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The boundaries between residential tenancies and commercial leases

David Grinlinton, University of Auckland, on *Holler v Osaki*

INTRODUCTION

The law of landlord and tenant in New Zealand is based primarily on the common law, although since the early part of the last century there has been increasing legislative protection for residential tenants. Early measures such as pt I of the War Legislation Amendment Act 1916, the Fair Rents Act 1936 (and its amendment in 1942), and the Tenancy Acts of 1948 and 1955 provided controls on rent increases and protections against early termination. A much expanded regime for residential tenancies was introduced under the current Residential Tenancies Act 1986 (RTA 1986). Commercial leases have also been subject to increasing legislative intervention including measures contained in the Property Law Act 1952 and its successor the Property Law Act 2007 (PLA 2007). While both measures enshrined many of the pre-exisiting common law principles applicable to leases, the 2007 Act made a number of fundamental changes. One such change provided commercial lessees with a limited immunity from claims by the lessor for negligently caused damage where the lessor has insured the premises (PLA 2007, ss 268–271). In this article, to avoid confusion, 'landlord' and 'tenant' will refer to parties to a residential tenancy, while 'lessor' and 'lessee' will refer to parties to a commercial lease.

The recent Court of Appeal decision in *Holler v Osaki* [2016] 2 NZLR 811 (CA) appears to have blurred the hitherto clear distinction, in terms of applicable legal principles, between residential tenancies and commercial leases. The case concerned a subrogated claim by the landlord's insurer against the tenant, Mr Osaki, for negligently caused fire damage to the premises. In that case the Court held that, in determining disputes between landlords and tenants, the Tenancy Tribunal may apply "general principles of law" found in pt 4 of the PLA 2007 to achieve a "fair and expeditious resolution" of the matter. Specifically it upheld the lower courts' findings that ss 268–269 of the PLA 2007 could be applied to residential tenancies to exonerate tenants from negligent damage where the landlord has insured the premises. This outcome may seem relatively innocuous and even consistent with the "fairness and expeditious resolution" and "merits and justice" focus of dispute resolution required of the Tribunal under s 85 of the RTA 1986. However, the decision to effectively extend to residential tenancies the immunity of commercial lessees from suit for negligently caused damage where the lessor has insurance has resulted in some residential tenants ignoring, or treating with impunity, their repair obligations under the terms of their tenancies and under ss 41 and 42 of the RTA 1986 (see Melissa Nightingale "Landlords struggle to claim on tenants accidental damage" New Zealand Herald (online ed, 14 October 2016)).

Of even greater concern is the apparent expansion of the jurisdiction of the Tribunal to a point where some provisions under the RTA 1986 may now be treated as interchangeable with, or able to be overridden by, general principles applicable to commercial lease relationships under pt 4 of the PLA 2007. This state of affairs has led the Principal Tenancy Adjudicator to write to the Minister of Housing pointing out the consequences to the Tribunal of the decision (letter from Melissa Poole, Principal Tenancy Adjudicator to the Hon Nick Smith, Minister of Building and Housing (23 September 2016) available at <www.beehive.govt.nz/release/tenancy-law-change-damage-claims-being-considered>). Some extracts of the letter include:

> The Court of Appeal decision demonstrably hampers the day-to-day functioning of the Tribunal …
>
> [T]he Tribunal's capacity to discharge its role as defined in the long title to the Act — "to determine expeditiously disputes arising between … landlords and tenants" — [is] … adversely affected.
>
> The *Osaki* decision also means that there is inconsistency of outcome for landlords and tenants depending on whether a landlord is insured for the particular risk …
>
> The Tribunal now operates daily with an unwieldy amalgam of legislation and binding judicial precedent that has effectively fettered a core principle of the Residential Tenancies Act 1986.

This is a clear call from the Tribunal for legislative intervention to rectify the outcome of *Holler v Osaki*, which may not be appealed further to the Supreme Court.

