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# GIVING CREDIT WHERE IT IS DUE

For several years, it has been widely believed that letters of credit are an excellent form of security for landlords, providing a straight route to cash in the event of a tenant default, irrespective of the tenant's bankruptcy. This belief, however, was supported by a disparate body of conflicting case law…until now. In *7636156 Canada Inc. (Re)*, the Ontario Court of Appeal laid any lingering concerns to rest, by confirming the enduring nature of letters of credit in a clear and authoritative decision.

## The Facts

The Tenant leased premises in an industrial building in 2014. The Lease required the Tenant to provide a $2.5M letter of credit, which was to be renewed annually. In 2018, the Tenant declared bankruptcy and the Bankruptcy Trustee disclaimed the Lease. At the time of the disclaimer, rent was up to date and the Landlord held no claim for arrears. The Landlord delivered a proof of claim to the Trustee, in the amount of $623,196.84, for its preferred claim equal to three months' accelerated rent under 136(1)(f) of the Bankruptcy and Insolvency Act (the "**BIA**"). The Landlord asserted that it reserved the right to draw on the letter of credit for lost rent for the balance of the term, as well as restoration costs and the unamortized portion of the tenant allowance. After the Trustee disclaimed the Lease, the Landlord drew down the entire letter of credit.

The Trustee applied to the Court for a determination of the amount of the letter of credit on which the Landlord was entitled to draw.

## The Arguments

The Trustee argued that the Landlord was only entitled to draw $623,196.84 (the amount equal to three months' accelerated rent). The Trustee also argued that the Landlord's draw was a fraud, as the certificates that the Landlord presented to draw on the letter of credit stated that the Tenant had defaulted in its obligations under the Lease after the Trustee had disclaimed it.

The Landlord argued that it was entitled to draw on the entire letter of credit. The Landlord relied on the 2004 Supreme Court of Canada decision of *Crystalline Investments Ltd. v. Domgroup Ltd.* ("***Crystalline***"), in which the Court held that disclaimer of a lease by a trustee in bankruptcy does not eliminate the obligations of third parties, such as guarantors or assignors. Relying on *Crystalline*, the Landlord argued that the Trustee had no legal right to recoup the letter of credit proceeds from the Landlord, since the letter of credit was an autonomous contract that was an independent, third-party obligation of the issuing bank.

## The Decision

The lower Court held that a disclaimer of a lease by a trustee in bankruptcy operates as a voluntary surrender of the lease for all purposes, thereby extinguishing all of the tenant's obligations. Citing *Peat Marwick Thorne Inc v. Natco Trading Corp.*, it concluded that security taken by a landlord is of no value following disclaimer of the lease, since the tenant has no further obligations to support. The

lower Court held that *Crystalline* did not apply to the letter of credit dispute, since the obligation of the issuer of a letter of credit to make a payment to the Landlord was "wholly dependent on the continued existence of the Tenant's obligations under the Lease" (and therefore not akin to an assignor or guarantor with independent contractual obligations to a landlord).

On that basis, the lower Court concluded that the Landlord was entitled only to $623,196.84 (for three months' accelerated rent). The lower Court did not address the Tenant's fraud argument. The Landlord was required to pay the balance ($1,876,803.14) of the amount drawn under the letter of credit to the Trustee.

The Landlord appealed.

The Ontario Court of Appeal overturned the lower Court's decision. It relied on *Crystalline* and its recent decision in *Curriculum Services Canada (Re)* in holding that the lower Court "overstated the effect of a trustee's disclaimer". The Court of Appeal clarified that a disclaimer does not operate as a voluntary surrender of a lease with the consent of the landlord "for all purposes", but rather, only to the extent that it benefits the insolvent tenant. The Court of Appeal held that the law enunciated in *Crystalline* applied equally to assignors, guarantors and issuers of letters of credit (most often a bank), in that none of them are relieved of their obligations by virtue of the disclaimer.

The Court of Appeal also affirmed that letters of credit are autonomous instruments, set apart from the underlying transaction to which they pertain. Accordingly, the issuer of the letter of credit is obligated to pay the beneficiary, solely on the terms stipulated in the letter of credit itself. The issuer's obligation to pay is independent of the terms of the main transaction (e.g. a lease), or the circumstances between the disputing parties.

The Court of Appeal rejected the Trustee's argument that the Landlord's drawing on the letter of credit was a fraud, as there was no evidence that the Landlord acted with impropriety, dishonesty, or deceit, and the provisions of the Lease clearly stated that the letter of credit was not only being held as security for rent but also for indemnification of the Landlord in respect of any losses resulting from a disclaimer of the Lease in connection with the Tenant's insolvency.

**The Takeaway**

There is now authoritative case law in Ontario for the proposition that letters of credit are beyond the reach of a trustee in bankruptcy. With the appropriate wording in the lease clause concerning the applicability of the letter of credit to a default, a landlord should have solid collateral to realize upon in the event of a tenant's breach of the lease.





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