The Impact of Bankruptcy and Insolvency Proceedings on Co-Tenancy Rights

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I. INTRODUCTION

Retail tenants typically try to negotiate “co-tenancy” clauses to protect themselves in the event of the loss of key or anchor tenants or high vacancy rates in a shopping centre. In such circumstances, tenants may be able to pay reduced rents or terminate the lease if the situation persists.

The exercise of co-tenancy rights can seriously hurt the interests of landlords in shopping centres which are already facing the loss of an anchor tenant or tenants.

However, there is one avenue of potential relief for landlords. In the event a key or anchor tenant files for protection under the *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 (the “CCAA”), the court can order a stay of co-tenancy rights during the period of protection.

This paper will briefly review the jurisdiction for an order staying the rights of other tenants in a shopping centre against the landlord, the history of cases where such orders have been made, the test for lifting the stay of proceedings and the ramifications for both landlords and tenants.

Separately, this paper will consider the assignability of co-tenancy rights to the purchaser of a bankrupt tenant’s assets and what steps can be taken by landlords to protect themselves from the assignment of co-tenancy rights that were intended to be personal to the original tenant.

II. AN OVERVIEW OF THE INSOLVENCY REGIME

There are four principal types of insolvency proceedings available in Canada:

1. Bankruptcy (voluntary or involuntary) under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 9 (the "BIA")
2. The filing of a proposal under the BIA;
3. The filing of an application under CCAA;
4. Receivership (private or court-appointed).

The BIA is a comprehensive statutory regime. Upon the bankruptcy of a debtor or the filing of a proposal (or notice of intention to file a proposal) there is an automatic stay of proceedings against the debtor/tenant, subject to the express provisions of the BIA.

The CCAA, on the other hand, is skeletal legislation. The CCAA is available to any debtor with debts that exceed $5 million. Unlike the BIA, this is a court-driven process. The debtor maintains control of its property and business operations, but subject to the supervision of a court-appointed monitor.

As in BIA proceedings, there is a stay of proceedings. However, the stay is by court order and the nature and scope of the stay is discretionary. Typically, the stay of proceedings will be in the form of a template "initial order", modified to suit the particular circumstances of the debtor. The initial order will be extended on notice to the company's creditors and is open to being expanded or modified from time to time.

With regard to lifting the stay of proceedings, section 69.4 of the BIA provides as follows:

> 69.4 A creditor who is affected by the operation of sections 69 to 69.31 or any other person affected by the operation of section 69.31 may apply to the court for a declaration that those sections no longer operate in respect of that creditor or person, and the court may make such a declaration, subject to any qualifications that the court considers proper, if it is satisfied
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> (a) that the creditor or person is likely to be materially prejudiced by the continued operation of those sections; or
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> (b) that it is equitable on other grounds to make such a declaration.

Any interested party may also apply to vary the court-ordered stay in a CCAA proceeding, although the criteria for doing so are not specified by statute.

Both the BIA and the CCAA contain other provisions specifically affecting the rights of landlords. For example, under both a BIA proposal and a CCAA filing, the tenant is required to pay rent for the use of leased premises until the lease has been disclaimed.

There are also special provisions dealing with the assignment of leases (and other contracts), with or without the landlord's consent.

Section 84.1(1) of the BIA provides as follows:

> 84.1 (1) On application by a trustee and on notice to every party to an agreement, a court may make an order assigning the rights and obligations of a bankrupt under the agreement to any person who is specified by the court and agrees to the assignment.

The factors to be considered in approving an assignment are as follows:

> (4) In deciding whether to make the order, the court is to consider, among other things,
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> (a) whether the person to whom the rights and obligations are to be assigned is able to perform the obligations; and
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> (b) whether it is appropriate to assign the rights and obligations to that person.

Pursuant to section 66 (1) and (1.1) of the BIA, this provision also applies to a proposal under the BIA, provided that the trustee under the proposal has approved the proposed assignment.

Section 11.3(1) of the CCAA is almost identical:

> Assignment of agreements
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> 11.3 (1) On application by a debtor company and on notice to every party to an agreement and the monitor, the court may make an order assigning the rights and obligations of the company under the

> agreement to any person who is specified by the court and agrees to the assignment.

