

LANDLORD ISSUES IN INSOLVENCIES – ONTARIO

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**INSOLVENCY INSTITUTE OF
CANADA**

SEPTEMBER, 2003

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Introduction

Recent insolvencies have seen tenants, receivers and trustees in bankruptcy become increasingly aggressive in challenging the rights traditionally enjoyed by landlords. What follows is a brief summary of the current state of the law in the Province of Ontario as it relates to the following key landlord/tenant issues in the context of an insolvency:

- conflict between applicable federal and provincial legislation;
- the ability to disclaim, repudiate and surrender leases;
- the obligation to pay occupation rent;
- the ability to force an assignment of a lease over the objection of the landlord;
- the ability to amend leases in proceedings under the *Companies' Creditors Arrangement Act*¹ ("CCAA");
- the ability to conduct liquidation sales from existing premises; and
- the use of letters of credit to secure a tenant's obligations under a lease.

This paper focuses on commercial leases in bankruptcy proceedings under the *Bankruptcy and Insolvency Act*² ("BIA"), and, where relevant, CCAA proceedings are also referenced.

¹ R.S.C. 1985, c. C-36, as amended.

² R.S.C. 1985, c. B-3, as amended.

I. Constitutional Issues

There is an ongoing tension where landlords are concerned between the federal constitutional powers relating to bankruptcy and insolvency and provincial powers relating to property and civil rights. However, the BIA for the most part avoids this tension by delegating authority with respect to landlords' rights to the provinces. Section 146 of the BIA provides that a landlord's rights and those of a trustee in bankruptcy with respect to real property leased by a bankrupt are to be dealt with according to the laws of the province where the real property is located. However, the quantum and priority of a landlord's claim in a bankruptcy remains as set out in the BIA, notwithstanding provincial law. Also, other provisions of the BIA which relate directly or indirectly to landlords take precedence over provincial laws, such as the requirement for the release to the trustee of property that is under seizure by a landlord at the date of bankruptcy pursuant to subsection 73(4) of the BIA. Section 30(1)(k) of the BIA gives the trustee the authority, with the permission of the inspectors of the bankrupt estate, to exercise the rights given to the trustee at provincial law, including the right to elect to retain, assign or disclaim leases.

The delegation of authority to the provinces pursuant to Section 146 of the BIA was enacted following a decision of the Québec Superior Court³ in 1923, which held that certain provisions of the *Bankruptcy Act*, as it was then, (which provisions permitted a trustee in bankruptcy to override a prohibition on assignment found in a lease) were unconstitutional and *ultra vires* the federal Parliament since matters of contracts involving real property do not properly come within federal "bankruptcy and insolvency" powers under the Constitution. Such interference with contractual rights was found to be a matter within provincial jurisdiction relating to property and civil rights.

In Ontario, the rights of landlords and trustees are governed by the *Commercial Tenancies Act*⁴ ("CTA"). Sections 38 and 39 of the CTA confirm that a trustee in bankruptcy has the right to, *inter alia*: (i) occupy premises leased by a bankrupt, provided that the trustee pays occupation

³ *Re Stober* (1923), 4 C.B.R. 34 (Que. S.C.).

⁴ R.S.O. 1990, c. L.7, as amended.

rent for the period of its actual occupation; (ii) disclaim or elect to retain a lease; and (iii) assign the lease, in certain circumstances. Each of these issues will be discussed further below.

II. Disclaimer/Surrender/Repudiation of Leases

When a corporation becomes insolvent, it is often a key preliminary step to evaluate whether current leases should be maintained and, if not, what rights the debtor or a trustee has with respect to avoiding undesirable leases. A trustee may wish to disclaim or surrender a lease. A disclaimer is a unilateral act on the part of a trustee terminating the lease. A surrender involves the giving up of the lease with the consent of the landlord. The legal effect of surrender or disclaimer is the same insofar as all of the rights and obligations which vested in the trustee upon the making of the receiving order or the assignment in bankruptcy are extinguished and the landlord has, at best, a limited claim for the rent for the remainder of the term of the lease (i.e. 3 months' accelerated rent under Section 136 of the BIA).⁵