The Government has responded with an expressed intention to intervene by allowing tenants to be pursued for negligently caused damage, even where the landlord holds insurance, but with liability restricted to the amount of the bond held by the landlord (Hon Nick Smith, "Tenancy law change on damage claims being considered" (press release, 15 October 2016)). This seems a hastily conceived and unprincipled solution to the specific problems caused by *Holler v Osaki*. It does not effectively address the broader implications of the decision which blurs the distinction between residential tenancies and commercial tenancies, allowing the Tenancy Tribunal to potentially apply other "general principles" from pt 4 of the PLA 2007 in residential tenancy

disputes. Nor does it address the impact upon established principles of insurance law, and an insurer's right of subrogation.

THE PURPOSE OF RESIDENTIAL TENANCY LEGISLATION

Traditionally tenancy protection legislation was enacted to protect tenants in situations of unequal bargaining power. The RTA 1986 continues this theme, although it takes a more balanced approach in an attempt to create a 'level playing field' between landlords and tenants. In his introduction speech in 1985 the then Minister of Housing, the Hon Phil Goff, noted the measure "leans in favour of neither side in the tenancy relationship" ((19 September 1985) 466 NZPD 6896).

The RTA 1986 introduced a number of major reforms including: better security of tenure with minimum periods for notice to quit, rent control, the holding of bonds by an independent government agency, alternative dispute resolution, and a dedicated Tenancy Tribunal to determine disputes. Section 85, RTA 1986, requires the Tribunal to exercise its jurisdiction "in a manner most likely to ensure the fair and expeditious resolution of disputes", and to determine disputes "according to the general principles of law relating to the matter and the substantial merits and justice of the case" while "not [being] bound to give effect to strict legal rights or obligations or to legal forms or technicalities". Section 142 of the Act (as amended by the PLA 2007) provides (emphasis added):

(1) Nothing in Part 4 of the Property Law Act 2007 applies to a tenancy to which this Act applies.

(2) However, the Tribunal, in exercising its jurisdiction in accordance with section 85 of this Act, *may look to Part 4 of the Property Law Act 2007 as a source of the general principles of law* relating to a matter provided for in that Part (which relates to leases of land).

Part 4 of the PLA 2007 contains a number of provisions and reforms applicable to commercial leases, including: form, duration and effect of leases (ss 208–214); the effect of sub-leases for terms equal to or longer than the head lease (ss 215–216); implication of certain covenants, powers and obligations (ss 218–223); consent to alienate, change use and so on (ss 224–229); the effect of transfers of reversions and assignment of leases (subpts 4 and 5); allowing personal covenants to run with the land (s 240); a specific code for cancellation of leases and relief (ss 243–264); abolition of distraint (s 265); removal of fixtures (s 266); unlawful eviction (s 267); and the exoneration of lessees from liability for negligent damage if the lessor is insured (ss 268–272). Section 8(4) of the PLA 2007 arguably limits the broad effect of s 142(2) RTA 1986 by providing that in the event of a conflict between provisions in the PLA and those in another Act, the provisions in the other Act must prevail. It is this complex matrix of provisions with which the Courts in the *Osaki* series of decisions had to deal.

THE COURT DECISIONS

The case followed a convoluted path with decisions from the High Court, Tenancy Tribunal, District Court, High Court (again) and Court of Appeal. With respect, all the decisions, with the exception of the Tenancy Tribunal determination which was overturned on appeal, raise concerns and have left the hitherto well understood legal regime for residential tenancies in disarray.

Mr Osaki entered into a tenancy agreement with the plaintiff landlords Andreas Holler and Katherine Rouse on 15 September 2006. In early 2009 Mrs Osaki accidentally caused a fire while cooking. This caused over $200,000 of damage. The landlords' insurer paid out for the repairs and brought a subrogated claim in the High Court against Mr Osaki for breach of s 41 of the RTA 1986, and against Mrs Osaki (who was not a party to the tenancy) in negligence. The Osakis challenged the jurisdiction of the High Court, arguing that (*Holler v Osaki* [2012] NZHC 939 at [11]):

- the Tenancy Tribunal had exclusive jurisdiction, and
- they were protected by the immunity provisions in ss 268 and 269 of the PLA 2007 as the landlord had insurance cover which they believed also protected them.

