Tenant bankruptcies in the COVID-19 era: tenant bankruptcy and letters of credit

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This is the second part of a two-part series

In the face of increased tenant bankruptcies caused by the COVID-19 pandemic, a key question arises for commercial landlords: what protection do I have from the security provided by my tenant? Tenant-supplied security under a lease can take many forms, including a third party guarantee or indemnity, prepaid rent, a cash deposit, and a letter of credit (an LOC). Crucially, certain forms of security will be more beneficial to a landlord in the face of a tenant bankruptcy, especially where the lease has been disclaimed by the tenant's trustee in bankruptcy.

What you need to know

- While there are multiple types of LOCs, including a revolving, revocable, and commercial LOC, the gold standard in the context of lease transactions remains the irrevocable standby LOC.
- An irrevocable standby LOC is an instrument issued by a third party, generally the tenant's financial institution (an Issuer), the terms of which cannot be unilaterally modified, nor can the financial institution cancel or withdraw the LOC. The LOC has a fixed term, often with automatic renewals, depending on the security offered.
- The named beneficiary on the face of the LOC (*i.e.,* the landlord) holds the LOC to secure the performance of the tenant's lease obligations.
- Properly worded, the LOC will enable a landlord to draw down on the amount of the LOC upon the landlord's confirmation to the Issuer that the tenant has defaulted under the lease.
- Landlords should carefully review the draft of the LOC before accepting it as security to ensure it aligns with the lease provisions.

Bankruptcy & landlord relief

For a landlord, the primary benefit of an LOC surrounds how this form of security is applied in the face of a bankrupt commercial tenant. Funds previously delivered by a bankrupt tenant as a cash security deposit automatically fall into the pool of property to

be distributed amongst the bankrupt tenant's creditors.[1] This may also be the case for prepaid rent, depending on the wording of the lease.[2] Additionally, though a guarantee or an indemnity may survive a tenant's bankruptcy and lease disclaimer,[3] each is only as good as the financial covenant of the party guaranteeing or indemnifying, and that covenant may have changed since the guarantee or indemnity was first provided.

Canada's *Bankruptcy and Insolvency Act* (the BIA) and Ontario's *Commercial Tenancies Act* (the CTA) provide certain statutory limits on the preferred (albeit unsecured) claim a landlord has over a bankrupt tenant's property, being up to three months of rental arrears, and three months of accelerated rent (providing the lease grants the latter right) (the Preferential Claim).[4] Depending on the extent of the bankrupt tenant's liabilities and the creditors who rank in priority to the landlord in priority, the landlord may recover little if anything.

It is in this context of legislative creditor hierarchy that the benefits of an LOC, particularly an irrevocable standby LOC, generally outweigh other forms of security.

Common law approach in a commercial leasing context

While jurisprudence has generally held that a landlord is able to receive payment under an LOC without having to compete with the bankrupt tenant's other creditors, there is some uncertainty with respect to the extent of an LOC's autonomy, and the amount a landlord would be permitted to draw down where a lease has been disclaimed in bankruptcy.

Historically, the courts have taken two distinct approaches to what effect bankruptcy can have on a landlord's ability to benefit from a third party's contractual obligation to make payment relating to a tenant's obligations under a lease (*e.g.,* a guarantor, or a third party Issuer). First, a number of decisions following the decision of *Cummer-Yonge Investments Ltd. v. Fagot et al.* held that, a bankrupt tenant's obligations under a lease came to an end once the lease was disclaimed, such that a landlord's recovery under a LOC with a third party Issuer was limited to its Preferential Claim.[5] Other courts took an alternative approach to the question, following the *obiter dicta* of the Supreme Court of Canada in *Crystalline Investments Ltd. v. Domgroup Ltd.*, in which the Court held that a third party's obligation to make payment could continue despite the lease being disclaimed, with the result that a landlord's draw on an LOC was not necessarily limited to its Preferential Claim.[6] While neither *Cummer-Yonge* nor *Crystalline* expressly dealt with LOCs, the legal community and subsequent case law applied the principles relating to third party payment obligations and disclaimers to LOCs held as security for commercial lease obligations.

The uncertainty of the extent of a landlord's entitlement to draw on an LOC came to a head in 2019 with the Ontario Superior Court decision of *7636156 Canada Inc. v. OMERS Realty Corporation* (OMERS).The Court held that the bank's obligation to make payment to the landlord under an LOC was wholly dependent on the continued existence of the bankrupt tenant's obligations to the landlord under the lease. The Court held that since the tenant's trustee's disclaimer of the lease extinguishes a bankrupt tenant's continued obligations under the lease, the landlord's entitlement to recovery under the LOC was limited to the Preferential Claim.[7] After being appealed, the Ontario Court of Appeal recently released its decision on OMERS,[8] which provides much needed clarity on the extent to which a commercial landlord can draw on an LOC,

holding that there is no provision within the BIA, nor principle of bankruptcy law, that overrides the autonomy principle, and barring the existence of an exception to the principle of autonomy, that the landlord was entitled to draw on the full amount of the LOC.[9]