The same factors apply, with the addition of the approval of the monitor:

> (3) In deciding whether to make the order, the court is to consider, among other things,
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> (a) whether the monitor approved the proposed assignment;
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> (b) whether the person to whom the rights and obligations are to be assigned would be able to perform the obligations; and
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> (c) whether it would be appropriate to assign the rights and obligations to that person.

There are many other provisions of the BIA and CCAA which affect the rights of landlords, but which are beyond the scope of this paper.

III. THE STAY OF CO-TENANCY RIGHTS

1. The Jurisdiction to Stay Co-Tenancy Rights

Section 11 of the CCAA sets out the general power of the court:

> 11 Despite anything in the Bankruptcy and Insolvency Act or the Winding-up and Restructuring Act, if an application is made under this Act in respect of a debtor company, the court, on the application of any person interested in the matter, may, subject to the restrictions set out in this Act, on notice to any other person or without notice as it may see fit, make any order that it considers appropriate in the circumstances.

This is where a potential stay of co-tenancy rights comes into play.

In *T. Eaton Co., Re*, 1997 CanLII 12405 (ON SC), the late Justice Lloyd Houlden made an order in Eaton's CCAA proceeding which contained a clause preventing tenants at retail shopping centres in which Eaton's was an anchor tenant from terminating their leases during the restructuring period.

The moving parties (referred to collectively in the decision as "Dylex") operated retail stores in regional shopping centres of which Eaton's was one of the anchor

stores. The Dylex leases contained co-tenancy clauses which generally permitted Dylex to terminate or otherwise alter the terms of their leases if Eaton's ceased to operate its store in a shopping centre. Dylex brought a motion to vary or amend the order staying the exercise of co-tenancy rights. Dylex made two arguments in favour of the variation:

1. The court had no jurisdiction to make the order as Dylex was not a creditor of Eaton's; and
2. Even if the court had jurisdiction to make the order, the prejudice to the moving parties outweighed the benefits of maintaining the stay.

Justice Houlden made short shrift of the first argument:

> With respect, I believe that s. 11 of the CCAA and the inherent jurisdiction of the court are sufficiently wide to permit the making of orders against third parties who are not creditors where their actions would potentially prejudice the success of a plan.

On the second argument, Justice Houlden gave the following reasons for maintaining the stay:

> (a) no Plan has been filed and it is unclear at this time how the claims of all the stakeholders will be addressed;
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> (b) the exercise of rights of the Moving Parties and others in similar circumstances at this time would have a negative impact on Eaton's ability to restructure, potentially jeopardizing the success of the plan and thereby the continuance of the company;
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> (c) if Eaton's were prevented from concluding a successful restructuring with its landlords, the economic harm would be far-reaching and devastating;
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> (d) the exodus of tenants could result in malls being forced to close; this could have a significant ripple effect throughout the local economies and cause further job loss;
>
> (e) Eaton's bankruptcy would have an even more devastating impact on all of Eaton's stakeholders, including its employees, suppliers, shareholders, creditors and landlords.

Thus, the jurisdiction and rationale for granting a stay of proceedings against third parties' co-tenancy rights was established.

The precedent has been followed in other large retail insolvencies, including the insolvencies of Sears and Target.

In *Target Canada Co. (Re)*, 2015 ONSC 303 (CanLII), Regional Senior Justice Morawetz (as he was then), provided the following rationale for granting a stay of co-tenancy rights:

> [45] The Applicants contend that the authority to grant the Co-Tenancy Stay derives from the broad jurisdiction under sections 11 and 11.02(1) of the CCAA to make an initial order on any terms that the court may impose. Counsel references *Re T. Eaton Co.*, 1997 CarswellOnt 1914 (Gen. Div.) as a precedent where a stay of proceedings of the same nature as the Co-Tenancy Stay was granted by the court in Eaton's second CCAA proceeding. The Court noted that, if tenants were permitted to exercise these "co-tenancy" rights during the stay, the claims of the landlord against the debtor company would greatly increase, with a potentially detrimental impact on the restructuring efforts of the debtor company.
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> [46] In these proceedings, the Target Canada Entities propose, as part of the orderly wind-down of their businesses, to engage a financial advisor and a real estate advisor with a view to implementing a sales process for some or all of its real estate portfolio. The Applicants submit that it is premature to determine whether this process will be successful, whether any leases will be conveyed to third party purchasers for value and whether the Target Canada Entities can successfully develop and implement a plan that their stakeholders, including their landlords, will accept. The Applicants further contend that while this process is being resolved and the orderly wind-down is underway, the Co-Tenancy Stay is required to postpone the contractual rights of these tenants for a finite period. The Applicants contend that any prejudice to the third party tenants' clients is significantly outweighed by the benefits of the Co-Tenancy Stay to all of the stakeholders of the Target Canada Entities during the wind-down period.
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> [47] The Applicants therefore submit that it is both necessary and appropriate to grant the Co-Tenancy Stay in these circumstances.
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> [48] I am satisfied the Court has the jurisdiction to grant such a stay. In my view, it is appropriate to preserve the status quo at this time. To the extent that the affected parties wish to challenge the

