

In This Issue

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Many commercial leases contain a right in favour of the tenant to renew or extend the lease. In this issue we discuss the importance of strictly complying with the terms of any such right to renew, and identify what relief might be available where this is not done by the tenant. Our first article also discusses the importance of landlords properly dealing with defective notices. In our second article we explore the use of letters of credit as security for tenant lease obligations and some unique issues that arise from this. Our final article comments on a recent case which reviews the statutory trust provisions found in the *Construction Lien Act* (Ontario). In this case, the sole officer and director of a corporation was found to be in breach of such provisions and the resulting liability to a subcontractor was found to survive bankruptcy.

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Renew Your Knowledge Before Renewing Your Lease

Introduction

Exercising a right to renew or extend a lease may seem like a simple administrative procedure but, in fact, it is an important legal process that should be performed with due care. It is prudent to take the time to fully review the terms of the lease before proceeding. In today's busy world, this essential step is often neglected, at great risk. As the old adage goes, "a stitch in time saves nine," and here is why.

If there is any doubt as to the manner of notice or the intended address, multiple notices (both in respect of the method and the address) should be considered.

Exercising renewal rights

The law regards an option to renew as a privilege attached to the original lease. As a result of its privileged status, the tenant must strictly comply with the terms and conditions of such renewal in order to obtain its benefit. This includes compliance with all stipulations as to time, place and procedure. If an option is exercised in compliance with all

the requirements, the lease is automatically extended or renewed. However, a landlord is not required to renew or extend a lease on any terms other than those which are specifically provided.

Take, for example, the situation where a tenant exercised its option by faxing a letter to the landlord's property manager instead of sending it by registered mail directly to the landlord – as was spelled out in the notice section of the lease. In the event of a dispute, the tenant in this situation would be seen to have not properly exercised its option and may not be entitled to renew, even if the landlord received the notice in time.

Similarly, if a tenant sends the landlord a notice using the address provided by the lease while being aware that the landlord had subsequently moved, the tenant's renewal may not be considered valid. In one case with this type of circumstance, a tenant's renewal was rejected despite the landlord's flawed method for providing an updated address.

These examples show the importance of checking the terms of the lease. In addition, relevant files should be reviewed to see if any change of address has been received from the other party. If there is any doubt as to the manner of notice or the intended address, multiple notices (both in respect of the method and the address) should be considered.

Relief available for defective notices

As with every rule, there are exceptions. Even where a tenant does not strictly comply with the lease requirements, there may be relief available in some limited situations. Under the principles of equity, Courts have the power to exercise discretion and allow a renewal despite a tenant's error in exercising its option and despite the landlord's desire to end the lease. Courts will exert this power by using the legal doctrines of estoppel, waiver and relief from forfeiture.

The principle of estoppel applies where one party has made a representation to another which affects the legal relations between them. If the second party acts on the representation to its disadvantage, the party making the representation cannot revert back to its earlier position as if the representation had not been made. For example, if a tenant is late in exercising its option but the landlord responds by beginning to negotiate terms of renewal, depending on the extent of negotiation, a Court may find the landlord's actions represented to the tenant that its renewal was accepted. Based on this representation, if negotiations later break down, the landlord would not be entitled to refuse the renewal on the ground that it was exercised late.

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Similar to the idea of estoppel is the concept of waiver, which is applied between two parties of a contract. When a contract provision has been inserted specifically for the benefit of one party, that party has a right to waive compliance with the provision. Once waiver has been established, the provision cannot be suddenly reinstated and insisted upon.¹ A waiver may be found to exist where a tenant has established a practice of giving notice in a modified way. If the landlord previously accepted this modified notice, it cannot refuse a renewal by suddenly demanding strict compliance with the notice provisions of the lease.

Finally, under its power of discretion, the Court may grant a tenant with relief from forfeiture. This may be awarded where a tenant has diligently attempted to comply with the terms of the lease but was unable to do so, or where there was improper conduct on the part of the landlord. Improper conduct includes having lulled the tenant into a false sense of security with regard to the lease. For example, if a tenant exercised its option in an incorrect way but the landlord gave no response, it may be said that the tenant was lulled into a false sense of security that the renewal was approved. In this instance, the Court will consider any prejudice suffered by the tenant and may grant relief. Among the factors to be considered is the amount of time remaining before the original lease expires, any possible interruption in business and whether the tenant has spent money preparing for the renewal term.

