I Thought My Security Blanket Would Always Cover Me!
Security Deposits and Prepaid Rent

By Melissa M. McBain, Daoust Vukovich LLP*

The strength of a tenant's financial covenant is, without a doubt, one of the most critical considerations for landlords when entering into a commercial lease. If the financial strength of a proposed tenant is not satisfactory, prudent landlords will request security in one form or another to secure the performance of the tenant's lease obligations. Most commonly landlords seek additional security in the form of third party indemnities/guarantees, letters of credit from financial institutions, security deposits and pre-paid rent. This paper addresses one of the issues surrounding additional security that has recently become the subject of much discussion; that is, will the landlord be able to realize on the security when it may matter the most – in the case of a tenant's bankruptcy or insolvency?

Some bankruptcy & insolvency basics

Upon a person or entity being declared bankrupt, the bankrupt's property is distributed to its creditors. In the case of a bankruptcy, secured creditors[1] may realize on their security on the basis of their relative priority under the governing legislation. However, the position of unsecured creditors is much weaker, to say the least. Upon the bankruptcy of a debtor, its

* I am very grateful for the stellar research skills of our associate, Brian Parker.

[1] Secured creditors hold mortgages, pledges, charges or liens over some or all of the assets of the debtor, which may be realized upon as security for the payment or performance of an obligation by the debtor. To the extent that there is more than one secured interest over an asset, the order in which the secured creditors may realize on their respective security is determined by the priority (aka "perfection") regimes of the applicable provincial personal property security legislation (in Ontario, the applicable legislation is the *Personal Property Security Act* RSO 1990, c P.10). For example, a security interest in intangibles, like money, is perfected by registering a financing statement. As a further example, a landlord may seek to have a personal property security interest over a tenant's present and/or future personal property, which is achieved through a general security agreement between the landlord and the tenant and the registration of a financing statement.

unsecured creditors are prevented (or "stayed") from pursuing their remedies (i.e. they cannot sue the bankrupt for the debt). Once the secured creditors have realized on their security, the remaining property of the bankrupt (if there is any) is transferred to the trustee in bankruptcy and distributed to the unsecured creditors in accordance with the priority regime set out in Canada's *Bankruptcy and Insolvency Act* ("*BIA*").[2]

When a tenant goes bankrupt, the trustee in bankruptcy has the option of electing to assign the lease to a new tenant or disclaim the lease. If the trustee elects to disclaim the lease, the lease is at an end, the tenant is released from its obligations and the landlord recovers possession of the premises. The *BIA* gives landlords a preferred claim, ahead of other unsecured creditors, for three months' of rent arrears (if there are any) and three months' accelerated rent following the disclaimer (but only if the governing lease provides for accelerated rent).[3] Not surprisingly, landlords will seek additional security at the outset of a leasing transaction to try to improve their recovery upon the bankruptcy of a tenant.

As an alternative to the bankruptcy regime in Canada, some corporations experiencing financial trouble may elect to file for protection from their creditors under the *Companies' Creditors Arrangement Act* ("*CCAA*").[4] Filing under the CCAA gives the debtor a chance to avoid bankruptcy by devising a plan of restructuring and compromise, most often with the view of allowing the company to continue to operate while allowing its creditors to receive some form of payment for the company's debts. 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 under the *BIA*.

[2] RSC 1985, c B-3 ("*BIA*").
[3] *BIA*, s 136(1)(f).
[4] RSC 1985, c C-36.

The *Alignvest* decision

The recent Alberta Court of Appeal case, *Alignvest Private Debt Ltd. v. Surefire Industries Ltd.*,[5] considered the position of a landlord holding a deposit in the context of a bankrupt tenant.

The facts of this case are straightforward. In February of 2013, the tenant, Surefire Industries Ltd., leased property from the landlord, York Realty Ltd., under a sale and leaseback transaction. The landlord retained a large portion of the purchase price ($3,187,500.00) as a deposit, to be held by it as security for the performance of the tenant's obligations under the lease, and to be applied to rent for specified months of the term. The lease also provided that, subject to being applied to remedy a breach, the deposit would be applied to rent falling due in various enumerated months after the thirteenth month of the term.

