Insolvent Landlords: Concerns of a Commercial Tenant

Mervyn D. Abramowitz and Stephen Wolpert
Kronis, Rotsztain, Margles, Cappel LLP

INTRODUCTION

Most landlords of any size or sophistication spend a good deal of time and effort trying to ensure that their prospective tenants will have the financially capacity to honour any monetary obligations during the term of any lease into which they wish to enter. The landlord typically asks for historical financial information, often accompanied by cross-corporate or personal guarantees, to provide the landlord with some comfort and protection in the case where the prospective tenant becomes incapable of honouring its commitments down the road. Further, leases are often drafted by the landlord with several clauses that provide for remedies for the landlord in the case where the tenant becomes unable to make payment or insolvent.

However, the converse is not always true. Tenants often assume that their prospective landlords will be around throughout the term of any lease, and rarely spend the time or effort to investigate the landlord's financial stability or health. This is true despite the fact that it is often the tenant who has just as much, if not more, at stake, financially and operationally, than the landlord, and it is also the tenant who will suffer greatly if the landlord is unable to live up to its financial commitments to its tenants. Thus, tenants often fail to address the potential consequences of a landlord's insolvency and how it could impact them. In so doing, they fail to take steps to protect their own interests, leaving themselves vulnerable to what may occur as landlords drift toward insolvency proceedings.

Note that while the term "insolvent" refers to the technical legal status of a particular debtor, and that there are several measures or definitions by which to determine whether a debtor is indeed insolvent, in this paper, when we refer to insolvency or to a debtor as being "insolvent", we reference the oft-cited definition of insolvency as being the inability of a debtor to make payment of its obligations generally as they become due.[1]

This paper will examine the context where a commercial tenant and its rights may be affected by a landlord's insolvency, both prior to a formal insolvency proceeding and once such a proceeding has been commenced. It will also propose certain steps that a commercial tenant ought to consider taking, in advance, so as to ensure greater protection of the tenant's rights.

THE LEGAL CONTEXT

The Commercial Tenancies Act

Commercial tenancies in Ontario are largely governed by two separate, but interacting, legal frameworks, one statutory, the other common law. In the case of the statutory framework, the *Commercial Tenancies Act*[2] (the "Act") (formerly the *Landlord and Tenant Act*), applies to all tenancies and tenancy agreements that are not governed by the *Residential Tenancies Act, 2006*.[3] Thus, the Act will apply to all commercial tenancies or tenancy agreements that are of a non-residential nature. However, the Act is fairly skeletal legislation, consisting of only 78 sections, most of which deal with issues respecting the rights of landlords and tenants in situations

[1] See *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 ("BIA"), s.2 for the definitions of "insolvent person"; also see e.g. *Keith G. Collins Ltd. v. Canadian Imperial Bank of Commerce* (2010), 2010 CarswellMan 15, 63 C.B.R. (5th) 32 (Man Q.B.); *Thorne Riddell v. Fleishman* (1983), 47 C.B.R. (N.S.) 233 (Ont. S.C.J.).
[2] *Commercial Tenancies Act*, RSO 1990, c L.7.
[3] *Commercial Tenancies Act*, s.2.

involving non-payment of rent by the tenant. Interestingly enough, while the Act does address the situation where a tenant becomes bankrupt, the Act is silent when it comes to dealing with a landlord who is bankrupt.[4]

Lease Agreements

The vast majority of dealings between landlord and tenant are governed by contract law jurisprudence. Indeed, the Act is written in a context where it is understood that the landlord and tenant will have come to some type of agreement as between themselves.[5] Thus, it is the tenancy agreement - the lease - and sometimes an offer to lease - that typically plays the central role in the relationship between landlord and tenant.

Lease agreements may vary significantly in length and complexity. Simple lease agreements may only be a few pages in length and contain little more than basic provisions setting out:

- the term of the lease;
- the amount of rent payable; and,
- the rights of the parties on default.

By contrast, more complex lease agreements may be much lengthier, and include provisions that provide for the rights and responsibilities of the parties in regard to, among other things:

- the permitted uses for the premises;
- specific insurance requirements for the tenant;

[4] *Commercial Tenancies Act*, ss. 38-39.
[5] See e.g. *Commercial Tenancies Act*, ss. 4, 5, 6, 9, 10, 11, 12, etc.

- pre-paid rent requirements;
- security deposits;
- payment of utilities, as well as municipal and other tax obligations;
- the tenant's entitlement to sub-let the premises, or assign the lease agreement;
- regular repairs and maintenance to the premises;
- damage to the premises, and any repair thereof;
- leasehold improvements;
- subordination of the tenant's interests to those of the landlord's mortgagees and chargees;
- attornment of rents; and,
- restrictions on the tenant's entitlement to set-off in the case where the landlord has failed to comply with its obligations.

In addition, more sophisticated lease agreements typically provide for certain events in the case of insolvency or bankruptcy. However, as noted earlier, those lease agreements that do address insolvency issues usually only do so from the perspective that it is the tenant facing insolvency or bankruptcy, not the landlord. As a result, commercial tenants are often left to wonder what may happen to them in the event of their landlord's insolvency.

