant be notified of any changes to the status of his or her interest and that he or she be made a party to an action involving his or her interest. The term "under-lessee" is defined broadly to ensure that every interested person will be notified and be made a party to an action involving his or her interest; the definition includes a person who derives an interest in the lease property from a tenant and also a person who derives an interest in the lease property from another person who himself or herself derives a lease interest from a tenant.

Tenant's option
17.5(1) Where a landlord commits a fundamental breach of a lease, the tenant may terminate the lease by serving a notice of termination.

A landlord who commits a breach of a lease cannot know, without being told, that the tenant considers the breach to be a fundamental breach which allows him or her to terminate the lease. In addition, even if a landlord realizes that the breach is serious enough to entitle the tenant to terminate the lease (such as after a court has made a declaration that the landlord committed a fundamental breach), the tenant is not obliged to terminate the lease for a fundamental breach and, as such, the landlord cannot be certain about how the tenant will respond to the breach. It is necessary, for certainty, that the landlord be informed of the tenant's opinion that the breach is a fundamental one and of his or her intention to terminate the lease for the breach. A lease will be terminated upon notice being received by those persons who have a lease interest.

Landlord's options
17.5(2) Where a tenant commits a fundamental breach of a lease, the landlord may

(a) terminate the lease by serving a notice of termination;

(b) cause the lease to be deemed to be surrendered in its entirety by serving a notice of deemed surrender; or

(c) where one or more original under-lessees separately hold an interest in part only of the lease property,

(i) cause the lease to be deemed to be partly surrendered by serving a notice of deemed surrender, so as to preserve any one or more of those partial interests; and

(ii) terminate the unsurrendered part of the lease by serving a notice of termination.

Similarly, a tenant who commits a breach of a lease cannot know, without being told, that the breach is a fundamental one entitling the landlord to terminate the lease. In addition, even when a tenant knows that a breach is a fundamental one entitling the landlord to terminate (after a declaration of fundamental breach), the landlord is not obliged to terminate the lease and may instead sue for damages or cause a deemed surrender of the tenant's lease interest. The landlord must inform the tenant of his or her opinion that the tenant's breach is a fundamental one and of his or her intention to terminate the lease or to cause a deemed surrender of all or part of the lease interest. The lease will be terminated or the tenant's lease interest will be deemed to be surrendered in whole or in part, upon notice being received by persons who have a lease interest.

Declaration of fundamental breach
17.5(3) A landlord or tenant may, prior to acting under subsection (1) or (2), seek a declaration of fundamental breach from a court.

A landlord or tenant who believes that a fundamental breach has occurred may not wish to risk the consequences of terminating the lease for an honest but mistaken belief. This provision allows a party to bring an action in the Court of Queen's Bench for a declaration of fundamental breach in order to confirm his or her belief. Where a Court declares that a fundamental breach has occurred, the innocent party can terminate the lease by serving a notice of termination on those persons who have an interest in the lease, secure in the knowledge that he or she is entitled to do so. An innocent landlord can also serve a notice of deemed surrender on persons who have a lease interest or may serve a notice of deemed surrender in respect of part of the lease property and a notice of termination in respect of the other part of the lease property on those persons who have a lease interest.

Form and service of notices
17.5(4) A notice of termination or a notice of deemed surrender shall be in writing, shall state the facts giving rise to the fundamental breach and shall be served on the other party to the lease and every under-lessee.

It is important that every person who has an interest in the lease property is made aware of the specifics of any allegation of a fundamental breach and of the innocent party's intention to terminate the lease or cause a deemed surrender. This knowledge provides the parties with certainty and also provides the alleged wrongdoer with enough specificity to refute the allegation if he or she wishes to do so. Unlike the requirements of notice for breaches which entitle a landlord to enforce a right to re-enter or forfeit the tenancy pursuant to subsection 18(2) of The Landlord and Tenant Act, the notice in this context does not require the alleged wrongdoer to remedy the breach or make compensation for it; this would be inconsistent with the very concept of fundamental breach.

Court declaration of fundamental breach
17.6 The Court of Queen's Bench may, upon action brought by a party to a lease, declare whether fundamental breach of the lease has occurred.

A judge of the Court of Queen's Bench, upon an action being brought by a landlord or tenant, is authorized to declare whether a fundamental breach of the lease has occurred. The declaration itself does not terminate the lease.

Interim diversion of rent
17.7(1) Upon motion, a court may order that, until an action for a declaration of fundamental breach is determined, a tenant shall pay into court, on such terms and conditions as the court considers just, any rent or any specified part of the rent due under the lease.

It seems unfair that a tenant, who believes that the landlord has committed a fundamental breach but who wants confirmation of this belief from a court before terminating the lease, should have to continue to pay rent to the landlord while waiting for the court to make its determination. This subsection addresses this concern by providing that, when a tenant who remains in possession while seeking a declaration of fundamental breach brings a motion, a court can order the tenant to pay the rent or a specified part of the rent into court until the court makes its declaration regarding the fundamental breach.

Priority
17.7(2) An order under subsection (1) takes precedence over any attornment or assignment of rent in respect of the premises.

When a court orders a tenant to pay the rent or a portion of the rent into court pending its declaration regarding the fundamental breach, the tenant must do so, even if the landlord has granted some other person, such as a creditor, the right to receive the rent.

Effect of deemed surrender

17.8(1) A deemed surrender preserves

(a) as provided in section 16, every derivative interest in the part of the property that is deemed to be surrendered; and

(b) every related derivative interest in any other part of the property.

Section 16 of The Landlord and Tenant Act sets out the consequences of a tenant surrendering his or her lease interest to the landlord: the landlord steps into the position of the tenant and all of the interests which derived from the tenant (such as subtenants and the subtenants of subtenants) continue.