After a short time in CCAA protection, in December of 2013, the tenant was declared bankrupt and a trustee in bankruptcy was appointed as manager of the tenant's assets. The trustee in bankruptcy disclaimed the lease on January 2, 2014. As of the date of the disclaimer, all rent owing under the lease had been paid to the landlord – there were no arrears.

One of the tenant's secured creditors, Alignvest Private Debt Ltd. ("Alignvest"), had a general security agreement over the tenant's assets. Alignvest applied to the Court for an order directing the landlord to pay the deposit to the trustee in bankruptcy.

The Alberta Court of Queens Bench was asked to determine whether the deposit was security for the performance of the tenant's obligations under the lease, or whether it was prepaid rent. If the deposit was security for the performance of the tenant's obligations under the lease,

[5] 2015 ABQB 148, aff'd 2015 ABCA 355 [*Alignvest*].

the deposit would vest in the trustee in bankruptcy, subject to the rights of other secured creditors. If the deposit was prepaid rent, it would (arguably) be the property of the landlord.

The landlord maintained that the deposit was prepaid rent. The landlord relied on the case of *Re Abraham*[6] for the proposition that a non-refundable deposit, to be applied either to rent or to defaults under the lease, is the property of the landlord from the date that it is paid. In *Re Abraham*, the Court found that it was obvious from the language of the lease that the deposit would not be returned to the tenant under any circumstances.[7] In *Alignvest*, the landlord argued that since under all circumstances it would receive the deposit, the deposit was the landlord's property and not that of the tenant.

Alignvest claimed that the deposit was not prepaid rent, but rather a security deposit. Alignvest argued that the deposit was therefore still the property of the tenant, but that the landlord simply held a security interest in it. Alignvest claimed that since it had perfected its security interest over all of the tenant's assets, it had priority over the landlord's unregistered interest in the deposit.

The trial Court determined that there were several factors in this case to suggest that the deposit was held as security and not as prepaid rent, including:

(1) the lease clause was entitled "Security Deposit" and the lease treated this term as distinct from "Advance Rent";

(2) the final statement of adjustments delivered by the landlord referred to the deposit as a "security deposit"; and

[6] [1926] 3 DLR 971 (ONCA).
[7] Note that in the *Re Abraham* decision, it was not clear whether or not the subject lease had been disclaimed in that case.

(3) although the lease clause entitled the landlord to apply the deposit to rent arrears, the landlord did not exercise this option when rent payments were late during the term.

With respect to the landlord's argument that the deposit was its property and that, in all circumstances, the landlord was entitled to receive it, the Court disagreed. The Court held that the deposit would be returned to the tenant in certain circumstances, such as where there was no breach of the lease and the term was interrupted by the landlord, or by operation of law, prior to the thirteenth month. The Court therefore held that the deposit was not conclusively the landlord's property; rather it remained the tenant's property and was available to creditors. The Court noted that even if the lease stated that the landlord was entitled to retain the deposit upon the tenant's bankruptcy, the bankruptcy proceedings would have stayed that remedy. The Court went on to state that the landlord held a security interest in the deposit, but its unregistered interest was subordinate to Alignvest's registered security interest.

The landlord appealed the decision. The Alberta Court of Appeal found that while there were some indicia in support of the landlord's claim, it was reasonable to conclude that the sum was intended to be a security deposit. The Alberta Court of Appeal concluded that there was no palpable and overriding error in the Court of Queen's Bench decision and the landlord's appeal was dismissed.

As noted above, the Court of Queen's Bench also held that the payment of the deposit was a security interest under the Alberta personal property security legislation and that the landlord's interest was subordinate to Alignvest's perfected security interest over the tenant's assets. The Court decision devoted numerous paragraphs to this issue; however, the Alberta Court of Appeal stated as follows:

> "Given the conclusion that the [deposit] is not prepaid rent and therefore not the property of the [landlord], it is unnecessary to address the second ground of appeal regarding registration of a "security interest" under the *PPSA*, and whether the exceptions in section 4(f) and (g) apply. That said, however, we do not endorse the bankruptcy judge's decision on this issue, nor was it necessary to the decision she was called upon to make."[8]

What does it all mean?

At first blush, the *Alignvest* decision may give the impression that landlords may avoid jeopardizing their right to a deposit (post-bankruptcy and disclaimer) so long as the lease provisions are clear that the deposit is prepaid rent and in no circumstances will it be returned to the tenant. However, this may not be true. The issue arises when a lease is disclaimed by the trustee in bankruptcy. Disclaimer of a lease has the same effect on the tenant as a consensual surrender/early termination. Therefore, the landlord may have no legal basis to retain rent paid by the tenant for periods following the disclaimer, notwithstanding that the rent was tendered in advance.