> broad nature of this stay, the same can be addressed at the "comeback hearing".

This is particularly noteworthy because in the Target CCAA proceeding, Target never had any intention of "restructuring" or continuing its business operations in Canada. Rather, this was from the outset a "liquidating CCAA", although Target ultimately filed a successful plan which resulted in substantial recoveries for Target's unsecured creditors, including landlords.

The stay of proceedings was extended a number of times without objection. Ultimately, the stay of co-tenancy rights was lifted on motion by a number of affected tenants, without opposition by Target or the affected landlords.

2. The Ramifications of a Stay of Co-Tenancy Rights

In *Livent Inc*. (Re), 1998 CanLII 14718 (ON SC), Justice Ground made the following observations, in declining to extend the principles in *Eaton* to inter-creditor disputes:

> I do, however, accept the submissions of counsel for the respondents that it is not appropriate, on a motion within Livent's CCAA application, to grant substantive relief as between creditors of Livent or as between Livent and third parties arising out of contractual arrangements. I have been referred to the decision of Justice Houlden in the T. Eaton Co. CCAA application (1997), 1997 CanLII 12405 (ON SC), 46 C.B.R. (3d) 293 (Ont. Gen. Div.), where a stay was granted against landlords of premises in malls where Eatons stores were located terminating the leases of other tenants in those malls. **It appears to me, however, that the effect of such order was simply to stay the right of termination and not to adjudicate upon or finally dispose of any substantive matters as between such landlords and the other tenants**. [emphasis added]

In *Luscar Ltd. v. Smoky River Coal Limited*, 1999 ABCA 179 (CanLII), the Alberta Court of Appeal addressed the issue of whether the CCAA court had jurisdiction over third parties to a dispute which was otherwise subject to arbitration in British Columbia. Although this case did not involve co-tenancy rights under a lease, the Court of Appeal referred to and relied on Justice Houlden's decision in *Eaton*

on the jurisdictional issue, with a similar comment to the comment in *Livent* on the ramifications of the stay:

> At 295-96, without extensive analysis, he opined that s. 11 and the inherent jurisdiction of the Court gave him the power to make orders against non-creditor third parties when their actions would potentially prejudice the success of the plan**. I acknowledge that it is not clear that his order had the effect of altering contractual rights permanently, since, depending on the outcome of the re-organization proceedings, at a future time the tenants might still be able to exercise their rights under the leases.** [emphasis added]

In contrast, the Supreme Court of British Columbia in *Jameson House Properties Ltd*. (Re), 2009 BCSC 964 (CanLII), in considering the rights of third parties in a CCAA proceeding and in discussing the *Luscar* decision, characterized the *Eaton* decision somewhat differently:

> [29] In coming to its decision, the Court of Appeal referred to a number of earlier decisions where third party rights had been affected by a stay order. It reviewed the Norcen decision earlier referred to and Re. T Eaton Company (1997) 1997 CanLII 12405 (ON SC), 46 C.B.R. (3d) 293 and Re Dylex (1995), 1995 CanLII 7370 (ON SC), 31 C.B.R. (3d) 106. **The latter cases each involved the permanent impairment of third party lessors' contractual rights.** [emphasis added]

There is a dearth of case law on co-tenancy rights, let alone on the impact of a CCAA stay of proceedings on co-tenancy rights, once the stay is lifted.

Although the stay of co-tenancy rights in the Target CCAA proceeding was ultimately lifted, the effect of the stay (including whether tenants could retroactively exercise co-tenancy rights that had been temporarily stayed by the CCAA order) was never ultimately determined by the courts.

This remains an open issue, with arguments on both sides.