This subsection brings about the same result for a landlord faced with a tenant who has committed a fundamental breach. It allows the landlord to end the tenant's interest without affecting others whose lease interest derives from the tenant. The landlord does this by effecting a deemed surrender. The rights and obligations of any person who derives an interest from the tenant, which interest would have been extinguished but for the deemed surrender, are preserved. The landlord takes the place of the former tenant as the landlord to the derivative interest holders.

When only part of a tenant's lease interest is deemed to be surrendered and a derivative interest in the surrendered part is related to a derivative interest in an unsurrendered part of the tenant's lease interest, then the related derivative interest is also preserved by a deemed surrender. This means that a person who holds a related derivative interest continues to benefit from his or her interest and be obligated by it after a deemed surrender. Subsection 17.8(2) explains the meaning of "related derivative interest".

Related derivative interests

17.8(2) For the purpose of this section, a derivative interest in one part of a property is related to a derivative interest in another part if

(a) the parts of the property in which the interests subsist have been sublet together under a tenancy which the parties intended to be a single tenancy; or

(b) there is a mortgage to which both interests are subject.

A derivative interest in an unsurrendered part of the lease property is related to a derivative interest in a part of the lease property that is deemed to be surrendered if the two interests, after being treated as two separate interests in the hands of two separate persons, later are treated as one property by being sublet or mortgaged together under a single agreement. An example of a related derivative interest is given in this Report at page 20.

Indemnity by tenant

17.9 Where a landlord causes a deemed surrender and becomes liable to a mortgagee of the lease due to default by the tenant, the tenant shall indemnify the landlord.

It is possible for a tenant to mortgage his or her lease interest. A tenant who does so continues to be liable on his or her covenant in the mortgage to repay the loan even after he or she commits a fundamental breach of the lease and the landlord causes a deemed surrender of the tenant's lease interest. Even though the tenant has lost his or her lease interest, the tenant must still make good on the loan and, if he or she defaults, the mortgagee is entitled to sue the tenant.

The mortgagee also retains his or her mortgage security in the lease interest. By virtue of the surrender, the landlord now holds the tenant's lease interest and so the mortgagee can claim from the landlord the amount owing on the mortgage. The landlord can meet the mortgagee's claim either by selling the lease interest to satisfy the mortgage debt or by paying the debt to the mortgagee from his or her own funds.

When a landlord satisfies the former tenant's debt to the mortgagee, he or she is entitled to recover from the former tenant the amount paid to the mortgagee. Of course, the landlord need not have put himself or herself in this position. The landlord could have terminated the lease, rather than causing the surrender of the tenant's interest.

Court relief

17.10 Where any party to a lease terminates the lease for a fundamental breach or where a landlord causes a deemed surrender

(a) the other party may apply to court for relief under section 19 and that section applies with such modifications as may be necessary;

(b) any under-lessee may apply to court for relief under section 19, a vesting order under section 20 or both and those sections apply with such modifications as may be necessary.

Where a landlord or tenant terminates a lease for a fundamental breach, the party who committed the breach can apply to court pursuant to section 19 of The Landlord and Tenant Act for relief from termination for the fundamental breach. A court may grant relief, having regard to all the circumstances as it thinks fit, and may include terms as to the payment of rent, costs, expenses, damages, compensation, penalty or otherwise, including the granting of an injunction to restrain a future breach. A person who derives his or her interest from the tenant, that is, a subtenant or mortgagee, also may apply to court for relief against termination pursuant to section 19.

A person who derives his or her lease interest from the tenant may apply for relief

under section 20 of The Landlord and Tenant Act. That section allows a court to vest a lease interest in an under-lessee. The court will make its order on the basis of the circumstances of the case as it thinks fit and may order the whole or a part of the lease interest to be vested in a subtenant or mortgagee for a period equal to or shorter than the remainder of the term of the lease but not greater than the term of the subtenant's own sublease. In making its order, the court can impose any terms, including terms as to the payment of rent, costs, expenses, damages, compensation or security. An under-lessee may choose to make use of this provision where the landlord is terminating the tenant's lease interest because of a fundamental breach, rather than causing a deemed surrender, and the under-lessee wishes to have his or her lease interest preserved.

Parties to action

17.11 Section 21 applies with such modifications as may be necessary to an action for a declaration of fundamental breach, regardless of whether it is brought by a landlord or by a tenant.

In an action for a declaration of fundamental breach, every person who claims to have an interest in the lease premises and whose claim is known to the person who brings the action and every person whose interest is registered in the relevant land titles office must be made a party to the action. This means, for example, that, when a tenant brings an action for a declaration, the tenant must serve notice of the action on the landlord and all subtenants and mortgagees of whom he or she is aware.

4 This Act comes into force on the day it receives royal assent.

CHAPTER 6

LIST OF RECOMMENDATIONS

The following is a reproduction of the recommendations contained in this Report.

1. Legislation should provide that an innocent party to a commercial lease has the right to terminate the lease when the other party commits a fundamental breach of the lease. (p. 13)

2. Legislation should provide that the common law rule concerning fundamental breach of contract applies to commercial leases. (p. 15)

3. Legislation should provide that a landlord or tenant may, prior to terminating the lease for a fundamental breach, seek a declaration from a court that the other party has committed a fundamental breach of the lease. (p. 15)

4. Legislation should expressly provide that a tenant should be able to withhold the payment of rent for a fundamental breach by the landlord when he or she seeks a declaration from a court that the landlord has committed a fundamental breach and when, upon motion, the court orders that rent due under the lease be paid into court pending its determination as to a fundamental breach. (p. 16)

5. The relief that is available to tenants and persons who derive an interest from a tenant pursuant to subsection 19(1) and section 20 of *The Landlord and Tenant Act* should be available to the same persons when a landlord seeks to terminate a tenancy for a fundamental breach of the lease by the tenant. (p. 17)

