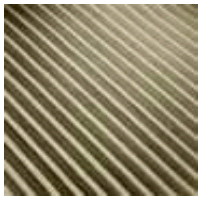

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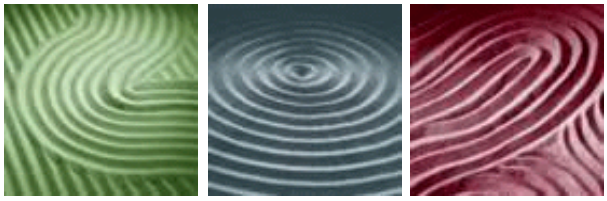

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How to Secure Security: Letters of Credit, Guarantees, Indemnities and *PPSA* Security

by Jennifer E. Babe
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1. Introduction

There have been a number of learned articles[1] analyzing the case law arising since Cummer-Yonge[2] effectively laid waste to security for landlords following disclaimer of a lease by a bankruptcy trustee of a tenant. I am not going to re-analyze those cases. Instead after a recap of the problem, I am going to try and suggest some alternate routes to try, thereby increasing the future income of the barristers among us.

2. The Problem: Disclaimer

Section 30(1)(k) of the *Bankruptcy and Insolvency Act*[3] (the "BIA") provides that:

> The trustee may, with the permission of the inspectors do all or any of the following things:
>
> (k) elect to retain for the whole or part of its unexpired term, or to assign, surrender or disclaim any lease of, or other temporary interest in, any property of the bankrupt;

"If by provincial law, the trustee is given the right to elect to retain, assign or disclaim leases, then s. 30(1)(k) gives the trustee the capacity, with the permission of the inspectors, to exercise those rights, but the rights of the trustee are to be determined by the provincial law"[4].

Section 38 of the *Ontario Commercial Tenancies Act*[5] provides the right of the trustee in bankruptcy to disclaim the lease.

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[1] See: (i) J. C. Carhart, "Cummer-Yonge Revisited: The Effect of Bankruptcy of a Commercial Tenant on Guarantees, Indemnity Agreements and Letters of Credit Pertaining to Lease Obligations", 19 CBR (3d) 170; (ii) J.W. Lem, "Cummer-Yonge Revisited Sub Nom: Spawn of Cummer-Yonge", 6 Minute Real Estate Lawyer, LSUC, Dec. 5, 2001; (iii) Debbie Rogers, "Revisiting Letters of Credit, Guarantees and Indemnities in a Fragile Economy", The 6 Minute Commercial Leasing lawyer, LSUC, Oct. 1, 2001

[2] Ontario Court of Appeal (1965) 8 CBR (NS) 62; 2 OR 157; 50 DLR (2d) Affirmed without reasons: 8 CBR (NS) 62; 2 OR 152; 50 DLR (2d) 25

[3] RSC 1985, c.B-3, as amended

[4] *The 2003 Annotated Bankruptcy and Insolvency Act*, L. Houlden and G. Morawetz, (2002: Toronto, Carswells) at page 72 and see the cases cited at note C.32.

[5] RSO 1990, c.L, as amended by SO 1997, c.24, ss 38 and 39

Section 30(1)(k) is supplemental to section 136(1)(f) of the BIA which caps the landlord to a claim for up to 3 months of actual arrears of rent prior to bankruptcy and 3 months of accelerated rent if provided for under the lease, netting from the accelerated rent any amount paid by the trustee for occupation rent.

Upon the disclaiming of the lease, the effect of the CTA is to terminate all rights under the lease to pay rent[6], leaving the landlord only its section 136(1)(f) claim as a preferred creditor. So what security may the landlord take to recover more than its section 136(1)(f) preferred claim when the bankruptcy trustee has unilaterally elected to disclaim the lease?

3. Letters of Credits

This topic was covered in Natalie Vukovich's paper that just preceded this one[7], Like Natalie, I think if a letter of credit has bald language securing generic "obligations under the lease", that permits the landlord to sign a truthful drawing certificate, such letter of credit should survive termination of the lease to cover non-rent obligations of the bankrupt tenant, such as

(i) damages to the property;
(ii) arrears of taxes or utilities charged apart from rent; and
(iii) repayment of inducement funds structured apart from rent.

A letter of credit, which by its terms stands as security for rent obligations cannot support a truthful drawing certificate (except to the extent of the preferred claim amounts), all other rent being extinguished by the disclaimer of the lease.

4. Guarantees and Indemnities

When in helping clients structure security we get to a discussion of guarantees and indemnities, I remind them to place little value on these documents in the credit analysis. I tell them that my definition of a guarantee is "a promise to litigate". Only twice in my practice has a guarantor agreed to pay upon receipt of my demand letter. Both times I was holding publicly traded securities as collateral to the guarantees, in a rising marketplace.

A guarantee is a secondary obligation, called upon only after the primary debtor has failed to pay or perform. The problem for the landlord is that the Cummer-Yonge decision held that upon the bankruptcy of the tenant, the guarantor will be released from its liability. This decision has been interpreted in Titan Warehouse

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[6] see Houldon and Morawitz, op.cit at pp 613 to 618 for case synopses on disclaimer generally, and security for tenant's obligations

[7] Natalie Vukovich, "Letters of Credit as Security for Tenants' Performance of Lease Obligations", Return of the 6 Minute Leasing Lawyer"; LSUC Feb. 19, 2003

Club Ltd. v. Glenview Corp[8] to mean the more correctly that the disclaimer of the lease, as a consequence, leaves no obligation of the remaining tenant for which the guarantor is liable.

An indemnifier is a primary, not a secondary liability party. The indemnifier's obligation is "an independent responsibility to perform the obligation of the tenant, whether or not the tenant performs or defaults on its obligation"[9].