On the one hand, it is open to tenants to oppose a co-tenancy stay, and failure to do so could result in tenants being estopped from asserting their rights retroactively after the stay has been lifted.

On the other hand, the purpose of the stay is solely to facilitate the proposed restructuring proceeding. Once this purpose is "spent", it is unclear whether there is a rationale for taking away the substantive rights of third parties.

In addition, the courts are generally loath to interfere with contractual rights between parties. See, for example, the recent decision of the Ontario Court of Appeal in *Hudson's Bay Company ULC Compagnie de la Baie D'Hudson SRI v. Oxford Properties Retail Holdings II Inc*., 2022 ONCA 585 (CanLII), which affirmed the importance of respecting contractual terms negotiated between sophisticated parties: "Certainty is important in commercial relations, as is the autonomy of the parties to settle the terms governing their commercial relationship."

In light of this case law, it is by no means a certainty in future CCAA cases that the courts will grant the kinds of co-tenancy stays made in the Eaton's, Sears and Target CCAA proceedings, particularly if vigorously resisted by the affected tenants, or that such stays, if granted, will take away (as opposed to merely postponing) substantive co-tenancy rights.

IV. THE ASSIGNABILITY OF CO-TENANCY RIGHTS IN INSOLVENCY PROCEEDINGS

As discussed above, both the BIA and the CCAA contain provisions allowing for the forced sale/assignment of leases (and other agreements), where the court finds that the proposed assignee would be able to perform the obligations and it would be appropriate to assign the rights and obligations to that person.

This is a potential trap for the unwary landlord.

In *Re Aeropostale Canada Corp.* (Notice of Intention), 2018 ONSC 1468 (CanLII), Aeropostale Canada Corp. ("Aeropostale"), as tenant, entered into a lease with Ivanhoe Cambridge Inc., as landlord, for a store in the Conestoga Mall in Waterloo, Ontario. The lease contained a co-tenancy clause, which applied "so long as the Tenant is Aeropostale Canada Inc."

In May 2016, Aeropostale filed a notice of intention to file a proposal under the BIA and a sale process was initiated with court approval to seek buyers for Aeropostale's various leased locations. Arden Holdings Inc. ("Arden") acquired a number of Aeropostale's leased locations and offered as well to acquire the Conestoga location. Aeropostale and Arden entered into an agreement to sell "all of the Vendor's right, title and interest as lessee/tenant". The landlord did not provide its consent, but did not oppose an order made under section 84.1 of the BIA approving the assignment of the lease to Arden.

At the time, an anchor tenant (not mentioned in the decision, but presumably referring to Target) had vacated the mall. There was no explanation as to why Aeropostale itself had not invoked the co-tenancy provision.

Approximately a year after purchasing the lease, Arden noticed the co-tenancy provision and invoked it. The landlord hotly contested its ability to do so. The matter was argued before Justice Dunphy on a motion for advice and directions.

The landlord's position was that the co-tenancy rights were personal to Aeropostale and not assignable. Arden's position was that the court had already approved the assignment of *all* Aeropostale's rights and obligations under the lease pursuant to section 84.1 of the BIA.

Justice Dunphy concluded that section 84.1 of the BIA and the terms of the sale approval and assignment order provided a complete answer to the question. Justice Dunphy did not accept the landlord's argument that the co-tenancy provision was non-assignable, and in any event held that the objection was out of time.

On the first point, Justice Dunphy held that the co-tenancy clause was not by its nature personal or non-assignable. In this context, he adopted the definition given by the Alberta Court of Appeal in *Ford Motor Company of Canada, Limited v. Welcome Ford Sales Ltd*., 2011 ABCA 158 (CanLII) of rights or obligations that by their nature are non-assignable:

> Agreements are said to be personal in this sense when they are based on confidences, or considerations applicable to special personal characteristics, and so cannot be usefully performed to or by another.

Justice Dunphy also held that freedom of contract could be abrogated by insolvency law:

> [36] Freedom of contract is indeed central to our economic and legal order. However, there are a number of ways that Parliament has chosen to interfere with that freedom in cases where it has judged there to be a compelling social case to do so. Minimum employment standards are an obvious example. Bankruptcy and insolvency is another and for reasons that are not hard to comprehend. In arm's length bi-lateral bargaining, there are essentially only two interests at the table. Neither side is particularly concerned to look after the interests of their creditors should they become bankrupt in future. These contingent future interests are vulnerable to compromise because neither side has a reason to see to them. However, where bankruptcy or insolvency intervenes, the interest of creditors and indeed social interests acquire a greater weight and collectively can displace the interest of the bankrupt wholly or in large part depending upon the circumstances. It is in such cases that Parliament has elected to compromise – carefully and subject to the court's discretion - the principle of freedom of contract.

