BSR
Baker Schneider Ruggiero LLP

Mortgage and Real Property Law Report



Vol. 17, No. 5 • October 2011

A Legal Newsletter for the Mortgage and Real Estate Industries

Seller Cannot Rely on its Own Breach of Contract to Avoid Deal with Buyer

The Ontario Court of Appeal has recently handed down a decision confirming the law on how a party's own breach of an agreement of purchase and sale affects that same party's right to terminate the contract.

The Court considered the facts: under the agreement of purchase and sale, the seller, the Toronto Catholic District School Board (the "Board") agreed to sell almost 5 acres of land to the buyer, Southcott Estates. The land was intended for a residential development, so the agreement stipulated that the Board was required to use its "best efforts" to obtain a severance from the Committee of Adjustments in advance of the closing date.

Unfortunately, the Board's severance application to the Committee was deferred at the municipality's request, because the Board's application did not include a development plan. The Board refused Southcott's request to extend the closing date, and instead declared the agreement terminated. It returned Southcott's deposit.

Southcott then sued for specific performance, or for damages in the alternative. At trial, the judge awarded Southcott its damages, finding that the Board as seller had breached its obligation use its "best efforts" to obtain the needed severance. It held that the Board should have promptly advised Southcott that a development plan needed to be filed, and should have done more to communicate with the planning authorities and municipal counsellor. Specific performance was not available in this case, since the land was being purchased by Southcott for investment purposes.

The Board appealed to the Court of Appeal. It did not deny that it failed in its contractual duty to use its "best efforts" to obtain the severance needed to close the deal. However, it argued that – contrary to the trial judge's findings – this breach was not the *reason* the severance was not obtained by the closing date. In other words, even if the Board had fulfilled its "best efforts" duty, it was not the cause of the failed deal because there would simply not have been enough time to obtain the severance before closing in any event. The Board also asserted that the judge should have found Southcott remiss in its duty to mitigate damages.

The Court of Appeal considered the Board's arguments. Firstly, the Court was bound by the trial judge's previous finding that the Board had been in breach of its obligations under the "best efforts" clause. With this fact established, the Board could not then turn around and rely on its own breach to terminate the deal (in this case by pointing to the "time of the essence" clause). In drawing this conclusion, the Court quoted from long-standing judicial precedent on contract law, observing:

"It is a well-established principle of contract law that a party cannot use its own breach or default in satisfying a condition precedent as a basis for being relieved of its contractual obligations…"

Next, the Court of Appeal considered damages. At the outset, it confirmed that: 1) Southcott had a duty to mitigate its damages; and 2) that the onus was on the Board to show that Southcott had failed to do so. Here, Southcott had clearly admitted that it never had any intention to take any steps to mitigate; this admission was enough to satisfy the Board's duty. The obligation then devolved back to Southcott to show that it could not have mitigated even if it wanted to. Southcott did not lead such evidence, so its case for damages against the Board could not stand.

Accordingly, in these circumstances the Appeal Court found that the proper remedy was to set aside the trial judgment, and to make order in Southcott's favour, but to award only nominal damages of $1. See *Southcott Estates Inc. v. Toronto Catholic District School Board*, 2010 (ONCA).

Court of Appeal Reviews Tenants' Duty to Repair Fixtures and Improvements

The law relating to a commercial tenant's duty to repair both trade fixtures and improvements to the property was addressed by the Ontario Court of Appeal in a recent decision.

The facts involved a tenant who leased premises in Mississauga that were used as a gas station. The property featured underground fuel storage tanks and fuel lines. One of these fuel lines leaked; as a method of repair the tenant simply capped the line and discontinued using it. When the tenant terminated the lease and vacated the premises in the usual course, it left behind the underground fuel lines, including the fuel line it had capped.

The landlord then applied to the court for a declaration that the tenant was the owner of the underground storage and fuel lines, and asked for an order directing them to be removed. The application judge dismissed the request. However, rather than launch an appeal, the landlord adopted a new strategy, and instead asked the court for an order requiring the tenant to repair the underground tanks and fuel lines. On that basis, the landlord was successful.

The tenant then appealed that decision to the Court of Appeal. It claimed that the terms of the lease simply did not impose any such repair obligation on the tenant in connection with the underground fuel line.

The case hinged on the proper interpretation of the lease, and more importantly on the characterization of the underground fuel tanks and lines as either "trade fixtures" or "improvements". In turn, this determination gave rise to a potential duty to repair by the tenant.

In undertaking the necessary analysis, the Court of Appeal began by clarifying that – in keeping with the traditional legal interpretation – improvements refer to things constructed on and attached to real property and which become part of it. Trade

fixtures, on the other hand, are placed on and connected to the real property, but in a manner that allows for the connection to be severed.

As with most contracts of this type, the lease in question provided that any improvements or equipment installed on the property would remain the tenant's property. The tenant was also allowed to remove any of its installed trade fixtures at the end of the lease term; anything not removed became the landlord's property. There was no right by the tenant to remove improvements.

With this in mind, the interpretation of the terms imposing repair obligations was key. The Court observed that traditionally, the law relating to repairs draws a distinction between improvements and trade fixtures, as follows:

... [B]ecause they cannot be removed, improvements made by a tenant will inevitably become the property of the landlord, giving the landlord an interest in ensuring their repair. On the other hand, a tenant's fixtures may be removed by the tenant, in which case the landlord has no stake in their repair.