Justice Abbott, relying heavily on Randerson J's decision in *Auckland City Apartments Ltd v Stars and Stripes Ltd* (HC Auckland CP 429/99, 9 November 1999), agreed and remitted the matter back to the Tribunal. *Stars and Stripes* involved a lease of premises that was for both residential and commercial purposes. The Judge considered that even though the claim exceeded the Tribunal's statutory limits, that body had jurisdiction to determine whether the tenancy was subject to the RTA 1986, and whether the term should be reduced in the circumstances of that case. Such matters, relating to the nature and term of a tenancy, are covered in various sections in the RTA 1986, and appropriately within the Tribunal's jurisdiction to determine. In contrast, it is unlikely that the legislature intended the Tribunal to decide the more fundamental matters of statutory interpretation that were raised in the *Holler v Osaki* case. These include the question of whether general sections in the PLA 2007 that dramatically changed the pre-existing rules of commercial lessee liability for negligently caused damage and the insurer's right of subrogation, extend to residential tenancies. Such questions require a legally complex analysis of whether s 142(2) of the RTA 1986 overrides the clear indications in s 142(1) of the RTA 1986 and s 8(4) of the PLA 2007 that the latter measure is not intended to apply to residential tenancies. The Tribunal is not a court of record, and its adjudicators do not necessarily have to be legally qualified (RTA 1986, s 67(5)(b)). This adds to the unlikelihood that such far-reaching legal questions were intended by Parliament to be determined by that body. In such cases the Tribunal may state a case for the High Court's opinion on questions of law under s 103, RTA 1986.

Having been given the task, the Tribunal adjudicator undertook a very thorough analysis of the legislation and decided that Mr Osaki was not protected by ss 268 and 269 for fire damage caused by his wife. He considered s 85 of the RTA 1986 did not give the Tribunal *carte blanche* to decide cases on its perception of merits and justice where this overrode relevant principles of law. Specifically it could not use its "broad jurisdiction" under s 85 (including the ability to look to pt 4 of the PLA 2007 as a "source of general principles" under s 142(2) of the RTA), to override the specific obligations of residential tenants in ss 40 and 41 of the RTA 1986 to keep the premises in a reasonably clean and tidy condition and not to carelessly damage the premises. The adjudicator also found the Tribunal had no jurisdiction over Mrs Osaki as she was not a tenant.

On appeal the District Court overturned the Tribunal decision finding that the Osakis were entitled to the protection of ss 268–269 of the PLA 2007, and were therefore

immune from a subrogated claim by the landlord's insurer (*Osaki v Holler* DC Auckland CIV-2012-004-002306, 23 September 2013). The District Court relied upon its assumption of the powers of the Tribunal under s 85 when hearing appeals (s 117(4), RTA 1986). It appears to have assumed that these powers included the extended ability of the Tribunal "to look to" pt 4 of the PLA 2007 for general principles of law as provided by s 142(2) RTA. However, s 85 is the statutory source of the District Court's jurisdiction on appeal, and that section does not import s 142(2). If the legislature had intended the District Court to also have that expanded jurisdiction, surely it would have clearly said so in s 117(4) RTA, as it did for s 85? It is an interesting paradox that the Tribunal, having had the legal question remitted to it in order for it to apply its "specialist knowledge and experience", and having determined the matter accordingly, should then be overturned by an appellate body not endowed with that specialist knowledge and experience. Through s 117(1) and (4) of the RTA 1986 the District Court assumed the extended jurisdiction of the Tribunal that neither the District Court, nor the higher courts, would be able to do in a claim that came directly to those courts.

The landlords appealed to the High Court, which upheld the District Court decision (*Holler v Osaki* [2014] 3 NZLR 791). Keane J referred to the Law Commission's first paper on reform of the PLA 1952 (*The Property Law Act 1952: A Discussion Paper* (NZLC PP16, 1991)) on reform of the Property Law Act. Ultimately he was persuaded that the legislative intention behind the measure allowed the immunities enjoyed by negligent commercial lessees under ss 268 and 269 of the PLA 2007 where the lessor has insurance should extend to residential tenants. He considered that, as a matter of public policy, the rules applicable to commercial leases and residential tenancies should not be "radically or inexplicably" different (at [37]).