Recognizing the varied case law that preceded OMERS, the Court engaged in a thorough analysis of the jurisprudence. The Court addressed the different approaches taken at length, ultimately refusing the trustee's argument that the principles of insolvency law automatically override the autonomy of LOCs as a result of a trustee's disclaimer of a lease, such that a landlord is only entitled to draw on an LOC up to the amount of the Preferential Claim.[10] The Court then reiterated the autonomy principle applicable to standby LOCs, being that the obligation of the Issuer to a beneficiary of an LOC must at all times be independent of the actual performance of the underlying contract (*i.e.,* the lease)[11]. The Court noted that such autonomy of LOCs is "essential for their commercial risk-minimization function",[12] and proceeded to consider a possible exception to the principal of autonomy, being where the beneficiary's request for a draw is fraudulent.

The Court proceeded to look to the language of the lease and the LOC, both of which contemplated the LOC continuing to stand in the event of bankruptcy and disclaimer, significant factors in the Court's conclusion that the landlord's draw on the LOC was not subject to the fraud exception to the autonomy principle[13]. However, an in-depth discussion of this exception to the autonomy principle is outside of the scope of this article. While the Court has provided guidance on how a tenant's bankruptcy impacts a landlord's ability to draw on a LOC, ultimately, whether the landlord is entitled to draw on an LOC and the amount of same involves a fact-based analysis, taking into account the language of the lease and of the LOC, as well as the circumstances surrounding the draw.

Notice of intention to make a proposal under the BIA

LOCs should also be considered within the context of a tenant that has filed a Notice of Intention to Make a Proposal under the BIA (a NOI).

Once a commercial tenant files an NOI, the tenant has the right to benefit from:

- A minimum 30-day stay of proceedings during which time the tenant is protected from claims by its creditors[14];
- A prohibition against enforcement of "insolvency" clauses in the lease during the stay[15]; and
- A right to disclaim the commercial lease, subject to certain conditions[16].

During the stay, the BIA requires the tenant to prepare and file a formal proposal with its creditors. While bankruptcy can be avoided if the tenant is successful in filing its proposal, and having its creditors approve same, if the tenant fails to file the proposal before the end of the stay, or if the creditors do not approve the proposal, the tenant is automatically deemed bankrupt.

Importantly, creditors, including landlords, may be entitled to challenge the stay. Section 69.4 of the BIA allows a creditor to request relief from the stay by providing evidence to

the court demonstrating that the continued operation of the stay is likely to materially prejudice the creditor, or that there are other equitable grounds on which the Court should relieve the creditor from the stay.[17] Similarly, Section 50.4(11) of the BIA allows a landlord (as a creditor) to seek a declaration for the earlier termination of the 30 day period for filing a proposal or any extension previously granted by the court, upon satisfying the court that:

- The tenant has not acted in good faith or with due diligence;
- The tenant will likely be unable to make a viable proposal before the deadline;
- The tenant will likely be unable to make a proposal that will be accepted by the creditors; or
- The creditors as a whole would be materially prejudiced by the court's refusal to make the declaration.

A recent decision of the Alberta Queen's Bench considered whether a landlord's demand for payment under an LOC may not fall within the scope of "proceedings" that are subject to the stay granted under Section 69.1 of the BIA. In *Tri-State Signature Homes Ltd, Re* the Court held that drawing down on an LOC is outside of the scope of the actions prohibited by a stay, on the basis that a landlord's demand for payment under an LOC relates to an obligation owed by the Issuer to the landlord, rather than an obligation of the tenant.[18]

Court ordered stays under the CCAA

In addition to NOIs under the BIA, it is necessary to consider the impact on an LOC where a tenant applies for, and the Court subsequently issues, an order under Section 11 of the Companies' Creditors Arrangement Act (the CCAA). While the process of restructuring under the BIA is relatively regimented, the CCAA is more flexible and allows the courts significant discretion in making orders that are appropriate in the circumstances to advance the restructuring.

That said, the CCAA also involves a stay of proceedings which restricts creditors from taking steps against the company or its assets, or from terminating contracts with the company (including based on "insolvency clauses"). One notable difference is how the CCAA deals with LOCs. Section 11.04 of the CCAA contains language clarifying that no order for a stay granted under Section 11.01 has an affect on any action, suit or proceeding against a person, other than the company in respect of whom the order is made, who is obligated under a letter of credit or guarantee in relation to the company.[19] As such, except for exceptional circumstances in which the Court exercises its inherent jurisdiction, drawing down on an LOC issued by a third party Issuer to a landlord would not fall within the scope of the activities prohibited by a stay granted under the CCAA.[20] Importantly, there is no equivalent to Section 11.04 within the BIA.