The availability to a tenant of the principles of estoppel, waiver and relief from forfeiture show that a landlord must also be alert to the lease in order to enforce strict compliance with its terms. If a tenant has improperly exercised its option and the landlord does not wish to renew the lease, the landlord should inform the tenant and reject the renewal in a timely fashion. If a landlord does not directly notify the tenant and a legal conflict later develops, the landlord may be surprised and disappointed with the results.

Conclusion

As you can see, the exercise of a lease renewal option is a highly defined legal process with many potential outcomes. If one is not careful in the process, the results may be disappointing and expensive. In order to prevent unnecessary complications, a tenant should review the lease and exercise its option strictly in accordance with the terms provided. Similarly, when a landlord receives a tenant's notice of intent to renew, it should review the lease to ensure the validity of the renewal and respond to the tenant accordingly. By double-checking with the lease in advance, both parties can best protect the outcome of their choice.

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¹ A waiver may be retracted by providing reasonable notice.

Letters of Credit, Leases and Bankruptcy

Introduction

Of all the situations a commercial landlord can face, few are more problematic than the bankruptcy of its tenant. Under applicable federal¹ and provincial² legislation, the trustee for a bankrupt tenant has the right to disclaim the lease, which terminates the tenant's obligation to pay any further rent. The landlord is limited to a preferred claim for up to three months of arrears of rent prior to the bankruptcy and three months of accelerated rent (if the lease specifically provides for such accelerated rent in the event of a default).

A landlord will often require the tenant to provide a letter of credit issued by a bank or other financial institution which can be drawn upon by the landlord in the event of a default by the tenant.

The time for the landlord to try to protect against this result is when the lease is being drafted. A landlord will often require the tenant to provide a letter of credit issued by a bank or other financial institution, which can be drawn upon by the landlord in the event of a default by the tenant, including bankruptcy or insolvency. On the surface, such an instrument would appear to be ideal security against the bankruptcy or insolvency of the tenant. Most letters of credit specify that they survive the termination, surrender or disclaimer of the lease. The issuer of the letter of credit is a bank or other financially stable institution. Letters of credit have traditionally been viewed as an autonomous contract between the issuer (i.e. the bank) and the beneficiary (i.e. the landlord), independent of any underlying obligations of the applicant (i.e. the tenant).³ Or so it would seem. As is often the case, the reality is far less clear.

Case law

The seeds of doubt were first sown in the case of *Cummer-Yonge Investments Ltd. v. Fagot*,⁴ in which the Ontario Court of Appeal affirmed that a guarantor's liability for a tenant's obligations are extinguished on the disclaimer of the lease where the guarantee was not an independent obligation to the landlord.

Once the courts began applying this principle to cases involving letters of credit, the viability of this form of security was thrown into serious doubt. In *Lava Systems Inc. (Receiver and Manager of) v. Clarica Life Insurance Co.*,⁵ the application judge held that the landlord was not entitled to draw on a letter of credit after the tenant's bankruptcy, since the underlying obligations had been disclaimed by the trustee in bankruptcy. In this case, the letter of credit stated that it was "given as security for the indebtedness of [the tenant] with respect of [sic] the lease and occupation of [the premises] ...", and was expressly said to "survive the termination, repudiation, surrender and/or discharge of the lease..." Nonetheless, the court restricted the landlord to its preferential lien for three months' arrears and three months' accelerated rent.⁶ In *Titan Warehouse Club v. Glenview Corp.*,⁷ the Ontario Court of Appeal refused a landlord's claim under a letter of credit which, the lease stated, was to "guarantee to the Landlord payment by the Tenant of the Rent."

However, in other cases the courts have upheld the landlord's right to draw on the letter of credit notwithstanding the disclaimer of the lease. For example, in *885676 Ontario Ltd. (Trustee of) v. Frasmel Holdings Ltd.*,⁸ the Court upheld the landlord's draw for future rent against a letter of credit which, the lease stated, was "to secure the tenant's obligation under the lease." In doing so, the Court distinguished *Cummer-Yonge* on the basis that there is a "fundamental difference" between a letter of credit and a guarantee. In other cases the landlord has been allowed to draw down on the letter of credit after the tenant's bankruptcy where the letter of credit secured obligations other than rent or where the letter of credit was unrestricted and unconditional.⁹ Finally, in a recent proceeding related to *Lava*, above, the bank challenged the landlord's entitlement to draw under the letter of credit. At trial, the Court upheld the landlord's claim. The bank recently abandoned its appeal.¹⁰