In practice, the terms disclaimer, surrender and repudiation are often used interchangeably, however, technically the “repudiation” of a lease may allow for a more significant damage claim by the landlord. The Supreme Court of Canada, in *Highway Properties Ltd. v. Kelly, Douglas and Co.*,⁶ held that following the repudiation of a lease by a tenant, a landlord has the option to hold the tenant to the lease or terminate it, and if the landlord chooses to terminate, has a right of action for damages for the remainder of the lease term. The Court overruled the lower court which had held that a lease and its covenants cease to exist upon the surrender of the lease, and, as such, a landlord could only recover damages for breaches of the lease occurring to the date of surrender. The Court stated that there was no logic in the conclusion that, by electing to terminate, a landlord limits damages such that it may only claim to the same scale that would result if the lease were kept alive. The Court stated that a landlord was entitled to terminate with notice to the defaulting tenant that damages would be claimed on the basis of a present recovery of damages for losing the benefit of the lease over its entire unexpired term.

⁵ *Cummer-Yonge Investments Limited v. Fagot et al.*, [1965] 2 O.R. 152 (Ont. S.C.); affirmed (1965), 8 C.B.R. (N.S.) 62 (Ont. C.A.).

⁶ [1971] S.C.R. 562 (S.C.C.).

Under Section 39 of the CTA, a trustee has the right, at any time prior to electing to retain the lease, by notice in writing, to surrender possession or disclaim the lease. The rights of a trustee following bankruptcy of a tenant in Ontario can be summarized as follows:

- to retain the leased premises for a period of three months following the date of bankruptcy;
- to elect to retain the leased premises for the whole or any portion of the unexpired term of a lease and any renewal thereof;
- to assign the lease with rights of renewal, if any, to a third party even if the lease prohibits assignment (subject to a “fit and proper person” test); and
- to disclaim or surrender the lease within three months of the date of bankruptcy.⁷

Under the BIA, a debtor who is proposing to restructure may, on 30 days’ notice to the affected landlord, disclaim a lease provided that the exercise of this right is limited to the period of time between the filing of the notice of intention and the filing of the proposal, or on the filing of the proposal. Landlords affected by the debtor’s right to disclaim may file a proof of claim in the proposal in an amount determined in accordance with Section 65.2(4) of the BIA. A landlord may object to a proposed disclaimer by applying for a court declaration that the disclaimer does not apply to a particular lease. In such cases, the court must grant the declaration unless the debtor satisfies the court that the debtor’s ability to make a viable proposal to its creditors will be jeopardized unless the lease in question is disclaimed.

Receivers and interim receivers do not have the ability to repudiate leases and are not recognized under the CTA. Accordingly, receiverships and interim receiverships may be combined with bankruptcies to allow for leases to be dealt with by a trustee.

In CCAA proceedings, although the CCAA itself is silent on the point, courts have held that a lease may be terminated by an insolvent person as part of a CCAA plan, notwithstanding the objections of a landlord (and initial CCAA orders typically provide for this).⁸ There is some

⁷ *Re Limestone Electrical & Supply Co.*, [1955] O.R. 291 (Ont. C.A.).

⁸ *Re Armbro Enterprises Inc.* (1993), 22 C.B.R. (3d) 80 (Ont. Gen. Div.).

uncertainty as to the appropriate means of valuing the resulting claim of the landlord and whether the BIA's provisions should apply in this regard.

III. Occupation Rent

The obligation to pay rent from and after the commencement of insolvency proceedings is not an issue in CCAA proceedings as the debtor remains in possession of its premises and is clearly obligated to pay rent as long as it occupies the premises (such requirement is often expressly included in the initial CCAA orders). Similarly, a receiver's obligation to pay occupation rent is clearly established in the case law and may be expressly included in the order appointing the receiver. However, such obligation only extends to those premises actually occupied by the receiver. Historically, an interim receiver appointed under the BIA was not liable for occupation rent as the estate of the debtor is not divested in the interim receiver upon its appointment. However, as the distinction between interim receivers and receivers is increasingly blurred, interim receivership court orders are increasingly providing for the payment of occupation rent.