For example, if there are no arrears owing as of the date of the disclaimer (as was the case in *Alignvest*), there are no lease obligations to which the funds can be applied, since no future rent is payable once the lease is disclaimed. A landlord's claim to rent for periods following bankruptcy and insolvency proceedings may be further diminished by provincial legislation under which landlords are limited to claiming three months of arrears and three months of accelerated rent from the bankrupt's estate.[9]

[8] *supra* note 5 at para 28.
[9] *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).

Accordingly, even if the deposit in *Alignvest* was held to be prepaid rent, it does not necessarily follow that the landlord would be entitled to retain it following disclaimer of the lease. The Court did not make any direct, unequivocal statements on that point, but the Court did indicate that once a stay is imposed under insolvency proceedings, landlords cannot enforce the lease provision permitting them to retain prepaid rent.[10]

With respect to a deposit that is obtained by a landlord as "security" for a tenant's performance of its lease obligations, the landlord should consider registering its interest in the deposit under the applicable provincial personal property security legislation. However, this is not always practical or possible. Firstly, it is an administrative burden for the landlord. Secondly, to have first priority over the deposit, the landlord would have to be the first to register and perfect its interest in that property. Usually, by the time the lease transaction arises, a tenant already has at least one registered secured creditor (or, if the tenant intends to enter into a future financing arrangement, neither it nor its future creditor will typically accept the landlord having first priority as a secured creditor).

Where do we go from here?

In the quest to improve security and recovery following the bankruptcy or insolvency of a tenant, landlords may be well advised to look to forms of security that flow from third parties (as opposed to accepting any type of deposit from a tenant). The rationale for this recommendation stems from the 2004 Supreme Court of Canada decision *Crystalline Investments Ltd. v Domgroup Ltd.*[11]

[10] *supra* note 5 at para 23.
[11] 2004 SCC 3 ("*Crystalline*").

For many decades prior to *Crystalline*, the judicial authority for the liability of third parties post-disclaimer of a lease by a tenant was *Cummer-Yonge Investments Ltd. v Fagot.*[12] In *Cummer-Yonge*, the Ontario Court of Appeal affirmed the lower Court's ruling that a third party who 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 upon disclaimer, all of the tenant's obligations under the lease came to an end; therefore, there were no longer any obligations for the guarantor to guarantee. Although the case law following *Cummer-Yonge* was not entirely consistent, the decision was frequently relied upon to relieve third parties (including guarantors, indemnifiers, assignors, and the issuers of letters of credit) from liability for a tenant's obligations after the lease was validly disclaimed or repudiated in accordance with Canadian bankruptcy legislation. Then along came *Crystalline*.

In *Crystalline*, it was held that that despite the lease being repudiated, the assignor of that lease remained liable. The Supreme Court of Canada stated 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."[13] In *obiter dicta* the Supreme Court expressly overruled the decision in *Cummer-Yonge* and further stated 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."[14]

Absent anything to the contrary in the assignment, indemnity or guarantee agreement, *Crystalline* is understood to be the precedent for the concept that the liability of third parties securing a tenant's lease obligations remains intact despite the disclaimer of the lease by a trustee

[12] [1965] 2 OR 152 (Ont HC), aff'd [1965] 2 OR 157 (ONCA) ("*Cummer-Yonge*").
[13] *supra* note 11 at para 28.
[14] *supra* note 11 at para 42.

in bankruptcy. We do not know if the ruling in *Crystalline* extends so far as to preserve the landlord's right to retain prepaid rent (only the liability of "third parties" was addressed by the Supreme Court of Canada). While the *Alignvest* decision seems to support this theory, the issue was not directly addressed in the judgments.

Because (i) the enforcement of a guarantee or indemnity may require a court action to establish a landlord's damages (due to the duty to mitigate); and (ii) there is always the possibility that a guarantor or indemnifier could have inadequate assets for the landlord to realize upon or they could become bankrupt or file for insolvency protection, bearing in mind the caveat about some uncertainty in the law that is noted in the next section, an irrevocable standby letter of credit issued by a reputable financial institution could be the best option for a landlord seeking security.

