SECURITY DEPOSITS & PRE-PAID RENT:
TREATMENT UPON TENANT'S BANKRUPTCY IN CANADA

Canadian landlords often require that tenants provide a deposit when entering into a lease. The deposit is intended to serve as a pool of money the landlord can draw on if the tenant breaches the lease. However, landlords may be surprised to learn that the tenant's other creditors may have a right to the deposit in priority to the landlord.

Security Interests & Bankruptcy

A security interest is the interest a creditor has in the debtor's property as security for payment or performance of an obligation. When more than one secured creditor has a security interest in the same property, their order of entitlement is determined by the order in which they "perfected" their security interests. A security interest in intangibles, like money, is perfected by registering a financing statement in accordance with provincial personal property security legislation, which in Ontario is the *Personal Property Security Act* ("*PPSA*").[1]

When a party is declared bankrupt, its property is distributed to its creditors. Secured creditors may realize on their security in the usual way, unimpeded by the bankruptcy. Unsecured creditors, however, are prevented (or "stayed") from pursuing the usual remedies, like suing for the debt. Instead, the bankrupt's property that remains after the secured creditors have realized on their security is transferred to the trustee in bankruptcy and distributed to the unsecured creditors in accordance with the priority scheme set out in Canada's *Bankruptcy and Insolvency Act* ("*BIA*").[2]

When a tenant goes bankrupt, the trustee in bankruptcy may choose to assign the lease to a new tenant not more objectionable than the bankrupt[3] or disclaim the lease. Disclaimer ends the lease, relieves the tenant of its obligations, and returns possession of the premises to the landlord. The *BIA* gives landlords a preferred claim, ahead of other unsecured creditors (but not ahead of secured creditors), for three months' rent arrears (if any) and three months' rent following a disclaimer (so long as the lease provides for accelerated rent).[4]

Canada also has bankruptcy protection legislation under both the *BIA* and the *Companies' Creditors Arrangement Act* ("*CCAA*").[5] These schemes are similar to Chapter 11 bankruptcy in the United States. They give debtors a chance to craft a plan to negotiate for payments to creditors and reorganise their struggling business. If the creditors accept the plan, the debtor is protected from bankruptcy. If the creditors reject the plan, the debtor is typically petitioned into bankruptcy and its assets are distributed in the usual way under the *BIA*.

Security Deposits

Recently, in *Alignvest Private Debt Ltd. v Surefire Industries* Ltd.,[6] the Alberta Courts were asked to determine who was entitled to a deposit held by the landlord after the tenant went bankrupt and the lease was disclaimed. The facts of the case are as follows:

The tenant paid a deposit of $3,187,500.00 to the landlord as part of a sale-leaseback transaction. The lease provided that the deposit was to be held by the landlord "as security for the performance by the Tenant of its obligations under the Lease" and that subject being applied to remedy a breach, the deposit would be applied to rent falling due in various enumerated months after the 13th month of the term. The tenant was declared bankrupt and the trustee disclaimed the lease. At the time of disclaimer no rent arrears were owing and the term had not yet reached the 13th month.

The landlord argued the deposit was "prepaid rent" and that this meant the deposit was the landlord's property and was unavailable to the bankrupt tenant's other creditors. Alignvest Private Debt Ltd. ("Alignvest") held a general security interest over all of the tenant's assets. It argued that the deposit was a "security deposit" and that this meant that the deposit was still the tenant's property, but that the landlord simply held an unregistered security interest in the deposit. Since Alignvest had registered its general security interest in all of the tenant's assets, Alignvest claimed that it had perfected its security interest in the deposit ahead of the landlord and therefore had first priority.

The Court looked to the wording of the lease to determine the parties' intention regarding the deposit. The Court noted that the lease referred to the money as a "Security Deposit" and "as security for the performance by the Tenant." The Court also noted that the default provisions of the lease referred to "advanced rent" and the "Security Deposit" as if they were separate concepts.

