"SECONDARY COVENANTS SECURING TENANTS' PERFORMANCE OF LEASE OBLIGATIONS IN CANADA"

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From Canada

In Depth

Secondary Covenants Securing Tenants' Performance of Lease Obligations in Canada

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Background

Last year, in the Spring issue of *Legal Update*, I wrote an article regarding the enforcement by landlords of letters of credit securing tenants' lease obligations. At that time, I reported on the state of the law in the Canadian common law provinces, to the effect that there was confusion over the enforceability of letters of credit following the bankruptcy of a tenant and the ensuing lease disclaimer by the tenant's bankruptcy trustee. This stemmed from the seminal case of *Cummer-Yonge Investments Ltd.* v. *Fago* [1965] 2 O.R. 152 (affirmed in the Ontario Court of Appeal), which held that a guarantor's liability for a tenant's obligations under the lease would be extinguished on the disclaimer of the lease. After that decision, for many years, landlords of properties located in common law jurisdictions of Canada and their lawyers tried to find ways to obtain better protection against the loss of a tenancy due to bankruptcy.

In last year's article, I reported that one successful way of retaining the liability of a guarantor for future rent after the disclaimer of the bankrupt tenant's lease was to cast the guarantor's obligations as those of an indemnifier {*Sifton Properties Limited* v. *Ruby Dodson* [1994] O.J. No. 1856, (Ont. Ct.) (Gen. Div.)} However, in the 2003 decision of the British Columbia Supreme Court KKBL No. 297, *Ventures* v. *Ikon Office Solutions* [2003] B.C.J. No. 2426 (B.C.S.C.), an indemnifier was relieved of liability following a bankruptcy disclaimer, based on a rather tortuous distinction that the disclaimer's effect of shortening the term of the lease amounted to a release of the indemnifier as well.

Although I reported last year that in the case of *Markborough Properties Ltd.* v. *Shiraz Rajan (1993)*, 24 C.B.R. (3d), 291 (B.C.S.C.), a landlord was allowed to recover under a promissory note given by one of the corporate tenant's principals despite the bankruptcy of the tenant and disclaimer of the lease, I also noted the opposite result reached in *Peat Marwick Thorne Inc., Trustee* v. *Natco Trading Corporation et al.* (1995), 22 O.R. (3d) 727 (Ont. Ct. Gen. Div.), in relation to the landlord's security interest over the tenant's equipment on the leased premises to secure the payment of all rent and any other obligations of the tenant under the lease or any renewal thereof. In the latter case, when the tenant went bankrupt and its trustee disclaimed the lease, the Court found that the security agreement secured nothing, as the trustee's disclaimer of the lease put an end to the tenant's obligations under the lease.

In relation to letters of credit (which are an arrangement whereby a bank, as the issuer, acting at the request and on the instructions of a customer, as the applicant, is to make payment to a third party as beneficiary, provided there is compliance with the terms and conditions of the credit), I reported on several conflicting decisions and the most recent case of *Lava Systems Inc. (Receiver and Manager of)* v. *Clarica Life Insurance Co.* [2001] O.J. No. 3365 (Sup. Ct. J.), in which the lease disclaimer by the tenant's bankruptcy trustee, following the landlord's draw upon a letter of credit issued by the tenant's bank as security for the tenant's lease obligations, was held by the lower court to disallow the landlord from keeping any portion of the bank's payment of the letter of credit (because the tenant's obligations under the lease were held to have come to an end upon the disclaimer of the lease). On appeal by the landlord, the Ontario Court of Appeal ([2002] O.J. No. 2526) allowed the landlord to keep the money, observing that the money paid under the letter of credit had been paid by the bank, which was not a party to the proceeding but presumably did not object to the landlord having cashed the letter of credit since it was not pursuing the matter. Unfortunately, the Court of Appeal dodged the main issue as to whether a letter of credit withstands the tenant's bankruptcy and its bankruptcy trustee's subsequent disclaimer of the lease. The bank then brought its own application [*Bank of Montreal* v. *Clarica Life Insurance Company, Unreported. (Ont. S.C.J.) No. 3-CL-4866)*], failed on the first round and was undertaking an appeal — when an interesting thing happened at the level of the Supreme Court of Canada.