Although Section 136(1)(f) of the BIA contemplates that a trustee will pay occupation rent, by Section 146 the matter of liability of the trustee for payment of occupation rent is left to provincial legislation.⁹ The fact that the landlord is unable to obtain possession of the leased premises because the trustee has not elected to disclaim or to retain the lease is immaterial. The liability of the trustee for occupation rent arises out of the trustee's occupation of the leased premises and not out of the inability of the landlord to obtain possession. It is a question of fact whether the trustee was in actual occupation.

Traditionally, in Ontario, a trustee would not be liable for occupation rent in respect of the premises not actually occupied by the trustee.¹⁰ This has led to some debate over the meaning of "actual occupation".

Another issue with respect to occupation rent has to do with the personal liability of a trustee for the rent. Pursuant to Section 146 of the BIA, this is a matter that must be determined by provincial law and, as such, there is considerable provincial variation. The CTA does not

⁹ *Sawridge Manor Ltd. v. Western Canada Beverage Corp.* (1995), 33 C.B.R. (3d) 249 (B.C.C.A.)

¹⁰ *Re Toyerama Ltd.* (1981), 37 C.B.R. (N.S.) 275 (Ont. S.C.).

specifically make a trustee in bankruptcy personally liable for occupation rent and the Ontario courts have split on the issue.¹¹ However, the prevailing view, consistent with the common law, is that a trustee who occupies the premises of the bankrupt is liable for occupation rent.

Finally, depending on the timing of the filing commencing the insolvency proceedings, issues may arise relating to the payment of per diem occupation rent. If, for example, a BIA proposal is filed on January 15 and, pursuant to the terms of the lease, rent is payable on the first of each month, a trustee may attempt to argue that the rent for the month of January constitutes arrears and it is not required to make a lease payment until February 1. Ground J. in *Re Cosgrove-Moore Bindery Services Ltd.*,¹² held that a landlord can require immediate payment of rent on a per diem basis as of the day immediately following the date of the filing of the Notice of Intention to make a Proposal. This decision is consistent with the general principle that a trustee must pay rent for all of the time that it is in actual possession of the leased premises.

IV. Assignment of Leases

As discussed above, a trustee has three months from the date of bankruptcy to decide whether to retain or disclaim/surrender a lease. Pursuant to Section 38 of the CTA, the trustee may elect to retain the lease and assign it to a third party. If a trustee wishes to exercise this right, it must comply with the following requirements:

- elect by notice in writing to the landlord to retain the premises, which notice must be provided within the three month period (the trustee is not required to make the election to retain before it finds a proposed assignee as long as the period has not expired);
- pay all arrears of rent outstanding under the lease;
- obtain from the proposed assignee a covenant to observe and perform the terms of the lease and an agreement to conduct on the premises a trade or business that is not

¹¹ For cases that have found the trustee to be personally liable see for example: *Sasso v. D. & A. MacLeod* (1991), 5 C.B.R. (3d) 239 (Ont. Gen. Div.); *1133 Yonge Street Holdings Ltd. v. Clarke Henning & Hahn Ltd.* (1991), 2 C.B.R. (3d) 11 (Ont. Gen. Div.); and *Re Yonemitsu Investments Ltd.* (1992), 14 C.B.R. (3d) 279 (Ont. Gen. Div.). For cases that have found that the trustee is not personally liable see for example: *Ottawa Elgin Investments Ltd. v. McKechnie* (1983), 42 O.R. (2d) 366 (Ont. Co. Ct.); and *Re Listowel Feed Mill Ltd.* (1990), 1 C.B.R. (3d) 230 (Ont. Gen. Div.).

¹² (2000), 17 C.B.R. (4th) 205 (Ont. S.C.J.).

reasonably more objectionable or hazardous than that which was conducted on the premises by the bankrupt; and

- make an application to a judge of the Ontario Superior Court of Justice for approval of the proposed assignee as a person fit and proper to be put in possession of the premises.

In order to qualify as a fit and proper person, the court must be satisfied that the proposed tenant is both motivated and able to honour the covenants in the lease, and will covenant that he will carry on a business no more objectionable or hazardous than that carried on by the previous tenant. The assignee must also satisfy the court that he will make fit and proper use of the premises. The court will require evidence of the assignee's reputation in the community, both as a tenant and as a businessman/company, as well as evidence of the assignee's credit-worthiness. The assignee must accept and abide by the terms of the lease, including any operating covenants, use provisions and restrictions on subletting or further assignment of the lease.

