Arbitrating ‘fair market rental’ in commercial rent reviews

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I was recently asked if the *Pacific West Systems Supply Ltd. v. B.C. Rail Partnership*[1] decisions from the British Columbia courts [*Pacific West*] are still good law for the proposition that use restrictions imposed by the terms of a ground lease are to be considered in a rent review. The answer is yes – maybe.

In this article, I will remind readers of general legal principles in the interpretation of leases, canvas the facts and the law relied upon by the courts in *Pacific West*, and comment on when it might be safe to conclude that a rent review involving the phrase ‘fair market rental’ will permit consideration of the lease including any terms restricting use.

Definition of ‘market rent’

In *White v. R.*[2], the Tax Court of Canada referred to an appraisal definition of ‘market rent,’ which is set out in part below:

> 7 Mr. Chappell relied on the *Fourth Edition of Real Estate Appraisal* (The Appraisal Institute, Chicago, 2002), which defined “market rent” as follows:
>
> The most probable rent that a property should bring in a competitive and open market reflecting all conditions and *restrictions of the specified lease agreement including term, rental adjustment and revaluation, permitted uses, use restrictions*, and expense obligations ...
>
> [Emphasis added.]

The definition in the sixth edition of the dictionary maintains the concept of considering permitted uses and use restrictions within a particular lease contract.[3] However, in legal proceedings such as court cases or arbitrations, the appraisal understanding of ‘market rent’ may or may not carry the day depending upon the court or arbitral tribunal determination of the intention of the lessor and lessee.

Lease interpretation: general principles

Interpreting any contract, including a commercial lease, is about objectively finding the intention of the parties from the plain and ordinary meaning of the words in the contract in the context of the contract as a whole and the surrounding circumstances that existed at the time the contract was entered. The surrounding circumstances are reviewed to elucidate the parties’ intention, not to subvert their intention.[4]

In the case of rent review clauses, the court will consider the usual commercial purpose behind rent review clauses. One expression of the commercial purpose is that unless there is a contrary intention expressed in the lease, the default purpose of a rent review is “... to enable the landlord to obtain from time to time the market rental which the premises would command if let on the same terms on the open market at the review dates. The purpose is to reflect the changes in the value of money and real increases in the value of the property during a long term.”[5]

But as Mr. Justice Lowry wrote in the British Columbia Court of Appeal decision in *Pacific West*, the question is how much protection is to be afforded the landlord? For example, is it intended that having initially agreed on a rate that was based on a restricted use, that basis would evaporate on a rent review even though the use restriction remains a term of the lease?

Pacific West

Pacific West concerned a long-term commercial ground lease that called for periodic reset of rent. The lease restricted use of the lands to the “construction and operation of a building

supply business." The rent to be decided was 'fair market rental;' the restricted use under the lease was not referenced in the rent review clause. The arbitrator concluded that the use restriction was not relevant in determining fair market rental. The tenant successfully appealed to the British Columbia Supreme Court. The landlord's appeal from the Supreme Court decision was dismissed by the British Columbia Court of Appeal. Both courts held that the restricted use provision of the lease should be taken into account in the rent review.

The British Columbia Supreme Court relied upon the Ontario Court of Appeal decision in *Canadian National Railway Company v. Inglis Ltd.*[6] [*Inglis*]. In *Inglis*, the lease restricted use of the land to manufacturing purposes in connection with the tenant Inglis' business. In addition, the lessor Canadian National Railway was entitled every five years to set rent at an amount it thought was fair and equitable. The Ontario Court of Appeal held that the lease had to be interpreted as requiring the lessor to objectively decide what was fair and equitable in light of all the circumstances. This had implications for the restricted use clause.

Robin J.A., writing for the Ontario Court of Appeal, stated in part, "In my view, as a general proposition, valuations of land for the purpose of determining rent should take into account restrictions imposed by the lessor on the use of the land unless the lease contains some provision clearly manifesting an intention that the restrictions are not to be considered in fixing value." He relied on the English Court of Appeal decision in *Basingstoke and Deane Borough Council v. Host Group Ltd.*[7] [*Basingstoke*] (bare land restricted to public house use).[8]

The *Pacific West* Court of Appeal decision affirmed the Supreme Court decision, relying upon *Basingstoke*, making no mention of *Inglis*. Lowry J.A., writing for the court, stated in part, "In the absence of express provision to the contrary, I see no sound basis on which it can be said that the parties to this lease can have intended that the tenant be put in the position of paying rent based on the unrestricted use of the lands when it is precluded from enjoying what may be the highest and best use."[9]

The *Pacific West* Court of Appeal decision illustrates the need for careful consideration of the precise wording to be used in a lease generally and in the rent review clause specifically. As noted above, the valuation objective in *Pacific West* was to determine

'fair market rental.' The court distinguished this objective from determining 'fair market value,' which was the objective, for example, in *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.* [*Janwest*],[10] an earlier decision of the British Columbia Court of Appeal, in which the lease restricted use of the land to operating a hotel. In *Janwest*, the majority of the court held that fair market value of the bare land was to be determined without reference to the lease at all. (*Janwest* is consistent with the prevailing judgement of Gonthier J. in the Supreme Court of Canada decision in *Musqueam Indian Band v. Glass*.[11]) In the opinion of the Court of Appeal in *Pacific West*, by altering the valuation objective to a determination of fair market rental, the restricted use provision becomes central.

