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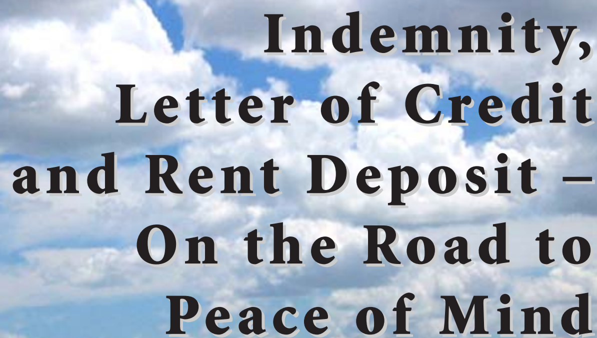

Indemnity, Letter of Credit and Rent Deposit – On the Road to Peace of Mind

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In the 1965 decision of *Cummer-Yonge Investments Ltd. v Fagot et al* ("*Cummer-Yonge*"), the Ontario Court of Appeal held that a guarantor's liability for a tenant's lease obligations was extinguished upon the disclaimer of such lease in bankruptcy.

This controversial decision has caused four decades of turmoil in the leasing community. Aside from calling into question existing guarantees, lawyers were challenged into the task of redrafting all forms of security, including guarantees, indemnities, rent deposits and letter of credit agreements in a form that would circumvent the consequences of *Cummer-Yonge* and survive a disclaimer of the lease.

As case law emerged, confusion heightened. Decisions were inconsistent and confusing resulting in an ever increasing sense of uncertainty as to whether or not these forms of security would survive bankruptcy. There was never any question that the decision was contradictory to the business intent of the parties entering into the particular security arrangement as it was precisely for circumstances where the tenant was unable to perform its obligations that the "indemnity", "rent deposit", "guarantee", or "letter of credit" was granted in the first place.

This issue was recently considered by the Supreme Court of Canada in the case of *Crystalline Investments Ltd. v. Domgroup Ltd.* ("*Crystalline*") and arguably some certainty, or at least some comfort level, has now emerged for landlords seeking to rely on third party assurances surviving their tenant's bankruptcy.

The facts of *Crystalline* are quite simple. A supermarket tenant assigned its two leases to an assignee who became insolvent and filed a proposal

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under the *Bankruptcy and Insolvency Act*. As part of the proposal, the leases were repudiated. The landlord claimed damages against the original tenant for the outstanding arrears and the loss of the tenancy. The Court considered whether the original tenant was liable.

The lower court, citing *Cummer-Yonge*, held that since the leases no longer existed, the liability of the original tenant to the landlords also disappeared. The Ontario Court of Appeal overturned the lower court decision and *Cummer-Yonge* was distinguished on the basis that it involved a guarantee, and therefore a secondary obligation which is enforceable only if the primary defaults. The Court held that: (i) the original tenant (assignor) is not a guarantor, but an entity who as principal, undertook obligations towards the landlord for the whole term of the lease; and (ii) there is nothing in the process of assignment which replaces this primary liability by a mere collateral liability of a surety who must pay rent only if the assignee does not.

On appeal, the Supreme Court of Canada upheld the Court of Appeal decision in *Crystalline*. However, in *obiter* (and we stress that it was only in *obiter*), the Supreme Court of Canada conferred upon landlords a small gift. The Supreme Court of Canada reviewed the facts of *Cummer-Yonge* and noted that the House of Lords had overruled an English Court of Appeal decision which had the same result as *Cummer-Yonge*. The Court stated that: “In my opinion, *Cummer-Yonge* should meet the same fate. Post disclaimer, assignors and guarantors ought to be treated the same with respect to liability. The disclaimer alone should not relieve either from their contractual obligations.”

Commercial Leasing

The Commercial Leasing Group offers some of the pre-eminent expertise in the field. Our team acts for developers, lenders, property and asset managers, landlords and tenants of all types of office, industrial and retail properties.

At Minden Gross, we are experienced in developing innovative lease document packages and systems that are tailor-made for clients. We appreciate, and share, clients' impatience with long and complex paperwork, and always strive to streamline our documents. We believe that short, well-drafted, easily understandable documents help achieve win-win results for landlords and tenants and greatly reduce legal costs and frustration levels.

Two members of our Commercial Leasing Group are named as two of Canada's most frequently recommended property leasing lawyers by the Canadian Legal LEXPERT Directory and the American Lawyer Media's Guide to the Leading 500 lawyers in Canada.