6. A landlord who terminates a lease for a fundamental breach by the tenant should be able to preserve derivative interests by causing all of the interest of the tenant to be deemed to be surrendered to the landlord. (p. 18)

7. The consent of a person who derives a lease interest from the tenant should not be required for a deemed surrender caused by the landlord. (p. 19)

8. Where a person who derives an interest directly from a tenant holds an interest in only part of the lease property, the landlord should be able to preserve the derivative interests in that part only of the lease property by causing the interest of the tenant in that part of the lease property to be surrendered to the landlord. (p. 19)

9. Where a landlord causes a deemed surrender of a derivative interest in one part of the lease property that is related to a derivative interest in another part of the lease property, he or she must also cause a deemed surrender of all the related derivative interests in the other part of the lease property. (p. 20)

10. A deemed surrender should be accomplished by written notice being served of the deemed surrender on the tenant and every derivative interest holder. (p. 20)

11. A landlord who covers a former tenant's mortgage default which occurs after he or she causes a deemed surrender should be entitled automatically to indemnification from the former tenant for the amount paid to the mortgagee. (p. 21)

12. Landlords should be entitled to seek relief from termination in the same way that a tenant can seek relief from forfeiture. (p. 22)

13. After a fundamental breach by a landlord, a person who derives his or her lease interest from the tenant should be entitled to apply to court for an order vesting him or her with the tenant's lease interest, or preventing termination by the tenant for the landlord's breach. (p. 22)

14. Legislation should provide that the common law principle of frustration of contracts and the consequences of *The Frustrated Contracts Act* should apply to commercial leases. (p. 24)

15. Legislation should also provide a scheme to meet the needs of landlords and tenants who wish to restore the lease premises and continue their leases. (p. 24)

16. A legislative scheme which provides for the rebuilding of buildings on leased premises should be limited in its application to destruction which occurs without the intentional fault or negligence of the landlord or tenant of those buildings that are crucial to the tenant's purposes. (p. 25)

17. The legislative scheme should not apply to the destruction of buildings on lease premises that are crucial to the tenant's purposes where the land which comprises the lease premises is also significantly destroyed. (p. 26)

18. Legislation should provide that, when a building on lease premises that is crucial to the tenant's lease purposes is totally destroyed without the intentional fault or negligence of the parties, either party may elect to terminate the lease. (p. 26)

19. Legislation should provide that, when a building on lease premises that is crucial to the tenant's lease purposes is only partly destroyed without the intentional fault or negligence of the parties, neither party may elect to terminate the lease because of the destruction. (p. 26)

20. Legislation should provide that, where neither party terminates a lease for the total destruction of a building that is crucial to the tenant's lease purposes or where a building that is crucial to the tenant's lease purposes is partly destroyed, the landlord shall be obliged to rebuild the building to make it fit again for the tenant's purposes. (p. 26)

21. Legislation should provide that a party who wishes to terminate a lease must serve the other party with notice within 60 days of the destruction of a building that is crucial to the tenant's lease purposes and that a court, on application, may grant an extension of this period. (p. 26)

22. Legislation should provide that, where one of the parties to a lease terminates the lease for the total destruction of a building that is crucial to the tenant's lease purposes, *The Frustrated Contracts Act* govern the rights and obligations of those parties. (p. 27)

23. Legislation should provide that, if a building or structure on the lease premises that is crucial to the tenant's lease purposes is rendered totally unfit and neither party has elected to terminate the lease, the parties should remain obligated to perform their lease

obligations except that the tenant should not have to pay any rent from the date of the destruction until the rebuilding is completed. (p. 27)

24. Legislation should provide that, if a building on the lease premises that is crucial to the tenant's purposes is rendered partly unfit for the tenant's lease purposes, the parties should remain obligated to perform their lease obligations but the tenant's obligation to pay the rent should be abated until the rebuilding is completed, in an amount which the portion of the premises that is rendered unfit bears to the entire premises on the date of the destruction. (p. 27)

25. Legislation should provide that, when a building on the lease premises is totally or partly destroyed, rendering the premises completely unfit for the tenant's purposes and the parties have not terminated the lease, the term of a lease should be extended for a period equivalent to the period from the date of the destruction to the date the premises are fully restored to their useful state. (p. 28)

26. Legislation should provide that any specified date for the exercise of a right or the performance of an obligation under the lease should be adjusted to correlate with the extended term. (p. 28)

27. The application to leases of the common law doctrine of frustration and *The Frustrated Contracts Act* should be made subject to the application of the foregoing scheme. (p. 28)

This is a Report pursuant to section 15 of *The Law Reform Commission Act*, C.C.S.M. c. L95, signed this 23rd day of January 1996.

Clifford H.C. Edwards, President

John C. Irvine, Commissioner

Gerald O. Jewers, Commissioner

Eleanor R. Dawson, Commissioner

Pearl K. McGonigal, Commissioner

APPENDIX A

THE LANDLORD AND TENANT AMENDMENT ACT

HER MAJESTY, by and with the advice and consent of the Legislative Assembly of Manitoba, enacts as follows:

C.C.S.M. c. L70 amended
1 *The Landlord and Tenant Act is amended by this Act.*

2 *Section 1 is amended by adding the following definitions in alphabetical order:*

"declaration of fundamental breach" means a declaration under section 17.6;

"deemed surrender" means the deemed surrender of a lease under subsection 17.5(2);

"notice of deemed surrender" means a notice of deemed surrender under subsection 17.5(4);

"notice of termination" means a notice of termination under subsection 17.5(4);

3 *The following is added after section 17:*

FRUSTRATION

Frustration
17.1 The common law regarding frustration of contract, as amended or supplemented by statute, applies to every lease.

"Commercial unit"
17.2(1) In this section, "commercial unit" means a building, structure or site on leased premises, the use or occupancy of which is central to the purpose for which those premises are rented.