This *Pacific West* distinction between 'fair market rent' and 'fair market value' had judicial precedent. In *Bondi v. Toronto (City)*, 1967 CarswellOnt 180 (Ont. C.A.), the Ontario Court of Appeal considered the rent to be paid on the renewal of a lease. The court held that the arbitrator had properly instructed himself that he was required to fix the rental value between the lessor and the lessee and not the sale value as between the vendor and purchaser. In so holding, the court referred to *Thompson and City of Toronto (Re)*, [1928] O.J. No. 196 (QL) (Ont. S.C. – Appellate Div.).[12]

Judicial consideration of the phrase 'fair market rental'

A question arising from the *Pacific West* decisions is whether the use of 'fair market rental' in a rent review clause will always result in use restrictions being considered in determining rent. As noted in the first paragraph above, the answer is maybe. First, *Pacific West* is binding authority in British Columbia but nowhere else in Canada. Other courts (and arbitrators) might be persuaded by the Court of Appeal's reasoning, but they are not required to follow the decision. [At time of writing, there are three reported Canadian decisions considering the Court of Appeal decision in *Pacific West*, none of which deal with the issue of the effect of restricted uses in determining fair market rental.] Second, even if the phrase 'fair market rental' is used in a lease, it will still be a matter of interpretation taking into account the entire lease whether the lessor and lessee intend use restrictions to be considered in resetting rent.

A search of Canadian legal databases turns up cases subsequent to *Pacific West* that address the meaning of 'fair market rent' and 'fair market rental,' but they are not generally in the context of rent reviews and are more likely to be in cases dealing with real property assessment and expropriation. The cases that deal with rent reviews focus on issues other than the effect of restricted use provisions when determining rent.

Default position to consider use restrictions

It can be argued that the essence of *Pacific West* is not the meaning the Court of Appeal attributed to 'fair market rental,' but rather the adoption by both the British Columbia Supreme Court and the Court of Appeal of the concept that absent words to the contrary, it will be taken as the default position that, in a rent review, the restrictions on use will be considered. This default position expressed in *Basingstoke* has found favour in some Canadian court decisions, but there is not a groundswell of cases on the topic from which to draw definitive conclusions.[13]

There are cases outside Canada endorsing *Basingstoke* and at least one citing *Pacific West*. The Western Australian Court of Appeal cited both cases when it held in *City of Subiaco v. Homebase Management Pty Ltd*[14] that 'fair market rent in a ground lease evinced an intention that the reset rent be based on the restricted actual use and not highest and best use.

Closing

The conclusions that can be drawn from the foregoing are:

- Be mindful of the commercial purpose for a rent review clause.
- There may be a default toward considering use restrictions in a rent review absent express wording to the contrary.
- But, if there is such a default, a lease may contain language that replaces the default.
- A valuation objective of 'fair market rental' might be taken as an indication that terms of a lease, including use restrictions are to be considered in a rent review.

For drafters and negotiators of leases, the best advice is to be precise; if use restrictions are to be considered in a rent review, expressly state this in the lease document.

This article has been restricted to a consideration of use restrictions that are terms of ground leases and the impact they might have in rent reviews. The article has not considered cases where use restrictions are imposed by legislation. Further, there are a plethora of potential considerations that might, or might not, be relevant in a rent review depending on what is determined to be the intention of the parties when entering a lease.

In preparing this article, I came upon quite an array of articles discussing various aspects of ground lease rent reviews. Three in particular were helpful: *Arbitrating the Value of Property: Approaches and Challenges*[15] by Wendy J. Earle; *Arbitrating 'Rent' – A Case Study of the Arbitration Process and Contract Interpretation*"[16] by Cynthia Kuehl and Rivka Birkan-Bradley; and *Ground Leases: Rent Reset Valuation Issues*[17] by Tony Sevelka.

End notes

[1] 2003 BCSC 391 affirmed 2004 BCCA 247

[2] 2010 TCC 530, para. 7

[3] *The Dictionary of Real Estate Appraisal*, 6th ed. (Appraisal Institute, 200 W. Madison, Suite 1500, Chicago, IL, 2015)

[4] *Creston Moly Corp. v. Sattva Capital Corp.*, 2014 SCC 53 at paras. 47, 57, 58; *Park Royal Shopping Center Holdings Ltd. v. Gap (Canada) Inc.*, 2017 BCSC 1257, paras. 51, 52

[5] *Basingstoke and Deane Borough Council v. Host Group Ltd.*, [1988] 1 WLR 348 (Eng. C.A.) quoting from *British Gas Corporation v. Universities Superannuation Scheme Ltd.* [1986] 1 W.L.R. 398, 401; adopted in *Pacific West* and other Canadian cases.

[6] (1997), 153 D.L.R. (4th) 291 (Ont. C.A.)

[7] [1988] 1 All E.R. 824 (Eng. C.A.)

[8] (1997), 153 D.L.R. (4th) 291 (Ont. C.A.), para. 18

[9] 2004 BCCA, para. 13

[10] (1993), 84 B.C.L.R. (2d) 273 (B.C.C.A.), leave to appeal to the Supreme Court of Canada denied (1994), 39 R.P.R. (2d) 60n

[11] 2000 SCC 52

[12] 1967 CarswellOnt 180, para. 8

[13] For examples see *Inglis, Ladoski v. British Columbia Assets & Land Corp.*, 2002 BCSC 114, paras. 8-11; *Revenue Properties Co. v. Victoria University,* 1993 CarswellOnt 722 (Ont. C.J. (General Division), para. 51

[14] [2015] WASCA 54, para. 61

[15] *Annual Review of Civil Litigation 2004*, Thomas Reuters Canada Limited

[16] *Annual Review of Civil Litigation 2015*, Thomas Reuters Canada Limited

[17] *The Appraisal Journal,* Fall 2011, pages 314-326

This article is provided for the purposes of generating discussion and to make practitioners aware of certain challenges presented in the law. It is not to be taken as legal advice. Any questions relating to the matters discussed herein should be put to qualified legal and appraisal practitioners.