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Landlord Consent Issues to Tenant Transfers

It is well settled in law that where a tenant requires the consent of a landlord to a transfer, a landlord is restricted to consider only those specific criteria outlined in its lease (e.g., proposed transferee has a satisfactory financial condition; good reputation in business community, etc.) (*Lehndorff Canadian Pension Properties Ltd. v. Davis Management Ltd.* [1989] B.C.J. No. 990 (B.C.C.A.)). This principle was relaxed in a recent case where an Ontario court confirmed that landlords are entitled to consider a proposed transferee's "profitability" in determining whether various transfer conditions specifically outlined in a lease have been satisfied (*1455202 Ontario Inc. v. Welbow Holdings Limited*, [2003] 9 R.P.R. [4th] 103 [S.C.J.]). In this case, the applicant tenant sought a declaration on the basis that the landlord unreasonably withheld its consent to an assignment of the tenant's lease to a potential purchaser of its restaurant business. The tenant was negotiating to sell its business to a purchaser with little experience in the restaurant business. Pursuant to the assignment provisions in the lease, the landlord could refuse to grant its consent if the proposed assignee (a) did not have a history of successful business operations in the business to be conducted in the premises, (b) did not have a good credit rating and a substantial net worth, or (c) would be unable to finance the acquisition of its interest in the premises and its operations in the premises without a material risk of defaulting under the lease and in a manner that would enable the proposed assignee to carry on business successfully in the premises throughout the term.

The court found that, based on the wording in the lease, the three conditions listed above were intended to be exhaustive, and it noted that if the landlord wanted the right to reasonably withhold its consent based on the landlord's opinion regarding the future profitability of the assignee, such criteria should have been drafted in the lease. However, the court also held that "it does not follow that the ability of the purchaser to carry on the business successfully is irrelevant" and in considering whether any or all of the three conditions were satisfied, the landlord was entitled to take into account the purchaser's ability to operate the business successfully.

While the conditions contained in the landlord's initial responses extended beyond the limits of reasonableness because they would have involved additions or alterations to the terms of the lease, the court was satisfied that, subsequently, when deciding whether to withhold consent, the landlord had regard to the three conditions in the lease. The court noted that three of the reasons set out in the landlord's final response closely followed the three conditions in the lease. In the end, the court held that the tenant had not discharged the burden of proving that the landlord's refusal to consent to the assignment was unreasonable, and the tenant's application was dismissed.

In contrast, where specific transfer criteria are not outlined in the lease, landlords must reasonably choose their own basis in determining whether or not to grant consent. The case of *Zellers Inc. v. Brad-Jay Investments Ltd.*, [2002] O.T.C. 795; [2002] O.J. No. 4100 (S.C.J.) provides an example of where a landlord was entitled to make a decision based on its own criteria. In this instance, the landlord leased the premises to the tenant who operated a Kmart

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department store. Zellers Inc. purchased the tenant's business, closed operations of the Kmart store and obtained the landlord's permission to run a Kmart clearance centre and then a Bay shoe clearance centre in the store. The tenant later requested the landlord's consent to sublet the premises to Close-Out King, a merchant that typically sells a wide variety of merchandise. The lease permitted the tenant to assign all or a part of its premises to "any lawful commercial retail use or uses" without obtaining consent of the landlord. However, if the assignment would result in a change of use of the premises from a "department store," the tenant was required to obtain the landlord's consent (not to be unreasonably withheld). The landlord had some concerns about the proposed sublet and, after seeking professional advice, ultimately refused consent, claiming the sublet would not protect the character and integrity of the shopping centre. The landlord also raised concerns about the "ambience" of the mall and conflicts in product lines with existing retailers. The court found that, without specific criteria outlined in the lease, the landlord's refusal to grant consent had to be exercised in good faith and not for any collateral or ulterior purpose. The court also held that the landlord could rely on whatever facts and arguments it might choose so long as the conclusions reached were ones that might have been reached by a reasonable person in similar circumstances.

Determination of whether an amalgamation constitutes an assignment under a commercial lease was revisited in *Prime Restaurants of Canada Inc. v. Grey Realty Holdings Limited*, [2003] O.J. No. 295 (S.C.J.). In *Prime*, the lease provided that "in the case of an assignment to . . . 13.1(b) a corporation resulting from an amalgamation of the tenant with another corporation," the tenant had to obtain the landlord's consent. Further, the lease provided for certain no-consent transfers, including to a "franchisee of the tenant that is creditworthy." The tenant amalgamated without the landlord's consent, and the landlord terminated the lease as a result. The tenant applied for relief from forfeiture. The court addressed two issues. Referring to the case of *Loeb Inc. v. Cooper* (1991), 5 O.R.(3d) 259, where the court held that absent language to the contrary, an "assignment does not include amalgamation," the court in *Prime Restaurants* first considered the impact of the recital in Section 13.1(b), which was based on an error at law. The court stated that although "a recital is not an agreement, it does, however, reflect a premise on which the parties were acting," and this was clear enough to be an implied expansion of the definition of "assignment". The second issue considered was what constituted creditworthiness, and for that the court looked to the *Canadian Oxford Dictionary* and accepted the definition of "considered suitable to receive commercial credit." The court found that securities held against the amalgamated company did not render its credit questionable as there was no evidence of any inability to obtain credit. Based on that evidence and the relationship between the original tenant and the amalgamated corporation, the court determined that although an amalgamation was included in the definition of "assignment" in this lease, this particular transaction was exempt and landlord's consent was not required.

