A WIN FOR LANDLORDS: LETTERS OF CREDIT AND THE AUTONOMY PRINCIPLE

Posted on January 4, 2021

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The Ontario Court of Appeal (the "**Court of Appeal**") released its decision in *7636156 Canada Inc. (Re)*, 2020 ONCA 681 on October 28, 2020. The Court of Appeal clarified the law regarding a landlord's entitlement to draw on a letter of credit where the underlying lease has been disclaimed by a trustee. Overturning the lower court decision, the Court of Appeal held the landlord was entitled draw down on the entire principal of the letter of credit pursuant to its terms and the terms of the disclaimed lease between the parties.

Facts and the Lower Court Decision

7636156 Canada Inc. (the "**Tenant**") and Omers Realty Corporation (the "**Landlord**") entered into a lease of an industrial building in 2014 (the "**Lease**"). The Lease required the Tenant to provide the Landlord with an unconditional letter of credit in the principal amount of $2.5 million (the "**Letter of Credit**"). The Bank of Nova Scotia ("**BNS**") issued the Letter of Credit on the terms that it was to provide "security of indemnification of [the] Landlord in respect of any losses etc. incurred by the Landlord arising out the failure by the Tenant to pay Annual Rent or any other amounts payable…".

The trustee in bankruptcy (the "**Trustee**") disclaimed the Lease shortly after the Tenant's assignment into bankruptcy. After the Trustee disclaimed the Lease, the Landlord drew down the full $2.5 million under the Letter of Credit for losses arising out of the disclaimer of the lease.

The Trustee brought a motion to determine the amount the Landlord was entitled to draw down on the Letter of Credit. The Trustee argued the Landlord was only entitled to draw down an amount equal to the statutory preferred claim for three months' accelerated rent pursuant to s. 136(1)(f) of the *Bankruptcy and Insolvency Act* (the "***BIA***"). The Landlord argued that it was entitled to draw down the full $2.5 million pursuant to the terms of the Letter of Credit, and that the Trustee had no claim against the Landlord.

The motion judge decided in favour of the Trustee. The motion judge concluded that Landlord was not entitled to draw on the Letter of Credit for any amounts in excess of the Landlord's three months' accelerated rent preferred claim under s. 136(1)(f) of the *BIA*. Relying on the *Mussens Ltd. Re.*, 1933 CarswellOnt 52 (Ont. S.C.) and *Cummer-Yonge Investments Ltd. v. Fagot*, [1965] 2 O.R. 152 (Ont. H.C.), aff'd [1965] 2 O.R. 157 (note) (Ont. C.A.)

decisions, the motion judge held the disclaimer of a lease operates as a voluntary surrender of the lease by the tenant, bringing all the rights and obligations, which the trustee inherited from the bankrupt, to an end. Accordingly, the motion judge concluded the BNS' obligations, as the issuer of the Letter of Credit, to make payments to the Landlord under the Letter of Credit ended because they were entirely dependent on the continued existence of the Tenant's obligations to the Landlord under the lease.

The Landlord appealed the decision.

The Ontario Court of Appeal Decision

The Court of Appeal allowed the appeal holding the Landlord was entitled to draw on the full $2.5 million principal under of the Letter of Credit pursuant to its terms and the terms of the lease. The Court of Appeal's decision raises five important takeaways regarding a lease of property in Ontario:

(1) A landlord will be entitled to draw on a letter of credit issued by a bank for losses that are otherwise not recoverable by the landlord against a bankrupt tenant's estate, assuming the lease and letter of credit are drafted appropriately.

(2) As a general rule, a bank, as the issuer of a letter of credit, has an independent obligation to honour a demand for payment when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the letter of credit. Referred to as the autonomy principle, a fundamental characteristic of letters of credit is their autonomy from the underlying transaction between the applicant (the tenant) and the beneficiary (the landlord). However, an exception to the general rule arises in the instance of fraud by the beneficiary which has been:

a. sufficiently brought to the knowledge of the bank before payment of the draft; or

b. demonstrated to a court called on by the customer of the bank to issue an interlocutory injunction to restrain the bank from honouring the draft.

(3) A landlord's claim against the bankrupt tenant's estate under the lease relating to the unexpired term of the lease, is limited to the preferred claim for arrears of rent for three months immediately preceding the bankruptcy, and accelerated rent for three months following the bankruptcy if entitled to accelerated rent under the lease. Apart from this statutory preference pursuant to s. 136(1)(f) of the *BIA* and a landlord's preferential lien for rent under s. 38(1) of the *Commercial Tenancies Act* (the "***CTA***"), a landlord does not have a claim for losses for unpaid rent for the balance of the term of the lease.

(4) However, a landlord may still be entitled to recover losses up to the full amount of a letter of credit. The Court of Appeal's decision reminds landlords that the terms of a lease and a letter of credit will ultimately

dictate a landlord's entitlement. To preserve a landlord's right to draw on a letter of credit, the three contracts involved (the lease, the letter of credit, and the contract between the issuing bank and the applicant) should be drafted as independent of one another. In light of the Court of Appeal's decision, recovery for losses and damages arising as a result of a breach, or disclaimer of the lease may be possible where:

a. the letter is drafted to provide security for indemnification of the landlord's losses; and

b. the terms dictate that the landlord's rights in respect of the letter of credit are not affected by the disclaimer of the lease.

If the letter of credit is drafted to guarantee to the landlord payment of rent by the tenant, a landlord's entitlement will likely be limited to the statutory preferred claim pursuant to s.136(1)(f) of the *BIA* and a landlord's preferential lien for rent under s. 38(1) of the *CTA*. Proper drafting to reflect the intent of the parties is critical in the context of a letter of credit.

(5) Where the contract between the bank issuing the letter of credit and the applicant tenant contains a right of reimbursement, the existence of such a contractual right will not frustrate the objective of the *BIA*. Additionally, security taken by the issuing bank in support of the letter of credit will not offend the anti-deprivation rule. A contractual right of reimbursement will validly allow the bank to seek reimbursement from the bankrupt tenant's estate, for any amounts it is required to pay out under a letter of credit.

Please contact McMillan for further guidance on drafting terms to ensure your lease, letter of credit, and reimbursement obligations protect your business in the event of a bankruptcy of a tenant.

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A Cautionary Note