Minden Gross LLP

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Landlord's Duty to Mitigate

It has been accepted since *Highway Properties Ltd. v. Kelly Douglas & Co.*, that a landlord has four potential remedies where a tenant is in breach of or has repudiated a lease:

1. the landlord may do nothing to alter the relationship but simply insist on performance and claim for rent or damages on the basis that the lease remains in force;

2. the landlord may elect to terminate the lease while retaining the right to claim for arrears of rent and damages to the date of termination for previous breaches of covenant;

3. the landlord may take possession of the premises and relet the premises on the tenant's account; and

4. in addition to 2 above where the landlord terminates the lease, provided that it serves notice on the defaulting tenant, the landlord may claim damages on the basis of a present recovery of damages for losing the benefit of the lease over its unexpired term.

Where the landlord avails itself of the fourth remedy, courts have generally found an obligation on the landlord to mitigate its damages by finding a new tenant and offsetting the arrears owed by the old tenant against the amounts received from the new tenant. The landlord is not held to a standard of perfection in satisfying this duty to mitigate, but only a standard of reasonableness. Thus, a landlord was found to satisfy this duty even where it has rejected an offer because it contains a non-competition clause, where a landlord has narrowed the market to only the medical profession, and where a landlord accepted a replacement tenant at a decreased rate of rent. Since what constitutes reasonable mitigation is a question of fact, it is often unclear what actions taken by a landlord satisfy or fail to satisfy this obligation to mitigate.

In the recent case of *577129 B.C. Ltd. v. Urban Life Enterprise Ltd.,* the landlord brought a claim against the tenant, assignee, and co-covenantor for outstanding, future, and lost rent. The landlord originally leased the premises to the tenant for use as a restaurant. The lease was later assigned with the consent of the landlord to the assignee. The assignee became ill and advised the landlord that he was unable to continue operating, but that he was searching for a buyer for the equipment which was worth approximately $20,000. Since the assignee was in arrears, the landlord terminated the lease effective May 31, 2008 and re-let the premises to a new tenant commencing December 1, 2008. The landlord provided the new tenant with a $50,000 improvement allowance and a rent-free fixturing period.

The court found that the landlord was entitled to sue for rent accrued up to the termination date, but any claim for future or lost rent thereafter was a claim for damages and subject to mitigation as set out in *Transco Mills Ltd. v. Percan Enterprises Ltd.* The court went on to consider the landlord's following actions in determining whether this duty had been satisfied. First, the landlord failed to distrain for rent or allow the defendants to sell their furnishings and equipment and apply the proceeds thereof to rent arrears. This failure was a failure on the part of the landlord to mitigate its loss. The court rejected the landlord's evidence that the furnishings and equipment were worthless despite the landlord's argument that it relied on the opinion of a bailiff who had driven by and informed them that there was nothing of value, given that some of the defendants' furnishings and equipment were used in furnishing the new tenant's restaurant, and given that the assignee had advised the landlord prior to the termination that the furnishings and equipment were worth approximately $20,000 and that he was looking for a buyer.

Second, the court found the $50,000 improvement allowance a failure by the landlord to mitigate its loss. This "sweetheart deal" offered to the new tenant involved benefits far in excess of what was being claimed as a loss and was unconscionable when the landlord was claiming that it suffered a loss as a result of the termination.

Third, the court found that the rent-free fixturing period offered by the landlord, which it was claiming as a loss from the previous tenant, was another indication of the landlord's failure to mitigate. The court ultimately found that the landlord was entitled to rent arrears and damages amounting to three months rent and the defendants were entitled to the same amount, being the discounted value of the furnishings and equipment which belonged to the defendants. The takeaway for landlords when terminating a lease and claiming damages for the unexpired term is that landlords should act reasonably, realize on assets that may have value, and be careful to ensure that any incentives being offered to any new tenant are reasonable.

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Update - Federal Budget "Targets" Planning Involving Minors[1]

Draft legislation implementing a number of items from the 2011 Federal Budget, including Budget Resolution 23 ("BR #23"), was released by the Department of Finance ("Finance") on August 16, 2011. The legislation implementing BR #23 proposes to add new subsections 120.4(4) and (5) to the *Income Tax Act* ("Act")(Canada)[2] (collectively, the "Draft Provisions").

When I wrote about this subject in the spring, I was concerned that the wording of BR #23 combined with other recent CRA administrative positions[3] appeared to be the end of many forms of planning involving capital gains splitting with minors.[4] Although the Draft Provisions may impact on certain types of capital gains splitting plans involving minors, fortunately, a number of opportunities appear likely to survive, more or less in tact, including planning involving the multiplication of the capital gains exemption among family members.