Non-application of section
17.2(2) This section does not apply when destruction of a commercial unit is accompanied by significant or total destruction of the land comprising the leased premises.

When parties may choose to terminate
17.2(3) A landlord or tenant may terminate a lease when total destruction of a commercial unit occurs without fault or negligence by any party to the lease.

Time for termination
17.2(4) Subject to subsection (5), a party who terminates a lease under subsection (3) shall serve on the other party written notice of termination within 60 days of the date of destruction of the commercial unit.

Extension of time
17.2(5) The Court of Queen's Bench may, upon application by a party to a lease, extend the time for service under subsection (4) for such period as it considers just.

When no termination allowed
17.2(6) A landlord or tenant may not terminate a lease by reason only of partial destruction of a commercial unit which occurs without fault or negligence by any party to the lease.

Effect of termination
17.2(7) Where a party terminates a lease under subsection (3), The Frustrated Contracts Act shall apply and determine the rights and liabilities of the parties.

Rebuilding when wholly unfit
17.2(8) Where neither party terminates a lease under subsection (3) or where partial destruction in accordance with subsection (6) renders a commercial unit wholly unfit for the purpose for which the premises are rented,

(a) the landlord shall rebuild the commercial unit with all reasonable speed and render it wholly fit for the purpose for which the premises are rented;

(b) the tenant is not obliged to pay rent to the landlord for the premises during the period between the date of destruction and the date the commercial unit is again wholly fit;

(c) the term of the lease shall be extended for a period equivalent to the amount of time between the date of destruction and the date the commercial unit is again wholly fit; and

(d) any specified date for the exercise of a right or the performance of an obligation under the lease shall be adjusted to correlate with the extended term.

Rebuilding when partly unfit
17.2(9) Where partial destruction in accordance with subsection (6) renders a commercial unit partly unfit for the purpose for which the premises are rented,

(a) the landlord shall rebuild the commercial unit with all reasonable speed and render it wholly fit for the purpose for which the premises are rented; and

(b) during the period between the date of destruction and the date the commercial unit is again wholly fit, the tenant is obliged to pay to the landlord for those premises a rent reduced according to the proportion which the part of the premises rendered unfit on the date of destruction bears to the entire premises.

TERMINATION BY FUNDAMENTAL BREACH

Common law applies
17.3 The common law of fundamental breach of contract applies to every lease.

"Under-lessee"
17.4 In sections 17.5 and 17.10, "under-lessee" means under-lessee as defined in subsection 18(1).

Tenant's option
17.5(1) Where a landlord commits a fundamental breach of a lease, the tenant may terminate the lease by serving a notice of termination.

Landlord's options
17.5(2) Where a tenant commits a fundamental breach of a lease, the landlord may

(a) terminate the lease by serving a notice of termination;

(b) cause the lease to be deemed to be surrendered in its entirety by serving a notice of deemed surrender; or

(c) where one or more original under-lessees separately hold an interest in part only of the lease property,

(i) cause the lease to be deemed to be partly surrendered by serving a notice of deemed surrender, so as to preserve any one or more of those partial interests; and

(ii) terminate the unsurrendered part of the lease by serving a notice of termination.

Declaration of fundamental breach
17.5(3) A landlord or tenant may, prior to acting under subsection (1) or (2), seek a declaration of fundamental breach from a court.

Form and service of notices
17.5(4) A notice of termination or a notice of deemed surrender shall be in writing, shall state the facts giving rise to the fundamental breach and shall be served on the other party to the lease and every under-lessee.

Court declaration of fundamental breach
17.6 The Court of Queen's Bench may, upon action brought by a party to a lease, declare whether fundamental breach of the lease has occurred.

Interim diversion of rent
17.7(1) Upon motion, a court may order that, until an action for a declaration of fundamental breach is determined, a tenant shall pay into court, on such terms and conditions as the court considers just, any rent or any specified part of the rent due under the lease.

Priority
17.7(2) An order under subsection (1) takes precedence over any attornment or assignment of rent in respect of the premises.

Effect of deemed surrender
17.8(1) A deemed surrender preserves

(a) as provided in section 16, every derivative interest in the part of the property that is deemed to be surrendered; and

(b) every related derivative interest in any other part of the property.

Related derivative interests
17.8(2) For the purpose of this section, a derivative interest in one part of a property is related to a derivative interest in another part if

(a) the parts of the property in which the interests subsist have been sublet together under a tenancy which the parties intended to be a single tenancy; or

(b) there is a mortgage to which both interests are subject.

Indemnity by tenant
17.9 Where a landlord causes a deemed surrender and becomes liable to a mortgagee of the lease due to default by the tenant, the tenant shall indemnify the landlord.

Court relief
17.10 Where any party to a lease terminates the lease for a fundamental breach or where a landlord causes a deemed surrender

(a) the other party may apply to court for relief under section 19 and that section applies with such modifications as may be necessary;

(b) any under-lessee may apply to court for relief under section 19, a vesting order under section 20 or both and those sections apply with such modifications as may be necessary.

Parties to action
17.11 Section 21 applies with such modifications as may be necessary to an action for a declaration of fundamental breach, regardless of whether it is brought by a landlord or by a tenant.

4 *This Act comes into force on the day it receives royal assent.*

REPORT ON FUNDAMENTAL BREACH AND FRUSTRATION IN COMMERCIAL TENANCIES

EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

The Manitoba Law Reform Commission's Report on *Fundamental Breach and Frustration in Commercial Tenancies* recommends that the common law principles of fundamental breach and frustration be made applicable to commercial leases.

BACKGROUND

The conventional view taken by the law is that a lease is a conveyance of an interest in land from a landlord to a tenant; this view has resulted in the law of property being applied in landlord and tenant disputes, rather than the law of contract. This approach is gradually changing and contract law principles are increasingly being applied to landlord and tenant disputes; however, several important principles of contract law have not yet been applied in Manitoba to commercial leases.