The landlord argued that since the deposit would either be (1) applied to remedy a breach, or (2) applied to rent due after the 13th month of the term, the deposit could not possibly be the tenant's property, because in all circumstances it would accrue to the landlord. The Court disagreed, finding that the deposit would be returned to the tenant in circumstances where the tenant had not breached the lease and the lease was terminated prior to the 13th month of the term. The Court noted that the landlord's termination right in the case the premises was destroyed by fire may have had such a result and in the Court's opinion, the disclaimer of the lease by the trustee before the 13th month had this result as well. The Court held that the property was not prepaid rent; it was still the tenant's property and available to the tenant's creditors. The landlord therefore held a security interest in the deposit, but its unregistered interest was subordinate to Alignvest's registered security interest. As an aside, the Court noted that even though the lease granted the landlord the right to retain the deposit upon the tenant's bankruptcy, the landlord was preventing from enforcing that right as a result of the stay of proceedings imposed by the bankruptcy.

The decision is somewhat jarring for landlords who often obtain a deposit under the belief that they are entitled to apply it to the tenant's unperformed obligations in any event. As the *Alignvest* decision makes starkly clear, this may not be true. Where the deposit is a "security" deposit, a prior ranking secured creditor will be entitled to the deposit ahead of the landlord, irrespective of a bankruptcy. Landlords should therefore consider registering their interest in security deposits under provincial personal property security legislation. In order to have first priority in the deposit, a landlord must register before any other creditor with security in the deposit, such as a creditor with a general security agreement. Registration is hardly a perfect solution since the administrative cost of registering may outweigh the benefit when the deposit is minimal.

Pre-Paid Rent …not so fast

The decision in *Alignvest* may give the impression that a landlord can avoid jeopardizing its right to the deposit so long as the lease is clear that the deposit is prepaid rent and in no circumstances will it be returned to the tenant. However, this is likely not true. Even if the landlord in the *Alignvest* decision was successful in convincing the Court that the deposit was prepaid rent, it is unlikely the landlord would be entitled to retain the deposit once the lease was disclaimed.

The landlord in *Alignvest* relied on the 1926 Ontario Court of Appeal decision in *Re Abraham*[7] as authority for the proposition that prepaid rent is the landlord's property and may be retained by the landlord following the tenant's bankruptcy. However, the decision in *Re Abraham* does not consider the effect of the lease being disclaimed. *Re Abraham* was decided only a few years after trustees were granted authority to disclaim leases and there is nothing in the decision to indicate that the lease was in fact disclaimed.

A trustee's disclaimer has the same effect on the tenant as if the parties consensually ended the lease.[8] Therefore, a tenant has no obligation to pay rent for portion of the term following the disclaimer. In *Cummer-Yonge Investments Ltd. v Fagot*[9] ("*Cummer-Yonge*"), the Ontario Court of Appeal affirmed the Ontario High Court's ruling that a third party who had guaranteed the tenant's obligations under the lease had no liability to the landlord after the lease was disclaimed. The Court's reasoning was that since upon disclaimer all of the tenant's obligations under the lease came to an end, there were no longer any obligations for the guarantor to guarantee. This reasoning was followed, albeit somewhat inconsistently, for four decades following *Cummer-Yonge* to relieve third parties (such as guarantors, indemnifiers, assignors, and issuers of letters of credit) of liability for the tenant's obligations after the lease was validly disclaimed or repudiated in accordance with Canadian insolvency legislation.

In 2004, in its ruling in *Crystalline Investments Ltd. v Domgroup Ltd.*[10] ("*Crystalline*"), the Supreme Court of Canada held that the assignor of a validly repudiated lease was liable notwithstanding the repudiation, stating "nothing …protects third parties…from the consequences of an insolvent's repudiation of a commercial lease. That is to say they remain liable when the party on whose behalf they acted becomes insolvent." In *obiter dicta* the Supreme Court expressly overruled the decision in *Cummer-Yonge* stating that "Post-disclaimer, assignors and guarantors ought to be treated the same with respect to liability. The disclaimer alone should not relieve either from their contractual obligations."

