Thornton Grout Finnigan LLP
RESTRUCTURING + LITIGATION

***7636156 Canada Inc. (Re)*, 2020 ONCA 681**

Overview

In its decision in *7636156 Canada Inc. (Re)*, 2020 ONCA 681, the Ontario Court of Appeal has clarified the law on a landlord's right to call on a letter of credit when its tenant becomes bankrupt. The lower court decision found that when the tenant became bankrupt, its landlord was limited to three months' accelerated rent, no matter how much higher its actual damages were. This reasoning extended to prevent the landlord from drawing more than the equivalent of three months' rent on a letter of credit it held and which was given as security for all of the landlord's losses, including as a result of a bankruptcy or disclaimer of the lease by a bankruptcy trustee.

The Court of Appeal, in a unanimous decision penned by Brown J.A., overturned the lower court ruling, and found that on the facts of the case, the landlord was entitled to draw on the letter of credit to the extent of the landlord's losses resulting from the termination or surrender of the lease. In coming to this conclusion, the Court of Appeal determined that:

i) the autonomy principle for letters of credit means that the obligation of the issuing bank to honour a draft on a credit is independent of the performance of the underlying contract for which the credit was issued, subject only to the fraud exception. There is no principle of insolvency law that trumps the landlord's rights as beneficiary of the letter of credit;

ii) landlords are not limited to three months' accelerated rent when drawing on a letter of credit following a tenant's bankruptcy. As against the assets of the bankrupt estate, landlords are limited to their statutory preferred claim for three months' rent. However, the landlord's rights against third parties are not affected by the bankruptcy; and

iii) the specific language of leases and letters of credit require careful drafting to ensure the letter of credit secures the landlord's damages and not the performance of the tenant's obligations under the lease.

An alternative argument was made by the Trustee that pursuant to the terms of the lease, the letter of credit should have been reduced in value to $1.35 million. The lease provided that this reduction could be made if, among other things, the Tenant paid its rent promptly. Although the evidence showed that the Tenant was late in payment of rent on two occasions, the lower court found that "promptly" should be interpreted as "within a reasonable amount of time", and the two late payments therefore did not disqualify the Tenant from a reduction of the letter of credit.

This conclusion was also overturned by the Court of Appeal, which found that "promptly" meant on the date due, and that the defaults by the Tenant violated this pre-condition for a reduction of the letter of credit.

Facts

7636156 Canada Inc. (the "**Tenant**") made an assignment in bankruptcy on May 1, 2018. Shortly thereafter, the Tenant's bankruptcy trustee (the "**Trustee**") disclaimed a lease the Tenant held with OMERS Realty Corporation (the "**Landlord**"). Pursuant to the terms of the lease, the Tenant had arranged for a $2.5 million letter of credit (the "**LOC**") issued by the Bank of Nova Scotia ("**BNS**") in favour of the Landlord, which was to stand as security to indemnify the Landlord for any losses it suffered, including in connection with the disclaimer of the lease in the event of the Tenant's bankruptcy.

The Landlord made draws on the LOC following the Tenant's bankruptcy for the full $2.5 million. The Trustee brought a motion to claw back the draws made by the Landlord in excess of the statutory preferred claim set out in the *Bankruptcy and Insolvency Act* ("**BIA**") for three months' accelerated rent. The Trustee also argued in the alternative that pursuant to the terms of the lease, the LOC should have been reduced to $1.35 million.

The motion judge held that: i) the Landlord was only entitled to draw on the LOC to recover the amount of its preferred claim for three months' accelerated rent under s. 136(1)(f) of the BIA; and ii) in the alternative, the LOC should have been reduced to $1.35 million on May 1, 2017, with the Landlord's draws limited to the reduced amount.

The Landlord appealed the motion judge's decision.

Issues on Appeal

There were two issues before the Court of Appeal:

i) whether the motion judge erred in holding that, upon the disclaimer of the Lease by the Trustee, the Landlord was not entitled to draw on the LOC for amounts in excess of the Landlord's three-month preferred claim under s. 136(1)(f) of the BIA; and

ii) whether the motion judge erred in holding that the amount of the LOC had been reduced.

Decision of the Court of Appeal

The Court of Appeal allowed the Landlord's appeal and overturned the motion judge's findings on both issues.

The Court decided the first issue, whether the Landlord was entitled to draw on the LOC in excess of its preferred claim under the BIA, based on two grounds.

First, the Court reviewed the legal principles regarding letters of credit. The motion judge had found that the LOC created no independent obligations between BNS and the Landlord, and was dependent upon the underlying obligations set out in the lease. Following this reasoning, once the lease had been disclaimed by the Trustee and no longer existed, there were no obligations being secured by the LOC.

