August 21, 2023

DOES THE DUTY OF GOOD FAITH LIMIT "UNFETTERED DISCRETION"?

It is not uncommon for a lease to provide one of the parties with a right to make a determination in its discretion. Sometimes the lease requires the party to exercise "reasonable" or "equitable" discretion.

In a recent Ontario case, the landlord had the right to allocate realty taxes among premises of the property in its "sole and unfettered discretion". The Court analyzed the scope of the Landlord's allocation authority against the organizing principle of "good faith" in contractual performance. Here's what happened.

100 Bloor Street West Corp. v Barry's Bootcamp et al.

In the fall of 2019, Barry's Bootcamp ("Barry's") leased a premises on Toronto's "mink mile" (a strip on Bloor Street that fetches some of the highest rents in Canada). Barry's shared the building with several high-end retailers who leased the prime spots fronting on Bloor Street. By contrast, Barry's premises were located mainly on the second floor and access from street level could only be made by way of an alleyway or courtyard.

The lease provided that Barry's would pay realty taxes as *separately assessed* against the premises, but that *if there was no separate assessment*, Barry's would pay a share of realty taxes attributable to the premises as determined by the landlord "in its sole and unfettered discretion…using such method…which the landlord shall choose".

Over two decades ago, Ontario municipalities ceased issuing separate assessments for individual premises in multi-tenanted properties. As a result, there was only one assessment and one realty tax bill for the entire property. Thus, the landlord's discretion in allocating realty taxes was invoked. It chose to allocate realty taxes based on each tenant's proportionate share of floor area. Barry's paid according to this allocation for the first few months of the term. Then COVID hit.

In March of 2020, Barry's was forced to close its business. The parties reached an agreement whereby Barry's would pay its base rent, plus what it considered to be its share of operating costs and realty taxes until such time as the parties reconciled the amount payable under the lease. Barry's determination of realty taxes applicable to the premises was lower than the landlord's, in part because the landlord was in the process appealing a 2017 assessment that had increased the realty taxes of the property from $59 million to $226 million.

The landlord accepted the lower payments made by Barry's, without protest, for over two years. When Barry's asked the landlord to resolve the final amount of realty taxes payable, the landlord deferred discussions until receipt of the refund resulting from its realty tax appeal.

In the spring of 2022, without warning, the landlord noted Barry's in default, claiming $1 million in realty tax arrears. The notice gave Barry's seven days to cure, failing which the landlord would have the right to terminate the lease. After the cure period expired without payment being made, the landlord attempted to re-take possession and terminate the lease, but the attempt was rebuffed by Barry's security guard, who prevented the bailiff's entry.

Barry's obtained an injunction prohibiting termination of the lease pending a Court determination as to the parties' rights. The landlord applied for a writ of possession, and, in turn, Barry's applied for a declaration that the landlord was not permitted to terminate the lease.

Discretion

The main issue before the Court was whether the landlord's determination of the tenant's share of realty taxes complied with the lease. Barry's argued that the landlord's election to use the proportionate share method violated its duty of good faith. It pointed to the tax assessor's internal working papers, which indicated that only 4-6% of the total tax bill was attributable to Barry's premises, despite the fact that they comprised 12% of the area used in the pro-rata apportionment. Barry's noted that the lease required any determination by the landlord to be "made and given on a reasonable basis".

Based on the Supreme Court of Canada's decision of *Wastech v. Greater Vancouver Sewerage*, which held that even an unfettered contractual discretion is subject to the duty of honesty and reasonableness, Barry's maintained that the landlord unreasonably allocated to its premises realty taxes that were fairly attributable to the street front units (which accounted for more of the assessed value).

The Court disagreed. It ruled that (1) the duty of contractual good faith requires a party to exercise discretion "honestly and in light of the purposes for which it was conferred" and (2) the landlord had exercised its discretion for the intended purpose (the allocation of a single realty tax bill among multiple premises of the retail component of the building), not for an ulterior purpose.

On appeal, the Court held that the tenant's argument (that the proper purpose for the landlord's discretion should be to allocate only realty taxes "attributable" to the premises), was not supported by the wording of the lease. It found that the lease clearly gave to the landlord the right to make the determination using any method it chose.

The Court found that the proportionate share method was a reasonable and common one. It held that the landlord was not required to use the best method, but rather that it had the "sole and unfettered" discretion to choose the method. In the Court's view, overlooking these words and compelling the landlord to allocate realty taxes based on the taxing authority's working papers would run contrary to the terms of the lease.

The Court stated: "although even an unfettered discretion must be exercised reasonably and honestly, that does not mean that Courts should subject the exercise of contractual discretion to microscopic examination. The fact that contractual discretion may be subject to review for reasonableness, good faith and honesty does not mean the Courts will now ignore language that gives a party 'sole and unfettered' discretion".

Plot Twist

However, the Court held that the landlord's purported termination was invalid. It found that the landlord was estopped from terminating the lease because it had lulled the tenant into a belief that the parties would discuss reconciliation of the realty tax amount once the landlord received its realty tax refund. It found the landlord's demand to pay $1 million on seven days' notice was unreasonable. The Court also noted that the landlord failed to provide annual reconciliations of additional rent over the two year period while the parties lived under the arrangement whereby Barry's was permitted to pay operating costs and realty taxes as it determined. The Court stated that "if the landlord wants to rely on its rights for the payment of [Additional Rent] under the lease, it must also comply with its obligations in respect of [Additional Rent]".

The Court was "troubled" by the fact that during the seven day period the tenant was given to pay $1 million, the landlord entered into a letter of intent for the premises with a high-end menswear operator (conditional on evicting Barry's). The Court drew the inference that the landlord's termination of the lease was motivated by its desire to enter into a new lease on better terms with the menswear retailer.

The Court gave Barry's 60 days to pay the $1 million of realty tax arrears.

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

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