The Draft Provisions propose to extend the rules in section 120.4 (the "kiddie tax" rules) to deem income from capital gains realized in respect of a disposition of shares by either:

1. a specified individual[5] (see subsection 120.4(4)); or

2. a trust, to the extent that amounts of the capital gains can reasonably be considered to be included in a specified individual's income pursuant to paragraph 104(13)(a) or subsection 105(2) (see subsection 120.4(5)),

to a person who is not at arm's length with the specified individual to be taxed to the specified individual as ineligible taxable dividends subject to the ordinary split income rules[6] ("NAL Capital Gains").

The Draft Provisions do not apply to sales of shares listed on designated exchanges, shares of mutual fund corporations or "excluded amounts"[7] and they are applicable to all NAL Capital Gains realized on or after March 22nd, 2011, without grandfathering. Consequently, planners will want to avoid NAL Capital Gains since top tax rate[8] ineligible dividends are taxed at 32.56% as opposed to a rate of 23.2% for top tax rate capital gains, resulting in NAL Capital Gains being taxed in a comparatively punitive manner.

The discussion below assumes that the Draft Provisions will be enacted without further amendments – such an assumption is always a dangerous one to make, as changes are always possible until legislation is formally enacted[9].

Winners

It appears that the Draft Provisions add legitimacy to strategies that may ultimately result in capital gains (exemption) splitting/ multiplication with minors, provided the gains are realized in connection with an arm's length share sale.

In the absence of an arm's length sale, draft amendments to subsection 48.1(1) specifically exclude the Draft Provisions from applying to a deemed disposition under subsection 48.1(1). As a result, it not only remains viable to have specified persons realize deemed capital gains in connection with going public transactions, including capital gains that are eligible for capital gains exemption treatment, it also appears that such planning has the blessing of Finance going forward[10].

Casualties?

As expected casualties of the amendments include income splitting transactions with minors that:

1. are intended to cause would-be dividend treatment to be "transmogrified" into capital gains[11];

2. involve gel transactions that would permit a parent or other non-arm's length person to buy back growth shares from a trust; and

3. involve bona fide family buy-out or other non-arm's length buy-out situations which have no income splitting motivation.

Although the Draft Provisions will eliminate opportunities for capital gains exemption multiplication among minors using any of these strategies, all is not lost. Even for existing planning[12] involving trusts where only minors are beneficiaries, income that in the absence of the Draft Provisions would have been allocated to minors can instead be taxed in the trust. By doing so, the income can maintain its character as ordinary capital gains[13] taxed in the trust at the same top tax rates[14] that would likely have been applicable to the client in the absence of any planning rather than being taxed at top rate ineligible dividend tax rates in the hands of minors[15]. If appropriate or desirable, capital of the trust could then be distributed to beneficiaries of the trust, including minors, without additional tax.

In addition to the casualties listed above, non-section 48.1 capital gains exemption crystallization transactions, which can only be effective if income realized upon a crystallization is earned by a specified individual or if such income is allocated from a trust to a specified individual, also appear to be casualties of the Draft Provisions. In this regard, unlike section 48.1 deemed dispositions, which are specifically deemed not to be dispositions for purposes of the Draft Provisions, it appears that a drafting solution could not be found to exempt dispositions that arise in connection with other crystallization transactions from the Draft Provisions. Based on informal discussions with Finance, it is still possible that if a workable drafting solution can be found during the consultation period,[16] internal crystallization transactions may ultimately be exempted from the Draft Provisions in a future draft of the legislation. Keep your fingers crossed.

