DRAFTING THE FAIR MARKET RENT DEFINITION

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Unless an option to renew a lease specifies either the rent at which the lease will be renewed or a formula for determining the rent, the option risks being viewed as an unenforceable agreement to agree. Most options to renew provide that the formula for determining the rent on renewal will be the fair market rent at the time of renewal. Further, most leases provide that if the parties are unable to agree as to the amount of fair market rent, the mechanism for determining such amount will be arbitration.

In its simplest form, the renewal clause may simply provide that the “rental payable under the [renewal] of the lease will be the fair market rent for the Premises as mutually agreed upon by the parties”. Surprisingly, there is little case law on what constitutes “fair market rent”. However, in an attempt to reduce risk and leave less to the vagaries of arbitration, a trend has emerged whereby landlords and tenants are increasingly qualifying renewal provisions with factors to be included or excluded in the determination of fair market rent. Ironically, qualifications, particularly those that are restrictive, can cause difficulties for appraisers in obtaining suitable market data and for arbitrators in making accurate determinations.

“Fair Rent” vs. “Fair Market Rent”

It is worth noting that there is a distinction between a “subjective” and “objective” approach to determining rent on renewal, as dictated by the terms of the renewal option. A renewal option which provides that the rent on renewal is simply to be “fair” or “reasonable” without reference to external market factors is considered a “subjective” approach. In this case, the rent would be determined on the basis of what would be fair or reasonable as between the particular landlord and the particular tenant in the particular circumstances.

Some authors have argued that a clause leading to a subjective determination can produce a better result for a tenant, as it gives the tenant the opportunity to argue for lower rent where (i) the tenant has paid for leasehold improvements it has installed in the premises, (ii) the tenant has a strong covenant (reducing the landlord’s risk), or even (iii) a lower rent would be required for the tenant to be able to make a profit in the premises. These clauses are rare, however, perhaps because the absence of an objective standard reduces certainty by allowing the determination as

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1 Fire Productions Ltd. v. Lauro, 2006 BCCA 497 at para. 3 [Fire Productions (CA)], rev’g 2005 BCSC 1414 (BCSC) [Fire Productions (BCSC)].


3 Thomas Bates & Son Ltd. v. Wyndham’s (Lingerie) Ltd., [1981] 1 All ER 1077 at 1088 [Thomas Bates].

to what is “fair” or “reasonable” in the circumstances to be made without the necessity of obtaining comparisons. It would be unusual to find such a clause today.

In *Fire Productions (CA)*, the tenant argued that because the renewal provision used the words “the fair market rent for the Premises”, an element of subjectivity was introduced by the word “fair”. The court dismissed the argument, determining that the word “fair” adds nothing to the meaning of market rent except that the market is to be considered a consistent market unaffected by significant transient fluctuations that may be evident at the time of renewal.5

**Value of Improvements**

A traditional source of negotiation between landlords and tenants is whether the premises should be viewed as being improved (“as is”) or unimproved (“as was”) when considering the fair market rent for the premises. The cases in Ontario on this point have gone in both directions, turning on the specific provisions of the lease.6

The impact of the inclusion or exclusion of leasehold improvements in fair market rent will have a larger impact on businesses which require larger investments in the premises, such as high end retailers. In *Desouza v. Sherwood Heights Plaza Ltd.*,7 the court considered the renewal of a lease for a dental office, in which the dentist had invested significantly in the improvements. The lease provided that the rent for the renewal period would be the fair market rental then prevailing for premises of a similar character in a similar location. The court held that “premises of a similar character in a similar location” should be interpreted as an “unimproved rental unit”.8

The positions typically taken by landlords and tenants in negotiating renewal provisions were played out between the British Columbia Court of Appeal and British Columbia Supreme Court in *Fire Productions Ltd. v. Lauro*.9 These cases dealt with a restaurant where the difference between the calculation of rent with or without the value of the improvements was $19.00 per square foot versus $13.66 per square foot.

The court at first instance was persuaded by the position often taken by tenants. By including the tenant improvements in the valuation of the premises for the calculation of rent, the tenant would be paying for its investment twice. The court quoted Chief Justice Davey in *Re The Queen in Right of Canada and Lynnwood Marinaland Ltd.*10 stating:

> Under the lease the tenant acquired a leasehold estate upon which he was entitled to make these improvements. To make him pay an increased rent for improvements which he had made during the term of the lease would be to make him pay rent upon a value created by his authorized expenditures, and so diminish

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5 *Supra* note 1 at para. 8.
6 *VAV Holdings Ltd. v. 720153 Ontario Ltd.*, [1996] 66 A.C.W.S. (2d) 1018 (Ont. C.A.) at para. 3.
8 *Ibid.* at para. 3.
9 *Supra* note 1
10 *Re The Queen in Right of Canada and Lynnwood Marinaland Ltd.*, [1971] 20 D.L.R. (2d) 589 (BCCA) [Lynnwood Marinaland].
the worth of his leasehold estate. I think if such a result was intended, it should have been expressed in clear language that is wanting.\textsuperscript{11}

The Court of Appeal, reversing the lower court decision, noted that under the terms of the lease, all improvements made by the tenant became the property of the landlords on affixation.