> Creditworthy: "considered suitable to receive commercial credit."

In another recent case, *Jens Hans Investments Co. v. Bridger* (2002), 2 R.P.R. (4th) 161 aff'd 2004 BCCA 340, the Supreme Court of British Columbia took tenant remedies a step further when it held that a failure by the landlord to reply to repeated requests for consent to a sublease was unreasonable and amounted to a fundamental breach of the lease, which entitled the tenant to treat the lease as terminated. Further, the Court held that the fundamental breach by the landlord served to absolutely discharge the indemnifier from all liability, as it had materially varied the risk assumed under the indemnity agreement.

Equitable/Proprietary Estoppel

Relying on the principles of equitable estoppel may prevent landlords from strictly enforcing lease provisions should they knowingly "turn a blind eye" to a tenant's breach of its obligations or restrictions under a commercial lease. Equitable estoppel, or sometimes referred to as "proprietary estoppel" where real property is concerned, will prevent a person from insisting on his strict legal rights, whether arising under a contract or on title deeds, or by statute, when it would not be equitable for him to do so, having regard to the dealings that have taken place between the parties.

In the case of *Aguacil v. 520301 Ontario Inc.*, [2003] O.J. No. 328 (S.C.J.), the lease permitted the tenant to use the premises for a vintage furniture reconditioning and graphic design establishment for a period of three years. Near the end of the original term, the tenant approached the landlord about renovating the premises in anticipation of using the space as a film, television and photographic production site. The parties signed a letter of agreement that extended the term of the lease, set out the rent payable during the renewal term, and permitted certain renovations by the tenant. However, the letter did not mention any change in use of the premises. Several months later, the landlord served the tenant with a notice of breach of the original use covenant after observing a wedding reception at the premises. The court accepted the tenant's assertion that the parties had entered into a binding agreement to expand usage, even though the letter agreement was silent on this issue, noting that the landlord was aware of the changes and had not attempted to stop the tenant or otherwise strictly enforce its rights under the lease. The court applied the doctrine of proprietary estoppel to prevent the landlord from enforcing the use clause in the lease because it would have been inequitable for him to do so having regard to the dealings that had taken place between the parties. Based on *Aguacil*, prudent landlords should not tolerate any breach by a tenant, no matter how minor, otherwise they may be estopped from requiring strict compliance by a tenant with its lease. Even more disturbing is the possibility that courts could apply proprietary estoppel where the tenant's intention is known to the landlord from the outset, despite language to the contrary contained in the lease.

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Court Notes

In 2004, an action was commenced in Toronto against our client, a retailer of electronic products based in New York City. In the action, the Ontario plaintiff sought payment from our client of alleged outstanding invoices totaling well in excess of U.S. $100,000.

Since our client did not carry on any business in Ontario and the plaintiff's invoiced services were performed in New York, we brought a motion to stay the action on the basis that the Ontario court did not have jurisdiction over our client and/or that New York City was the most convenient forum for the conduct of the action.

The judge released her decision granting our client's motion in its entirety, together with costs of the motion.

In the end, we were successful in putting a stop to the Ontario lawsuit at the beginning of the action (i.e., shortly after the statement of claim was served on our client). Our client was represented by A. Irvin Schein and Stephen Nadler.

Firm News

Following the expiration of his term as a member of the Board of Directors of Meritas, we are pleased to announce that Ken Kallish has been appointed as Vice-Chair of the organization. In that capacity, Ken will chair the Member Relations Committee of Meritas. This committee is charged with maintaining member firm quality (including the recertification of member firms), credentials, addressing member issues and communicating them to member firms, member retention and referral reporting.

We are pleased to announce Senator Jerry S. Grafstein has been elected as the Chair of the Senate Standing Committee on Banking, Trade and Commerce.

Senator Grafstein is also Co-Chair of the Canada/US Interparliamentary Group, Treasurer of the Organization for Security and Co-operation in Europe Parliamentary Assembly (OSCE PA), President of the Liberal Democratic Reform Group (LDR) of the OSCE PA, and a member of the Senate Foreign Affairs Committee.

Professional Notes

Howard Black was awarded the Osgoode Hall Law School Teaching Award in recognition of teaching excellence. Howard is the first recipient of this annual award that Osgoode Hall Law School awards to a member of the adjunct faculty. He also won the 2003/2004 Legal and Literary Society Teaching Excellence Award. Howard has been an adjunct professor at the law school since 1991 teaching Estates and Estate Litigation.

Timothy Dunn spoke on the topic of "Tax Related Insolvency Issues" that included information on the utilization of tax loss carry forwards at the CAIRP Annual Conference in May 2004.

Stephen J. Messinger participated in a panel on “Know the Lease: Who Pays For What?” for the Royal LePage Professional Development Day held on June 21, 2004.

Daniel Sandler's book, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States* was published by the Canadian Tax Foundation in July 2004. For more information visit the Canadian Tax Foundation's website, http://www.ctf.ca/whatsnew/pdf/tp108.pdf.

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