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Leasing Bulletin:

Looking Back at 2020

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In 2020, COVID-19 stopped the world and changed everything. Commercial leasing was similarly affected. This recap highlights some noteworthy cases from 2020.

Can a tenant stop paying rent as a result of COVID-19?

In *Hengyun International Investment Commerce Inc. c. 9368-7614 Québec Inc.*, 2020 QCCS 2251 ("*Hengyun*"), a gym tenant, forced to stop operating as a result of government-mandated shutdowns, sought rent relief from the Superior Court of Quebec. The Tenant's lease contained a superior force (force majeure) clause but provided that it did not excuse payment of rent. Despite this language, the Court found that the Tenant was not liable for rent during the impacted period because the Landlord was prevented by superior force from providing peaceable enjoyment.

The lease provided that the premises were to be used "solely as a gym." Because this activity was prohibited by government order, the Court determined that the Tenant had no peaceable enjoyment of the premises (even though the Tenant continued to store its equipment and have access to the premises), and the Landlord could not insist on payment of rent per Article 1694 of the Civil Code of Québec.

Since *Hengyun* was rendered under civil law in Québec, many landlords anxiously waited to see if Courts in the common law provinces would rely on this case. The case of *Durham Sports Barn Inc. Bankruptcy Proposal*, 2020 ONSC 5938 ("*Durham*"), brought some much-needed clarity.

In *Durham*, the Tenant operated an elite athletic performance centre and was forced to shut down temporarily due to government orders. The Tenant sought to rely on *Hengyun* and argued that because force majeure interfered with its quiet enjoyment, the Landlord cannot insist on payment of rent.

The Court refused to apply *Hengyun*. It found that the doctrine of "superior force" in the Quebec Civil Code (which was relied on in *Hengyun*) does not exist in Ontario. In addition, while the force majeure clause relieved the Landlord from providing quiet enjoyment, the lease specifically provided that it did not relieve the Tenant from paying rent. The Landlord's obligation to provide quiet enjoyment hinged on the payment of rent. Since the Tenant did not pay rent during the subject

periods, the Landlord's obligation to provide quiet enjoyment did not arise. As a result, the Court found that the Tenant was not entitled to any rent relief during the government-mandated shutdown.

Does resulting physical damage under an insurance policy require actual tangible damage or can it include loss of use?

Although not a leasing case, *MDS Inc. v. Factory Mutual Insurance Company (FM Global)*, 2020 ONSC 1924 ("*MDS*") caught the attention of many in the industry who were fielding questions on business interruption coverage for COVID-19 losses. Traditionally, insured parties do not have coverage where there is no "physical" damage (or loss). In *MDS*, the Ontario Superior Court of Justice considered the specific language of the policy, the factual matrix, and the parties' reasonable expectation. The Court broadly interpreted the term "physical damage" in that policy to include the "impairment of function or use of tangible property."

It is still uncertain whether a Court would broadly interpret "physical damage" to include "impairment of function or use of tangible property" in the context of a claim for COVID-19 business interruption loss. *MDS* did not deal directly with COVID-19 business interruption losses. However, this case sparked hope for the possibility of coverage – something that would have previously been denied outright due to no "physical" damage or loss.

Rights of a Commercial Landlord as a Creditor in Bankruptcy of Tenant

The case of *Curriculum Services Canada/Services Des Programmes D'Etudes Canada (Re)* 2020 ONCA 267 ("*Curriculum*") deals with the rights of a commercial landlord, as a creditor, following the disclaimer of a lease by the trustee in bankruptcy (the "Trustee"). Following the Tenant's bankruptcy, the Landlord filed a proof of claim for a preferred claim pursuant to the *Bankruptcy and Insolvency Act* ("*BIA*") for three months of rental arrears and three months of accelerated rent, as well as an unsecured claim for tenant inducements and rent payable for the unexpired portion of the term ("Future Damages"). The Trustee disclaimed the lease and allowed the Landlord's preferred claim for rental arrears (limited to the value of the property on the premises), but the Trustee was silent on the Landlord's claim for accelerated rent and disallowed the Landlord's claim for Future Damages.