Thus, prior to entering into any lease, and indeed when considering the various premises available, a prospective tenant should pay particular attention to the identity of the landlord, whether it is financially stable, whether it has a history of honouring its financial commitments, whether its leased premises are well-maintained and whether other or prior tenants speak well of the landlord and its actions. Requests ought to be made for documentation from the prospective

landlord, just as is the case when the landlord is seeking information from the prospective tenant. This may go some way to ensuring that the tenant will not be faced with a situation where the landlord cannot live up to its obligations and honour its covenants under the lease. Further, the parties may wish to address the situation that may result if the landlord becomes insolvent or is otherwise unable to comply with its obligations under the lease.

Thus, in dealing with a landlord or prospective landlord from the outset, and in particular, when negotiating a lease, a tenant may wish to include a clause in the lease providing for the availability of set-off, such that a tenant may set-off any amounts that the tenant has had to pay, and that would otherwise be the responsibility of the landlord, against any amounts due to the landlord under any covenant to pay rent or additional rent. At a minimum, the parties may wish to consider what remedies may be available to the tenant if the landlord fails to comply with its obligations under the lease.

LEARNING OF THE LANDLORD'S INSOLVENCY

Once the parties are already bound by a lease agreement, there may or may not be ongoing obligations to provide ongoing financial disclosure or other information. More involved leases, particularly retail leases, provide for payment of additional rent, based on sales or revenues. Under those provisions, tenants provide regular, updated financial information to the landlord, so that the landlord may determine the applicable additional rent amounts. Further, many leases require that the tenant provide regular financial statements to the landlord, such that the landlord is able to gauge the financial stability of the tenant. However, once again, the obligation is usually that of the tenant, and not the landlord. Thus, the tenant finds itself in the situation where

the landlord is aware, at least to some extent, tenant's financial situation, but the tenant is unaware of the of the landlord's financial situation.

How does the tenant typically learn of the landlord's financial problems? While a tenant may note that:

a. a landlord has failed to perform repairs or maintenance to the premises, and in particular in the common areas;
b. the premises haven't been renovated for some time; or
c. certain portions of the premises are vacant

these may or may not be true indicators of the landlord's financial status or solvency. Often, certain landlords are slow to fix the premises, leaving them in a sub-optimal state. However, this may have little to do with the landlord's financial means.

Unfortunately, most tenants only learn of their landlord's financial problems if and when they receive a copy of a Notice of Sale Under Mortgage from the landlord's mortgagee, or receive documentation in respect of a proposal (or Notice of Intention to Make a Proposal), a receivership order, a bankruptcy order, or documentation from a trustee in bankruptcy referring to the landlord's assignment in bankruptcy. As the tenant is usually not a creditor of the landlord, even this information may not be forthcoming and it may be that the tenant learns of the landlord's financial situation from others. In more extreme cases, the tenant may only learn of the landlord's insolvency when utilities or services to the premises are cut off.

This lack of transparency into the landlord's business affairs may have a direct impact upon tenants and the decisions they make, ranging from investing in expensive leasehold improvements to the leased premises, for which the landlord may be responsible, to foregoing opportunities to lease or move to other leased premises.

When the tenant does learn of their landlord's insolvency, some of its primary concerns likely include:

1. Whether the tenant will continue to be allowed to occupy and operate its business at the leased premises;
2. What are its obligations in the circumstances, or more particularly, does the tenant have to keep paying rent, and if so, whether it can pay rent at a reduced amount;
3. Who will manage the leased premises;
4. Whether repairs and maintenance will be performed;
5. Whether utilities and other services will be maintained;
6. What will happen to any security deposits and prepaid rent; and
7. What happens to any leasehold improvements made to the premises.

We discuss each of these below. However, as much is dependent upon the particular type of proceeding in which a landlord is involved, we set out a brief list and description of these proceedings first.

INSOLVENCY PROCEEDINGS

Mortgage enforcement proceedings and Receivership proceedings

In most cases, commercial landlords rely upon financing to purchase their properties. Almost without exception, these properties are therefore subject to mortgage interests. As the property is typically the landlord's primary asset, the mortgage debt typically represents the landlord's primary debt.

If the landlord / mortgagor defaults under its mortgage, the mortgagee will have the right to sell the mortgaged property following a three month waiting period, subject to the requirements in the *Mortgages Act*.[6] The mortgagee may take steps to sell the property on its own. However, depending on the value, size and uniqueness of the property, the availability of buyers, environmental issues, as well as certain other factors, the mortgagee may decide to appoint a receiver pursuant to the terms of the mortgage (a private receiver) or alternatively seek the appointment of a receiver by the court (a court-appointed receiver).

In a sale situation, the tenant may receive a Notice of Sale Under Mortgage.[7] In a receivership situation, the tenant may be advised by the receiver of its appointment, either by letter or when provided with a copy of a court order appointing the receiver.

[6] R.S.O. 1990, c M.40, s. 24. For the requirements to exercise a power of sale, see Parts II, III and IV of the *Mortgages Act*.
[7] *Mortgages Act*, s.26.