The specific language of the renewal provision provided that:

\[\ldots\text{the rental payable under the [renewal] of the lease will be the fair market rent for the Premises as mutually agreed upon by the parties hereto within one (1) month after the giving of such notice}\ldots\text{.} \textsuperscript{12}\]

Justice Lowry for the Court of Appeal interpreted the meaning of “fair market rent” as follows:

It seems clear to me that the use of the word “market” in this lease to define the rent paid for the renewal can only mean that the rent to be paid is the rent the premises would attract if exposed to the market at the time of renewal. In my view, the language precluded excluding the value of the tenant’s improvements in calculating the rent.\textsuperscript{13}

Given that the tenant improvements became the landlord’s property on installation, the court held:

The tenant has not been disadvantaged if on exercising his right of renewal he is required to pay the rent the landlord would be able to obtain if the lease was not renewed. The tenant may in one sense be paying interest on the improvements he made, but he has the continued use of the improvements, which have become the property of the landlord, to the end of the renewal period.\textsuperscript{14}

The court then noted the importance of the renewal language in the particular lease:

It is all a matter of the bargain driven when the parties enter into the lease and it is then essential that effect be given to the wording the parties actually employed to express their bargain in any given instance. In this case, the bargain made in terms of the renewal rent to be paid favoured the landlords.\textsuperscript{15}

Given the fact-based and language-specific nature of the cases relating to the inclusion or exclusion of the value of leasehold improvements in the calculation of fair market rent, landlords should not assume that the value of leasehold improvements will always be included in the calculation. On the other hand, tenants should assume that the value of leaseholds will likely be excluded and, if they have bargaining power, negotiate for the exclusion of the value of the leaseholds improvements.

\textsuperscript{11} Supra note 1, Fire Productions (BCSC) at para. 21.
\textsuperscript{12} Supra note 1, Fire Productions (CA) at para. 3.
\textsuperscript{13} Ibid. at para. 7.
\textsuperscript{14} Ibid at para. 14.
\textsuperscript{15} Ibid.
Tenant Inducements

A tenant, when deciding whether to renew or relocate, will likely consider a number of factors, including the age of the existing premises, the cost of moving, the loss of any goodwill associated with the current location (or the opportunity to improve business through operating at a better location), any write-off of existing assets, and the cost of building or completing the new premises. Tenant inducements associated with the alternative premises, including a tenant allowance and rent free period, will also factor into the analysis.

Leasing professionals sometimes employ the concept of “net effective rent” as a means to compare different lease offers on an “apples to apples” basis. This concept takes into account, among others things, tenant inducements, operating costs, leasing commissions, length of term, and the timing of rent increases.

While there does not appear to be any case law determining how tenant inducements should be treated in the determination of fair market rent absent specific language in the lease, it stands to reason that tenant inducements should be considered in any analysis of comparables in order to determine market rent. Some landlords’ forms attempt to overcome the impact of inducements, by avoiding any reference to “fair market rent” and instead providing for the renewal rent to be determined on the basis of “the market face rate for similarly improved space”. Simply looking at other market face rates arguably avoids any discussion of the impact of tenant inducements. Tenants may deal with the issue directly by negotiating for the inclusion of language such as “such fair market rent shall be reduced to reflect tenant inducements”.

Taking a different approach, one large U.S. landlord puts all relevant information on the table in the determination of fair market rent and specifies taking into consideration:

- Location in the Building or other building, tenant improvements or allowances existing or to be provided, rental abatements, lease takeovers/assumptions, moving expenses and other forms of rental concessions, proposed term of lease, extent of service provided or to be provided, the ownership of the comparable space, whether or not the transaction is a sublease, the time the particular rate under consideration became or is to become effective and any other relevant terms or conditions. Costs which are incurred by a landlord in connection with the negotiation and documentation of a lease transaction, and other costs incurred by a landlord which are not paid to or for the direct benefit of the tenant, shall not be considered. Comparable transactions in which the rent for a renewal was discounted to a rate below the fair market rate, whether by the application of a percentage to the fair market rate or otherwise, shall be adjusted to reflect the fair market rate before the discount was applied. Renewal transactions in which the rent was either established at a pre-determined amount by reason of the exercise by the tenant of an option to renew or extend at a fixed rental rate or was established due to the operation of a pre-determined minimum or maximum amount shall not be regarded as comparable transactions.
Restrictions on the Use of the Premises

While not commonly used, some landlords’ forms of leases provide that in determining the fair market rent, the use of the premises is assumed to be the “highest and best use”.

