MINDEN GROSS LLP

Fall 2021

TOPIC:

Recent Developments in Property Leasing PART 2

Be Careful not to Lose Your Claim for Prospective Rent by Claiming Accelerated Rent

In *Can-Faith Enterprises Inc. v. 0932784 B.C. Ltd.*, 2019 BCSC 1332, the Tenant exercised its option to renew but sought a second option, which the Landlord ignored. In accordance with the lease, the matter proceeded to arbitration to determine market rent; the Tenant did not attend and denied the option

(Part 1 was released in our Summer 2021 Newsletter)

had been exercised. The Tenant stopped paying rent and the Landlord terminated the lease and commenced an action for breach of contract.

The Court considered whether the Landlord was entitled to recover, as separate remedies, damages for the loss of prospective rent for the five-year renewal term and three months' accelerated rent. The Landlord argued that it was entitled to recover both, as the accelerated rent clause was included to provide a remedy if the Tenant became insolvent. The Tenant argued that the accelerated rent clause was a liquidated damages clause, which represented all the damages that the Landlord may recover for the loss of prospective rent.

The Court found that the accelerated rent clause was a pre-contractual estimate of damages for the Tenant's breach of the lease. By seeking to enforce this clause as a separate remedy, the Landlord had elected to accept this amount as a complete remedy for the Tenant's default.

Depending on the wording in a lease, an accelerated rent clause may either be an advanced payment of rent or separate liquidated damages. Where a landlord wants to recover damages for prospective loss arising from a breach, it must be careful not to enforce an accelerated rent clause, which is a liquidated damages clause, or risk being found to have accepted the accelerated rent as a complete remedy for the entire breach.

Rights of a Commercial Landlord as a Creditor in the Bankruptcy of a 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.

Following the Tenant's bankruptcy, the Landlord filed a proof of claim in bankruptcy asserting a preferred claim under the *Bankruptcy and Insolvency Act* ("*BIA*") for three months' accelerated rent and an unsecured claim for tenant inducements and rent payable for the unexpired portion of the term ("Future Damages"). The trustee in bankruptcy disclaimed the lease and allowed the rental arrears portion of the Landlord's preferred claim (limited to the value of the property on the premises). 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 the lease are 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. However, it found that the disclaimer of the lease by the trustee in bankruptcy 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 explained that *Mussens Ltd., Re*, [1933] O.W.N. 459 (Ont. S.C.) ("*Mussens*"), stands for the principle that, under Ontario law, the trustee of a bankrupt tenant is permitted by statute to bring an end to the lease and all future obligations of the tenant thereunder by surrendering possession of the leased premises or disclaiming the lease within three months of the bankruptcy.

The Court found that while it would not support an interpretation of *Mussens* that would characterize a disclaimer as a consensual surrender for all purposes, *Crystalline Investments Ltd. v. Domgroup Ltd.*, [2004] 1 S.C.R. 60 (S.C.C.), left intact the rule articulated in *Mussens* that on disclaimer of a commercial lease by its trustee, an Ontario landlord has no claim as an unsecured creditor in the bankrupt tenant's estate for Future Damages, except to recover the 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, it is questionable, in our view, whether their 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 in bankruptcy to reject a landlord's unsecured claim for Future Damages.

Anti-Deprivation Rule and its Impact on Enforceability of Provisions in Commercial Leases

On October 2, 2020, the SCC released its decision in *Chandos Construction Ltd. v. Deloitte Restructuring Inc.*, 2020 SCC 25. The case reaffirmed the common law rule of anti-deprivation, which renders invalid any provision taking away value from a bankrupt or insolvent estate. The "anti-deprivation rule" voids contractual provisions that operate to remove value from an insolvent person's estate that would otherwise be available to the creditors. The rule involves a two-part test: (i) the clause must be triggered by an event of insolvency or bankruptcy; and (ii) the effect of the clause must be to remove value from the insolvent's estate. The rule exists to protect unsecured creditors who may lose out on rightful compensation due to contractual provisions triggered by bankruptcy or insolvency.

In this case, Chandos Construction Ltd. ("CCL"), a general contractor, entered into a construction agreement with Capital Steel Inc. ("CS"). The agreement included a provision requiring payment of 10% of the agreement price to CCL if CS committed any act of bankruptcy, insolvency, or ceased to run its operation, as an inconvenience fee for completing the work using alternate means. CS made an assignment in bankruptcy before the completion of the subcontract. CCL sought to set-off the 10% fee against amounts it owed to CCL under the subcontract. Deloitte Restructuring, the trustee in bankruptcy, sought a determination on whether this provision is enforceable.

The lower court ruled in favour of CCL and found that the provision was valid based on: (i) there was no attempt to avoid the bankruptcy laws, but, rather, the provision serves a commercial purpose; and (ii) the anti-deprivation rule protects against devaluing the estate, but does not prohibit parties from making claims for liquidated damages. The Court treated the provision as a liquidated damages clause as opposed to an attempt to circumvent bankruptcy laws or a penalty clause.