The landlords appealed again to the Court of Appeal (*Holler v Osaki* [2016] 2 NZLR 811 (CA)). They argued *inter alia* that s 8(4) of the PLA 2007 states that in the event of inconsistency between a provision in that Act and another Act, the other Act prevails. Thus, as ss 268 and 269 of the PLA 2007 are inconsistent with ss 40 and 41 of the RTA 1986 (which require tenants and others for whom a tenant is responsible not to intentionally or carelessly damage the premises), ss 40 and 41 must prevail (at [13]–[14]). They further argued that, while s 142(2) of the RTA 1986 allowed the Tenancy Tribunal to look to pt 4 of the PLA 2007 for guidance where the RTA is silent on a matter, it did not "permit a provision to apply that is inconsistent with the general scheme of the RTA" (at [15]).

The Court considered there was no conflict between ss 40 and 41 of the RTA 1986 and the immunity provisions in ss 268 and 269 of the PLA 2007 such as to contravene s 8(4) of the PLA 2007 (at [27]). It justified this finding on the basis that there is no direct obligation on a tenant to make good the damage or compensate the landlord. Furthermore, while the Tribunal has jurisdiction under s 77(2)(n) of the RTA 1986 to order damages to be paid by a tenant in such a case, the Court considered that to be a provision with general application and not in conflict with ss 268 and 269 (at [28]). With respect, whether the discretion in s 77(2)(n) to order damages may conflict with ss 268 and 269 of the PLA 2007 seems irrelevant. A s 77(2)(n) order is discretionary, and in fact the application of ss 268 and 269 by the Tribunal under s 142(2) of the RTA is also discretionary. Rather, the critical question is whether the obligations of a tenant under ss 40 and 41 of the RTA 1986 are in conflict with the application of ss 268 and 269 of the PLA 2007 to exonerate residential tenants from the clear obligation to ensure that premises are not carelessly or intentionally damaged simply because the landlord holds insurance. With respect, to apply ss 268 and 269 to residential tenancies via the circuitous route of s 142(2) and s 85 of the RTA 1986 to override a tenant's obligations under ss 40 and 41 of the RTA 1986 appears to be in clear contravention of s 8(4) of the PLA 2007.

The Court also found support from the lack of any direct reference in the RTA 1986 to the right of a landlord's insurer to bring a subrogated claim against a tenant in the case of damage. This is a curious justification given that the right of subrogation is a general principle of the common law applicable to insurance and has never required a specific facilitating legislative provision for its exercise.

The Court also considered that it was necessary to give s 142(2) some meaning, or its inclusion would be pointless. Examining the various matters in pt 4 of the PLA 2007 that could be classified as "general principles of law", it concluded there were very few, and that ss 268 and 269 were probably the "best candidates" (at [24] and [30]). With respect, this analysis appears to overlook many other "general principles" in pt 4 of the PLA 2007 which could be looked to for guidance by the Tribunal, and may not necessarily conflict with specific provisions of the RTA. These might include the provisions in ss 225–228 concerning the situation where a lessor has a discretion to give consent and unreasonably refuses to do so; principles relating to quiet enjoyment (s 218 and sch 3, cl 9); non-derogation of the grant (s 218 and sch 3, cl 8); and granting of relief where a landlord refuses to grant a renewal of a lease, honour a right of first refusal for the tenant to purchase the reversion, or cancel a lease (ss 253–262). Given the quite dramatic effect of ss 268 and 269 on the legal *status quo ante*, and the clear confict with ss 40 and 41 of the RTA, there is a strong counter-argument that ss 268 and 269 are the *least likely* candidates in pt 4 of the PLA 2007 to be regarded "general principles of law" available to the Tribunal for guidance under s 142(2) of the RTA 1986.

As in the High Court, the Court of Appeal looked to the historical development of the reform of the PLA 1952, and the various reports and draft Bill developed by the Law Commission in the 1990s. The Court gave significant emphasis to comments in the Law Commission's 1991 *Discussion Paper* (NZLC PP16, 1991) that supported the argument that the immunities for commercial lessees provided in ss 268 and 269 should extend to residential tenants (at [466]). It gave much less emphasis to the Commission's final 1994 report (*A New Property Law Act* (NZLC R29, 1994)), which did not repeat those comments, and in fact stated that the measures in the draft Bill relating to leases should not apply to residential tenancies (at [4]). Similarly, both the introduction speech ((14 November 2006) 635 NZPD 6461), and the introductory notes to the Property Law Reform Bill 2006 (89-1, at 79) indicate the measures were intended to apply to commercial leases only.