BIA Proposals and CCAA Plans of Arrangement

If a landlord is already insolvent, but believes that it may be able to make a viable proposal to its creditors, the landlord may file a proposal or a notice of intention to make a proposal ("NOI") with a licensed trustee pursuant to the *Bankruptcy and Insolvency Act* ("BIA").[8] If the landlord owns a number of properties or has more complex financial difficulties, it may be eligible to apply to the court for protection from its creditors pursuant to the *Companies' Creditors Arrangement Act* ("CCAA") while it formulates a plan of arrangement to restructure itself.[9] In the case of the filing of a proposal or an NOI, the BIA provides for an automatic stay of proceedings that would prevent a landlord's creditors from taking steps to enforce any rights in connection with payment and prevent creditors from commencing or continuing any proceedings to recover funds owing to the creditors.[10] In the case of a CCAA filing, the typical initial order granted by a court includes a similar stay of proceedings, though there is no automatic stay in a CCAA proceeding.[11]

The governing statutes in restructurings provide for payment of one's secured creditors in priority to any unsecured claims, and it is rare that a tenant would have a secured claim against a landlord.[12] However, situations may arise in respect of prepaid rent and / or expenses, for which the tenant may have claims against the landlord. These are dealt with below.

[8] See BIA ss. 50 and 62 regarding requirements for filing a proposal, s.50.4 regarding filing a notice of intention to make a proposal, and ss.50-66 generally regarding the general scheme for proposals.
[9] R.S.C. 1985, c C-36 ["*CCAA*"]
[10] See BIA s. 69 regarding stays of proceedings on the filing of a NOI and s.69.1 regarding stays of proceedings on the filing of a proposal.
[11] See *CCAA* s. 11.02(1) and (2) for the main provisions relating to stays of proceedings.
[12] See BIA s. 136(1), which sets out the scheme of distribution in a bankruptcy.

Bankruptcy

Bankruptcy, like insolvency, is a legal status. For a debtor to become bankrupt, it must either make an assignment of its property to a trustee for the benefit of its creditors (make an "assignment in bankruptcy"), be the subject of a successful application for a bankruptcy order by one or more of its creditors (a bankruptcy order), or be deemed bankrupt, either resulting from its failure to file a proposal within the time prescribed by the BIA or due to the rejection of its proposal to its creditors at a meeting held to consider the debtor's proposal.[13] In each case, the bankrupt's assets, including any leases, vest in a trustee in bankruptcy, who will then seek to liquidate those assets in a manner that maximizes their value for the creditors of the bankrupt's estate.[14]

In the case of a bankruptcy, there is an automatic stay of proceedings under the BIA that prevents creditors from taking any steps to enforce their rights or commencing or continuing any proceedings for such purposes.[15] Creditors may file claims with the trustee in bankruptcy who will then distribute the bankrupt's assets in accordance with the priorities set out in s.136 (1) of the BIA.[16]

TENANT'S CONCERNS

In virtually all cases involving an insolvent landlord, a tenant will want to know its rights and obligations. The vast majority of tenants seeking advice will not have experienced a situation

[13] For assignments in bankruptcy, see BIA s.49; For bankruptcy orders, see BIA ss. 42-43; For deemed bankruptcies, see BIA ss.50.4(8) and 57(a).
[14] BIA s.71.
[15] BIA s.69.3
[16] BIA ss.124, 136.

where their landlord has become insolvent, or been the subject of insolvency proceedings, and tenants will approach the legal practitioner for advice, often feeling quite uncertain and vulnerable.

Whether the tenancy continues

In most cases, most or all of a tenant's business assets and operations are located in the leased premises. If a landlord becomes insolvent, the tenant may be concerned that there may be some interruption of its ability to occupy the leased premises and continue its business operations.[17] If a mortgagee, receiver or trustee in bankruptcy wishes to sell the property where the leased premises are located, the tenant's ability to continue to occupy the leased premises and thus continue operations will depend on such factors as:

1. whether the tenant's leasehold interest has priority over the interest of the landlord's mortgagee;
2. whether the tenant has given notice of its lease to any prospective purchaser;
3. the terms of the lease, including any subordination agreements; and
4. any non-disturbance agreement between the tenant and the landlord's mortgagee(s).

Priority of interest – the mortgagee

First, the starting point in determining whose interest has priority is the order in which a particular party obtains its interest. Where a mortgagee obtains its interest in the property prior to the tenant obtaining its leasehold interest, the interest of the mortgagee will be first in time and first in priority. In such a case, it is said that the only thing a landlord can grant to the tenant is

[17] While many businesses obtain insurance to cover interruptions of operations, these typically only provide coverage for interruptions caused by fires, floods, etc.

akin to a partial interest in the landlord's equity of redemption.[18] As the Ontario Court of Appeal stated in *Goodyear Canada Inc. v. Burnhamthorpe Square Inc.*, where the granting of the mortgage was prior in time to the date of the lease:

