

Leasing Bulletin: Good News for Landlords

Letter of Credit draws are not limited to a Landlord's preferred claim under the BIA

By Minden Gross LLP's [Commercial Leasing Group](#)*

On October 28, 2020, the Ontario Court of Appeal released its decision in [7636156 Canada Inc. \(Re\), 2020 ONCA 681](#) ("OMERS"), on appeal from the decision of the Ontario Superior Court of Justice in [7636156 Canada Inc. v. OMERS Realty Corporation, 2019 ONSC 6106](#). The case held that the landlord was entitled to draw on the full amount of a letter of credit obtained under its lease with an insolvent tenant instead of just the preferred claim equal to three months' worth of accelerated rent under the insolvency laws.

Background

Law

Upon a tenant's assignment in bankruptcy, a trustee in bankruptcy has the power to disclaim any lease of property (see [Bankruptcy and Insolvency Act](#), s. 30(1)(k) ("BIA") and [Commercial Tenancies Act](#), R.S.O. 1990, c. L.7, s. 39(1)).

Following a tenant's assignment in bankruptcy, the landlord is entitled to a preferred claim for three months' worth of accelerated rent under s. 136(1)(f) of the BIA if such accelerated rent is provided under the lease.

An important legal principle pertains to the autonomy of documentary letters of credit. An issuing bank is obliged to honour a draw or other demand for payment under a letter of credit ("LOC") upon compliance with the conditions specified in the LOC. A fundamental characteristic of such securities is the autonomy from the underlying transaction between the applicant and the beneficiary.

Facts

OMERS Realty Corporation ("Landlord") leased its property to 7636156 Canada Inc. ("Tenant") for a term of 10 years, commencing on May 1, 2014, and expiring on the last day of April 2024 (the "Lease"). In May 2018, the Tenant made an assignment in bankruptcy and in July 2018, the Trustee disclaimed the lease.

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Schedule C of the Lease required the Tenant to arrange for a LOC in favour of the Landlord as beneficiary. The Lease stipulated that the LOC stood as security in the event of the Tenant's bankruptcy. The LOC was issued by Bank of Nova Scotia for \$2.5 million and was backed by cash collateral supplied by or on behalf of the Tenant. Per its rights under the Lease, the Landlord made draws on the LOC after bankruptcy, before and after the Trustee disclaimed the Lease, to the full amount of the LOC, \$2.5 million. The Trustee moved for a determination of the total amount that the Landlord was entitled to draw on the LOC.

Lower Court Decision

The Trustee's Motion - Ontario Superior Court of Justice

The Trustee sought repayment of excess LOC withdrawals by the Landlord.

The motions judge found in favour of the Trustee and rejected the Landlord's submission that it was entitled to draw on the LOC for damages suffered as a result of the disclaimer of the Lease. The motions judge concluded that the Landlord was only entitled to draw on the LOC for three months' accelerated rent for the following reasons: 1) a trustee's disclaimer of a lease operates as a voluntary surrender of a lease by the tenant with consent of the landlord, which extinguishes all obligations of the tenant under the lease; and 2) upon disclaimer of the lease, a bankrupt tenant no longer owes any obligations to the landlord under the lease. According to the motions judge, this conclusion was not affected by the decision of the Supreme Court of Canada in [*Crystalline Investments Ltd. v. Domgroup Ltd.*, 2004 SCC 3](#), because in *OMERS*, the bank's obligation (as issuer of the LOC) to make payments was wholly dependent on the continued existence of the tenant's obligations under the lease.

Ontario Court of Appeal

The Landlord's appeal was allowed and the Court of Appeal found that the motion judge erred in finding that the Landlord's entitlement to draw on the LOC is limited to its preferred claim under the BIA. The following points are worth noting:

- The Court noted that the lower court did not have the benefit of the Court of Appeal's decision in [*Curriculum Services Canada/Service Des Programmes D'Études Canada \(Re\)*, 2020 ONCA 267](#), which clarified that the trustee's disclaimer of a lease does not operate as a voluntary surrender of a lease with the consent of the landlord for *all purposes*. Rather, a trustee's disclaimer of a bankrupt tenant's lease ends the rights and remedies of the landlord *against the bankrupt tenant's estate* with respect to the unexpired term of the lease, apart from the three months' worth of accelerated rent provided under the BIA and the [*Commercial Tenancies Act*](#) (Ontario).
- The principle of independence or autonomy (also referred to as the "autonomy principle") applies to LOCs because the issuing bank has an obligation to make payment to the beneficiary, independent of the underlying transaction.

- Upon an in-depth review of jurisprudence, the Court found that the principles of insolvency law do not override the principle of autonomy of LOCs, nor do they limit the landlord's right to draw on the LOC in excess of its preferred claim under the BIA.
- The Court recognized the recent Supreme Court of Canada decision in [Chandos Construction Ltd. v. Deloitte Restructuring Inc., 2020 SCC 25](#) ("*Chandos*"), which deals with the "anti-deprivation rule". The anti-deprivation rule invalidates contractual provisions triggered by an event of bankruptcy or insolvency and which have the effect of removing value from a bankrupt's or insolvent's estate. Applying the *Chandos* case, the anti-deprivation rule is not offended when commercial parties protect themselves against a contracting counterparty's insolvency by taking security, acquiring insurance, or requiring a third-party guarantee.

Takeaway and Implications

Canadian landlords are breathing a collective sigh of relief now that the Ontario Court of Appeal has overturned the troubling lower court decision in the *OMERS* case. There are a few key takeaways from the appeal decision. First, a landlord's entitlement to draw on a LOC in the event of a tenant's bankruptcy or insolvency is not limited to the landlord's preferred claim under the BIA for three months' worth of accelerated rent. Second, based on the decisions in *Chandos* and *OMERS*, the anti-deprivation rule will not be offended when a landlord protects itself against a tenant's bankruptcy or insolvency by taking security or requiring a third-party guarantee.

If you have any questions or would like to obtain legal advice on commercial landlord or tenant issues or disputes as well as bankruptcy or insolvency, please contact any lawyer in our [Commercial Leasing Group](#).

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