The rights provided by the CTA override any prohibition on assignment that may be found in a lease.¹³ The rationale for this is to enable the trustee to realize upon the bankrupt's leasehold interest for the benefit of creditors of the estate.¹⁴ It is important to emphasize that it is only the prohibition on assignment that can be avoided. Other terms of the lease, including any use provisions, must be complied with and, as such, the lease must be assigned without amendment.

There is some question with respect to the liability of a trustee for rent following the assignment of a lease. There are decisions in which Ontario courts have held that a trustee who elects to retain leased premises and makes an assignment of the lease becomes personally liable for the rent if the assignee fails to pay.¹⁵ The crux of the issue appears to be whether, by electing to retain the lease prior to assignment, the trustee creates privity of contract with the landlord which remains extant after assignment, providing the landlord with recourse to the trustee if the assignee fails to perform the covenants contained in the lease.¹⁶ Alternatively, some courts have

¹³ *Micro Cooking Centres (Canada) Inc. (Trustee of) v. Cambridge Leaseholds Ltd.* (1988), 68 C.B.R. (N.S.) 60 (Ont. H.C.J.).

¹⁴ *Ibid.*

¹⁵ See for example *Re Surplus Merchandisers Ltd.*, [1950] O.W.N. 677 (Ont. S.C.).

¹⁶ S. Roebuck, "Trustee Liability on Assignment of Lease", 78 C.B.R. (N.S.) 246.

accepted that the property of the bankrupt vests automatically in the trustee without the necessity of acceptance by the trustee of the bankrupt's leasehold interest. This vesting creates a relationship based on privity of estate, not privity of contract, and, as such, when the trustee assigns the lease, the liability of the trustee thereunder ceases.¹⁷

It appears to be accepted that a court-appointed receiver, an interim receiver or a debtor corporation in CCAA proceedings can only assign a lease if a lease so provides, in which case the assignment must take place in accordance with the terms of the lease. In addition, any arrears of rent owing under a lease proposed to be assigned must be paid prior to assignment. This is because most leases only permit assignment if they are in good standing. Accordingly, a receiver or debtor under the CCAA will have to bring a lease into good standing in order to complete the assignment. As a matter of practice therefore, the effect is to bring the treatment of receivers, interim receivers and debtor companies in line with the requirements placed on trustees by the CTA.

V. Amending Leases in CCAA Proceedings

A current issue in CCAA proceedings involves whether the terms of a lease can be unilaterally amended in the course of CCAA proceedings without the consent or approval of the landlord. Clauses that have been challenged include assignment clauses, use clauses, signage clauses and hours of operation clauses. Leases also frequently contain clauses prohibiting any liquidation, bankruptcy or fire sale from being carried out on the premises.

There is not a great deal of decided law with respect to the ability to unilaterally impose lease amendments under CCAA proceedings, however, Farley J. in *Re T. Eaton Co.*¹⁸ held that the debtor was required to comply with the terms of the lease during the course of the restructuring. These issues have been considered under the BIA and it is relatively clear that the terms of a lease cannot be unilaterally altered (save and except for an assignment pursuant to the CTA).¹⁹

¹⁷ *Re Hip Pocket Ltd.* (1977), 24 C.B.R. (N.S.) 72 (Ont. S.C.).

¹⁸ *Re T. Eaton Co.* (1999), 12 C.B.R. (4th) 130 (Ont. S.C.J.).

¹⁹ See *Micro Cooking Centres*, *supra* note 12; *Sunys Petroleum Inc./Les Petroles Sunys Inc. (Trustee of) v. 653129 Ontario Ltd.* (1999), 12 C.B.R. (4th) 27 (Ont. S.C.J.); and *Dylex Ltd. (Trustee of) v. Westwood Mall (Mississauga) Ltd.* (2001), 33 C.B.R. (4th) 292 (Ont. S.C.J.); and *Dylex Ltd. (Trustee of) v. Westwood Mall (Mississauga) Ltd.*, [2001] O.J. No. 5021 (Ont. S.C.J.).