The courts have found the liabilities of indemnifiers survive the tenant's bankruptcy[10], but only based on the specific wording of the obligation in issue. Other indemnities have not been upheld, again based on the drafting of those covenants[11].

And so the battle continues as to what wording of guarantees and indemnities will or will not survive disclaimer. In any event, unless secured by the other collateral, both of these documents likely result in litigation in any event.

5. PPSA Security

While *Personal Property Security Act*[12] ("PPSA") security has been a great thought to try to obtain secured creditor status to escape the perils of section 136(1)(f), it has not worked.

In Peat Marwick Thorne Inc. v. Nates Trading Corporation et al[13] the landlord took a security interest over the tenant's equipment to secure the lease obligation to pay future rent for the period up to termination. Justice Feldman held that the CTA capped the landlord's claim to the 3 months of actual arrears and 3 months of accelerated rent upon the happening of the bankruptcy. She held that once the base lease obligations ended, then the PPSA security could not be enforced to collect future rent or damages.

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[8] (1988), 67 CBR (NS) 204 (Ont. H.C.); affirmed (1989) 75 CBR (NS) 206 (Ont. C.A.)

[9] Deborah Rogers, op.cit at page 1

[10] i) Sifton Properties Ltd v. Dodson (1994), 28 CBR (3d) 151 (Ont. Gen. Div.); (ii) Andy and Phil Investments Ltd. v. Terrie Craig (1991), 9 CBR (3d) 52; 5 OR (3d) 656 (Ont. Gen Div.) Here the guarantee said the guarantor covenanted "as principal and not as surety".

[11] Crown Pacific Developments Ltd. v. Ferster (1991), 7 CBR (3d) 91 (BCSC)

[12] Personal property Security Act, RSO 190, c.P-10.

[13] (1995), 22 OR (3d) 727; 31 CBR (3d) 119; 44 RPR (2d) 207 (Ont. Gen. Div.)

6. **So What to Do?**

a) careful drafting

In reviewing the cases on letters of credit, indemnities and guarantees I tried to find some bright line test to see what words would survive disclaimer and afford the landlord protection. I found no clear guidance or "magic words" upon which one could rely.

All of the authors of the articles[14] referred to in this paper recommend spare and clean drafting to capture obligations of the tenant apart from the section 136(1)(f) rent limitations. Try focusing on obligations apart from rent or structured as separate obligations other than rent payments under the lease. These are still worth trying.

b) assignment of lease as a guarantee

So if a guarantee can be wiped out by disclaimer, what about having a head lease to the deep pocket guarantor, and have it sublet to the riskier operating entity? In short, use a head lease as a different and direct covenant to the financial source.

This has worked in Daniel Ignat Kaneff Holdings Ltd. v. National Trust Co.[15] and may have failed in Crystalline Investments Ltd. v. Domgroup Ltd.[16], subject to what the Supreme Court of Canada decides when this appeal is heard.

c) building materials

Note that the PPSA section 1definition of "personal property" excludes "building materials that have been affixed to real property". The PPSA does not have a definition of either "building materials" or "fixtures". The lease could have the parties agree that certain described matters, especially those funded by the landlord as leasehold improvements, as being "building materials" incorporated into and forming part of the landlord's realty. These might include built in structures in restaurants [bars; walk-in freezers; dishwashers] or offices [computer cabling; filing cabinets; built in boardroom tables; reception area desks] or shops [cabinetry/shelving].

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[14] See footnote no.1.

[15] (1988), 68 CBR (NS) 134 (Ont. HC)

[16] (2001) 39 RPR (3d) 49; 210 DLR (4th) 659 (Ont. CA); leave to appeal to Supreme Court of Canada granted December 12, 2002, with a tentative hearing date of November 7, 2003.

Thus in the event of a receivership coupled with a bankruptcy, the secured party's PPSA general security agreement would arguably not "attach" to the "building materials" and the landlord would be left with an improved facility more capable of reletting.

c) priority agents with leasehold mortgagee

It may be safest for a landlord to consent to a mortgage of the lease. In the insolvency of a tenant, a bankruptcy is now frequently coupled with a receivership to stop the landlord's distraint rights and to subordinate some crown claims. In such case, the trustee's right to the lease is subject to the charge of the secured creditor[17].

At the time of the creation of the leasehold mortgage and grant of PPSA security, the lender and the landlord should enter into an agreement as to their respective entitlements to:

a) fully mobile chattels to lender;
b) what goods are agreed to be removable tenant fixtures[18];
c) what items are no longer personalty at all, but building materials incorporated into the landlord's realty;
d) first rights of landlord to purchase any particular key item;
e) access and terms of access for lender or its receiver if some rent paid to facilitate of a sale of tenant's operations as a going concern; and
f) terms for consents to assignment of lease by lender or its receiver.

It may sound strange but a deal with the tenant's secured lender may be much safer than a bankruptcy with disclaimer of the lease and capped recoveries.

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[17] Re Lumbering Home and Garden Centre Ltd. (1975), 20 CBR (NS) 181; 8 OR (2d) 563; 58 DLR (3d) 531; affirmed at (1975), 20 OR (2d) 563n; 58 DLR (3d) 531n (Ont. C.A.)

[18] Given the conflicting case law over "fixtures", I still don't have a clue as to what will or will not be a removable trade fixture since 859587 Ontario Ltd. v. Starmark property Management Ltd. (1999) 164 DLR (4th) 167; 40 OR (3d) 481 (Ont. C.A) and the removable spray paint booth. See also: Ivan F. Ivankovitch, "Chattels and Fixtures: Clarity and Confusion the Saga Continues", (1999), 14 BFLR 371