The Alberta Court of Appeal reversed the trial court's decision and held that the provision was invalid on two grounds by: (i) violating the penalty clause rule; and (ii) violating the anti-deprivation rule. The Court looked at the history of the anti-deprivation rule in Canadian jurisprudence. It noted that it has not been eliminated either by subsequent cases or legislation. The most significant point, however, was to characterize the rule as *effects-based* as opposed to *purpose-based*. This means that as long as a provision is triggered by the bankruptcy or insolvency of a person and has the effect of devaluing the estate to the prejudice of the creditors, it will be invalid.

The SCC dismissed CCL's appeal. The Court agreed with the Court of Appeal's reasons and held the provision to be invalid. The following points are worth noting: (i) the Court gave effect to the legislative scheme set out by the Parliament in s. 71 of the *BIA*, which provides that the property of the bankrupt must pass and vest in the trustee. As such, "any avoidance, whether intentional or inevitable, is surely a fraud on the statute"; (ii) the Court confirmed the effect-based approach. This was done to promote certainty in contracts and ensure the rule is effective in all situations, not just ones involving the clearest cases of avoidance of insolvency or bankruptcy laws.

The Court also held that the anti-deprivation rule does not apply in the following situations: (i) contractual provisions that eliminate property from the estate, but not its value; (ii) contractual provisions not triggered by bankruptcy or insolvency; and (iii) contractual provisions that protect parties against a counterparty's insolvency or bankruptcy by taking security, acquiring insurance, or requiring a third-party guarantee.

It is also worth noting that a strong dissent argued against the application of the anti-deprivation rule if there is a *bona fide* commercial purpose, allowing parties to freely contract and protect their self-interest.

The bottom line is that when applying the anti-deprivation rule, courts will look at whether the contractual provision has the effect of depriving the estate of assets upon bankruptcy, and not whether the intention of the contracting party was commercially reasonable. It is also important to note that the SCC held that the anti-deprivation rules 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.

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 the 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 insolvency laws.

In *OMERS*, the Landlord leased its property to the Tenant for a term of 10 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 favor 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 favor 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 the Landlord was only entitled to draw on the LOC for three months' accelerated rent for the following reasons: (i) 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 (ii) 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 SCC's decision in *Crystalline* because, in *OMERS*, the bank's obligation to make payments (as the issuer of the LOC) was wholly dependent on the continued existence of the tenant's obligations under the lease.

The Landlord appealed. 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*. The following points are worth noting: (i) 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 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 for 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); (ii) 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; (iii) 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*; and (iv) the Court recognized the recent SCC decision in *Chandos*, which deals with the "anti-deprivation rule." 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.

Canadian landlords can now breathe a collective sigh of relief since the Ontario Court of Appeal has overturned the troubling lower court decision in *OMERS* and confirmed that: (i) 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; and (ii) 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.

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Firm News

Welcome!

Minden Gross LLP is pleased to welcome the following lawyers to our firm.

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Minden Gross LLP announces Brian Temins as new Managing Partner

Brian Temins has been named by the firm's partnership to succeed **Raymond Slattery** as Minden Gross LLP's Managing Partner starting September 1, 2021. This change comes as Raymond, Minden Gross LLP's Managing Partner for over 20 years, stepped down from the role on August 31, 2021. Brian joined the firm in 2007. He has served as a member of the Executive Committee for five years and as the Chair of Minden Gross LLP's Business Law Group for over 10 years.

Best Lawyers in Canada 2022

Minden Gross LLP is pleased to announce that 13 of our lawyers have been recognized by their peers in the 2022 edition of *The Best Lawyers in Canada*. We extend our congratulations to the following lawyers: **Timothy Dunn** (Banking and Finance Law), **Andrew Elbaz** (Mining Law), **Joanne Golden** (Trusts and Estates), **Arnie Herschorn** (Corporate and Commercial Litigation), **Michael S. Horowitz** (Commercial Leasing Law/ Real Estate Law), **Joan E. Jung** (Trusts and Estates), **Christina Kobi** (Commercial Leasing Law), **Steven Pearlstein** (Real Estate Law), **Stephen Posen** (Commercial Leasing Law/ Real Estate Law), **Samantha Prasad** (Tax Law), **Reuben Rosenblatt, LLD, QC, LSM** (Real Estate Law), **Marc Senderowitz** (Real Estate Law), and **Raymond Slattery** (Insolvency and Financial Restructuring Law).

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Minden Gross LLP congratulates new Partners

Minden Gross LLP is pleased to announce the admission to partnership of **Melodie Eng** (Commercial Leasing), **Rachel Goldman Robinson** (Wills and Estates), and **Sepideh Nassabi** (Financial Services/Litigation/Business Law).

Irvin Schein elected to the Minden Gross LLP Executive Committee

We are excited to announce that **Irvin Schein** has been elected by the partnership of Minden Gross LLP to its Executive Committee. As a member of Minden Gross LLP for more than 35 years, Irvin is the Chair of the Litigation Group and is a recognized mediator and arbitrator.

Minden Gross LLP names three new practice group Chairs

Congratulations to **Ryan Gelbart**, who has been named as Chair of Minden Gross LLP's Business Law Group, **Rachel Goldman Robinson**, who has been named as Chair of Minden Gross LLP's Wills and Estates Group, and **Sepideh Nassabi**, who has been named as Chair of Minden Gross LLP's BSA Industry Group and Intellectual Property Litigation Group.

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