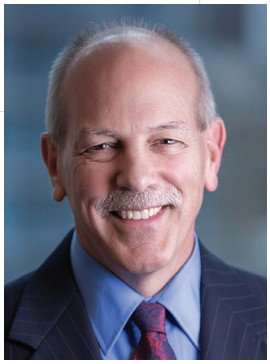

‘Unimproved’ property and rent re-set provisions

Case Comment: The Manufacturers Life Insurance Company v. Parc-IX Limited

BY JOHN SHEVCHUK
Barrister & Solicitor, C. Arb., AAIC (Hon.), RI(BC)

My colleague and fellow arbitrator Richard Olson brought to my attention an interesting rent re-set decision from the Ontario Supreme Court in *The Manufacturers Life Insurance Company v. Parc-IX Limited*, 2018 ONSC 3625 (*Parc-IX*). In *Parc-IX*, Mr. Justice McEwen considered the proper interpretation of a ground lease that called for rent re-set as if the property was “unimproved.” The question was whether “unimproved” should be construed to also mean “unencumbered.” If so, then the re-set rent would be considerably higher.

The background

Parc-IX Limited (Parc-IX) owned an apartment building on land owned by Manufacturers Life Insurance Company Limited (Manulife). In 1964, Parc-IX and the predecessor of Manulife executed a 99-year ground lease that, among other things, called for rent re-sets every 25 years. After the lease was entered, legislation was passed in Ontario that restricted Parc-IX as a leaseholder from using the property for freehold condominium development. There were also demolition controls and rent restrictions that impacted the value as an apartment building. However, as the holder of the freehold interest in the land, Manulife was not so restricted and could have developed freehold condominiums.

The contractual interpretation issue was the effect of the phrase “as if it were unimproved” in the rent re-set clause that provided in part as follows:

> 4. AND YIELDING and paying ...
> (a) for the 25 year period from the 15th day of August 1989 to the 14th day of August 2014, both days inclusive, a sum equal to 6¾% of the fair market value of the property ***as if it were unimproved*** (hereinafter called the “land market value” as of the 15th day of March 1989;
> (b) for the 25 year period from the 15th day of August 2014 to the 14th day of August 2039, both days inclusive, a sum equal to 6¾% of the fair market value of the property ***as if it were unimproved*** (hereinafter called the “land market value” as of the 15th day of March 2014;
> [Emphasis added.]

Manulife argued that the rent re-set must take into account its unrestricted ability to redevelop, whereas Parc-IX argued that the rent could not reflect a potential it was legally prohibited from exploiting.

The first rent re-set in 1989 led to arbitration and judicial review over the interpretation of “as if it were unimproved.” Manulife’s predecessor argued that the phrase incorporated “unimproved” and “unencumbered.” The 1989 arbitration panel disagreed holding that “as if it were unimproved” only referred to the physical state of the property and that the lease itself and the legal encumbrances were not to be taken into account. On judicial review, the court held that the decision was reasonable and dismissed the landlord’s application, but, in *dicta*, the court said that, if the matter had been heard by it in the first instance, they would have interpreted “unimproved” to also include “unencumbered.” Manulife relied upon this *dicta* in the judicial review application before Mr. Justice McEwen.

The 2018 decision

In the 2018 court decision, the court held that the arbitration decision in the first rent re-set was binding on the parties. Mr. Justice McEwen could have stopped there, but he went further and wrote that, while there was support in past case law for Manulife’s position, the law has evolved so that, by itself, the phrase “as if it were unimproved” only allows the parties to disregard the physical improvements and that absent express wording in the lease to the contrary, the parties cannot ignore the legal encumbrances affecting the property.

Consistent with guidance from the Supreme Court of Canada, the judge in *Parc-IX* held that he was to find “... the intention of the parties, as revealed by the plain, literal and ordinary meaning of the words considered in the context of the contract as a whole.”

In *Parc-IX*, the parties agreed that the purpose of the rent re-set clause was to link rent to the changing value of the underlying property and that

"value of the property" refers to the landlord's freehold interest. The parties disagreed on the meaning of "unimproved."

Mr. Justice McEwen referred to the definitions of "improvement" and "encumbrance" in *Black's Law Dictionary,* noting that the former referred to buildings and permanent structures, while the latter related to legal interests that might lead to a dimunition of value. "A property can be unimproved yet encumbered. Conversely, it may be improved and unencumbered. The two words are not synonymous." The court also noted evidence that suggested commercial leases routinely distinguish between improvements and encumbrances.

In *Parc-IX*, the court addressed case law that held it is to be implied that "unencumbered" is intended by the parties on a rent re-set. The logic underpinning those cases is that, since rent re-set is intended to determine a rent based on the value of the land without regard to the terms of the lease in place, it followed that land value should be based on its highest and best use without regard for the restrictions that arise by the type of the improvements and the ownership of those improvements.

On the other hand, more recent cases had taken a different view. In *Musqueam Indian Band v. Glass*, 2000 SCC 52 [*Musqueam*], Mr. Justice Gonthier concluded that, where the lease stipulated for a percentage factor to be applied to the underlying value of the land as the basis for the rent, legal encumbrances could not be ignored absent express wording to the contrary. In *Board of Regents of Victoria University v. G.E. Canada Real Estate Equity,* 2016 ONCA 646 [*Victoria University*], the court took its lead from *Musqueam,* holding that legal encumbrances arising from the lease agreement were to be accounted for in the rent re-set.

At paragraph 111 of *Parc-IX* is the following passage:

> [111] The Court of Appeal [in *Victoria University*] dismissed the landlord's appeal ... Justice Pepall, writing for the court, explained the current state of the law as she saw it arising from *Musqueam*. At para. 40, Justice Pepall stated:
>
> > In conclusion, *Musqueam Indian Band* establishes that, absent a contrary intention in the lease: (a) the word "land" refers to the freehold or fee simple interest in the lands at issue; (b) the word "value" means the exchange value of the land, calculated by determining the "highest and best use" possible; and (c) **fair market value should reflect legal restrictions on the land but should ignore any particular restrictions imposed by the lease itself.** [Emphasis in *Parc-IX*]

In the end, Mr. Justice McEwen in *Parc-IX* relied upon *Musqueam* and *Victoria University* in holding that legal encumbrances affecting Parc-IX were not to be ignored.

Closing

The takeaways from the *Parc-IX* decision include the following:

- Setting rent pursuant to a re-set clause depends upon applying the intention of the parties when the lease was entered.
- The intention of the parties is to be found in the words of the lease according to their plain, literal, ordinary meaning.
- "Improvement" will generally refer to buildings and permanent structures.
- "Unimproved" will generally reference the physical state of the property.
- "Encumbrance" relates to a legal interest in property.
- Absent express wording to the contrary, "unimproved" will not include "unencumbered."
- Rent re-set, under the hypothetical situation of unimproved property, will take into account the effect on value that legal encumbrances have on the property.

End notes

1 Richard Olson is a lawyer, arbitrator and author of *A Commercial Tenancy Handbook* (Carswell) as well as numerous works for British Columbia Continuing Legal Education.

2 *Parc-IX* at paragraph 69 relying upon *Creston Moly Corp. v. Sattva Capital Corp.*, 2014 SCC 53 at paragraph 47.

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.