A little note on letters of credit

A letter of credit is a separate instrument from the underlying lease. Provided the terms of the letter of credit are complied with, the issuing financial institution will act upon the request of the customer (i.e. the tenant) to make payment to a third party beneficiary (i.e. the landlord). In the ordinary course, the tenant's financial institution issues the letter of credit, which allows the landlord to draw upon it in the event of a default under the lease. There are several advantages of letters of credit for landlords (with some corresponding disadvantages to tenants) – not the least of which is that typically the financial institution must honour the letter of credit when the landlord presents it (that is, just presenting the required documents is sufficient to trigger the bank's obligation to pay). Note that careful drafting is required both in the letter of

credit itself as well as the underlying lease provisions – the do's and don'ts of that drafting is beyond the scope of this paper.

The important question for this paper is whether or not the letter of credit continues to offer security to the landlord if a tenant becomes bankrupt or insolvent. It has been suggested that letters of credit are not the tenant's property and as such, if properly drafted, a landlord drawing upon a letter of credit against the issuing bank would not be attempting to realize upon the tenant's property. Applying the Court's logic in *Crystalline*, it makes sense that these third party obligations should survive bankruptcy and lease disclaimer. Unfortunately, the caveat is, the existing case law on this issue has not provided us with a definitive answer.

While some of the pre-*Crystalline* decisions refused to enforce letters of credit following disclaimer[15], other pre-*Crystalline* decisions emphasized that letters of credit were "specialized" forms of security, which should not be treated like guarantees, and that a bank's obligations would continue despite the lease being terminated.[16] In *Lava Systems Inc. (Receiver and Manager of) v. Clarica Life Insurance Co.*,[17] the Ontario Court of Appeal dodged the main question of whether or not a letter of credit is good security for a tenant's obligations under a lease post-bankruptcy and ruled that the landlord could keep the money from a previous draw on a letter of credit on the basis that the bank had not objected to the withdrawal. In other decisions, the Courts emphasized the wording of the documents and noted that that a letter of credit could be drafted to secure an obligation that survives bankruptcy[18]

---

[15] Examples of such cases include: *West Shore Ventures Ltd. v. K.P.N. Holding Ltd.*, 2001 BCCA 279 and *Titan Warehouse Club Inc. v. Glenview Corp.*, [1989] OJ No 3059 (CA).

[16] *885676 Ontario Ltd. (Trustee of) v. Frasmet Holdings Ltd.* 12 O.R. (3d) 62. Similarly, in *Dunlop Construction Products Inc. (Receiver of) v. Flavelle Holdings Inc.* 31 OR (3d) 58, the Court supported the landlord's claim under a letter of credit post-bankruptcy to satisfy a claim for damage to the premises that occurred before the date of disclaimer.

[17] (2002), 161 OAC 53, 27 BLR (3d) 19 (CA).

[18] *Peat Marwick Thorne Inc. v. Natco Trading Corp.*, 22 OR (3d) 727.

With respect to letters of credit, another issue is that courts have been concerned with is the potential for over-compensation. The crux of the issue is that post-disclaimer of a lease, a landlord may incur losses that are less than the compensation they may receive from the letter of credit (the theory being that the landlord retains the asset (the premises) and can mitigate its damages by leasing the space to another tenant). For example, in *Victoria Butcher & Baker Restaurants Inc. v. Schroeder Properties Ltd.*,[19] the Court held that a tenant's obligation to provide a landlord with a letter of credit equal to two years' rent as security for the performance of certain lease obligations was a penalty clause and unenforceable. In that case, the Court expressed concern that the landlord's draw on the entire letter of credit might not be in proportion to the breach, which could be unconscionable.

The long and the short of it

It is not clear whether the courts are primarily concerned with the precise wording of the letter of credit (and the governing lease provision) or preventing the over-compensation of landlords (or perhaps a combination of both). As noted above, following the *Crystalline* decision, it has been suggested (and members of the commercial leasing bar are cautiously optimistic) that letters of credit should be enforceable by landlords post-disclaimer of a lease. However, due to the uncertain status of the law, careful drafting, as always, is critical. In any event, post-disclaimer of a lease, the prospects for enforcing pre-paid rent deposits and unregistered security deposits are bleak.

[19] [1992] BCJ No 1843 (SC).