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April 30, 2018

Bankruptcy/Insolvency: The Basics for Leasing Professionals*

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There are four major insolvency proceedings in Canada: (i) bankruptcy; ii) receivership (private or court appointed); iii) proposals under the *Bankruptcy and Insolvency Act* (“*BIA*”); and iv) *Companies’ Creditors Arrangement Act* (“*CCAA*”) proceedings. Each has differing and varying effects on landlords’ rights and obligations. Below is a brief outline of how each proceeding impacts upon the landlord and tenant relationship when a court officer such as a receiver or trustee is appointed.

As each process has unique statutory provisions and a debtor may utilize more than one regime at the same time, reference should be made to the applicable federal legislation, the applicable provincial legalisation and any court order(s) to determine the complete and specific implication of each particular insolvency proceeding and the impact on landlords in each province. This summary is based on federal insolvency laws and the applicable laws of the Province of Ontario. Reference should be made to provincial legislation for the other provinces to verify the interplay between the federal insolvency laws and each particular provinces’ legislation.

I - BANKRUPTCY OF THE TENANT

“Bankruptcy” is a legal status of an insolvent individual or corporation governed by the *BIA*. An individual or a corporation can become bankrupt in three ways: making an assignment in bankruptcy, making a failed proposal or being subject to a bankruptcy order upon the application of a creditor. Upon becoming bankrupt a court officer known as a Licensed Insolvency Trustee (formerly, Trustee in Bankruptcy) is appointed. The assets of the bankrupt (with certain exceptions) vest in the Trustee to be distributed to creditors in accordance with the provisions of the *BIA*.

Bankruptcy of a tenant dramatically changes a landlord's rights and remedies. The Trustee obtains significant statutory rights to control the premises and the lease and such rights have priority over the landlord's rights of termination, lease enforcement and distress. The 2009

*This paper was previously published by the Law Society of Upper Canada “The Six-Minute Commercial Leasing Lawyer 2018”: February 2018

amendments to the *BIA* have given Trustees rights which were previously only available pursuant to provincial legislation.

The landlord's position on the bankruptcy of the tenant is as follows:

- upon a bankruptcy, all creditors (except for secured creditors in limited circumstances) are automatically stayed under the *BIA* from enforcing any remedy against the insolvent person or its property or from commencing or continuing any action, execution or other proceeding for recovery of claims provable in bankruptcy (post-filing rent obligations are not considered “claims provable in bankruptcy” and therefore the stay does not apply to prohibit enforcement for post-filing rent obligations);
- the landlord loses the right to terminate the lease for pre-filing defaults;
- the landlord loses the right to commence or continue any action against the tenant;
- the landlord loses the right to distrain; and
- the landlord obtains a preferred claim for three months arrears of rent and three months accelerated rent – if provided for in the lease. The preferred claim is restricted to the value of the realization of the property on the premises. Claims for accelerated rent must be off-set by occupation rent paid by the Trustee. Arrears of rent older than three months have no priority and are simply unsecured claims against the bankrupt.

Retention of Lease and Occupation Rent

- Pursuant to the *Ontario Commercial Tenancies Act* (“*CTA*”), a Trustee obtains the right to retain the premises for a three month period following the tenant's bankruptcy.
- A landlord is entitled to occupation rent from the Trustee for the period that the Trustee is in *actual* occupation of the premises. The Trustee is personally liable for occupation rent.
- There is no requirement that occupation rent be paid monthly. Often Trustees will pay occupation rent at the end of the three month period or when the lease is disclaimed.

Unless the Trustee has disclaimed the lease, a landlord must ensure the premises are available to the Trustee for the full three month period even if the Trustee is not in occupation of the premises and no rent is being paid.

Payment of Arrears of Rent

- A landlord has no entitlement to demand that the Trustee pay arrears of rent at any time or as a condition of occupation. However if the Trustee assigns the lease, arrears of rent are to be paid.

Use of Premises - Liquidation of Goods from Leased Premises

- Although there are no statutory provisions entitling a Trustee to disregard positive use clauses in leases, such clauses are not usually binding on the Trustee during its period of occupation.

- Terms in leases which prohibit bankruptcy sales are usually not binding on a Trustee. Other lease clauses are usually binding on the Trustee except for forfeiture provisions due to bankruptcy.