FUNDAMENTAL BREACH

When one party's failure to perform a contractual obligation deprives the other party of substantially the whole benefit which the parties intended that he or she should obtain from the contract, a fundamental breach occurs. The innocent party can sue the wrongdoer for damages and continue the contract or can end the contract.

In Manitoba, the fundamental breach principle has not been applied to commercial leases. Commercial landlords are not greatly affected by this because *The Landlord and Tenant Act* provides that a landlord can terminate a lease for certain breaches by the tenant (section 17) and because, generally, a landlord holds the superior bargaining position when negotiating a lease and can insist that he or she will be entitled to re-enter the lease premises for specified breaches by the tenant. Commercial tenants, on the other hand, are affected adversely: a tenant continues to be responsible for performing the lease obligations and is not entitled to end the lease, no matter how serious the breach by the landlord. A tenant's only option, to sue the landlord for damages, is often an inadequate remedy.

The Commission recommends that the contract law principle of fundamental breach should be made applicable to commercial leases. Since, on occasion, a tenant may hold an equal or superior bargaining position to a landlord, the Commission recommends that the principle should apply to landlords as well as tenants. As a result, the innocent party to a lease would have the option to terminate it when a breach or breaches by the other party deprives him or her of substantially the whole benefit that he or she was to have obtained from the lease.

Court declaration

An innocent landlord or tenant may not want to risk the losses which could result from acting unilaterally upon a wrongly held belief that a particular breach entitles him or her to terminate the lease. The Commission recommends that, prior to terminating the lease, a landlord

or tenant should have the option of seeking a declaration from a court that the other party has committed a fundamental breach.

Rent withholding

A tenant who seeks confirmation from a court regarding his or her entitlement to terminate the lease for a fundamental breach should not later have to recover rent paid to the landlord for the period between the breach and the court's declaration of fundamental breach. A landlord's right to receive the rent should also not be jeopardized by a tenant who wishes to rely on a trivial default by the landlord to avoid paying rent. The Commission proposes that these rights be balanced by allowing a tenant who seeks a declaration of fundamental breach and so remains in possession of the lease premises to withhold rent when a court, upon motion by the tenant, orders that rent due under the lease be paid into court pending its determination concerning fundamental breach.

Relief from termination for tenant and others claiming under tenant

The Landlord and Tenant Act provides that, when a landlord enforces a right to re-enter or forfeit a lease for a breach by the tenant, a tenant or his or her subtenant may apply to court for relief against forfeiture; in addition, a subtenant may apply for an order making him or her the tenant for the remainder of the lease. The Commission recommends that tenants and subtenants should be able to apply to court for the same types of relief when a landlord terminates a lease for a fundamental breach.

Preservation of derivative interests by landlord

A landlord who wishes to end a lease relationship with a tenant who has committed a fundamental breach may want the tenant's subtenant to remain in possession, paying rent. While a subtenant can seek a court's consent to step into the shoes of the former tenant or can agree to enter into a lease with the landlord, the parties must expend time and money to prepare, execute and register new lease documents or to apply to court. The Commission recommends that, when a tenant commits a fundamental breach, a landlord should be able to preserve the derivative interests of the tenant simply by causing a deemed surrender of the tenant's lease interest to the landlord. A subtenant whose interest is preserved would not be harmed since the effect is simply to preserve the term of the subtenancy and the subtenant takes on no new obligations.

A tenant may sublet the lease interest to more than one person and those persons also may sublet their interests to one or more persons. A landlord should not be able to disrupt those existing contractual relationships arbitrarily. The landlord should be able to preserve the interest of all of the tenant's subtenants or of any one or more of them; in other words, the landlord should be free to choose among the tenant's immediate subtenants. However, the preservation of the interest of a given subtenant should automatically result in the preservation of all of the interests which derive from that subtenant.

Liability of landlord for tenant's mortgage

When a tenant surrenders an interest to a landlord, the rights of someone who derives an interest from the tenant are preserved. This means that when a tenant mortgages his or her lease interest and later surrenders that interest, the mortgagee retains his or her rights in respect to the lease interest. If the former tenant defaults on the mortgage payments, the mortgagee can sue the

landlord, who holds the lease interest after the surrender, for the mortgage debt; the landlord is entitled to be indemnified by the former tenant, but only if this was a condition of the landlord's consent to the surrender.

Given that a landlord's consent is a prerequisite of an actual surrender, the rule respecting indemnification is appropriate in that case. However, the rule is not appropriate for a deemed surrender. It would not be fair for a landlord who causes a deemed surrender of the tenant's lease interest after a fundamental breach by the tenant to be compelled to cover the former tenant's mortgage default without being entitled to indemnification from the former tenant. The Commission recommends that this aspect of the law of surrender should not be adopted and that, instead, a landlord who covers a former tenant's mortgage default following a deemed surrender should be entitled to indemnification from the former tenant.

Termination by tenant: relief to subtenants and landlords

The Commission recommends that, just as a subtenant may apply to court for relief from forfeiture or to be put into the position of the tenant when a landlord seeks to enforce a right to re-enter or forfeit the lease, so too should a subtenant be able to protect his or her interest by asking to be put into the position of the tenant when a tenant seeks to terminate the lease for a fundamental breach by the landlord. An equivalent right should be granted to landlords: a landlord should be entitled to seek relief from termination by a tenant for a fundamental breach committed by himself or herself.

FRUSTRATION

A contract is frustrated when an unexpected event occurs without the fault of either party to the contract which results in the contract becoming impossible to perform. After a contract is frustrated, the parties to the contract are relieved of the obligations which they have not yet performed. In addition, *The Frustrated Contracts Act* governs the adjustment of rights and obligations of the parties respecting money paid, benefits received and expenses incurred prior to the frustrating event. In Manitoba, the courts have not yet considered whether this contract law principle applies to commercial leases.