The impact of *Crystalline Investments*

The recent Supreme Court of Canada decision in *Crystalline Investments v. Domgroup Ltd.*¹¹ represents a potentially significant development in this somewhat confused area of law. The case concerned the liability of the original tenant after the original tenant assigned the lease,

the assignee went bankrupt and its trustee disclaimed the lease. The assignment clause provided that the original tenant would continue to be liable throughout the term of the lease notwithstanding the assignment. The trial judge held that the original tenant's obligations were extinguished when the assignee's trustee in bankruptcy disclaimed the lease. He cited *Cummer-Yonge*, above, in support of this

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position. The Court of Appeal held the original tenant liable notwithstanding the disclaimer of the lease. It distinguished *Cummer-Yonge* on the basis that it dealt with a guarantor, which has a secondary obligation, while the original tenant in this case had a primary obligation. The act of assigning the lease did not convert this primary obligation into a secondary obligation analogous to that of a guarantor.

On further appeal, the Supreme Court agreed with the Court of Appeal that the original tenant remained liable under the lease. However, Major J., for the Court, went on to make additional comments criticizing the uncertainty that *Cummer-Yonge* had created in leasing and bankruptcy and stating that, in his opinion, *Cummer-Yonge* should be overruled and assignors and guarantors should be treated the same with respect to liability post-disclaimer. The disclaimer alone should not relieve either from their contractual obligations.

It is too early to tell whether courts will interpret Major J.'s comments as being limited to the liability of third-party guarantors, or will use them as authority to uphold any form of security, including letters of credit, after disclaimer. In any event, the decision has been widely hailed as a major step forward for Canadian landlords. Notwithstanding that Major J.'s comments were made outside of his rationale for deciding the case, they will certainly be carefully considered in any future cases involving letters of credit.

Drafting

Despite the *Crystalline* decision and other recent cases which may indicate an increasing tendency to uphold letters

of credit after bankruptcy, the issues raised in this paper remain unsettled. Therefore, the drafting of the tenant's letter of credit obligations remains critical. The following drafting tips should improve a landlord's chances of enforcing its security when a tenant goes bankrupt:

1. If possible, draft the letter of credit so that it is unconditional and unrestricted, and contains no reference to any underlying obligations. Even so, a court may look to the underlying obligations in dealing with a dispute.
2. If the letter of credit is not unconditional, the obligations secured must be described extremely carefully. Avoid bald statements such as "the letter of credit is security for the tenant's obligations under the lease" (although, in at least one case, the Court upheld a letter of credit where the lease used similar language – see *Frasmet Holdings*, above). In one case where a claim under the letter of credit was disallowed, the court remarked that a letter of credit might be enforceable after the tenant's bankruptcy where the obligations secured were independent obligations to make good losses suffered by the landlord by reason of the tenant's bankruptcy.¹² The distinction may seem subtle, but it could make a difference.
3. Create an independent obligation between the parties, such as an indemnity agreement, and have the letter of credit secure this obligation. You should ensure that this indemnity is drafted as a primary obligation and is not a secondary obligation – i.e. a guarantee of the tenant's obligations under the lease. As discussed under point 2, above, state that the indemnity is with respect to any losses or damages incurred by the landlord as a result of insolvency, bankruptcy or other default of the tenant. The indemnity should ideally be a stand-alone document, not part of the lease.
4. If possible, obtain the foregoing indemnity from a third party, rather than the tenant. This increases the chance that a court will treat the indemnity as an independent obligation, separate from the lease. As discussed above, this approach is further bolstered by the Supreme Court of Canada decision in *Crystalline*, which held that third-party guarantors should remain liable when the party on whose behalf they acted becomes insolvent.
5. As has been seen above, a clause providing that the letter of credit survives the bankruptcy, termination or disclaimer of the lease may not always be sufficient to

save a letter of credit. However, it is important that such language is included in every letter of credit, since the courts will look at all the evidence before them in determining whether a landlord is entitled to draw after the tenant's bankruptcy.¹³

Pending a clear judicial application of Major J.'s comments in *Crystalline* to letters of credit, there may be no completely reliable way for a landlord to secure a bankrupt tenant's obligations in the event the trustee in bankruptcy disclaims the lease. However, careful drafting can give a landlord a fighting chance to enforce its letter of credit, even if it's not quite "money in the bank."