> [76] …although a new tenancy may be created after possession *between the mortgagee and the tenant*, the original lessee's interest in the equity of redemption does not come to an end, and the original lease does not terminate merely as a result of the mortgagee taking possession. Burnhamthorpe [the purchaser] concedes that the mortgagor, as a result of his default under the mortgage, has placed the lessee in the precarious position of possibly being evicted by a mortgagee with paramount title. The mortgagor, by his default, breached his covenant for quiet enjoyment, and the lessee, if he does not remain in possession, cannot be sued by the mortgagor. However, if the lessee remains in possession under a lease with the mortgagee, that lease can only be a lease of the mortgagee's interest in the property, since the mortgagor still retains the equity of redemption. The mortgagee's right to possession will come to an end on payment by the mortgagor of the mortgage debt.
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> [77] There can be no doubt that this analysis of the position of the parties is correct as far as it goes. The next step in the analysis, and one for which we were given no clear authority, is Burnhamthorpe's proposition that after redemption by a mortgagor, the lessee (who is still in possession under a lease with the mortgagee) can enforce the original lease against the mortgagor's interest in the land. It seems to me that he must be able to do so, since otherwise a mortgagor, by virtue of his own default, could later redeem the mortgaged premises free and clear of the lease agreement which he himself entered into.
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> [78] If the lessee then stays in possession after redemption by the mortgagor, the lease, being enforceable by him, must be enforceable against him. If the lessee does not wish to stay in possession, then it should follow, that the mortgagor, having breached his covenant for quiet enjoyment, should not be able to force the tenant to remain in possession and abide by the lease.[19]

Thus, where the mortgagee's interest is prior in time to that of the tenant, the mortgagee will be entitled, in appropriate cases, to evict the tenant and obtain possession of the property.

[18] *Land Registration Reform Act*, RSO 1990, c L.4, s.6
[19] 41 OR (3d) 321; 166 DLR (4th) 625; 116 OAC 1, at paras 76-78.

In these cases, it will therefore be important for a tenant to negotiate at the outset a non-disturbance agreement with the mortgagee to protect itself from possible future eviction if the landlord defaults under the mortgage. Ideally, the tenant should try to negotiate such a non-disturbance agreement prior to entering into any lease with the landlord / mortgagor, and should ensure that such an agreement addresses (a) the rights between the mortgagee and tenant for claims against the landlord arising prior to the date the mortgagee enforces its security, and, (b) the conditions under which the mortgagee will assume the existing lease.[20]

Priority of interest – the tenant

In contrast, where a landlord grants a leasehold interest to a tenant prior to granting an interest in the property to a mortgagee, and where the mortgagee has notice of the lease, the mortgagee and any subsequent purchaser obtain their interests subject to that of the tenant. A tenant can give notice either by registering a Notice of Lease on title or by giving actual notice of the lease to the mortgagee or prospective purchaser. Once a mortgagee or purchaser has actual or constructive notice of a lease, any interest they obtain in the property will be subject to the lease interest.[21]

In this situation, sections 7 and 8 of the *Commercial Tenancies Act* combine to effect a result where a new purchaser becomes the new landlord, such that the tenant will be able to remain in occupation of the premises, provided that the tenant continues to pay rent and complies with all of its other obligations under the lease agreement.

Sections 7 and 8 of the *Commercial Tenancies Act* provide:

[20] Richard Olson, *A Commercial Tenancy Handbook*, (Carswell: Toronto, 2004), Vol. 1 pg 3-22.1.
[21] *Binion v. Evans*, [1972] Ch. 359, [1972] 2 All E.R. 70 (C.A.) ["*Binion"*]

> **7.** All lessees and grantees of lands, tenements, rents, portions, or any other hereditaments for term of years, life or lives, their executors, administrators, and assigns shall and may have like action, advantage, and remedy against all and every person who shall have any gift or grant of the Queen, or of any other persons, of the reversion of the same lands, tenements and other hereditaments so let, or any parcel thereof, for any condition, covenant, or agreement, contained or expressed in the indentures of their leases as the same lessees or any of them, might and should have had against their said lessors, and grantors, their heirs, or successors. R.S.O. 1990, c. L.7, s. 7.
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> **8.** The obligation of a covenant entered into by a lessor with reference to the subject-matter of the lease shall, if and as far as the lessor has power to bind the reversionary estate immediately expectant on the term granted by the lease, be annexed and incident to and shall go with that reversionary estate, or the several parts thereof, despite severance of that reversionary estate, and may be taken advantage of and enforced by the person in whom the term is from time to time vested by conveyance, devolution in law, or otherwise, and, if and as far as the lessor has power to bind the person from time to time entitled to that reversionary estate, such obligation may be taken advantage of and enforced against any person so entitled. [Emphasis added]

Thus, if the tenant fulfills its obligations, and the purchaser has knowledge of the tenancy, the tenant will be entitled to remain in possession of the leased premises, regardless of any default by the landlord / mortgagor. If the purchaser nonetheless enforces its remedies vis-à-vis the landlord and takes possession of the premises, and in the process locks out the tenant from the leased premises, the tenant would likely be entitled to relief from forfeiture and/or damages for breach of the covenant of quiet enjoyment of the premises.[22]