Disclaimer or Surrender of Lease

- The Trustee may, by notice in writing to the landlord, surrender possession or disclaim the lease.
- If the lease is disclaimed, the lease is terminated as between the bankrupt and the landlord. There is no statutory notice period that must be complied with before a Trustee may disclaim a lease.

Retain the Lease

- A Trustee has the right to elect to retain the premises for the whole, or any portion, of the unexpired term and any renewal thereof upon the terms of the lease.
- If the lease is retained but not assigned the Trustee will be personally liable on the lease. Failure to elect to retain the lease will not automatically result in the termination of the lease.

Assignment of Leases

- Section 84.1(1) of the *BIA* entitles a Trustee to apply to the court, on notice to the landlord, for an order assigning the rights and obligations of a bankrupt under an agreement (including a lease) without reference to the provisions of provincial legislation. However, if a Trustee wishes to exercise the right given to it to assign leases, it must not have disclaimed the lease and must either have elected to retain the lease or commenced its application within the three month occupation period provided for in the *CTA*. In deciding whether to grant the order, the court will consider:
 - the proposed use;
 - whether the person to whom the rights and obligations are to be assigned would be able to perform the obligations; and
 - whether it would be appropriate to assign the rights and obligations to that person.
- The court may not make this order unless it is satisfied that all monetary defaults in relation to the agreement (other than those arising by reason only of the person's bankruptcy, insolvency or failure to perform a non-monetary obligation) - will be remedied on or before the day fixed by the court.
- Under the *BIA* provisions, besides an objection based on whether the proposed tenant will be able to perform the obligations of the lease (similar to the requirement included in the *CTA*), the question to be answered in connection with the assignment of leases is “whether it would be appropriate to assign the rights and obligations to that person”.

Proof of Claim

- Prior to the first meeting of creditors, the Trustee will send a Proof of Claim form to all known creditors. Completion and filing with the Trustee of the Proof of Claim is necessary in order to obtain a distribution from the bankrupt estate (if any) and in order to vote at the first meeting of creditors. The components of a landlord's claim consist of:
 - All arrears of rent and additional rent unpaid as at the date of bankruptcy, together with all damages resulting from pre-bankruptcy breaches of the lease, e.g. failure to repair;
 - Three months of accelerated rent - if provided for in the lease; and
 - In Ontario, a landlord does not have a claim for damages for nonpayment of post-bankruptcy rent for the balance of the term of the lease.
- Landlords are entitled to a priority claim under Section 136(1)f) of the *BIA* for the portion of the claim relating to three months of pre-bankruptcy unpaid arrears of rent and will also be entitled to a priority claim for the three months accelerated rent referred to above save that a landlord's priority claim for three months accelerated rent is subject to: (i) the value of goods in the premises as at the date of bankruptcy, and (ii) must be reduced by any occupation rent paid. If a priority claim is lost, landlords can still claim the amount as a regular unsecured claim.

II - NOTICE OF INTENTION TO FILE A PROPOSAL UNDER THE BIA

- A proposal may be made by an insolvent person to avoid bankruptcy or by a bankrupt to annul the bankruptcy.
- A "proposal" is a restructuring proceeding wherein a debtor remains in possession of its assets and business while it develops a proposal to submit to its creditors for the restructuring of its debt/business. The proposal proceedings are overseen by a court officer called the Proposal Trustee.
- Upon filing a NOI or a proposal under the *BIA*, all creditors (except for secured creditors in limited circumstances) are automatically stayed under the *BIA* from enforcing any remedy against the insolvent person or its property or from commencing or continuing any action, execution or other proceeding for recovery of claims provable under the *BIA*. Similar to the stay affecting bankruptcies, the automatic stay in proposal proceedings only affects pre-filing obligations and does not apply to prohibit enforcement for post-filing rent obligations.
- The stay continues in force for an initial period of 30 days and if extended, until a proposal is filed or the debtor becomes bankrupt. The total stay period cannot exceed 6 months.
- Knowledge that a NOI or a proposal has been filed or that the debtor has become bankrupt is unnecessary for a stay to be effective as against the landlord. If a creditor cashes a cheque that it has received from the debtor after the debtor has filed an NOI, the money must be repaid.
- As a result of the stay, the landlord,

- Loses the right to terminate the lease for pre-filing defaults;
 - Loses the right to commence or continue any action against the tenant;
 - Loses the right to distrain or issue and continue execution proceedings; and
 - Is unable to make a claim for accelerated rent by reason of insolvency, or because rent was in arrears at the date of the filing.
- Where rent falls due after the filing of a NOI and is not paid by the debtor, the stay of proceedings should have no application and the landlord may exercise all its legal rights.