In the course of the restructuring of Woodward's Ltd., the company attempted to unilaterally reduce leased space and the amount of rent payable per square foot. However, the landlords who were involved agreed to vote in favour of the reorganization and, as such, the issue was never litigated.

With respect to the delegation of landlords into classes in CCAA proceedings, the British Columbia Supreme Court in *Woodward's Ltd.* had ruled that landlords who were having their leases amended unilaterally could be part of the same class as landlords who were having their leases repudiated, for purposes of voting on the plan. The court noted having a single class was appropriate because landlords who were having their leases amended were having rents adjusted to market rates and landlords with terminated leases would be re-letting at market rates.²⁰ This decision suggests that if the leases for premises being retained were being unilaterally amended in a manner not consistent with the prevailing market conditions facing the landlords with terminated leases, the former group of landlords would be entitled, at the very least, to a separate class as a result of their special interest.

In the context of a bankruptcy, the Ontario courts have prohibited the imposition of a lease amendment on a landlord by a trustee when a trustee has elected to assign a lease.²¹ In *Micro Cooking*, the lease in question related to a store in a shopping mall and had a use clause that limited use of the premises by the tenant to the sale of micro-wave ovens and kitchenware, and stipulated that the premises could not be used for the sale or distribution of any food product. The potential assignee sold frozen yogurt. The trustee submitted that the assignment should be authorized by the court notwithstanding the restriction on use as it achieved the best recovery for the creditors of the estate. The court disagreed and stated that "to confer a right on the assignee to ignore the use clause in the lease would be to emasculate the terms of the lease by sweeping aside what is, in the context of a shopping mall, a fundamental term". The court concluded that if a trustee elected to assign the lease, it was bound by all of the terms of the lease as if it were the original tenant, and noted that the assignee can be in no better position than the bankrupt tenant or the trustee.

²⁰ *Woodward's Ltd., Re* (1993), 20 C.B.R. (3d) 74 (B.C.S.C.).

²¹ *Micro Cooking, supra*, note 13.

In a more recent decision, an Ontario court observed, in considering a use clause in a lease that a trustee was attempting to transfer to a dollar store chain, that a use clause could be adjusted by the court if it is so narrowly drafted such that only the business carried on by the bankrupt can satisfy it.²² However, the court concluded that on the facts of the case the use made by the dollar store would be a change from the use permitted in the lease and, as such, the dollar store was not in a position to covenant to perform the terms of the lease. The proposed assignment was not approved by the court.

It remains to be seen whether the courts will incorporate the rationale underpinning these BIA cases into cases decided under the CCAA.

VI. Liquidation Sales

In retail insolvencies there is often tension between a debtor (or trustee in bankruptcy or receiver) and its landlords with respect to the ability to carry out liquidation sales at the leased premises. Landlords in shopping malls are often particularly concerned with the effect that liquidation sales have on other tenants and on the perceived quality of the shopping mall. As a result, landlords attempt to limit the ability of insolvent tenants to liquidate inventory in their malls, especially where this involves the use of a third party liquidator taking possession of premises and directing retail operations.

Generally, insolvent tenants have been allowed to liquidate existing merchandise in their stores. The more controversial issues involve whether tenants can have a third party liquidator conduct the liquidation and whether the terms of the lease must be complied with during the course of a liquidation. In *Re T. Eaton Co.*, Farley J. held that the terms of the lease had to be honoured in this scenario. However, Farley J. also went on to say that at least in circumstances where the lease does not contain a prohibition against liquidation or bankruptcy sales, an arrangement may be made with a liquidator to sell the debtor's inventory, including allowing the liquidator to occupy and use the premises as agent of the debtor notwithstanding that the lease permits only the debtor to do so.²³ In the Eaton's insolvency, the Court prevented the liquidator from

²² *Dylex Ltd. (Trustee of) v. Westwood Mall (Mississauga) Ltd.*, *supra*, note 19.

²³ *Re T. Eaton Co.* *supra*, note 18.

augmenting existing inventory by selling goods that the liquidator had purchased as principal. The liquidator was able to sell goods that it had purchased as agent for the interim receiver (i.e. the delivery of outstanding orders from suppliers), but was not permitted to indiscriminately bring in inventory and make use of the premises to sell it.