Final thoughts

When entering into a lease, a landlord should consider which form of security best meets its specific needs. If it is an LOC, special attention must be paid to, , the form, terms and conditions as well the creditworthiness of the Issuer, among other things. Where a landlord will prefer an irrevocable standby LOC, a tenant may prefer a conditional revocable LOC. There may be limitations on the amount a landlord is permitted to draw upon, and the timing for same, depending on the facts at hand. This

includes whether the LOC is worded such that it intended to provide security for rental arrears or for all of a tenant's obligations, whether it is to continue to apply in the event the tenant files for bankruptcy or if the lease has been disclaimed, whether there is a stay of proceedings, and if fraud is suspected.

Any entity (including landlords) considering accepting an LOC as security, or holding an existing LOC as security for another entity's performance under an agreement should carefully consider the optimum time to draw down on that security, especially if there have been one or more defaults under the agreement in question, and the likelihood of future defaults. With the unprecedented economic uncertainty caused by the COVID-19 shutdowns, it remains to be seen whether the courts will distinguish the current law even further, in an effort to provide recourse to the "aggrieved" party.

BLG is here to help landlords and tenants in these challenging times. Reach out to the contacts listed below or email your questions to whatsnext@blg.com, where we are helping businesses navigate these challenging times. Basic questions will be answered free of charge, and we will offer information and resources for more complex queries.

[1] *York Realty Inc. v. Alignvest Private Debt Ltd.,* 2015 ABCA 355, 2015 CarswellAlta 2108, at paras 2 and 28; *Abraham, Re*, [1926] 3 D.L.R. 971, 1926 CarswellOnt 257 (Ont. C.A.); *Sills, Re*, 1956 CarswellOnt 42, [1956] O.R. 494, 35 C.B.R. 217, 4 D.L.R. (2d) 432.

[2] Ibid.

[3] The courts have taken an inconsistent approach that a disclaimer of the lease by a tenant in bankruptcy has on the continuing obligations of guarantors, with the Ontario Court of Appeal in Curriculum Services Canada/Services Des Programmes D'Études *Canada (Re)*, 2020 ONCA 267, at paras 35, 62-65, citing obiter of the Supreme Court in *Crystalline Investments Ltd. v. Domgroup Ltd*. at paras 37-42 stating that a guarantor is not automatically released from its guarantee under the lease where a trustee in bankruptcy disclaims the lease in question.

[4] *Commercial Tenancies Act*, R.S.O. 1990, c. L.7, s. 38; *Bankruptcy and Insolvency Act*, RSC 1985, c B-3, s. 136(1).

[5] Cummer-Yonge Investments Ltd. v. Fagot et al., [1965] 2 OR 152 (Ont HC), aff'd [1965] 2 OR 157 (ONCA), at pg. 3; Titan Warehouse Club Inc. (Trustee of) v. Glenview Corp, 1988 CarswellOnt 135, [1988] C.L.D. 285, at para 18; 7636156 Canada Inc. v. OMERS Realty Corporation, 2019 ONSC 6106 (CanLII), at paras 24, 37 and 39.

[6] *Lava Systems Inc. (Receiver & Manager of) v. Clarica Life Insurance Co*., 2002 CarswellOnt 2053, [2002] O.J. No. 2526, [2002] O.T.C. 529, 115 A.C.W.S. (3d) 494, 161 O.A.C. 53, 1 R.P.R. (4th) 50, 27 B.L.R. (3d) 19, at paras 3-4; *885676 Ontario Ltd. (Trustee of) v. Frasmet Holdings Ltd. (1993)*, 17 C.B.R. (3d) 64, at paras 29-43.

[7] *6156 Canada Inc. v. OMERS Realty Corporation*, 2019 ONSC 6106 (CanLII), at paras 24, 37 and 39.

[8] 7636156 Canada Inc. (Re), 2020 ONCA 681.

[9] Ibid., at paras 108- 109.

[10] *Ibid*. at para 31.

[11] *Ibid*. at para 39.

[12] *Ibid*. at para 41.

[13] *Ibid*. at para 58.

[14] *BIA*, ss. 69(1) and 69.1(1).

[15] *BIA*, ss. 65.1(1) and (2).

[16] *BIA*, s. 65.2(1).

[17] *BIA*, s. 69.4.

[18] Tri-State Signature Homes Ltd (Re), 2017 ABQB 587, at para 29; Meridian Developments Inc. v. Toronto Dominion Bank, 1984 CanLII 1176 (AB QB), at paras 38 and 42.

[19] *Companies' Creditors Arrangement Act*, RSC 1985, c C-36, s. 11.04; L.W. Houlden and Geoffrey B. Morawetz, Bankruptcy and Insolvency Law of Canada, 4th Edition (Toronto: Carswell, 2009), Companies' Creditors Arrangement Act, at N§87.

[20] *Northern Transportation Co.,* Re, 2016 ABQB 522, 2016 CarswellAlta 1834, at para 101; *Re Meubles Dinec inc*., Re, 2006 CarswellQue 4986, 2006 QCCA 747, at paras 21-24.

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