From the preceding analysis it would seem that there are a number of critical aspects of the Courts' reasoning at all levels of the litigation that are, with respect, arguably flawed.

The Court of Appeal decision may not be appealed further in this case, so unless the decision is overruled in subsequent litigation on the same issue, or there is legislative intervention, the decision stands.

THE PRACTICAL IMPLICATIONS OF *HOLLER V OSAKI*

In summary, the decision has:

- altered the delicate balance in the landlord/tenant relationship and specifically the ability of landlords to enforce basic obligations of tenants to take care of premises;
- removed the right of a landlord's insurer to bring a subrogated claim to recover the loss caused by a negligent or careless tenant and thus altered the risk that underpins insurance contracts for leased premises;
- created confusion and uncertainty in the relatively settled law applicable to residential tenancies, including the potential application of other "general principles of law" contained in pt 4 of the PLA 2007 to residential tenancies; and
- undermined the effective and efficient delivery of the administration and dispute resolution functions of the Tenancy Tribunal.

The Tribunal has set out in its *Practice Note 2016/1: Tenant Liability for Damages* (26 July 2016) the procedure it will follow in such cases following *Holler v Osaki*. First the landlord must show on the balance of probabilities that the damage was caused by the tenant, or someone on the premises with the tenant's permission, and exceeds fair wear and tear. The tenant must then show the damage was not intentional or the result of an illegal act. Once these thresholds are met the Tribunal may exercise its jurisdiction under s 85 (as expanded by s 142(2) of the RTA), and exonerate the tenant if ss 268 and 269 of the PLA 2007 apply. If those sections do not apply, or the Tribunal chooses not to exercise its discretion to "look to Part 4 of the PLA 2007", the Tribunal can proceed to adjudicate on the matter unless the claim exceeds $50,000, in which case it is remitted to the District Court. It is worth noting at this point that approximately 14 per cent of residential landlords are local councils, or Housing New Zealand, which usually 'self-insure'. This is a significant anomaly as tenants in such housing — who may be the least likely to afford to be able to pay compensation for damage — would not be entitled to the immunity available under ss 268 and 269 of the PLA 2007.

The immunity provisions are also inapplicable where damage has been caused by the intentional acts of the tenant or his/her invitees (perhaps persistent breach of 'no pet' clauses, or failure to rectify a recurring cause of damage could be regarded as intentional); where damage is caused by imprisonable offences (violent confrontations, illegal drug manufacture); or where the landlord's insurance is not recoverable due to some act of the tenant (s 269(3)).

Section 270 also counterbalances to some extent the immunity provisions in ss 268 and 269 by allowing the landlord to terminate the lease on reasonable notice where he/she cannot obtain or retain insurance on reasonable terms due to damage caused by the tenant or the tenant's invitees. Section 271 allows the tenant to acknowledge that the landlord does not have insurance over the premises or some part thereof, in which case the tenant would be liable. Assuming the Tribunal would also "look to" ss 270 and 271 of the PLA 2007 if it decided to apply ss 268 and 269, this raises further conflicts with the protective purpose of the RTA 1986. For example, a landlord may elect to terminate a tenancy by invoking s 270(1) arguing insurance cannot be obtained on reasonable terms. Is the "reasonable notice" required in such a situation governed by the guaranteed 90-day termination period that is a fundamental protection for tenants under the RTA 1986? At a broader level it also foreshadows the possibility that landlords may elect to divest themselves of rental property, thus reducing the available stock in a time of housing shortages in some urban areas. The ability to recover higher insurance premiums from tenants under s 270(2) directly conflicts with restrictions on rent increases in ss 24–28 of the RTA, and the obligation of a residential landlord to pay for insurances held under s 39(2)(b) of the Act. How is this to be resolved without undermining quite specific statutory protections for tenants in the RTA 1986? The option for a tenant under s 271 PLA 2007, to agree that the landlord does not carry insurance, or may only have partially insured the premises, carries further risks for both landlords and tenants.