The Court of Appeal overturned this finding. The Court confirmed the long-standing foundational principle that letters of credit create independent obligations between an issuing bank and a beneficiary that are autonomous from the underlying transaction between the beneficiary and the applicant.

The Court noted that in this case, BNS was obligated to honour the Landlord's demand on the LOC as long as the Landlord tendered its documents in conformity with the LOC's terms and conditions (which it did).

The only exception to this obligation arises in cases of fraud. Although the fraud exception was not referred to by the motion judge in his reasons, the Court of Appeal addressed this exception comprehensively. It noted that the fraud exception does not arise merely in the context of a legitimate contractual dispute, but requires some impropriety, dishonesty or deceit, which would include instances where the demand can be said to be clearly untrue, without justification or it is made where there is no apparent right to payment. The Court determined that the Landlord made its demands under the LOC in conformity with its terms, and BNS was obligated to honour these demands; the fraud exception did not apply on the facts of this case.

Second, the Court considered whether the law of bankruptcy and insolvency restricted the Landlord to only claiming for three months' rent. The lower court had found that it did, relying on a case of the Ontario High Court of Justice in *Cummer-Yonge Investments Ltd. v Fagot*, [1965] 2 O.R. 152 ("***Cummer-Yonge***"). In *Cummer-Yonge*, the Court had found that a disclaimer of a lease brought the lease to an end as though it had been mutually terminated, and therefore no obligations under the lease survived. It followed that a guarantor who had guaranteed the obligations under a lease could not be pursued by the landlord, because the obligations that had been guaranteed no longer existed.

Cummer-Yonge was overturned by the Supreme Court of Canada in *Crystalline Investments Ltd v Domgroup Ltd*, 2004 SCC 3 ("***Crystalline***"), where Major J. found that a disclaimer of a lease does not terminate it for all purposes, and that a guarantor can still be liable for the obligations of a tenant in a lease even after that tenant's bankruptcy trustee had disclaimed the lease. *Crystalline* was noted by the motion judge, but he distinguished it as dealing with guarantors, and not beneficiaries of letters of credit.

The Court of Appeal reviewed several decisions that had previously dealt with whether a letter of credit was enforceable where a lease had been disclaimed. It noted that there were inconsistent results. It also noted that all of the relevant cases put before it by the parties were decided before *Crystalline*.

In a well-reasoned decision that sets out the legal framework and brings clarity to this muddled area of the law, the Court of Appeal overturned the motion judge's decision. It found that, following *Crystalline* and the Court of Appeal's recent decision in *Curriculum Services Canada (Re)*, 2020 ONCA 267 (which had been decided after the motion judge's decision), a letter of credit is not rendered unenforceable by a landlord or limited to three months' rent as a result of the disclaimer of the underlying lease. While the Tenant's obligations under the lease are at an end due to the disclaimer, the lease is not at an end for all purposes. Rights against third parties relating to the lease may still be pursued.

The Court of Appeal was careful to note that a landlord's entitlement to draw on a letter of credit in any given case will turn on the particular language of the lease and letter of credit. Where the letter of credit stands for security for the landlord's losses and provides it will not be affected by the bankruptcy of the tenant or the disclaimer of the lease, the landlord will be entitled to draw on the letter of credit for its damages up to the limit of the letter of credit.

On the alternative issue, the Court held that the motion judge made an extricable error in law, and therefore, the Landlord was entitled to the full amount of the LOC. The provisions of the lease provided that if the Tenant had promptly paid rent at all times, it may be entitled to a reduction in the LOC. The Tenant had been late paying rent by a few days on two separate occasions. The motion judge determined "promptly" meant within a reasonable time and not on the actual date that rent is due. The Court of Appeal held that, when examining the contract as a whole, "promptly" meant payment of rent when due on the first day of the month. Consequently, the Tenant did not satisfy the conditions under the lease for a reduction in the LOC.

Key Takeaways

There are some important points to note arising out of the Court of Appeal's decision:

1. Landlords who wish to protect themselves from the consequences of a tenant's bankruptcy should pay special attention to the wording of the lease and letter of credit. Language which indemnifies the landlord for all losses and damages arising as a result of a breach, surrender or termination of the lease is much preferred to language which guarantees performance of the tenant's obligations under the lease.

2. *Cummer-Yonge* is a case that has had its reasoning relied upon in multiple areas of the law since it was first decided in 1965. However, in light of its reversal in *Crystalline*, parties should be very wary of relying on it or its principles going forward.

3. When a lease requires the tenant to pay rent "promptly", that means – as it did in this case – on the day it is due. Even paying rent a day or two late can cause a tenant to be off-side such a provision, which could have significant consequences.

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