Usually, lawyers will ensure that the leases which they draft specify the consequences of a frustrating event. However, other leases will not necessarily specify what should happen on a frustrating event; thus, the rights and obligations of some landlords and tenants following a frustrating event are uncertain. The Commission recommends that, where a commercial landlord and tenant have not addressed the issue in their lease, the common law principle of frustration of contracts and the consequences of *The Frustrated Contracts Act* should apply to that commercial lease. The application of this law to commercial tenancies would make commercial tenancy law, residential tenancy law and contract law in Manitoba uniform in this respect.

Rebuilding scheme

Commercial leases will only rarely become impossible to perform; accordingly, the extension of the doctrine of frustration will be of limited effect. More commonly, lease premises will be damaged or destroyed in a way which the law, in its strict application, will not regard as rendering the lease impossible to perform; for example, a building may be totally destroyed yet be capable of being rebuilt within a period of time that is short, compared to the term of the lease. The Commission believes that the law should provide for the consequences of such a serious, though not necessarily frustrating, event and that those consequences not presume the

termination of the lease (as would be the case in the event of frustration). Even when lease premises are totally destroyed and rebuilding will take a great deal of time, many commercial landlords would prefer to rebuild and continue in their leases rather than to have them end and to commence uncertain lease relationships with new tenants, while tenants would prefer to rebuild and continue so as not to have to relocate their businesses. The Commission believes that commercial landlords and tenants who wish to restore the lease premises and continue their leases should be allowed to do so. To achieve these reforms, the Commission proposes a rebuilding scheme which would apply where a landlord and tenant have not stipulated their own scheme in their lease. Should there be a conflict, the application of this scheme would take precedence over the application of the common law principle of frustration and *The Frustrated Contracts Act*.

The Commission proposes that the rebuilding scheme should apply only to destruction that occurs without any intentional fault or negligence by the landlord or tenant and only in respect of buildings that are crucial to the tenant's purposes. In addition, the scheme should not pertain where the land that comprises the lease premises is also significantly destroyed.

Furthermore, the Commission recommends that, where the rebuilding scheme applies, a landlord or tenant should be able to terminate a lease only when a building on the lease premises that is crucial to the tenant's purposes is totally destroyed. Where damage is less significant or where neither party terminates the lease, the landlord should have to restore the building as quickly as possible so that it is fit again for the tenant's purposes.

The Commission also recommends that a decision to terminate should be communicated within 60 days of the destruction of the commercial unit but that it be possible to have this period extended by a court. *The Frustrated Contracts Act* should govern the rights and obligations of the parties in respect to money paid or due prior to the destruction when one of the parties to a lease terminates the lease pursuant to the scheme.

The time required to restore damaged buildings to a usable state may be considerable. The Commission proposes that the tenant's obligation to pay rent should be suspended during the rebuilding period where the premises are rendered totally unfit for his or her purposes and, in other cases, rent should be abated in an amount that is proportionate to the portion of the lease premises that is unusable for the tenant's purposes at the date of the destruction.

There may be little benefit to a tenant if the rebuilding process takes most or all of the time that remains of the term. The Commission proposes that, where a building on the lease premises that is crucial to the tenant's lease purposes is rendered totally unfit for those purposes, the term of the lease should be extended for a period equal to the rebuilding period. Furthermore, when a lease provides that rights must be exercised within a particular time, the time for the exercise of those rights should be extended to correspond with the extended term.

LEGISLATION

The Report includes draft amendments to *The Landlord and Tenant Act* which would give effect to its recommendations.

RAPPORT SUR LES VIOLATIONS ESSENTIELLES ET L'IMPOSSIBILITÉ D'EXÉCUTION EN MATIÈRE DE BAUX COMMERCIAUX

SOMMAIRE

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Dans son rapport sur les violations essentielles et l'annulation des baux commerciaux devenus inexécutables, la Commission de réforme du droit du Manitoba recommande que l'on applique aux baux commerciaux les principes de la common law relatifs aux violations essentielles et aux contrats devenus inexécutables.

RENSEIGNEMENTS GÉNÉRAUX

Il est entendu, en droit, qu'un bail sert à faire passer d'un locateur à un locataire un intérêt dans un bien-fonds, ce qui explique que l'on a tendance à recourir plus volontiers au droit des biens qu'au droit des contrats pour régler les différends entre locateurs et locataires. Cette manière de faire tend toutefois à se modifier. En effet, on a de plus en plus recours aux principes du droit des contrats pour régler les différends entre locateurs et locataires, bien que plusieurs des principes importants ne soient toujours pas appliqués aux baux commerciaux au Manitoba.

VIOLATION ESSENTIELLE

Il y a violation essentielle lorsqu'une partie ne s'acquitte pas d'une obligation contractuelle et, de ce fait, prive essentiellement l'autre partie de la totalité de l'avantage que devait procurer le contrat. En pareil cas, la partie lésée peut poursuivre la partie fautive en dommages-intérêts et conserver ou résilier le contrat.

Au Manitoba, le principe de la violation essentielle ne s'applique toujours pas aux baux commerciaux, ce qui ne touche pas beaucoup les locateurs commerciaux puisque la *Loi sur le louage d'immeubles* leur permet de résilier le bail en cas de violations précises de la part du locataire (article 17). De plus, comme ils sont généralement en position de négociation supérieure lorsqu'ils négocient les conditions d'un bail, ils peuvent se réserver le droit de reprendre possession des locaux loués en cas de violations précises. Par contre, les locataires commerciaux ne sont pas aussi privilégiés. En effet, ils sont tenus de continuer à respecter les conditions du bail qu'ils ne peuvent résilier, peu importe la gravité des violations du locateur. La seule possibilité qui s'offre à eux, soit celle de poursuivre le locateur en dommages-intérêts, se révèle souvent une solution inappropriée.