Assignment of Leases

- A debtor has the right to apply to the court, on notice to the landlord, for an order assigning a lease. The same test as that applicable to a Trustee wishing to assign a lease applies. In this regard, in determining whether to grant the order, the court will consider:
 - whether the person to whom the rights and obligations are to be assigned would be able to perform the obligations; and
 - whether it would be appropriate to assign the rights and obligations to that person.
- The court may not make this order unless it is satisfied that all monetary defaults in relation to the agreement (other than those arising by reason only of the person's bankruptcy, insolvency or failure to perform a non-monetary obligation) - will be remedied on or before the day fixed by the court.

Right to Disclaim or Resiliate Commercial Leases

- A debtor who is a commercial tenant has the right to disclaim a lease by giving 30 days' notice to the landlord.
- Within 15 days after receiving the disclaimer, the landlord may apply to the Court for a declaration that the disclaimer does not apply in respect of the lease. In such an application the onus is upon the tenant to satisfy the Court that it would not be able to make a viable proposal "*without the disclaimer of that lease and all other leases that the tenant has disclaimed*".

Proof of Claim

- As in a bankruptcy, the Proposal Trustee will send a Proof of Claim form to known creditors. As in a bankruptcy, completion and filing with the Proposal Trustee of the Proof of Claim is required in order to vote at creditor meetings and to receive a distribution under any proposal.

Landlord's Claim

- Where a lease is disclaimed, the *BIA* stipulates the manner in which a landlord's claim is to be calculated. The amount of the claim that will actually be paid to the landlord depends on the terms of the proposal. The proposal must indicate whether the landlord may file a Proof of Claim for the actual losses resulting from the disclaimer, or, in accordance with the formula in the *BIA*.

Meeting of Creditors and Voting

- A proposal, once ready, is to be filed by the Proposal Trustee with the official receiver. The Proposal Trustee must call a meeting of creditors to vote on the proposal within 21 days after the filing.
- If a proposal is accepted by the creditors by the requisite majorities in each class of creditors, the Proposal Trustee must apply to obtain the Court's approval of the proposal. Even if a proposal receives the recommendation of the Proposal Trustee and the overwhelming support of the creditors, the Court does not have to approve it.
- If a proposal is defeated by the creditors or fails to obtain Court approval, then the insolvent person is deemed to have "*thereupon*" made an assignment in bankruptcy.

III - RECEIVERSHIP OF THE TENANT

Receivership occurs when a secured party under a general security agreement or other security agreement appoints or obtains the appointment of a receiver or a receiver and manager as a result of the debtor's default.

- A "receiver" has the power to take possession of and liquidate assets and to receive rents and other income. A "receiver and manager", in addition to the above powers, has the power to operate the debtor's business.
- A receiver may be privately or court appointed. If appointed privately, the receiver derives its powers from the relevant security documents. If court appointed, its duties and powers are derived from the court order appointing it. Most receiverships are now court appointed receiverships.
- A receiver is not afforded any comparable rights or powers to that of a Trustee by statute (though pursuant to the *BIA*, receivers, in certain situations, are now subject to various statutory duties and obligations).

Private Receiver: Rent/Use/Control of the Premises

- As against a landlord, a privately appointed receiver for the secured creditor of the tenant has **no** greater rights than those enjoyed by the tenant and is bound by all provisions of the lease including:
 - payment of rent in accordance with the terms of the lease;

- assignment and subletting provisions as they affect receivers own interest in the lease and its further ability to dispose of the lease or occupy the leased premises; and
 - usual remedies clause that gives the landlord the right to terminate on appointment of a receiver.
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- As there is no stay of proceedings to assist a privately appointed receiver, if there should be a default in the payment of rent (or there were arrears of rent owing when the receiver was appointed), the landlord's right to terminate the lease and its right to distrain are unaffected by the appointment of a receiver.
 - As noted above, the appointment of the receiver may itself constitute an event of default entitling the landlord to require the payment of accelerated rent and to terminate the lease.