VII. Letters of Credit

As the claim of a landlord is limited following the bankruptcy of a tenant under Section 136 of the BIA to three months' arrears and three months' accelerated rent for the period following the bankruptcy, landlords are often concerned with finding a mechanism to secure future lease payments in the event of a tenant's bankruptcy. The BIA language limiting a landlord's claim is mirrored in Section 38 of the CTA. The BIA and CTA limit the potential recovery for a landlord to avoid the possibility of a "windfall" that would result if the landlord could both recover for the balance of the lease term and re-let the premises to a new tenant.

One method for a landlord to deal with the limitations created by the BIA is to obtain from a tenant a letter of credit to secure the tenant's obligations under the lease. There have been conflicting decisions from Ontario courts with respect to the enforceability of letters of credit as against a trustee in bankruptcy of an insolvent tenant. In some cases, courts have held that a landlord was afforded the protection of the letter of credit for any amount of rent owing up to the date of disclaimer by the trustee but not thereafter.²⁴ When courts have declined to allow the landlord to draw on the letter of credit, the primary rationale has been that the BIA and the CTA have created a scheme for administering the leasehold interests of bankrupt tenants, which scheme should not be circumvented (i.e. that Parliament has determined that landlords should not recover more than three months' accelerated rent), and further, that the disclaimer of a lease by a trustee terminates the whole lease and all obligations to pay rent thereunder.

However, in other instances letters of credit have been characterized as separate contractual arrangements between the landlord and the bank that provided the letter, and courts have held

²⁴ *Titan Warehouse Club Inc. v. Glenview Corp.* (1988), 67 C.B.R. (N.S.) 204 (Ont. S.C.); aff'd (1989), 75 C.B.R. (N.S.) 206 (Ont. C.A.); and *Re Peat Marwick Thorne Inc. v. Natco Trading Corp.* (1995), 22 O.R. (3d) 727 (Ont. Gen. Div.).

that there is no basis for undermining that relationship.²⁵ In such cases, the courts have emphasized that letters of credit are a “specialized form of commercial credit that are meant by their very nature to be clear of the equities between the parties to the underlying transaction which they are issued to secure.”²⁶

In addition to letters of credit, landlords may obtain guaranties or indemnities to secure lease obligations. With respect to guaranties, the Ontario Superior Court and the Ontario Court of Appeal have held that guarantors of rental payments under a lease may be liable for arrears of rent under the lease but have no responsibility for the balance of the lease, as a bankruptcy terminates the liability of the principal to pay rent. Once a lease has been disclaimed by a trustee, the tenant has no further obligation to pay rent, accordingly there is no longer anything to guarantee and thus no further obligation of the guarantor.²⁷

With respect to an indemnity, the obligation of a surety survives the bankruptcy of one of the parties to the agreement, unlike that of a guarantor.²⁸ However, the fact that a surety is called a “guarantor” in an agreement may not be sufficient to absolve such party of liability if a court has, after considering the surety document as a whole, found that a party described as a “guarantor” was, in fact, an indemnifier.²⁹

Conclusion

It is clear that debtors, trustees and receivers will continue to aggressively push the boundaries of the law in respect of landlord issues. What remains to be seen is the limits which the courts will impose on these attempts, whether debtors will increasingly be permitted to depart from their contractual obligations and whether landlords will be required to adhere to leases that are unilaterally amended contrary to the terms of such leases and without landlord consent.

²⁵ *885676 Ontario Ltd. v. Frasmét Holdings Ltd.* (1993), 17 C.B.R. (3d) 62 (O.C.J.). See also *Dunlop Construction Products Inc. (Receiver of) v. Flavelle Holdings Inc.* (1996), 42 C.B.R. (3d) 302 (Ont. C.A.).

²⁶ *Ibid.*, at 71.

²⁷ *Cummer–Yonge*, *supra*, note 5.

²⁸ *Dawson Properties Ltd. v. Miskelly’s Electronics Inc.*, [1995] O.J. No. 2350 (Ont. Gen. Div.).

²⁹ *Ibid.*

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