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Letters Of Credit As Security For Tenants' Performance Of Lease Obligations

Ever since *Cummer-Yonge v. Fagot*, which held that a guarantor's liability for a tenant's obligations under the lease would be extinguished on the disclaimer of the lease, Canadian landlords and their lawyers have been trying to find ways to obtain better protection against the loss of a tenancy due to bankruptcy.

Casting a guarantor's obligations as that of an indemnifier proved to be a successful means of retaining the liability of the guarantor/indemnifier for future rent after the disclaimer of the bankrupt tenant's lease (*Sifton v. Ruby Dodson*).

And a landlord was allowed to recover under a promissory note given by one of the corporate tenant's principals, after the bankruptcy of the tenant and disclaimer of the lease (*Markborough v. Shiraz Rajan*).

But in *Peat Marwick v. Natco*, the landlord enjoyed a security interest in the tenant's equipment, "to secure the payment of all rent and any other obligations of the tenant under the lease", yet when the tenant went bankrupt and its trustee disclaimed the lease, the Court found that the trustee's disclaimer of the lease put an end to the tenant's obligations under the lease, so the security interest secured nothing.

Where landlords protect themselves against a defaulting tenant through a letter of credit issued by the tenant's bank, it seems that anything can happen.

Letters of Credit

A letter of credit is an arrangement whereby a bank (as issuer) acting at the request and on the instructions

of a customer (as applicant) is to make payment to a third party (as beneficiary) upon compliance with the terms and conditions of the credit. Landlords seek letters of credit to obtain recourse against a neutral, trustworthy and solvent holder of funds (the bank).

Lava v. Clarica dealt with a lease disclaimer by the tenant's court-appointed receiver, following which the receiver contested the landlord's previous draw upon a letter of credit in response to a lease default. Although in similar circumstances, in the case of *885676 v. Frasmet*, a landlord was allowed to realize part of a future rent claim against a letter of credit provided to secure the tenant's obligations under the lease, the lower court in *Lava* found that the landlord's right under the letter of credit was restricted to an amount owing under the lease (i.e. arrears) and did not permit payment to the landlord on its claim for future rent where the tenant's obligations under the lease came to an end upon the disclaimer of the lease.

Courts in British Columbia and Alberta have looked at the same issue and landed on different sides of it. In *West Shore v. K.P.N.*, the British Columbia Court of Appeal held that a landlord was not entitled to draw upon the letter of credit but in *36604 v. Pensionfund*, the Alberta Court of Appeal concluded that the landlord was entitled to draw on the letter of credit/guarantee.

Before *Lava*, courts in Ontario had both upheld and struck down attempts by landlords, in instances of bankruptcy/disclaimer by the trustee, to claim payment under letters of credit. (*Dunlop v. Flavelle* supported the landlord's claim under the letter of credit, whereas *Titan v. Glenview* refused it. As already mentioned, *Frasmet* upheld the landlord's claim.)



Lava - Appeal

The appeal decision in *Lava* was released on June 27, 2002. Although the Ontario Court of Appeal reversed the decision and found in favour of Clarica (the landlord), the decision is of little help in terms of assuring landlords that they may access letters of credit provided as security for failed leases. The Court of Appeal noted that the funds drawn on by Clarica were the property of the bank and not of the tenant. As a result, neither Lava nor its receiver and manager had a legal right to recover any funds that may have been improperly paid under the letter of credit. The bank was not a party to the proceeding. The fact that the bank didn't join in or initiate the Court action was determinative.

Clarica's second ground of appeal, that the lower court had incorrectly concluded that the landlord's future rent claim could not be supported by the letter of credit, was not addressed by the Court of Appeal. Unfortunately for landlords and their lawyers, this issue was the one that had posed the greatest problem in terms of how to frame a letter of credit to withstand bankruptcy/disclaimer.

What now?

It is suggested by some that it may be sufficient to simply state that the letter of credit will be available despite bankruptcy and disclaimer. This ignores the careful analysis the courts have applied to the structure of the letters of credit in the cases before them. Why are the courts so caught up in the structure instead of looking past the structure to the purpose and to the efficacy of letters of credit, allowing them to serve their clear purpose (i.e. to withstand bankruptcy and lease disclaimer)?

Our theory

In *Victoria Butcher v. Schroeder*, the letter of credit represented the monetary equivalent of 2 years' rent, which the Court regarded as an unenforceable penalty. The Court noted that in respect of several possible breaches permitting the letter of credit to be drawn upon, drawing on the letter of credit would yield a disproportionate and unconscionable remedy. The fact that the landlord could draw down only a partial amount did not save the clause, since that would be at the landlord's discretion.

The law does not favour over-compensation of wronged individuals. There is a perception that following the loss of a lease in bankruptcy, the landlord has not suffered as great a loss as the letter of credit will compensate. The reason for this perception is that the landlord retains the asset, i.e. the leased premises. The landlord can, it is presumed, mitigate by re-leasing the premises to another. We believe that the difficulty in enforcing letters of credit lies in this perception.

If this theory is correct, then it is likely that virtually no letter of credit can be structured to secure a lease with certainty of enforceability. Courts will simply look past the wording to the outcome, regardless of the actual terms of the letter of credit.

If this theory is incorrect and the courts truly are concerned with proper structuring of the letter of credit, then there are a few possible arrangements that might pass muster, for those with the temerity to chance it. Unfortunately, there isn't enough space on this News Release to describe them.

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