Court Appointed Receiver

- Unlike a privately appointed receiver, a court appointed receiver will have additional rights granted by the court. Typical court orders appointing receivers will usually contain a stay of all proceedings against the debtor. Hence a landlord would be unable to distrain or terminate a lease without leave of the court.
- As receivers often request and are generally granted extended rights that override the terms of leases, it is essential that each order appointing a receiver be reviewed to assess the rights of the receiver as they impact upon landlords.
- Landlords may wish to ensure that the appointment order includes the following:
 - that landlords be given adequate notice before leased premises are vacated or a lease repudiated¹;
 - that the sale of inventory be carried out only in compliance with the terms of the leases and that the receiver comply with the doing business, signage and advertising provisions of the leases;
 - that the receiver limit the movement of inventory between leased locations to ensure that percentage rent clauses are not adversely affected and that the preferred claim of landlords in the event of a bankruptcy is not lost;²and
 - that, save for the terms specified in the order, the receiver will comply with the terms of the leases (including the restriction on the assignment of leases³).

¹ Although receivers have no statutory entitlement to disclaim leases, the courts may grant receivers this right.

² Pursuant to s. 136(1)(f) of the *BIA*, a landlord's "priority" claim is limited by, among other things, the amount realized from the property on the premises under lease at the date of bankruptcy.

³ Unlike trustees in bankruptcy, receivers have no statutory entitlement to assign leases as of right.

Sale of Assets/Liquidations

- If requested, receivers are often granted the right to liquidate assets from the leased premises. Liquidation sales always raise various concerns for landlords. In order to control the use of the leased premises and avoid the premise being used as a “liquidation centre” landlords need to ensure at a minimum the following:
 - that the sale is limited in duration with a specified end date;
 - that any signs to be used to advertise the sale and the location of such signs be pre-approved by the landlord;
 - that hours of operation be adhered to and that if fixtures/equipment are sold, such fixtures/equipment be removed *via* loading dock doors after business hours;
 - that there be no or limited augmentation of the merchandise being sold; and
 - that if the liquidation is to be done by another entity, that any agreement permitting the other entity occupation of the leased premises include provisions that all parties comply with the terms of the leases.

Receiverships and Bankruptcies

- Because the rights of a receiver to control and deal with the lease and the premises are generally subordinate to those of the landlord, secured creditors may also make an application to bankrupt the tenant. By doing so, the Trustee (who is often the receiver) obtains significant statutory rights to control the premises and the lease and such rights have priority over the landlord's rights of termination, enforcement and distress. Yet the rights of the Trustee to deal with the lease and the premises are, by virtue of the *BIA*, subordinate to the rights of a secured creditor. The net effect is that a secured creditor and its receiver gain control of the lease and the premises through the Trustee.

Distributions to Landlords

- Unlike bankruptcy, there are no statutory provisions dealing with a landlord's claim in a receivership. Accordingly, unless the lease is assigned, upon the termination of the lease by the receiver, the landlord will have an unsecured claim for all damages that it suffers as a result of the termination *i.e.*, all arrears of rent and additional rent, all damages for breaches of the terms of the lease and damages for loss of future rent. There is no statutory claims process or proof of claims process in a receivership. Typically, after realizing on the assets of the debtor, the receiver will obtain a court order authorizing payment of priority payables such as withholding taxes and sales taxes and payment of secured creditors. If any proceeds remain available for distribution to unsecured creditors, the receiver will typically bankrupt the debtor and then distribute the remaining proceeds using the Proof of Claim and distribution provisions of the *BIA*.

IV - COMPANIES' CREDITORS ARRANGEMENT ACT (CCAA)

The purpose of the CCAA is to afford debtors the opportunity to “arrange” their business with a view to continuing operations. In this regard, the debtor may file a “Plan of Arrangement” to be considered and voted on by the creditors.

Throughout the process, the debtor corporation maintains possession and control of its property and operations with a Court appointed Monitor overseeing and reporting on matters to the Court.