On the other hand, if the tenant fails to provide a purchaser with notice of the lease agreement, the purchaser will not be bound by the terms of the lease agreement and the tenant may be limited, in a case of enforcement, to a claim for breach of the covenant of quiet enjoyment of the

[22] *Nywening v. Melton Holdings Ltd*., (1998) 16 R.P.R. (3d) 302, 1998 CarswellAlta 205, reversed on other grounds 2000 ABCA 171; *Superior Acceptance Corp. v. 22 College Street Inc.* (1992), 25 R.P.R. (2d) 208, 1992 CarswellOnt 595.

premises against the insolvent landlord, a contingent and unsecured claim that may yield little or nothing for the tenant in the circumstances.[23] Similarly, if a mortgagee of a property does not have knowledge of a lease and subsequently takes possession of the property, the mortgagee-in-possession will not be bound by the lease.[24] For the above-noted reasons, it is critical that the tenant register a Notice of Lease on title to the premises as soon as possible.

Subordination agreements and non-disturbance agreements

As with most matters involving commercial tenancies, the terms of the lease agreement itself will be highly relevant. Even if the tenant's interest is in priority, temporally, to that of the mortgagee, lease agreements, particularly those involving sophisticated landlords, often provide that the prior tenancy will be subject and subordinate to any subsequent mortgages or charges. In these circumstances, a tenant may not be able to maintain occupation following the taking of possession by the mortgagee and / or subsequent sale of the property.

To address this situation, even if the landlord or mortgagee insists on the tenant subordinating its interest, the tenant should seek to ensure that its subordination does not result in the disturbance of the tenant's possession and occupation of the premises, so long as the tenant continues to abide by all of the terms of the lease. The tenant should seek to negotiate a non-disturbance agreement in these circumstances that would protect its interest and result in its being able to maintain its occupancy of the leased premises.

[23] *Binion, supra* note 9.
[24] *Coast Capital v. 482451 B.C. Ltd. et al*., (2004) CBR (5th) 1; 30 BCLR (4th) 177 at para 12.

Proceedings under the BIA / CCAA

The position of the parties may be quite different when formal insolvency proceedings have been commenced. Generally, when a landlord (or any other debtor) files a proposal or NOI pursuant to the BIA, or obtains protection from its creditors under the CCAA, it obtains the statutory power to disclaim or resiliate certain agreements.[25] Section 65.11(1) of the BIA provides:

> Subject to subsections (3) and (4), a debtor in respect of whom a notice of intention was filed under section 50.4 or a proposal was filed under subsection 62(1) may — on notice given in the prescribed form and manner to the other parties to the agreement and the trustee — disclaim or resiliate any agreement to which the debtor is a party on the day on which the notice of intention or proposal was filed. The debtor may not give notice unless the trustee approves the proposed disclaimer or resiliation. [Emphasis added]

However, both statutes explicitly prevent a debtor landlord from disclaiming leases of real property, thereby ensuring that such leases remain in force. For example, BIA s.65.11(10)(e) states:

> 65.11 (10) This section does not apply in respect of
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> …
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> (*e*) a lease of real property or of an immovable if the debtor is the lessor.[26]

Thus, under the BIA proposal sections and the CCAA, a landlord debtor seeking to restructure its affairs cannot disclaim leases of real property. The tenancy continues as before.

Further, the situation is the same in the case of a landlord's bankruptcy. A trustee in bankruptcy of a landlord with real property leases cannot disclaim those leases. In *Re: Palais des sports de Montreal*, the Quebec Court of Appeal held that a trustee's power, pursuant to section 30(1)(k)

[25] Also see CCAA s.32, which contains similar language.
[26] Also see CCAA s.32(9)(d), which contains similar language.

of the BIA to "elect to retain for the whole part of its unexpired term, or to assign, surrender, disclaim or resiliate any lease of, or any temporary interest or right in, any property of the bankrupt", only applies where the bankrupt is the lessee and not when they are the lessor.[27]

Tenant's Obligations

The tenant's obligations are those set out in the lease agreement. They apply irrespective of the financial situation of the landlord. The lease agreement is a contract between the landlord and the tenant and until such time as the lease is terminated, it must be complied with by all parties, failing which the aggrieved party may have recourse to its rights under the lease, the prevailing statutes, or the common law.

Thus, where the landlord remains in possession of the leased premises, the tenant must comply with the requirements of the lease and pay rent to the landlord. If the interest of the landlord in the rents has been transferred to someone else, be it a mortgagee, a receiver or a trustee in bankruptcy, the tenant will be required to pay the rent to that party. Indeed, s. 62 of the *Commercial Tenancies Act* has the effect of requiring a tenant to pay rent to any grantee of rents, reversionary interests or remainder interests, such as a mortgagee, without formal attornment. That section provides:

> **62.** (1) Every grant or conveyance of any rent or of the reversion or remainder of any land is good and effectual without any attornment of the tenant of the land out of which such rent issues, or of the particular tenant upon whose particular estate any such reversion or remainder is expectant or depending.

