Do I have to reserve the last day of a lease for a sublease? ONCA says maybe not

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In *V Hazelton Limited v. Perfect Smile Dental Inc*., 2019 ONCA 423 (the Decision), the Ontario Court of Appeal (the Court) considered the longstanding common law requirement that a sublessor reserve at least the last day of the term in any sublease to avoid the sublease being considered a full or absolute assignment, resulting in the forfeiture of the sublessor's leasehold interest. The Court relied on Section 3 of the *Commercial Tenancies Act, Ontario* (CTA), in force in Ontario in various forms since 1895, to clarify that this statute has modified, but not overturned, the common law principle.

In the Decision, the Court finds clear intention to avoid creating an absolute assignment and held that Hazelton reserved the right to extend the term of the lease pursuant to an option contained therein. Accordingly, the Court determined Hazelton, as sublandlord and not as assignor, had properly exercised its option to renew and ordered Perfect Smile (as defined below) to grant possession of the leased premises to Hazelton as soon as possible. Rental rates to be paid during the renewal term will be determined by arbitration.

Background

The appellant, V Hazelton Ltd. (Hazelton), leased commercial premises from the respondent, Perfect Smile Dental Inc. (Perfect Smile) starting in 2010. The lease provided Hazelton a five-year renewal option. In 2016, Hazelton, with the consent of Perfect Smile, entered into a sublease with a retail clothing store. This sublease did not reserve the last day of the term of Hazelton's lease, so that both the sublease and the head lease were set to expire the same day. In the sublease, Hazelton expressly denied the subtenant the right to avail themselves of the renewal option.

In 2017, Hazelton exercised its right to renew the lease, but could not come to agreement with Perfect Smile on rental rates. Two days before the end of the lease, Perfect Smile delivered a letter to Hazelton stating it had no right to exercise its renewal option. Hazelton brought an application seeking, among other relief, a declaration that it had validly exercised its right of renewal, an order that Perfect Smile and the clothing retailer deliver vacant possession, and an order that new rental rates for the renewal term be determined by an arbitrator.

The application judge considered case law standing for the propositions that:

(i) generally speaking, where rights granted in a sublease are more restrictive than those contained in a head lease, the result is that the rights not granted to the subtenant are reserved to the tenant (relevant in this case as Hazelton had specifically reserved the renewal option in the sublease)

(ii) the "ancient common law" proposition that where a tenant has sublet the tenancy but has not reserved at least the last day of the head lease term for itself, the sublease is deemed an assignment.

The application judge did not reconcile these two competing ideas, but found instead that Perfect Smile had breached its contractual duty of good faith (*Bhasin v. Hrynew*, 2014 SCC 71) and that Hazelton did not suffer any losses and therefore could not claim damages.

Court of Appeal Decision

The Court of Appeal reviewed the nature of a commercial lease, the common law rule regarding the failure to reserve the last day and case law from other Canadian jurisdictions that expanded the notion of a reversionary interest, though chose not to import any of the latter into Ontario law. Instead, the Court noted that neither Hazelton nor Perfect Smile had brought Section 3 of the CTA to the attention of the application judge. Section 3 of the CTA stipulates "four negatives":

1. The relation of landlord and tenant does not depend on tenure;
2. A reversion in the lessor is not necessary in order to create the relation of landlord and tenant;
3. A reversion in the lessor is not necessary in order to make applicable the incidents of law belonging to the landlord-tenant relation; and
4. An agreement is not necessary in order to give a landlord a right of distress.

The leading case on Section 3 is *Kennedy v. Agricultural Development Board (1926)*, 59 OLR 374 (HC) and the court notes few cases have dealt with the provision since. After a quick overview of the few cases and commentators that have discussed Section 3 over more than a century, the Court interprets Section 3 to mean that "there may be a sublease even if the last day in the head lease is not reserved, but only where there is sufficient evidence to show that the objective intention of the parties, as reflected in the sublease, was not to create an assignment". This interpretation maintains the distinction between subleases and assignments and recognizes the dual-nature of leases as both conveyances and contracts. Going forward, parties engaged in leasing in Ontario will need to consider the influence of Section 3 of the CTA on the drafting of subleases and expressly indicate or make clear that there is or is not an intention to assign absolutely.

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