The issue relates to whether, in considering the fair market rent, restrictions on the use of the premises must be taken into account, and if so, whether such restrictions would decrease the rental value of the premises. Where “use” under a lease is restricted to a generic use such as “office use” and the building is located in the downtown core, it is hard to imagine the restriction on use making any difference to the rental value. However, where the use is more specific, such as operation of a “family restaurant”, for instance, the issue arises as to whether the restriction on use would decrease the potential rental value in the market.

The British Columbia Court of Appeal considered this issue in *Pacific West Systems Supply Ltd. v. B.C. Rail Partnership* where the lease restricted the use of the premises to the construction and operation of a building supply business. The landlord maintained that the use restriction was not to be considered in determining fair market rent for the lands in the absence of specific direction to that effect in the lease. The tenant took the position that restrictive terms of the lease should be taken into account in determining fair market rent. The court looked to the intention of the parties and held:

> In the absence of express provisions to the contrary, I see no sound basis on which is 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 land when it is precluded from enjoying what may be the highest and best use.

The court determined that in considering the rental rate that the landlord would be able to obtain in the market at the time of the review, the terms of the lease must be taken as they are and that the restriction on use must be considered. The court said that it cannot be assumed that the landlord would be able to obtain a higher rate by informing a prospective tenant that the stated restriction on the use of the lands would be waived. In this case, the decision resulted in a forty percent reduction in the rent assessed by the arbitrator in the first instance.

*Pacific West* suggests that with respect to leases containing unique restrictions on use, landlords would be well-served by including in the renewal provision that restrictions on use contained in the lease are not to be taken into account in the determination of a fair market rent.

The case also suggests that other factors contained in a lease may have an effect on a determination of the fair market rent. One can imagine an argument that an exclusive use granted to a tenant would increase the market value of the rent.

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16 The Canadian Uniform Standards of Professional Appraisal Practice effective January 1, 2012 defines “highest and best use” at paragraph 2.30 in the definitions section as “the reasonably probable and legal use of property, that is physically possible, appropriately supported, and financially feasible, and that results in the highest value.”

17 *Pacific West Systems Supply Ltd. v. B.C. Rail Partnership*, 2004 BCCA 247 [*Pacific West*].

Strength of Covenant

A tenant with a stronger financial covenant (or a tenant providing the guarantee of a company with a strong covenant) should pose less risk to a landlord than a tenant with a weaker covenant. The issue of risk has inevitably come into greater focus in the last few years because of the weaker economy.

There do not appear to be any cases dealing with whether the strength of tenants’ respective covenants should be considered when assessing comparable locations. In practical terms, trying to compare the strength of financial covenants would often be difficult to accomplish as financial information is frequently not readily available.

Most often, there would be no way to predict whether including the strength of tenants’ financial covenants would work in favour of a tenant or a landlord in the determination of market rent. In some cases, the tenants occupying the comparable premises would be stronger and in other cases weaker. However, a tenant with a particularly strong covenant could be well-advised to negotiate the inclusion of reference to strength of covenant when looking at comparables, as it could only work to that tenant’s advantage.

Other Considerations

In a perfect world, all relevant factors would be considered in the calculation of the fair market rent. In some cases, however, landlords are drawing particular attention to the distinguishing elements of their own buildings in order to disqualify other potentially comparable premises from being included in the sample of comparables. For example, one Toronto landlord’s lease provides that the renewal rent will be determined by the then current market rate for similar premises with similar amenities such as LEED Certification and connection to the PATH.

The timing of the market rate is sometimes specified in the renewal option (such as “the fair market rent as of one month prior to expiry of the term”). While such specificity may reduce later conflict in the event of a shift in the market, it is difficult to see how in general terms this could benefit one party over the other.

Generally speaking, once the tenant validly exercises its right of renewal, both parties are locked into the renewal process; some leases provide otherwise. At least one landlord’s form of lease provides that if the tenant does not adopt the landlord’s estimation as to market rent, the tenant may rescind the exercise of its option, failing which the tenant is deemed to have accepted the landlord’s estimation. Conversely, at least one tenant’s lease affords the tenant the opportunity to rescind the exercise of its option to renew if it does not prefer the arbitrator’s determination of the market rent.

Conclusion

Market rent provisions seem to be expanding as landlords and tenants try to reduce the risk inherent in third party determinations of what constitutes fair market rent. While there is currently surprisingly little case law, one would only expect these clauses to continue to expand as further case law develops and the respective parties attempt to overcome perceived deficiencies in their legal positions.