The implications of *Holler v Osaki* on the residential tenancy sector have become apparent in the latter half of 2016 with many well-publicised cases of tenants treating their repair obligations with impunity relying upon their perceived immunity from suit. It has arguably created a significant change in the balance of power between landlords and tenants in respect of such obligations, with increasing hostility and distrust in landlord-tenant relationships.

In terms of implications for the insurance sector, the effective removal of the right to bring a subrogated claim against a negligent tenant has taken away a fundamental element of the insurance contract, and has altered the assessment of risk. Flow-on effects include increased insurance premiums, greater limitations on coverage and increased excess charges for individual claims.

There have also been serious implications for the Tenancy Tribunal's functions, including its ability to expeditiously determine disputes between parties. These have already been adverted to in the introductory comments in this article.

A greater concern, however, is the potential of the decision to allow a wide range of rules and legal principles contained in pt 4 of the PLA 2007 into the resolution of residential tenancy disputes through the avenue of ss 142(2) and 85 of the RTA 1986. This would appear to be the broader effect of the decision given that ss 268 and 269 have been accepted by the Court of Appeal as appropriate matters for the Tribunal to "look to" via s 142(2) despite the clear conflict with the repair obligations of tenants in ss 40 and 41 of the RTA 1986. In this writer's view the decision has created an unacceptable blurring of the rules and legal principles that apply to commercial leases and residential tenancies.

POSSIBLE SOLUTIONS

The Government has recently suggested that it will amend the legislation to limit tenant liability for damage caused by carelessness or negligence "to the value of their landlord's insurance excess but not exceeding four weeks' rent" (being the standard tenancy bond). The parties could agree to a different amount, and the tenant could still take out their own insurance if they preferred (Hon Nick Smith, "Tenancy

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law change on damage claims being considered", above).

While pragmatic, the solution appears hastily conceived, arbitrary and unprincipled. First, it fails to address the common situation where a tenant may commit a number of successive acts of carelessness or negligence over a long period of time, which normally constitute separate claims in an insurance context. Does the proposal mean the limit will be the value of the insurance excess or a maximum of four weeks rent for each claim, or in total over the life of the tenancy? How will this be calculated, and when would payment be levied — after each event, or at the end of the tenancy? Is it anticipated that the bond itself be used to pay for the claim, or the amounts can be levied as additional charges? If the former, it will erode the value and statutory purpose of the bond. If the latter it will offend the limitations on other charges and rent increases in the RTA 1986. Secondly, it does not take account of the fact that a bond is not always required, or may only be required for a lesser amount, in some tenancies. Bonds can vary dramatically depending upon the rental value of the premises, so bear little relation to the excesses for insurance policies. Renters of higher-value premises will therefore have a disproportionately higher level of potential liability. Thirdly, it does not address the fundamental intrusion into principles of insurance, including rights of subrogation and risk analysis. It will therefore still result in considerable increases in premiums, higher excesses and tighter provisions around claims. Fourthly, allowing the parties to contract out of the measures will likely result in tenants being required to carry a higher liability than their bond, or to agree to take out their own insurance. If the tenant is not able to get insurance, or they neglect to arrange it, they will remain fully liable for any damage. Finally, the government's solution is also confined to the issue of liability for negligent damage and insurance matters. It does not address the broader consequences of the *Holler v Osaki* decision that have blurred the bundaries between the distinctive legal regimes applicable to residential tenancies and commercial leases.

A better solution is to specifically provide in the RTA 1986 for a limited immunity from liability for residential tenants smilar to that provided for commercial lessees in ss 268–271 if that is felt desirable from a public policy perspective. This should include additional features allowing some liability for tenants to pay insurance excesses up to a prescribed amount in order to provide a motivation for tenants to honour their repair obligations. At the same time the ambit of s 142(2) RTA 1986 should be specifically clarified to avoid the potential of other provisions in pt 4 of the PLA 2007 intended for commercial lease relationships from being applied to residential tenancies under the broad discretionary powers of the Tribunal. In particular, such an amendment should make it absolutely clear that the ability for the Tribunal to "look to" pt 4 for general principles is only intended as a supplemental aid in interpreting the rights, obligations and principles set out in the RTA 1986, and not to substitute or override those measures in an arbitrary and ad hoc manner with rights, obligations and principles intended to have application to commercial leases under the PLA 2007. ❐