[27] *Re Palais des sports de Montreal*, [1960] Que. Q.B. 1012, 1 C.B.R. (N.S.) 260; also see *Coopérants, Mutual Life Insurance Society (Liquidator of) v. Dubois*, [1996] 1 SCR 900 at para 38.

> **Tenant not to be prejudiced**
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> (2) A tenant shall not be prejudiced or damaged by the payment of rent to any grantor or by breach of any condition for non-payment of rent before notice to the tenant of such grant by the grantee.[28]

To protect itself, the tenant should insist on receiving written notification, signed by the person alleging a transfer of interest, or a copy of any court order requiring the payment of rent to another person.

Further, subject to two notable exceptions, a tenant's financial obligations typically will not increase as a result of the landlord's insolvency. The first exception applies when the mortgage was registered prior to the Notice of Lease. In this case, the tenant may be evicted unless it agrees to enter into a new, and likely more onerous, lease. This is common when the existing lease was particularly favourable to the tenant under prevailing market standards at the time of the landlord's insolvency.

The second exception exists where a bankrupt landlord was a landlord pursuant to a sub-lease, but was also a tenant pursuant to a head-lease. In such circumstances, the sub-tenant may incur additional obligations if it wishes to remain in possession of the premises. In particular, the sub-tenant would be required to pay the greater of the amount it was already paying to its landlord and the amount that its landlord was paying to the head-landlord.[29]

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[28] *Commercial Tenancies Act*, RSO 1990, c L.7.
[29] *Commercial Tenancies Act*, s. 39(2); also see s. 21.

Can a tenant reduce the amount of rent it pays to a landlord or other party, as a result of the landlord's insolvency? Likely not. The tenant should carefully examine the lease agreement between the parties to see if it maintains a right of set-off for the tenant or the right of the tenant to deduct any amounts owing by the landlord to the tenant against any amounts owing by the tenant to the landlord. Most leases provide that the tenant may not set-off any amounts owing to it by the landlord for any reason whatsoever. In those cases, if the tenant has a claim for amounts owing against the landlord, the tenant is restricted to commencing an action in the courts against the landlord to recover those amounts.

If the landlord has already become the subject of formal insolvency proceedings, either under the BIA or the CCAA, those claims would, in all likelihood, become unsecured claims to be advanced within the particular proceeding, with no possibility of commencing or continuing any actions in the courts, and would also likely result in little or no recovery for the tenant.

Failure by the tenant to fulfill its obligations may result in the landlord or other party:

1. leaving the lease in place but suing for damages as they accrue;
2. terminating the lease and suing for damages;
3. notifying the tenant that it will take possession of the premises and re-let them on the tenant's account, thereafter claiming from the original tenant the difference between the obligations of the original tenant and the rent received from the new tenant; or
4. exercising the right of distress against the assets of the tenant.[30]

[30] *Highway Properties Ltd. v. Kelly, Douglas and Co.*, [1971], S.C.R. 562; see also *Landlord and Tenant Issues in the Bankruptcy and Insolvency Context*, Pamela J. Clarke, Kershman's Collection of Bankruptcy and Insolvency Articles.

It is critical that the tenant not take any steps that could give the landlord, or any mortgagee, receiver or trustee, the right to terminate the tenancy where such right might otherwise not exist.

Managing the Premises

A landlord will remain in possession of the premises and empowered to manage the premises unless:

1. the mortgagee enforces on the mortgage and becomes a mortgagee-in-possession;
2. a receiver is appointed; or
3. the landlord becomes bankrupt and a trustee in bankruptcy is appointed.

Further, the landlord debtor will remain in possession of the premises where there is a BIA proposal or a CCAA Plan of Arrangement, subject to any concurrent enforcement steps taken by a secured creditor, such as the appointment of a receiver. Where the landlord remains in possession, the landlord remains bound by the terms of the lease and must observe all of its covenants.[31]

When a mortgagee takes possession of leased premises, it will typically only do so for the purpose of selling the property. Similarly, a receiver or trustee in bankruptcy will, in most cases, seek to sell a property promptly to minimize the costs and obligations of managing the property. However, as a trustee in bankruptcy has an obligation to maximize value for the estate's

[31] Note, however, in cases where a stay of proceedings is operative, either by court order (in a court-ordered receivership or in a CCAA initial order) or by operation of law (BIA proposal or NOI), the failure of an insolvent landlord to take steps to comply with the lease obligations, such as managing or maintaining the property, may give rise to a right of action. However, the stay of proceedings operates to prevent the tenant from taking any steps to enforce its rights, or from commencing or continuing any proceedings in that regard. Again, the tenant is confined to filing a proof of claim in respect of any amounts it claims owing to it.

creditors, and is empowered to enter into new leases,[32] a trustee could manage a multi-unit property for a more extended period if it believes that adding one or more new tenants to other units could result in a higher price for the property that would maximize value to the bankrupt landlord's creditors. A receiver may be able to take a similar approach[33], depending on the terms of its appointment.[34]

In these cases, tenants are best advised to monitor the situation with respect to the leased premises and may wish to ensure that the landlord or mortgagee in possession, or other representative of the creditors, takes steps to ensure that the rights of the tenants are respected.