In this specific lease, the terms were clear as to the tenant's differing repair obligations as between "trade fixtures" and "improvements": the duty to repair clearly applied to improvements only.

Against this background, the Court of Appeal found two grounds on which to allow the tenant's appeal. First, it observed that: 1) the application judge had characterized the underground storage tanks and fuel lines as being "trade fixtures" belonging to the tenant; and 2) the lease stated that any trade fixtures left behind by the tenant became the landlord's property. Since the tenant did not remove the fuel tanks and lines when the lease ended, they became the landlord's property in law. Bolstering this conclusion was the fact that the application judge had dismissed the landlord's request for an order declaring the tenant to be the owner, which finding was not appealed.

The application judge had also found that the tenant's capping of the fuel lines did not fulfill its repair obligations. However, since the Court of Appeal found that the judge had mischaracterized the lines and tanks in the first place, and since the lease terms only required the tenant to repair "improvements", there could be no obligation on the tenant to repair them at all.

As a result, the Court of Appeal allowed the tenant's appeal, and substituted an order dismissing the landlord's application outright. See *Caledonia Service Station Inc. v. Cango Inc.*, 2011 (ONCA).

Mortgagee Not Liable for Interfering with Tenancy

The buyer built a single-family home on land he purchased in Ottawa. Equitable Trust granted the buyer a mortgage, and had the buyer sign a statutory declaration that he would be the owner/occupier of the property as his principal residence, and that it would not be leased. Moreover, the mortgage terms required him to obtain the written consent of Equitable Trust prior to leasing the property; otherwise the mortgage was deemed to be in default.

Nonetheless, the buyer leased out the property to the Republic of Cameroon without obtaining Equitable Trust's written consent. The rent was $144,000 per year, payable in two instalments.

Equitable Trust learned of the lease and spoke directly with the tenant to extract a promise that it would not make any further rental payments to its landlord, the buyer. It then advised the buyer that it considered him in default, and served notice on both him and the tenant that it would be applying to the court to set aside the lease. The tenant terminated the tenancy.

With no rental income, the buyer had to sell property. Equitable Trust demanded three months' interest penalty (about $38,000) to discharge the mortgage; the buyer had to borrow money to make that payment. The buyer then sued Equitable Trust for breach of contract and for wrongful interference with economic relations.

Equitable Trust applied successfully to have the court strike the buyer's claim as disclosing no cause of action. A claim for inducing a breach of contract was contingent upon there being a legally enforceable contract. Here, under the mortgage the buyer had a contractual obligation not to enter into a lease. He was "adopt[ing] blinders" by asking the lease to be considered in isolation, the court said. It observed:

"The foundational fault in the plaintiff's action is his claim for damages regarding a lease he contracted not to enter into because he lacked the prior written consent of the mortgagee."

In other words, the buyer could not seek damages founded on his own contractual breach.

As for the buyer's claim for wrongful interference with economic relations, it lacked two essential elements, namely that Equitable Trust: 1) intended to cause the buyer's loss; and 2) used unlawful means to cause it. Here, persuading the tenant not to pay rent was not "unlawful", as it did not interfere with the tenant's reasonable enjoyment and was not itself actionable by the tenant. Nor could the buyer show that Equitable Trust intended to cause him loss under a contract that he had agreed not to enter into. See *Valenti v. Equitable Trust Co.*, 2011 (ONSCJ).

Supreme Court of Canada Rules on Secured Lender's Rights Over Fraudulently-Obtained Collateral

Banks should take comfort from a recent decision of the Supreme Court of Canada, which considered the rights of secured lenders in situations where the assets that are subject to the security interest were originally obtained by fraud.

In *i Trade Finance Inc. v. Bank of Montreal* the contest was between two innocent creditors, and involved the proceeds of shares that were credited to an investment account, but which stemmed from funds that had been fraudulently obtained. The funds used to buy the shares had been loaned to the fraudster by i Trade Finance ("i Trade"), which was eventually forced to obtain a court order entitling it to any assets traceable to the funds that had been fraudulently obtained. On the other hand, the Bank of Montreal ("BMO") was a secured creditor, and had been pledged the fraudulently-obtained shares by the fraudster. The question was whether the Bank became a purchaser for value without notice of the fraud, which would essentially trump i Trade's interest in the funds.

The Supreme Court of Canada determined that the fraudster's rights in the shares were sufficient to legally support it granting BMO a security interest in them. This conclusion derived from the well-established legal principle that a contract tainted by fraud is merely *voidable* at the election of the party defrauded; it is not automatically *void*. When the shares were pledged to BMO, the fraud had not yet been discovered; therefore BMO in the role of pledgee was considered a "purchaser" within the concept of a *bona fide* purchaser for value, which in turn amounted to an exception to the tracing order obtained by i Trade.

This decision is important because it elaborates upon the law as to rights over collateral obtained by fraud. Still, banks and other lenders should be aware that this decision will likely not be of assistance where the fraud is uncovered prior to the point in time when their security interest attaches to the collateral. See *i Trade Finance Inc. v. Bank of Montreal*, 2011 (SCC).