The Landlord appealed the Trustee's decision to the Ontario Superior Court of Justice, pointing to the seminal case of *Highway Properties Ltd. v. Kelly Douglas and Co. Ltd.*, [1971] S.C.R. 562 (S.C.C.) ("*Highway Properties*"), where the Supreme Court of Canada ("SCC") introduced the concept that a landlord, who terminates the lease of a defaulting tenant, is entitled to claim damages equal to the rent that would have been payable for the unexpired term of the lease, less the rentable value of the premises for that period of time. The Landlord argued that its losses flowing from the disclaimer of lease were contractual damages and should be treated equally with

any contractual damages potentially suffered by the Tenant's other creditors. The Superior Court sided with the Trustee and dismissed the Landlord's appeal.

The Ontario Court of Appeal allowed the Landlord to rank as an unsecured creditor for the balance of its preferred claim (for three months of accelerated rent). However, it found that the disclaimer of the lease by the Trustee operated to end the Tenant's obligations under the lease and dismissed the Landlord's claim as an unsecured creditor for the Future Damages.

The Court of Appeal found that on disclaimer of a commercial lease by a Trustee, a landlord has no claim as an unsecured creditor for Future Damages, except for three months' accelerated rent as provided under the *BIA*. Further, while *Highway Properties* recognized that a lease is also a contract and provided for a landlord's option to accept a tenant's repudiation and sue for Future Damages, the case did not address a situation of bankruptcy or insolvency. The remedies for a tenant's repudiation do not apply once a Trustee has disclaimed the lease.

While the Ontario Court of Appeal correctly allowed the Landlord's preferred claim for three months accelerated rent, in our view it is questionable whether its decision regarding Future Damages is correct in law given the SCC's decision in *Highway Properties*. Unfortunately, since the Landlord chose not to appeal to the SCC, the Court of Appeal's decision in *Curriculum* is now binding law in Ontario and will be relied upon by Trustees to reject a landlord's unsecured claim for Future Damages.

Good news for Landlords – Letter of Credit draws are not limited to a Landlord's preferred claim under the BIA

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 a landlord was entitled to draw on the full amount of a letter of credit obtained by virtue of its lease with an insolvent tenant, instead of just the preferred claim equal to three months' worth of accelerated rent under the *BIA*.

In *OMERS*, the Landlord leased its property to the Tenant for a term of ten years. After four years, the Tenant made an assignment in bankruptcy and shortly thereafter, the Trustee disclaimed the lease. Schedule C of the lease required the Tenant to arrange for a letter of credit ("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. In accordance with its rights under the Lease, the Landlord drew down the full amount of the LOC after the bankruptcy. The Trustee moved for a determination of the total amount that the Landlord was entitled to draw on the LOC and sought repayment of any excess 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 because:

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 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 SCC's decision in *Crystalline Investments Ltd. v. Domgroup Ltd.*, [2004] 1 S.C.R. 60 (S.C.C.). In *OMERS*, the bank's obligation to make payments (as issuer of the LOC) was wholly dependent on the continued existence of the tenant's obligations under the lease.

The Landlord's appeal was allowed and the Ontario Court of Appeal found that the motions judge erred in finding that the Landlord's entitlement to draw on the LOC is limited to its preferred claim under the *BIA*.

It's worth noting the following points:

(a) the Court noted that the lower court did not have the benefit of the Court of Appeal's decision in *Curriculum*, 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 <u>all purposes</u>. Rather, a Trustee's disclaimer of a bankrupt tenant's lease ends the rights and remedies of the landlord <u>against the bankrupt tenant's estate</u> 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);

(b) 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 which is independent of the underlying transaction;

(c) 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*;

(d) the Court recognized the recent SCC decision in *Chandos Construction Ltd. v. Deloitte Restructuring Inc.*, 2020 SCC 25 ("*Chandos*"), which reaffirmed the "anti-deprivation rule" which voids contractual provisions that operate to remove value from an insolvent person's estate that would otherwise be available to the creditors. Applying the *Chandos* case, the anti-deprivation rule is not violated when commercial parties protect themselves against a

contracting counterparty's insolvency by taking security, acquiring insurance, or requiring a third-party guarantee.

Canadian landlords breathed a collective sigh of relief when the Ontario Court of Appeal overturned the troubling lower court decision in *OMERS*. Unfortunately, this may be short-lived as the Trustee is seeking leave to appeal to the Supreme Court of Canada.

Conclusion

As we continue into 2021, we expect there will be more COVID-19 and insolvency-related leasing cases, as tenants continue to struggle with the economic challenges brought on by COVID-19.

We will continue to provide regular updates on commercial leasing issues in Canada. If you have any questions or would like to obtain legal advice on any leasing issues or commercial leasing litigation, please contact any lawyer in our Commercial Leasing Group.

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