Further, in a formal insolvency proceeding, tenants may ask to be added to a service list that is maintained and updated by the receiver, monitor, proposal trustee or trustee in bankruptcy, thus ensuring that tenants have timely access to information and may be in a position, if appropriate, to take steps to protect their interests, particularly at any upcoming court hearings. In certain circumstances, it may be appropriate for tenants to retain counsel, either on an individual basis, or as part of an ad hoc group, to represent their interests before a court. This applies not only with respect to managing the premises, but with equal force to such other matters as are appropriate in the circumstances.

[32] BIA s. 30(1)(b) states: "The trustee may, with the permission of the inspectors, do all or any of the following things: …(b) lease any real property or immovable…"
[33] See e.g. *Bayhold Financial Corp v. Clarkson co.* (1991), 10 C.B.R. (3d) 159.
[34] See for example the Commercial List's Model Receivership Order , and in particular paragraph 3. Available at http://www.ontariocourts.on.ca/scj/en/commerciallist/

Repairs and Maintenance

Commercial tenants are typically required, pursuant to the lease, to perform all or most of the repairs and maintenance on the leased premises. These obligations are unlikely to be affected by the landlord's insolvency or any subsequent legal proceeding.

Landlords are sometimes obliged by the terms of the lease to address reasonable wear and tear, as well as repairs and maintenance of common elements in multi-unit properties. As long as the landlord remains in possession, they will remain responsible to fulfill these obligations. If a mortgagee, receiver or trustee in bankruptcy comes into possession of the property, they will inherit the obligations of the landlord.[35] In some cases, this may be favourable to a tenant as the mortgagee, trustee or receiver may perform repairs and maintenance that the landlord, due to its insolvency or for other reasons, neglected to perform.

A tenant may also consider performing certain repairs or maintenance that are the obligations of landlord. However, this should only be undertaken in circumstances where it is clear that the tenant is entitled to, and will in fact, be reimbursed by the landlord in short order. In the event that restructuring proceedings are commenced pursuant to the BIA or CCAA, or the landlord becomes bankrupt, the tenant's claim for reimbursement will become an unsecured claim against the company or in the estate. As unsecured claims may only be paid a pro-rata distribution by the company once all secured claims have been satisfied, the tenant may recover little or none of the amount spent on any such repairs.

[35] Note, however, that a mortgagee with a mortgage that is prior in interest to the lease could choose to either evict the tenant or negotiate a new lease agreement, in which case the mortgagee-in-possession's obligation may be eliminated or altered.

Utilities and services

Some tenants may be concerned that non-payment of utilities by an insolvent landlord may result in utilities, such as water, gas and electricity, or services, such as internet services, being suspended or cut off entirely. Tenants ought to be aware that this could happen and that they ought to make whatever arrangements are required to protect themselves in the event that this does happen. Until such time as a proposal or NOI is filed, or an order is made by a court in respect of a court-appointed receiver staying such actions, or a CCAA proceeding is commenced, utility companies are not precluded from taking steps to recover amounts owing to them, including steps such as discontinuing such utilities. The same applies to entities that provide services such as internet connections.

However, once the insolvent landlord files under the BIA or commences proceedings under the CCAA, or where a court makes a stay order in respect of a court-appointed receivership, the utility or service companies will be bound by the statutes or the court orders. For example, section 34(3) of the CCAA states:

> 34. (3) No public utility may discontinue service to a company by reason only that proceedings commenced under this Act, that the company is insolvent or that the company has not paid for services rendered or goods provided before the commencement of those proceedings.[36]

[36] Also see *BIA* s.65.1(3), which contains similar language.

However, arrangements will have to be made promptly with respect to ongoing services, as utility companies are not required to extend credit once proceedings have been commenced,[37] and failure by the landlord, tenant or other party to make arrangements for payment going forward could result in the premises 'going dark'.

Once again, the tenant should consider its position carefully to ensure that it does not get caught in the middle of any dispute between the landlord and its creditors. It is highly questionable whether any payments by the tenant to assist the landlord in maintaining utilities would ever be repaid, in whole or in part, and a tenant facing these circumstances would do well to seek legal advice.

Security Deposits and Prepaid Amounts

It is standard practice for landlords to require and for tenants to provide security deposits and/or prepaid amounts for such things as rent, utilities and taxes. Tenants may be concerned about what happens to these amounts in the event of their landlord's insolvency, and whether those amounts will be returned by an insolvent landlord or credited to them by a mortgagee in possession or purchaser.

With respect to claims against the landlord, recovery will likely depend on how the monies are characterized in the lease, and whether the tenant can establish that the funds were being held in trust by the landlord. In most cases, the lease will be drafted using landlord-friendly language that characterizes the security deposit as property that belongs to the landlord and is kept to

[37] *BIA* s.65.1(4)(b); *CCAA* s.34(4)(b).

secure the tenant's performance of the covenants under the lease. In those cases, the lease will not create, and there will be no reason for a court to impose, a trust over the security deposit. In these cases, again, the tenant will only have an unsecured claim against the landlord for the amount of the security deposit (or whatever portion of it remains), and will likely recover little or none of the actual security deposit.