La Commission recommande que l'on applique le principe de la violation essentielle du droit des contrats aux baux commerciaux. De plus, comme il peut parfois arriver qu'un locataire soit dans une position de négociation égale ou supérieure à celle d'un locateur, ce principe devrait s'appliquer aussi bien aux locateurs qu'aux locataires. Ainsi, la partie lésée aurait la faculté de résilier le bail en cas de violation qui la priverait essentiellement de la totalité de l'avantage que devait lui procurer le bail.

Déclaration du tribunal

Il est normal que les locateurs et les locataires lésés désirent se protéger contre les pertes qu'ils pourraient subir s'ils décidaient unilatéralement de résilier un bail en raison de ce qu'ils croient être, à tort, une violation les autorisant à le faire. Par conséquent, la Commission recommande que l'on accorde aux locateurs et aux locataires, avant qu'ils ne résilient le bail, la possibilité d'obtenir d'un tribunal une déclaration comme quoi l'autre partie a commis une violation essentielle.

Retenue du loyer

Le locataire qui demande à un tribunal de confirmer son droit de résilier un bail pour motif de violation essentielle ne devrait pas avoir à récupérer, à une date ultérieure, le loyer qu'il a versé au locateur pour la période allant de la date de la violation à celle de la déclaration de violation essentielle du tribunal. De même, le droit du locateur au loyer ne devrait pas être compromis du fait que le locataire veuille profiter d'un manquement mineur du locateur pour se soustraire au paiement du loyer. La Commission propose que l'on équilibre ces droits en autorisant le locataire qui demande une déclaration de violation essentielle et qui conserve la possession des locaux loués à retenir le loyer qu'il doit payer aux termes du bail jusqu'à ce qu'un tribunal lui ordonne de le lui remettre, en attendant qu'il soit déterminé s'il y a eu ou non violation essentielle.

Réparation en cas de résiliation du bail par le locataire ou le sous-locataire

Selon la *Loi sur le louage d'immeubles*, les locataires et les sous-locataires peuvent s'adresser à un tribunal pour obtenir réparation d'une déchéance lorsque le locateur se prévaut de son droit de reprise de possession ou de déchéance en raison d'une violation. De plus, les sous-locataires peuvent demander une ordonnance faisant d'eux les locataires pour le reste du bail. La Commission recommande que l'on autorise les locataires et les sous-locataires à s'adresser à un tribunal pour obtenir les mêmes types de réparation en cas de résiliation du bail pour violation essentielle par le locateur.

Protection des intérêts dérivés du locateur

Il est possible que le locateur qui désire mettre fin à ses relations d'affaires avec un locataire qui a perpétré une violation essentielle veuille que le sous-locataire de ce dernier conserve la possession des locaux et paie le loyer. Même si un sous-locataire peut s'adresser à un tribunal pour obtenir les droits de l'ex-locataire ou conclure un bail avec le locateur, il n'en demeure pas moins que les parties doivent dépenser temps et argent pour rédiger, valider et enregistrer le nouveau bail ou pour présenter une requête au tribunal. La Commission recommande que l'on permette aux locateurs, en cas de violation essentielle de la part des locataires, de conserver l'intérêt dérivé de ces derniers dans le bail tout simplement en faisant en sorte qu'il y ait cession réputée de cet intérêt en leur faveur. En pareil cas, le sous-locataire ne subirait aucun préjudice puisque cette mesure n'a pour effet que de protéger la durée du sous-bail et qu'il n'assumerait aucune nouvelle obligation.

Le locataire peut sous-louer son intérêt dans le bail à plusieurs personnes qui peuvent à leur tour le sous-louer à plusieurs autres personnes. Il ne devrait pas être permis au locateur de rompre d'une façon arbitraire des relations contractuelles existantes. Le locateur devrait pouvoir conserver l'intérêt de tous les sous-locataires ou de l'un ou plusieurs d'entre eux. Autrement dit, il devrait pouvoir choisir parmi les sous-locataires immédiats du locataire. Toutefois, la conservation de l'intérêt d'un sous-locataire donné devrait se traduire automatiquement par la conservation de tous les intérêts découlant du sous-bail.

Obligation du locateur à l'égard de l'hypothèque du locataire

Sont protégés les droits des personnes qui ont un intérêt dérivé dans le bail d'un locataire qui cède son intérêt au locateur. Ainsi, si un locataire hypothèque son intérêt dans le bail et qu'il cède par la suite cet intérêt, le créancier hypothécaire conserve ses droits par rapport à l'intérêt dans le bail. Si l'ex-locataire manque à ses versements hypothécaires, le créancier hypothécaire peut intenter des poursuites contre le locateur qui détient l'intérêt dans le bail après la cession afin d'obtenir paiement de la créance hypothécaire. Le locateur a le droit de se faire indemniser

par l'ex-locataire pour autant que cette mesure constituait une condition à son consentement à la cession.

Comme les cessions sont subordonnées au consentement des locateurs, il est justifié d'appliquer la règle de l'indemnisation dans ces cas. En revanche, il ne serait pas indiqué de l'appliquer dans les cas de cession réputée. Il ne serait pas équitable pour un locateur, qui se prévaut de la cession réputée de l'intérêt d'un locataire dans un bail par suite d'une violation essentielle de la part de ce dernier, d'avoir à absorber le non-paiement de la créance hypothécaire du locataire sans pouvoir se faire indemniser par l'ex-locataire. La Commission recommande que l'on n'adopte pas cet aspect du droit relatif aux cessions et que l'on accorde plutôt aux locateurs qui assument le non-paiement de la créance hypothécaire d'un ex-locataire par suite d'une cession réputée le droit de se faire indemniser par ce dernier.