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1 *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 30(1)(k), 136(1)(f).
2 *Commercial Tenancies Act*, R.S.O. 1990, c. L.7, s. 38, 39(1).
3 See, for example, *Lava Systems (Receiver and Manager of) v. Clarica Life Insurance Co.*, [2001] O.J. No. 3365 (Ont. S.C.J.) at para. 46.
4 [1965] 2 O.R. 152 (H.C.J.), aff'd [1965] 2 O.R. 152 (C.A.). In *Peat Marwick*

Thorne Inc., Trustee v. Natco Trading Corporation et al. (1995), 22 O.R. (3d) 727 (Gen. Div.), the same principles were applied to deny a landlord's claim under its security interest over the bankrupt tenant's equipment.

5 *Supra*, note 3.

6 On appeal, the Court of Appeal reversed the lower court decision on the grounds that the funds drawn on the letter of credit belonged to the bank (which was not a party to the application) and not the bankrupt tenant. Therefore, neither the tenant nor its receiver had any right to recover any amounts paid to the landlord under the letter of credit. The Court declined to rule on the pivotal question of whether the landlord's draw was limited to its statutory entitlement. [2002] O.J. No. 2526.

7 (1989), 75 C.B.R. 206. See also *Westshore Ventures v. K.P.N. Holding Ltd.* (2001), 25 C.B.R. (4th) 139 (B.C. C.A.).

8 (1993), 12 O.R. (3d) 62 (Ont. Gen. Div.).

9 In *Dunlop Construction Products Inc. (Receiver of) v. Flavell Holdings Inc.* (1996), 31 O.R. (3d) 58 (C.A.) (Ontario Court of Appeal), the landlord's claim was upheld where the letter of credit stated it was "intended to secure the obligations of [the tenant] under the Lease." In this case, the obligations sought to be compensated were unfulfilled repair obligations, rather than unpaid rent. In *366604 Alberta Ltd. (Trustee of) v. Pensionfund Properties Ltd.*, [1998] A.J. No. 980, the Alberta Court of Appeal upheld a claim under a letter of credit which secured the tenant's repayment of a cash inducement. The letter of credit did not contain a reference to the lease or any rent or inducements, and the landlord's right to demand payment from the bank was unrestricted and unconditional.

10 *Bank of Montreal v. Clarica Life Insurance Company* (4 June 2003), Toronto, Court File No. 03-CL-4866 (Ont. Sup. Ct. (Civ. Div.)); appeal dismissed as abandoned [2004] O.J. No. 633 (C.A.).

11 (2004), 16 R.P.R. (4th) 1

12 *West Shore Ventures Limited v. K.P.N. Holdings Ltd.*, *supra* note 7.

13 See, for example, *Bank of Montreal v. Clarica Life Insurance Company*, *supra* note 10.

When Debt Obligations to Subcontractors Survive Bankruptcy: A Case Comment on *Superior Crane (Canada) Inc. v. Justan Consulting Ltd.*

In a recent decision of the Ontario Superior Court of Justice, Mr. Justice Archibald concluded that Mr. Stanley Kinsman, the sole officer and director of Justan Consulting Ltd. ("Justan"), intentionally decided to pay himself and other expenses in contravention of the trust provisions of the *Construction Lien Act* (Ontario) (the "Act").

Insofar as Mr. Justice Archibald found that Mr. Kinsman's breach of the statutory trust provisions of the Act was intentional, Mr. Kinsman was ascribed with liability under the common law for breach of trust. As a result, the debt obligation owing to Superior Crane (Canada) Inc. ("Superior"), for the purposes of section 178(1)(d) of the *Bankruptcy and Insolvency Act* (Canada), led to the result that the judgment survived Mr. Kinsman's personal

proposal in bankruptcy which followed the financial failure of Justan.

The consequence of this decision, which all actors in the construction industry should be aware of, is that a proposal in bankruptcy by a trustee of funds under the Act may not spell the extinguishment of the debt obligations owed to the beneficiary of the trust funds under the Act.

The facts

The plaintiff, Superior, is in the business of renting mobile cranes to construction sites. Superior provided crane services to the defendant, Justan, between November 2000 and the end of 2001 in connection with the construction of

five cellular communication sites in the city of Toronto. In connection with the crane services, Superior delivered invoices totaling \$34,847.22 to Justan.

For each of the five cellular tower construction sites, Justan charged overhead in the amount of \$5,453, business expenses in the amount of \$13,349 and paid to Mr. Kinsman, the sole director and officer of Justan, fees in the amount of \$5,000 per site representing his salary. It was conceded, at trial, that all of these payments were in contravention of the provisions of the Act.