In other words, the freedom of the parties to provide that co-tenancy rights are personal to the individual tenant or non-assignable can be abrogated by the "greater good" of realizing assets for the benefit of Aeropostale's creditors.

While this may at first blush seem to collide with the principle of freedom of contract more recently espoused by the Ontario Court of Appeal in *Hudson's Bay Company ULC Compagnie de la Baie D'Hudson SRI v. Oxford Properties Retail*

Holdings II Inc., 2022 ONCA 585 (CanLII) (cited above), there are indeed special considerations in the insolvency context.

These special considerations were discussed by the Supreme Court of Canada in *Chandos Construction Ltd v Deloitte Restructuring Inc*, 2020 SCC 25, which affirmed the existence of the "anti-deprivation rule", whereby contractual clauses that deprive creditors of value on a bankruptcy are void as against public policy. A full discussion of this rule is beyond the scope of this paper, but suffice it to say that Justice Dunphy's reference to public policy considerations on insolvency has some merit.

On the second point, Justice Dunphy held that the time for the landlord to raise its objections was *before* and not after the order was made under s. 84.1(1) of the BIA. Once the order was made, there was an implicit finding that *all* rights and obligations – including the co-tenancy provision – could be assigned.

Justice Dunphy's decision was not appealed to the Ontario Court of Appeal. Given the hotly contested nature of the proceeding, it is reasonable to assume that the case was settled prior to the hearing of an appeal. There are no court decisions following or even referring to this case. In the long term, this case may prove to have been a unique situation which turned on its own peculiar factual circumstances. However, the case provides some valuable lessons for landlords and tenants.

With respect to the assignability of co-tenancy rights, it may be possible to avoid the result in *Aeropostale* by drafting the co-tenancy clause differently or by providing that the rights terminate on assignment.

For example, in *Urbancorp Toronto Management Inc.* (Re), 2022 ONCA 181 (CanLII), a non-arm's length lease was drafted to provide for nominal rent of $100 per annum (rather than market rent of $200,000 per annum), but stipulated that in the event the lease was sold or transferred for valuable consideration, such consideration would be payable to the landlord as additional rent. The

lease was assigned in the tenant's CCAA proceeding, with the approval of the supervising judge. The monitor moved for directions on distribution of the proceeds. The monitor took the position that the transfer provision of the lease violated the anti-deprivation rule. Chief Justice Morawetz held that it did not and that the landlord was entitled to the value attributed to the lease. The Ontario Court of Appeal denied leave to appeal this decision.

This case demonstrates that a well-drafted clause restricting rights on assignment of the lease can survive a court challenge.

In addition, of course, the time to contest assignability of the lease is at the court hearing to approve the assignment, not some time period after the fact.

V. CONCLUDING COMMENTS

While the courts generally respect the sanctity of contractual terms that are freely negotiated between sophisticated parties, including terms of leases, these rights can give way in an insolvency situation. Carefully considered co-tenancy provisions may be stayed on the insolvency of an anchor tenant. Contractual protections against the assignability of co-tenancy rights may be overridden based on public policy considerations.

In the former case, tenants whose leases contain co-tenancy clauses may wish to contest a stay order early in the proceeding. While the jurisdiction to grant a stay is well-established, judges may be reluctant to do so in the face of strong opposition, without compelling evidence that such a stay is essential to facilitate a restructuring. In situations such as the Target CCAA proceeding, for example, where the sole intention was to liquidate the operations, the case for a stay was less compelling than in the Eaton's restructuring efforts.

In the latter case, if the parties intend a co-tenancy provision to be personal to the original tenant, it should be possible to draft the clause so as to avoid the

result in *Aeropostale*. In any event, it is important for the landlord to assert its rights prior to the assignment.

As a general matter, in any situation involving bankruptcy or insolvency proceedings, both landlords and tenants should obtain advice from insolvency counsel early in the process, rather than trying to assert rights after the fact.