This decision is understood by the Canadian leasing bar to mean that third party sureties remain liable for rent for the balance of the term notwithstanding the disclaimer. However, neither the decision in *Cummer-Yonge* nor *Crystalline* purport to preserve a creditor's right to enforce lease obligations for the post-disclaimer period against the tenant. The Supreme Court referred to liability of "third parties." Since disclaimer of a lease by the trustee has the same effect on the tenant as a consensual surrender, the landlord likely has no legal basis to retain rent paid by the tenant for periods following the disclaimer, notwithstanding that the rent was paid in advance (that is "prepaid rent").

A landlord's claim to rent from the tenant for periods following disclaimer is further weakened by two other factors. First, provincial legislation limits the landlord's claim from the bankrupts' estate to the three months of arrears and three months of accelerated rent as provided in the *BIA*.[11] Second, a landlord

is prevented from enforcing a lease covenant entitling it to retain prepaid rent following a stay imposed by insolvency proceedings.[12] Accordingly, even if the deposit in *Alignvest* was held to be prepaid rent, it is unlikely the landlord would be entitled to retain it following the trustee's disclaimer of the lease.

Recommendations for Landlords

Landlords are encouraged to seek assurances for the tenant's lease obligations from the tenant and third parties. To this end, many landlords obtain prepaid rent, security deposits, guarantees, indemnities, or letters of credit. An irrevocable standby letter of credit is the most resilient to a tenant's bankruptcy. Security deposits and prepaid rent are vulnerable to the challenges discussed above and enforcing a guarantee or indemnity may require a court action to establish the landlord's damages, given its obligation to mitigate. Also, there's a chance that a guarantor or indemnifier may themselves become insolvent or simply have insufficient assets to make good on the landlord's damages.

A letter of credit, on the other hand, entitles the landlord to draw on the credit without requiring the landlord to prove its damages. The letter issuer's obligation to honour the credit is independent of the underlying transaction (i.e. the lease). So long as the landlord provides the documents stipulated in the letter (generally a notice of tenant default and request to draw on the letter of credit), the issuer is obligated to pay and there is no reason to believe that the issuer is entitled to refuse because of the tenant's bankruptcy and disclaimer of the lease. Further, letters of credit are typically obtained from large lending institutions, giving the landlord an assurance from someone with assets to back it up.

If a landlord prefers to take a deposit from the tenant over third party assurances (such as guarantees, indemnities, and letters of credit), the landlord should strongly consider registering a security interest in the deposit under the applicable provincial personal property security legislation, particularly where the security deposit is large. Landlords are cautioned not to consider prepaid rent to be anything more than rent paid in advance. If the tenant goes bankrupt and the lease is disclaimed, the landlord will likely have to forfeit rent paid for the post-disclaimer period to the trustee.

1. RSO 1990, c P.10 ("*PPSA*").
2. RSC 1985, c B-3 ("*BIA*").
3. *Commercial Tenancies Act*, RSO 1990, c L7 s 38 (2).
4. *BIA*, s 136(1)(f).
5. RSC 1985, c C-36.
6. 2015 ABQB 148 aff'd 2015 ABCA 355.
7. [1926] 3 DLR 971 (ONCA).
8. *Linens 'N Things Canada Corp. (Re)*, [2009] OJ No 2091.
9. (1965), 2 OR 152 (Ont HC), aff'd (1965), 2 OR 157 (ONCA).
10. 2004 SCC 3.
11. *Linens 'N Things Canada Corp. (Re)*, [2009] OJ No 2091 (ONSC); *Principal Plaza Leaseholds Ltd v Principal Group Ltd (Trustee of)* (1996), 188 AR 187 (ABQB).
12. As noted by the Court in *Alignvest*.

[Word Court = 2073]