Réparation en cas de résiliation par le locataire

La Commission recommande que l'on protège l'intérêt des sous-locataires en leur permettant d'obtenir les droits des locataires qui demandent la résiliation de leur bail en raison d'une violation essentielle de la part des locateurs tout comme on leur permet de s'adresser à un tribunal afin d'obtenir réparation en cas de déchéance ou d'obtenir les droits des locataires lorsque les locateurs font valoir leur droit de reprise de possession ou de déchéance. Elle recommande également que l'on accorde aux locateurs un droit équivalant ainsi que la possibilité d'obtenir réparation en cas de résiliation pour violation essentielle de la part des locataires.

CONTRATS INEXÉCUTABLES

Un contrat est inexécutable lorsqu'un événement imprévu, qui n'est attribuable à aucune des parties, fait qu'il est impossible de s'acquitter des obligations qui y sont prévues. Après qu'un contrat est devenu inexécutable, les parties ne sont pas tenues de s'acquitter des obligations qui ne sont pas encore éteintes. De plus, la *Loi sur les contrats inexécutables* régit les sommes payées ou dues, les avantages reçus et les frais engagés avant que le contrat ne devienne inexécutable. Au Manitoba, les tribunaux n'ont pas encore déterminé si ce principe du droit des contrats s'applique ou non aux baux commerciaux.

Habituellement, les avocats veillent à ce que soient précisées dans les contrats qu'ils rédigent les conséquences d'un événement rendant ces derniers inexécutables. Par contre, ces conséquences ne sont pas précisées dans certains baux. Ainsi, les droits et les obligations qui échoient aux locateurs et aux locataires après la survenance d'un tel événement ne sont pas clairs. La Commission recommande que l'on applique aux baux commerciaux qui ne précisent pas les conséquences d'un événement les rendant inexécutables le principe de la common law relatif aux contrats inexécutables et les mesures prévues par la *Loi sur les contrats inexécutables*. L'application de ce principe de droit aux baux commerciaux aurait pour effet de rendre uniformes le droit des baux commerciaux, le droit des baux résidentiels et le droit des contrats au Manitoba.

Plan de reconstruction

Il est plutôt rare que des baux commerciaux deviennent inexécutables; par conséquent, l'extension du principe relatif aux contrats inexécutables n'aura qu'un effet limité. Il arrive plus souvent que les locaux loués soient endommagés ou détruits d'une manière telle que les baux ne sont pas considérés comme inexécutables au sens strict de la loi. Par exemple, un immeuble qui est complètement détruit peut souvent être reconstruit en une période de temps relativement courte par rapport à la durée du bail. La Commission estime que la loi devrait prévoir les conséquences d'événements aussi graves, mais qui n'entraînent pas nécessairement l'inexécution

des baux, et que ces conséquences ne devraient pas supposer la résiliation des baux (comme dans les cas d'inexécution). Même en cas de destruction totale des locaux et malgré le temps considérable que peut prendre la reconstruction, bon nombre de locateurs commerciaux préfèrent reconstruire et conserver les baux plutôt que de les résilier et de recommencer de nouvelles relations d'affaires incertaines avec d'autres locataires. De même, bon nombre de locataires préfèrent attendre la reconstruction des locaux et demeurer au même endroit plutôt que d'avoir à déplacer leur entreprise. La Commission estime qu'il faut permettre aux locateurs et aux locataires commerciaux qui le désirent de reconstruire les locaux loués et de conserver leurs baux. À cette fin, elle propose un plan de reconstruction qui s'appliquerait lorsque les locateurs et les locataires n'en ont pas prévu un dans leurs baux. En cas de différend, l'application de ce plan aurait préséance sur le principe de la common law relatif aux contrats inexécutables et la *Loi sur les contrats inexécutables*.

La Commission recommande que le plan de reconstruction ne s'applique que dans les cas de destruction où il n'y a aucune faute intentionnelle ou négligence de la part des locateurs ou des locataires et que dans les cas d'immeubles qui sont cruciaux pour les locataires. En outre, elle recommande que le plan ne soit pas appliqué lorsque le bien-fonds sur lequel sont situés les locaux loués est aussi détruit en grande partie.

Qui plus est, la Commission recommande que l'on permette aux locateurs ou aux locataires, lorsque le plan de reconstruction s'applique, de résilier le bail, mais uniquement dans les cas où l'immeuble dans lequel se trouvent les locaux loués est crucial pour les locataires et est complètement détruit. Si les dommages sont de moindre importance ou qu'aucune des parties ne résilie le bail, les locateurs devraient être tenus de réparer l'immeuble aussi rapidement que possible de sorte qu'il convienne à l'entreprise des locataires.

La Commission recommande également que la décision de résilier un bail soit communiquée dans les 60 jours qui suivent la destruction des locaux commerciaux, mais qu'il soit possible de faire prolonger cette période par un tribunal. La *Loi sur les contrats inexécutables* devrait prévoir les droits et les obligations des parties en ce qui concerne les sommes payées ou dues avant la destruction lorsqu'une des parties résilie le bail conformément au plan.

Comme le temps nécessaire à la remise en état d'immeubles endommagés peut être considérable, la Commission propose que l'obligation des locataires de payer le loyer soit suspendue pendant la reconstruction lorsque l'immeuble dans lequel se trouvent les locaux loués est crucial et est tout à fait inutilisable et, dans les autres cas, que le loyer soit réduit en proportion des locaux inutilisables à partir de la date de leur destruction.

Comme la reconstruction pourrait durer pendant le reste de la durée du bail, ce qui serait très peu avantageux pour les locataires, la Commission propose que le bail soit prolongé d'une période équivalant à celle de la reconstruction lorsque les locaux qui sont cruciaux pour les locataires sont tout à fait inutilisables. Elle recommande de plus que les délais impartis pour exercer un droit soient prolongés d'une période correspondant à la prolongation de la durée du bail.

LOIS

La Commission a intégré à son rapport des propositions de modification à la *Loi sur le louage d'immeubles* visant à donner suite à ses recommandations.