NEWS Release

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SECURITY DEPOSIT INSECURITY

Landlords often require that tenants provide a deposit when entering into a lease. Sometimes it's a security deposit, sometimes it's prepaid rent, and sometimes it's a combination of both. In the landlord's mind, the deposit is a pool of money it may draw on if the tenant fails to fulfill its obligations under the lease. However, an Alberta Court of Appeal decision demonstrates that this is not true in all circumstances, leaving landlords with security deposit insecurity.

Security Deposits

In *Alignvest Private Debt Ltd. v Surefire Industries* Ltd., the tenant paid a deposit of about $3 million 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 unless it was applied to remedy a breach, the deposit would be applied to various months' rent after the 12th month of the term. About 10 months into the term the tenant was declared bankrupt and the trustee disclaimed the lease. At the time of disclaimer the tenant was current on its rent.

The tenant's general secured creditor ("Alignvest") sought an order that it, and not the landlord, was the party entitled to the $3 million deposit in the landlord's possession. Alignvest argued that according to the lease, the deposit was a "security deposit," meaning the money was still the tenant's property and was held by the landlord as collateral for the tenant's performance of its obligations under the lease. Therefore, Alignvest alleged, the landlord only had an unregistered security interest in the deposit that ranked behind Alignvest's registered general security interest over all of the tenant's assets. The landlord argued that since under all circumstances the funds would ultimately accrue to the landlord (either as rent or to remedy a breach), the deposit was "prepaid rent" and it became the landlord's property at the time it was given.

The Court noted that the lease referred to the deposit as a "Security Deposit" and "as security for the performance by the Tenant." The Court disagreed with the landlord that under all circumstances the deposit would accrue to the landlord, stating that where, for example, the lease was terminated prior to the 12th month without breach by the tenant (for instance, if the premises were destroyed by fire), the deposit would be returned. Although there were elements of the funds that were akin to prepaid rent inasmuch as they were earmarked for certain specific months, the deposit was more accurately described as a "security deposit". Therefore Alignvest had first priority to the funds. The decision was upheld on appeal.

As the *Alignvest* decision makes starkly clear, landlords may be left empty-handed 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. A possible solution might be for a landlord to register its interest in a security deposit under provincial personal property security legislation in an attempt to preserve priority.

Pre-Paid Rent

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 would not be true in circumstances where the tenant goes bankrupt and the trustee disclaims the lease.

Disclaimer has the same effect on the tenant as if the parties had agreed to end the lease. Therefore, following disclaimer, a tenant has no obligation to pay rent. While some cases have held that prepaid rent becomes the landlord's property at the time it is

paid, there is an argument that a landlord has no legal basis to retain rent paid by the tenant for periods following the disclaimer, notwithstanding that the rent was paid in advance. Any claim by a landlord to rent from the tenant for periods following disclaimer is further weakened by two other factors.

First, most provincial legislation limits the landlord's claim from the bankrupt's estate to the three months of arrears and three months of accelerated rent. (These amounts are treated as a preferred claim under the *Bankruptcy and Insolvency Act*, but preferred claims do not have priority over secured claims). Second, a landlord is prevented from enforcing lease covenants following a stay imposed by insolvency proceedings, including any entitlement to prepaid rent. This means that, even if the deposit in *Alignvest* had been held to be prepaid rent, it is far from certain that the landlord would have been entitled to retain it following the trustee's disclaimer of the lease.

Forget Deposits - Look to 3rd Parties

What is a landlord to do when secured creditors may have priority to "security deposits" and "prepaid rent" may have to be returned upon a tenant's bankruptcy or insolvency? Since entitlement to advance funds in bankruptcy scenarios is uncertain, landlords are advised to look to third parties, rather than taking a deposit from the tenant itself. (Common examples are guarantees, indemnities, and letters of credit.)

The Supreme Court of Canada has held that "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." This is understood to mean that guarantors and indemnifiers remain liable for the tenant's obligations following disclaimer, including liability for rent due over the unexpired balance of the term.

However, guarantees and indemnities are not without issue. First, enforcing the guarantee or indemnity entails commencing a claim in court and proving damages. Second, there's a risk that the guarantor or indemnifier will not have sufficient assets to make good on the award.

Letters of credit, specifically irrevocable standby letters of credit, are therefore a good option. The letter issuer's obligation to honour the credit is independent of the lease. Letters of credit are typically obtained from banks or other large financial institutions, giving the landlord access to a source of stable funds. Further, it is unlikely that a landlord would have to commence a claim or prove its damages depending on how the letter of credit is worded. However, many tenants are unwilling to tie up credit to sign a lease. Little wonder that landlords have security deposit insecurity.

ANNOUNCEMENT

Daoust Vukovich LLP is pleased to welcome **DANIEL WALDMAN** to the firm as an associate lawyer in the area of litigation. Daniel brings several years of commercial litigation experience to the firm. He is a graduate of Osgoode Hall Law School and was admitted to the Ontario Bar in 2010. Daniel can be reached at: 416-479-4355 (dwaldman@dv-law.com).

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