Tenant bankruptcies in the COVID-19 era: Security deposits, prepaid rent and distress rights

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This is the first part of a two-part series

Commercial tenant bankruptcies and COVID-19

Many commercial tenants have been significantly impacted by the government-ordered closures and economic turmoil caused by the COVID-19 pandemic. With little to no revenue, these tenants are struggling to pay their rent and may be considering bankruptcy. Landlords should consider the security they currently have in place with their tenants and how this affects their ability to claim that security and enforce their rights under a lease once they are dealing with a bankrupt tenant.

This article refers to tenants in states of solvency, insolvency and bankruptcy in Canada. When a tenant is insolvent (*i.e*. in a state of financial distress where they are unable to pay the debts they owe to lenders on time), they may choose to file for bankruptcy (the legal process for an insolvent debtor to surrender assets in exchange for relief from debts, which is governed by the *Bankruptcy and Insolvency Act* (BIA)). They may choose to deal with their debts through other options such as a consumer proposal or debt consolidation.

Larger tenants will often seek creditor protection under the *Companies' Creditors Arrangement Act* (CCAA). In this article, we examine a landlord's ability to claim security deposits, prepaid rent and enforce their distress rights in the context of a tenant bankruptcy.

Security deposits

In general, leases require a tenant to provide a cash deposit as prepaid rent, or as security for the tenant's performance of its obligations under the lease. The distinction is relevant to the question of whether the landlord can keep the deposit upon tenant bankruptcy. This is a fact-driven determination and depends on the language in the lease and the intention of the parties.[1]

Where the deposit has been determined to be security for the tenant's obligations under the lease and remains the property of the tenant (particularly, where the lease states that such a deposit is to be returned to the tenant), the deposit will likely form part of the bankrupt estate, to be surrendered to the tenant's trustee in bankruptcy, and is not available to the landlord.

What are my options?

Apply the security deposit now

If the lease entitles the landlord to apply the security deposit against unpaid rent or as compensation for the tenant's default and the tenant is still solvent then the landlord may want to do so, particularly if the financial situation of a tenant is worrisome.

Registration

Some landlords may prefer to register their security interest under the provincial personal property security legislation, notwithstanding the cost and administrative burden. Landlords should remember that registering a security interest does not mean they will be able to recover any or all of the security deposit.

Prepaid rent

Landlords have generally been entitled to retain prepaid rent in the event of a tenant bankruptcy, provided that the sum is properly characterized as such. The courts have held that prepaid rent is paid to a landlord on a non-refundable basis, to be applied towards rent for specific periods during the term and therefore not recoverable by a tenant's trustee in bankruptcy[2]. This is, as noted above, subject to a multi-faceted assessment of the character of the deposit, including a thorough review of the lease.

Distress rights

In the normal course, the right of distress allows a landlord to seize and sell the goods of a defaulting tenant within the leased premises in order to satisfy existing rental arrears. This common law right is a standard provision in Canadian commercial leases. However, when a tenant declares bankruptcy, rights of distress are stayed by law and are therefore no longer available to the landlord.

Much like the application of security deposits, a landlord seeking to distrain should act quickly when a tenant is in arrears, especially when the financial health of a tenant is of concern. A distress completed not long before a tenant's bankruptcy runs the risk of a court finding it to be a "fraudulent preference," and the proceeds will belong to the tenant's trustee in bankruptcy.[3]

What you should do now

- **Review your leases today.** Understanding who is likely to be entitled to a deposit can be a critical component of a landlord's analysis of whether and when to enforce its rights under a lease. Remember that whether the courts will

consider a sum a security deposit or prepaid rent depends on the factual circumstances, the language of the lease and the parties' intentions.

- **Timing matters. Act as early as possible.** It is in the landlord's interest to act as early as possible when dealing with a tenant in financial distress. A landlord that applies a security deposit to outstanding rental payments or exercises rights of distress close to a tenant filing for bankruptcy, risks a challenge or reversal by the court. Provided it is permitted by the lease, consider applying any existing security deposits towards a rent shortfall now, rather than waiting until the tenant's financial condition deteriorates and the tenant is at the precipice of bankruptcy.
- **Involve a lawyer in the process.** If you are dealing with defaulting tenants, are in the process of negotiating rent abatements or rent deferral agreements, reviewing government assistance programs (such as *Canada Emergency Commercial Rent Assistance*) or your tenant has gone bankrupt, we encourage you to seek legal advice as early in the process as possible.

The takeaway

As the economic fallout of the pandemic continues and the financial pressure on businesses grows, landlords are advised to take a proactive approach, rather than relying on the security and default rights set out within the four corners of their lease. While security deposits, prepaid rent and rights of distress may have provided some comfort to landlords in a pre-COVID-19 landscape, these options need to be reconsidered in light of the current circumstances and the increased likelihood of tenant bankruptcies.

Amid the unfortunate consequences of this crisis, landlords may be well advised to look to forms of security that flow from third parties rather than relying on any type of deposit from a tenant. One alternative is to use letters of credit, the pros and cons of which will be addressed in Part II of this article.

The BLG National Leasing Centre and Insolvency and Restructuring team are here to help landlords and tenants in these challenging times. Reach out to the contacts listed below or email your questions to whatsnext@blg.com, where we are helping businesses navigate the more than 100 federal and provincial funding measures. Questions will be answered free of charge and we will offer information and resources for more complex queries.

[1] As discussed in *Alignvest Private Debt Ltd v Surefire Industries Ltd*, 2015 ABQB 148, upheld by the Alberta Court of Appeal

[2] *Champion Machine & Tool Co*, Re, 1971 CarswellOnt 59 (Ontario Supreme Court)

[3] As seen in *Canadian Imperial Bank of Commerce v Canotek Development Corp*, 1997 CarswellOnt 3216 (Ontario Court of Appeal)

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