1. For the original article, see The Estate Planner No. 195, April 2011, "Federal Budget "Targets" Planning Involving Minors" (" My Article"). My partner, David Louis, has also written about this subject in Tax Notes No. 580, May 2011, "Freeze Structures – Under Attack" and, more recently, in Tax Notes No. 583, August 2011, "Freeze Structures – Under Attack" (collectively, "David's Articles").
2. Unless otherwise noted all statutory references are to the Act.
3. See document number 2010-0373621C6. This French only document contains views of the CRA provided in question 34 of the 2010 APFF Round Table regarding what the CRA views as abusive uses of family trusts.
4. David's Articles voiced similar concerns.
5. Generally a Canadian resident minor.
6. The language of the Draft Provisions might lead one to believe that these provisions create their own charging provision separate and apart from subsection 120.4(2). Based on informal discussions with Finance, I understand that Finance intends deemed income under the Draft Provisions to be caught by the split income definition in subsection 120.4(1) and therefore subject to subsection 120.4(2).
7. Generally amounts of income or capital gains from inherited properties under defined circumstances (see subsection 120.4(1)).
8. For illustration purposes I have used Ontario tax rates.
9. These days even enactment isn't always the final word…but what's a practitioner to do.
10. Based on recent comments from the CRA (see My Article under the heading "APFF Round Table Question 34") prior to the release of the Draft Legislation, planners may want to approach Finance's blessings with a certain amount of caution.
11. A high/low stock dividend could be paid on common shares held by a family trust (subject to applicable corporate law), i.e., such that the taxable dividend will be restricted to the increase in stated capital, which would also be the ACB of the high/low share. The trust would then sell the share at the redemption price (e.g., to a parent in consideration for a promissory note), triggering the capital gain to the trust, which would be allocated to the beneficiaries in order to utilize low marginal tax rates. The purchaser of the shares would sell the high/low share to a Holdco connected with the corporation that paid the stock dividend, e.g., in consideration for a promissory note from Holdco. The shares would then be redeemed and the proceeds would be used to repay the promissory note to the parent and then to the family trust, which would distribute the proceeds to the beneficiaries. Such planning strategies are the subject of a number of pending GAAR cases.
12. Traditional estate planning objectives are unaffected by the Draft Provisions.
13. The CRA may continue to view transmogrification strategies as GAAR able transactions, even though there will no longer be income splitting advantages associated with such planning.
14. A testamentary trust could access low marginal tax rates.
15. The income would, of course, belong to the trust not the client/freezor.
16. Submissions can be made until September 16, 2011.

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It is with deep sadness that we announce the untimely death of our partner and friend, Martin Maierovits.

Martin was a devoted member of our firm for over 30 years.

Martin was held in the highest regard by clients and colleagues and was considered by many to be their trusted advisor.

Martin was dedicated to his family and his community, and most recently served as Chairman of the Kashruth Council of Canada.

He will be missed.

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Professional Notes

Steven I. Pearlstein spoke on "Bare Trusts" at the Law Society program called Commercial Mortgage Transactions: Complex Issues in Documentation and Due Diligence on September 13, 2011. His article entitled "The Next Generation of Conveyancing" was published in the October 3, 2011 edition of The Lawyers Weekly. He is also speaking on "Assignments of Mortgages" at the Law Society program called The Six Minute Real Estate Lawyer 2011 on November 22, 2011.

Stephen Posen was the moderator of a panel at the RealLeasing Conference of September 27, 2011. His panel topic was "Landlord and Tenant Rights and Remedies: Five Common Default Scenarios and Other Issues that You Need to be Aware of in Today's Market". At the same conference, he also co-chaired a roundtable on green leasing.

The Commercial Leasing Group participated in the RealLeasing Conference held on September 27, 2011 in Toronto. **Christina C. Kobi** was appointed to the planning committee for the conference.

Joan E. Jung spoke on "LLCs after the Fifth Protocol" at the INAA (International Network of Accountants and Auditors) North American forum on August 15, 2011.

The Commercial Leasing Group participated in the ICSC Canadian Conference held October 20-21, 2010 in Toronto. **Stephen J. Messinger** was the Moderator of the Economic Session at the ICSC Canadian Convention on October 20, 2011. Stephen was also the Chairman of ICSC Retail Forum in Toronto at the Liberty Grand Event Centre on September 21, 2011.

Hartley R. Nathan, Q.C. will be presenting a paper on "The Preparation and Conduct of Board and Committee Meetings" to the Director's College on November 8, 2011. His book entitled "Nathan's Company Meetings and Rules of Procedure", 9th edition was published on October 14, 2011. Hartley together with **Phillip G. Bevans** will be conducting a webinar on Contentious Issues at Board, Members and Shareholders meetings in connection with the publication of the book.

The Commercial Leasing Group will be participating in the Lexpert Conference - "Dealing with the Lease" on November 24, 2011. **Stephen J. Messinger** will be the course leader for this conference.

Timothy R. Dunn and **Ryan U. Gelbart** spoke on "The Rights of Unpaid Suppliers" on October 19, 2011 at an event held by Minden Gross and the Association of Corporate Counsel.

Firm News

Minden Gross LLP is pleased to welcome **Daniel R. Wiener** to our Commercial Leasing Group.

Adam L. Perzow was featured as the Lawyer of the Week in the September 16, 2011 edition of *Law Times.*

Stephen Posen and **Stephen J. Messinger** are identified in the Lexpert Special Edition: Canada's Leading Infrastructure Lawyers which was an insert in the Report on Business October 2011 edition.

Minden Gross LLP will hosting the third "Bettering Yourself in Business" evening speaking series on October 26, 2011. Our guest speaker will be Diane Craig.