If, however, the deposit or other monies are the subject of an explicit trust, this will be more beneficial for the tenant, as property held in trust for another person does not form part of the holder's property.[38] This includes property held by a bankrupt in trust for another person. [39] Thus, if a tenant can prove that the security deposit was intended to be held in trust for the tenant, it would be entitled to its return, without regard to the claim of any creditors. Practically speaking, however, it is more likely that the lease will contain provisions stating that the security deposit becomes the absolute property of the landlord or that it is held for the benefit of the landlord to secure payment or performance of the tenant's obligations, rather than it being held in trust for the benefit of the tenant. This reasoning will apply in respect of all prepaid amounts by the tenant.

With respect to claims in respect of such prepaid amounts as against mortgagees-in-possession or purchasers of the property, the primary questions are (a) whether the mortgagee or purchaser agreed to be responsible for the obligations of the landlord that existed prior to the conveyance of the property and (b) whether the mortgagee or purchaser received the deposit from the landlord.

[38] *Ramgotra (Trustee of) v. North American Life Assurance Co*., [1996] 1 S.C.R. 325, 37 C.B.R. (3d) 141.
[39] BIA s. 67(1)(a).

In *Canada Trustco Mortgage Co. v. Mundet Industries*[40], a tenant who had overpaid amounts to a landlord in respect of pre-paid taxes sought to recover its overpayments from, among others, a subsequent purchaser of the property. The court reviewed the transaction between the landlord vendor and the purchaser, and determined that the purchaser had not agreed to be liable for any of the landlord's obligations prior to the conveyance. Accordingly, while the purchaser became responsible for the performance of the landlord's covenants *after* the conveyance, they were not liable for the landlord's prior obligations and therefore did not have to compensate the tenant for the tax payments received by the landlord vendor. The court further clarified that this principle applies to both purchasers and mortgagees in possession.

If the tenant wishes to take steps to protect itself in respect of these matters, it ought to attempt to include such a term in a non-disturbance agreement with the mortgagee, as referenced above.[41] The tenant may also wish to indicate on an estoppel certificate that amounts are owed to it by the landlord, but a qualified estoppel certificate may not be sufficient to protect the tenant.

Leasehold Improvements

Complex commercial leases will typically include a provision that any leasehold improvements become the absolute property of the landlord immediately upon installation, and that the tenant is not to receive any payment for those leasehold improvements. In such cases, any sale by the landlord or other party of the property will likely include any leasehold improvements installed by the tenant. While this may not be a concern for the tenant if it is permitted to stay in

[40] [1996] O.J. No. 3746, 17 O.T.C 71 (Ont. Gen. Div.)
[41] See e.g. *473807 Ontario Ltd. v. TDL Group Ltd.* (2006), 271 D.L.R. (4th) 636, 47 R.P.R. (4th) 1.

possession of the premises, the value of the leasehold improvements would be lost to the tenant in the event that the tenant ceases to occupy the premises.

In less complex or lengthy leases, a tenant may remain the owner of leasehold improvements, including improvements that have been affixed to the premises. These leasehold improvements may include machinery, air conditioners, walk-in freezers, and more, and may be of considerable value to the tenant. Further, unless prohibited by the lease, the tenant is entitled to grant security interests in these leasehold improvements to other parties.[42] Where the tenant grants a security interest in leasehold improvements, the tenant (or its secured creditors) should ensure that if the landlord, mortgagee, receiver or trustee sells the property in which the premises are located, or terminates the tenancy, the tenant's interests in these leasehold improvements are protected. To avoid any ambiguity, the lease agreement should clearly address the subject of leasehold improvements and any ownership interest therein.

If the agreement provided that the tenant would be responsible for the construction of any leasehold improvements, and the landlord would then reimburse the tenant for any such amounts, once again, the tenant ought to act quickly to ensure that it is paid. If the landlord becomes insolvent, as previously noted, the tenant may be forced to advance its unsecured claim within an insolvency proceeding, where any recovery would be far from certain. If the tenant is permitted under the terms of the lease or other agreement to set off any such amounts against any amounts owing to the landlord, the tenant ought to do so, making it clear that it is exercising its right of set-off in accordance with the agreement.

[42] *See Personal Property Security Act*, R.S.O. 1990, c. P10, s. 34

CONCLUSION

While the bargaining power between a landlord and tenant will largely determine the extent to which a tenant can protect itself in the event that the landlord becomes insolvent, the tenant should be aware of the risks it faces and, where possible, take steps to mitigate those risks. While it may be difficult for a tenant to anticipate and address all of the risks it may face when entering into a tenancy agreement, the long term nature of most leases requires that tenants think and plan ahead, just as it requires landlords to do the same. At a minimum, the tenant should take steps to ensure that it can continue to occupy the premises and continue its operations. As always, there is no substitute for obtaining proper and considered legal advice from a practitioner who is knowledgeable and experienced in these areas.