Initial Orders

- CCAA proceedings are commenced by application to the court. It is common for these applications to be brought by debtors without notice to any of its unsecured creditors. At the first hearing of the debtor’s application, the Court may grant an Initial Order.

Stay of Proceedings

- Although the granting of a stay of proceedings is discretionary under the CCAA, in an effort to assist debtors, typically Initial Orders will include a stay of proceedings against the debtor company. The purpose of the stay is to maintain the *status quo*.
- The Court has a broad discretion to impose terms and conditions on the granting of the stay, including the power to vary the stay and allow the company to enter into agreements to facilitate the restructuring.
- The stay of proceedings will usually prevent landlords from taking any steps to terminate leases, commence or continue actions against the tenant and eliminates the landlord’s ability to distrain or execute on the tenant’s goods.
- All landlord and tenant issues in CCAA are determined principally by reference to the Court orders issued pursuant to CCAA.

Model Order

- As a result of the continued and sustained involvement of several large national landlords in responding to retail CCAA proceedings, the first model order was amended by the Commercial Court Users Committee (in which McLean & Kerr LLP is involved), which amendments included many provisions protective of landlords.

Assignment of Leases

- In the CCAA proceeding, the debtor will often try to sell leases through a Sale and Investment Solicitation Process.
- If leases are sold, the CCAA grants a debtor the right to apply to the court, on notice, for an order assigning leases. The same test as that applicable to a Trustee wishing to assign leases applies. In this regard, in determining whether to grant the order, the court will consider:
 - whether the Monitor has approved the proposed assignment;

- whether the person to whom the rights and obligations are to be assigned would be able to perform the obligations; and
- whether it would be appropriate to assign the rights and obligations to that person.
- The court may not make this order unless it is satisfied that all monetary defaults in relation to the agreement (other than those arising by reason only of the debtor's insolvency, the commencement of *CCAA* proceedings or the debtor's failure to perform a non-monetary obligation) will be remedied.

Right to Disclaim or Resiliate Commercial Leases

- A debtor is entitled to disclaim a lease by giving 30 days' notice to the landlord. *CCAA* (unlike *BIA*) does not include any restriction or formula for the calculation of a landlord's claims for repudiated leases. Debtors have, however, tried to import a formula in *CCAA* proceedings.

Proof of Claim

- The *CCAA*, unlike the *BIA*, does not have any provisions dealing with Proofs of Claim or a claims process. In the normal course the debtor or the Monitor will apply to the court for the approval of a claims procedure and the forms to be used (the "Claims Procedure Order"). The Claims Procedure Order will also set a "claims bar date" – the date by which Proofs of Claim must be filed failing which claims will be extinguished. Unlike the *BIA*, there is no statutory provision giving the landlord a preferred claim for any portion of its arrears or accelerated rent.

Sale of Assets/Liquidation

- Although the object of the *CCAA* is to enable debtors to "arrange" their business with a view to continuing operations, in many cases, either due to the fact that the "arrangement" of the debtor's business requires the liquidation of a portion of the debtor's business or the plan of arrangement fails and the entire business must be liquidated, the need to sell assets out of the ordinary course of business, is a common occurrence.
- If the liquidation of assets becomes necessary, the debtor must, on notice to all creditors, obtain the Court's approval for such sale. It has become common to include "Terms of Sale" in an approval order.
- A liquidation sale raises various concerns for landlords. In particular, most landlords wish to ensure that the leased premises are not used as a liquidation centre – contrary to the terms of the lease.
- In order to preserve and control the use of the premises, landlords need to ensure at a minimum the following is addressed in any court order approving the liquidation of assets:
 - that the sale is limited in duration with a specified end date;

- that any signs to be used to advertise the sale and the location of such signs, be pre-approved by the landlord;
- that hours of operation be adhered to and that if fixtures/equipment are sold, such fixture/equipment be removed via loading dock doors after business hours; and
- that there be no or limited augmentation of the merchandize being sold.

CONCLUSION

Canadian insolvency laws are complex and intertwined, which complexities are further augmented when a debtor utilizes two processes at the same time (*i.e.* a bankruptcy and receivership). The foregoing is intended only as a brief summary review of the impact each process has on landlords. It is recommended that you seek appropriate legal advice regarding the rights, remedies and impact a specific proceeding will have on the various parties.

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