Crystalline v. *Domgroup*

On January 29, 2004, a very important decision was handed down in the case of *Crystalline Investments Ltd.* v. *Domgroup Ltd.* [2004] S.C.J. No. 3 (S.C.C.). In that case, a grocery store tenant had assigned its two leases with the same landlord to an assignee. Eventually, the assignee became insolvent and attempted reorganization under the Bankruptcy and Insolvency Act ("BIA"). The assignee disclaimed the leases without protest by the landlord. The landlord informed the original tenant/assignor that the assignee had repudiated the leases and demanded payment of the rent from the original tenant. The landlord pointed to the assignment clause in the lease, which stated: "notwithstanding any assignment or sublease the [tenant] shall remain fully liable under this lease and shall not be released from performing any of its covenants, obligations or agreements in this lease and shall continue to be bound by this lease."

The assignor refused to pay, and the landlord sued. At the first court appearance, the landlord's claim was dismissed. The landlord appealed to the Ontario Court of Appeal, which overturned the lower court's decision and found that the assignor was liable. The assignor appealed to the Supreme Court of Canada, which upheld the Court of Appeal's decision.

In coming to its decision, the Supreme Court of Canada decided that the lease disclaimer provisions of the BIA were established solely to assist the bankrupt. The Supreme Court found that the purposes of the section were to: "free an insolvent from the obligations under a commercial lease that have become too onerous, to compensate the landlord for the early termination of the lease, and to allow the insolvent to resume viable operations as best it can. Nothing in [the section] or any part of the Act protects third parties (i.e., guarantors, assignors or others) from the consequences of an insolvent's repudiation of a commercial lease."

Relative to the liability of the assignor, Mr. Justice Major of the Supreme Court stated: "from the time a lease is completed, the original tenant is bound by all conditions, including the term. Despite the hardship that may later develop, the covenant is fully enforceable even it has been assigned."

The true importance of this case lies in what came next. The Supreme Court was asked to regard the assignor as a guarantor, whose liability (as in *Cummer-Yonge*) would come to an end with the bankruptcy disclaimer of the lease. The Court decided that there was no justification for distinguishing between a guarantor and an assignor in a situation where the bankrupt has disclaimed the lease. It held 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." The Court looked at *Cummer-Yonge* and compared it to a similar British decision, which had been overruled by the British House of Lords. The Court said that Cummer-Yonge should meet the same fate.

Cummer-Yonge, Overruled!

As a result, *Cummer-Yonge* no longer stands as good authority relative to continuing obligations of co-covenantors or other such security in circumstances of a tenant's bankruptcy.

How does this relate to last year's article regarding letters of credit? In *Bank of Montreal* v. *Clarica Life Insurance Co.* [2004] O.J. No. 633 (Ont. C.A.), the Ontario Court of Appeal summarily dismissed the Bank's appeal, not even three weeks after *Crystalline* was decided. The ruling acknowledges the decision of the Supreme Court of Canada in *Crystalline* and declares the Bank's appeal to be "dismissed as abandoned."

There remains some suggestion among practitioners that lawyers acting for landlords must sharpen their pencils and come up with solid wording for secondary obligations such as guarantees, indemnities, security interests, promissory notes, letters of credit, etc. — to ensure that they achieve the desired effect. Given the latest ruling in *Crystalline*, it is difficult to conceive of an instance in which a lawyer would be prepared to recommend to its client, even in the face of the most poorly drafted wording, that it use *Cummer-Yonge*-based arguments to attempt to wiggle out of a "backstop-type" of liability for a tenant's obligations under a commercial lease in circumstances where the tenant goes bankrupt and the lease is disclaimed. To quote from the British House of Lords decision mentioned above, What sort of a law would this be?

Crystalline is welcome news for landlords.

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