In August of 2001 Justan's financial struggles began culminating in the financial failure of the company on February 28, 2002. Mr. Kinsman, as the sole officer and director of Justan, admitted he was responsible for all business decisions and operations of Justan.

A proposal in bankruptcy by a trustee of funds under the Act may not spell the extinguishment of the debt obligations owed to the beneficiary of the trust funds under the Act.

The issue

The issue before Mr. Justice Archibald can be stated as follows: When does a breach of the trust provisions contained in section 13 of the Act result in a finding of a common law breach of trust?

The analysis

In explaining the difference between the statutory trust set out in section 13 of the Act and a common law breach of trust, Justice Archibald provided as follows:

What separates the section 13 statutory trust from a common law breach of trust is the degree of knowledge that would have to be ascribed to a constructive trustee in order to find liability on either the concept of "knowing receipt" or "knowing assistance." In addition, the nature of the breach of trust must also be examined in the totality of the circumstances of each case.

To some degree, the section 13 statutory trust imports a deemed knowledge provision. That deemed knowledge provision, however, can not be part of the

common law test. A plaintiff who alleges a common law breach of trust must show that the degree of knowledge on the part of the constructive trustee must be at least at the level of wilful blindness or recklessness or specific knowledge.

In determining Mr. Kinsman's liability, the Court found that Mr. Kinsman was in receipt of and charged with trust property when the critical decision as to which creditors would be paid over others was made. As Justice Archibald stated: "As the sole officer and director, these decisions were his and his alone."

Mr. Justice Archibald further noted that: "[Mr. Kinsman] made a conscious decision to pay himself and certain creditors over others, as previously stated, in order to ensure that his business stayed afloat for as long as it could."

In addition, the Court made a positive finding that "Mr. Kinsman knew full well that he could not pay himself a management fee while his subcontractors remained unpaid. I find that to be a flagrant violation of the *Construction Lien Act*. In addition, I find that to be a flagrant violation of the common law test for breach of trust. My conclusion that Mr. Kinsman's misconduct was cloaked with actual knowledge and intention, and, at a bare minimum, recklessness..."

In support of his findings, Mr. Justice Archibald relied on the three key pieces of evidence:

1. The filing of unsworn statutory declarations by Justan which indicated that all accounts for labour, sub-contracts, products, construction machinery and equipment, as well as other indebtedness, had been paid in full when, in fact, Superior had not been paid in full.
2. The issuance of cheques knowing full well that the cheques would eventually be returned NSF.
3. The fact that Mr. Kinsman personally benefited from the payment of the expenses. As Mr. Justice Archibald noted: "It cannot be forgotten that he paid himself management fees of \$5,000 per site during the time that Superior's invoices were unpaid. It also cannot be forgotten that he was reimbursed by his company for expenses that he had paid on behalf of the company, again during the time that Superior's bills were outstanding. That too is a significant factor in my assessment of Mr. Kinsman's intentions and conduct during this period of time."

The debt survives bankruptcy

As a result of the Court's conclusion that Mr. Kinsman intentionally decided to pay himself and other expenses instead of paying Superior's invoices with full knowledge that he was in contravention of the Act, the Court found that Mr. Kinsman had also breached his trust obligations as a constructive trustee.

The obligations imposed by the trust provisions in the Act require trustees to carefully administer and account for all monies received in performance of their obligations in the construction project.

Pursuant to section 178(1)(d) of the *Bankruptcy and Insolvency Act*, a debt or liability arising out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity as a trustee survives a proposal into bankruptcy.

The Court went on to find that Stanley Kinsman breached his fiduciary obligation "with a significant element of dishonesty, wrongdoing, and misconduct."

Accordingly, the Court held as follows: "It is his dishonest handling of the company's bank account which makes him liable under the common law for breach of trust. As a consequence, any debt or liability arising out of these circumstances will survive the proposal."

Commentary

It is clear from the *Superior v. Justan* decision that the Court's interpretation of the obligations imposed by the trust provisions in the Act require trustees to carefully administer and account for all monies received in performance of their obligations in the construction project.

Those concerned with the potential for allegations similar to those made against Mr. Kinsman are well advised to consult with their advisors (lawyers and accountants) to ensure that an appropriate accounting system is in place to avoid disbursing trust funds in violation of the Act.



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