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So You're Thinking of Going Back to Work… A Legal Perspective for Leasing Professionals | Part 2

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What is a tenant or landlord to do if the tenant can no longer afford the premises they have leased?

Despite a rent deferral agreement, abatement or forbearance, or in the absence of any of them, despite both of the landlord and the tenant making efforts to keep the relationship alive, there will be circumstances in which a tenant cannot pay its rent and honour its other commitments as well. Despite government assistance to backstop some of these obligations, it may not be feasible for some tenants to continue. And there is presently no assurance that relief from insurers will be forthcoming.

Regardless, the discussion always starts with the lease. At the very beginning, everyone needs to take a close look at their contractual obligations, the impact of a default on personal and other rights, and to what extent there are indemnities or other forms of security to support those obligations. Everyone needs to have a clear understanding as to whether or not the lease anticipates change in any way – whether in the nature of alterations to premises, or what are the requirements of the right to assign or sublease. Are there any other early termination rights?

Most of us have already taken a look at force majeure provisions in our leases and the impact that those clauses have had on our lease obligations. But it is reasonable to expect that in the future there will be some focus on doctrines like frustration or fundamental breach – to excuse performance. We think that the general consensus is that recourse to either of these doctrines is unlikely to be successful – frustration demands that there be an unforeseeable event that renders performance of the contract impossible, for instance. But it is not inconceivable that tenants will give it a try and there are some good reasons to think that people will want to revisit the doctrine. It is definitely something that tenants might want to think about canvassing with their lawyers. If a claim for frustration to succeed, that would render the lease over and terminated. For a claim for breach of the covenant of quiet enjoyment or derogation from grant, on the other hand, the remedy is not termination of the arrangement, but rather an abatement of rent.

These decisions will inevitably have a strategic focus – depending on the need for space, you might find making changes to your existing contractual arrangements negotiable. In others, you may find yourself between a rock and a hard place. Each of the landlord and the tenant need sophisticated advice to know the difference.

It is important that both landlords and tenant carefully consider their options when the prospect of default under a lease is being considered. There are a lot of affected parties – in the case of the landlord – its partners, its lenders, and its other tenants. In the case of a tenant – its lenders, its employees and its indemnifiers to name a few.

There will be tenants (and perhaps landlords) looking at their options under insolvency laws, whether under the *Bankruptcy and*

Insolvency Act (the "BIA") or the *Companies' Creditors Arrangements Act* ("CCAA"). The latter has been used more widely as of late – by large tenants like Sears and Target, while Division 1 Proposals under the BIA have also been used by tenants small and large, like Bentley Leathers and Bouclair, so there is a lot of current information about what we can expect the courts to do to protect the respective rights of landlords and tenants and their indemnifiers, and their respective creditors under that legislation. For the purposes of this review, while there are four principal ways (proposal, CCAA, bankruptcy and receivership) for a tenant to proceed in the event of its insolvency, we are going to synthesize the discussion – because no matter what proceedings are taken, the filing of formal insolvency proceedings by a tenant dramatically changes what a landlord can and cannot do.

For landlords, a tenant's bankruptcy has always put them in a difficult place. Even if not technically "bankrupt", if a tenant seeks protection under Division 1 of the BIA or the CCAA, or a receiver is appointed over the tenant, there is a stay of proceedings that affects the landlord and all others affected by the bankruptcy, including creditors. In addition, under Division 1 Proposal or CCAA proceedings, certain termination rights are suspended by law. At this point in time, an additional hiccup may be the impact of deferral agreements to which the landlord and the tenant might be a party. It goes without saying that if there is a prospect of bankruptcy or insolvency, a landlord is well advised to act promptly in respect of the default – and in this regard, legal advice is essential.

Generally speaking, under the BIA, the trustee can disclaim the lease within three months of the filing, or elect to keep the lease and endeavour to try and find a new tenant. Most landlords in such proceedings are treated as "preferred creditors", standing behind the secured creditors but ahead of many of the other unsecured creditors. They will be entitled to occupation rent, during any period of time that a trustee occupies the premises. Otherwise, a landlord's preference under s. 136 of the BIA is for 3 months' arrears and 3 months' accelerated rent (if provided for in a lease) less any occupation rent paid by the trustee from the date of bankruptcy. Similarly, if a tenant has taken Division 1 Proposal or CCAA proceedings, then it can continue to avail itself of the lease post-filing, irrespective of existing rental arrears before the filing, as long as it continues to pay post-filing rent. More importantly, the tenant in such a proceeding also has the option to disclaim a lease by providing 30 days' notice to the landlord. In these proceedings, the tenant may never become a bankrupt and as such the landlord will not be entitled to its s. 136 preference. Receivers do not have the power to disclaim a lease in the same way, but often combine their actions with a bankruptcy so that the trustee can disclaim the lease.

If that rent has been deferred then arguably it is not currently owing and at the time of the bankruptcy, may not get the benefit of any preference. If on the other hand, the deferral arrangement was structured as a forbearance, there are a couple of different possible scenarios. For instance, if the landlord and the tenant did a forbearance for April, May and June 2020 rent (the "Arrears") and there is a bankruptcy before July 1, then these three months of arrears should be a preferred claim in a bankruptcy (paid before some unsecured creditors). If the forbearance permits these Arrears to be paid over time, say until December 31, 2020, and the bankruptcy occurs on December 1, then the result could be different: (i) if the tenant was current for all rent July to November, then the unpaid Arrears are no longer 3 months' from the date of bankruptcy and the landlord will only have a regular unsecured claim for the Arrears – not a preferred claim; (ii) if the landlord (with the agreement of the tenant) applied all payments received to the oldest payments first, then the most current months' rent will be in arrears, thereby preserving the preference. I.e. payment for July rent received on July 1, applied to pay April arrears (and if applicable, part of May arrears); and so on.

A practical consideration in structuring arrangements with a tenant now, whether there is a prospect of bankruptcy, is the likelihood of distribution to unsecured creditors. If it is a small business, or business with very little assets, then there is very little likelihood of there being amounts to distribute after paying the bank and so, the benefit in making sure the forbearance is structured in a complicated way to preserve the 3 month priority may not be worthwhile.

There is a variety of case law relating to the treatment of deposits – the general rule seems to be that a security deposit that represents prepaid rent can be retained by the landlord, while a deposit that secures future performance of tenant obligations is likely to be treated as the property of the trustee in the event of a bankruptcy. There is similar case law relating to a landlord's entitlement to draw down on a letter of credit after bankruptcy. In addition, where a trustee disclaims a lease, the legal effect has been held by the courts to effectively void the lease, thereby eliminating any notion of future rent or damages and preventing the reliance on such

letters of credit or other security to apply to the unexpired portion of the lease.

In summary, as we all move forward in these precarious times, a realistic look down the road at what the parties' respective options under their lease and at law is time well spent.

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The information and comments herein are for the general information and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, please contact any of our lawyers for further guidance.

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