JUNE 2013

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Blaneys on Business

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This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, the editor, or the head of our Corporate/Commercial Group:

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"The Supreme Court... has raised some new hurdles for the country's banks and their business customers and... bolstered protection for lenders of last resort who finance insolvent companies."

SUPREME COURT OFFERS SOME FINANCIERS PROTECTION, CREATES NEW RISKS FOR OTHERS, IN ITS DECISION ON *SUN INDALEX, LLC V. UNITED STEELWORKERS*

John Polyzogopoulos and Varoujan Arman

The Supreme Court of Canada, in a decision that has implications for borrowers and lenders alike, particularly where pension funds are involved, has raised some new hurdles for the country's banks and their business customers and, at the same time, has bolstered protection for lenders of last resort who finance insolvent companies.

The court's decision in *Sun Indalex Finance, LLC v. United Steelworkers*, issued earlier this year, addresses critical questions in insolvency law regarding pension funds and DIP financing.

The decision, which was not unanimous, has drawn a lot of attention from the insolvency law bar. It has been the subject of many articles and even a Wikipedia entry. Here is our assessment of the importance of the decision for clients.

Regarding pension funds, the court confirmed that the Ontario *Pension Benefits Act* contains provisions that establish a deemed trust super-priority in favour of pensioners where an employer is winding up a pension fund. Those provisions make an employer responsible for any deficiency in an underfunded plan, including contributions not yet due. (A pension deficiency refers to amounts owed to the plan but that have not actually been contributed.)

The impact of this decision on lenders such as banks and other financial institutions is significant because it means that unfunded pension liabilities take priority over a bank's security that would normally rank in first position ahead of all other creditors.

DIP financing is a long-standing and necessary tool that allows companies to restructure their affairs successfully. An insolvent company that is under court protection under the *Companies' Creditors Arrangement Act* (CCAA) can obtain financing to continue operations while it remains in control of the management and affairs of the business (hence the term debtor in possession, or DIP, financing). The only way anyone could be expected to lend money to an insolvent company, however, would be if they received a first-ranking priority over all of the assets and business of the debtor company,

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"Without the availability of DIP lending, an insolvent corporation may be forced to shut its doors permanently, resulting in a loss of jobs and other harm to the economy."

If you or your business are experiencing economic challenges, you may need advice on the options available to restoring your business to growth and prosperity. Blaney McMurtry has considerable expertise in this. Please contact John Polyzogopoulos at 416.593.2953 or jpolyzog@blaney.com.

John is a partner in the firm's Commercial Litigation practice group. His practice covers a wide variety of commercial and business matters. This includes helping clients in all aspects of financial restructuring and asset recovery law and assisting creditors, debtors and professionals appointed under the Bankruptcy and Insolvency Act or the Companies' Creditors Arrangement Act.

including over prior first-ranking secured creditors and other creditors, such as the Canada Revenue Agency (CRA) and pension funds.

While the Ontario Court of Appeal had struck down the first-ranking priority granted to the DIP lender in this case, the Supreme Court unanimously reversed that ruling and restored the first-ranking position of the DIP lender.

Impact for DIP Lenders

DIP lenders can take some assurance from the *Indalex* decision that funds advanced during an insolvency proceeding under the CCAA will be well secured. The court's decision is a common-sense recognition of the function served by appropriately-protected DIP lenders. Without the availability of DIP lending, an insolvent corporation may be forced to shut its doors permanently, resulting in a loss of jobs and other harm to the economy. The Supreme Court was clearly alive to the policy considerations and business practicalities at play.

Accordingly, the position of the DIP financer was strengthened by this decision, but curiously only with respect to insolvent corporations seeking protection under the CCAA. Upon bankruptcy and liquidation under the *Bankruptcy and Insolvency Act* (BIA), the priority of many statutory deemed trusts is reversed by the BIA. That includes the super-priority established by the *Pension Benefits Act*.

Given that different priorities exist depending on whether the insolvent company seeks protection under the CCAA or rather proceeds with a liquidation under the BIA, the decision in *Indalex* encourages both debtors and creditors to "forum shop" by picking the statute that suits them best.

Debtors and their first-secured creditors will now be more inclined to avoid CCAA protection and seek to make proposals under the BIA. It remains to be seen whether the federal government will seek to harmonize the priority rules that apply to proceedings under the CCAA and the BIA, which, after all, are both insolvency statutes that have similar goals.

Lenders in the Ordinary Course of Business

Unlike DIP lenders, lenders in the ordinary course of business will be alarmed by the finding in *Indalex* that the deemed trust established under the *Pension Benefits Act* applies to the entire shortfall in an underfunded defined benefits plan upon its wind-up. Employers are on the hook for the entire deficiency in the fund, including amounts not yet due. Those amounts will form the basis of a potentially large claim that ranks ahead of secured creditors who would normally be in first position.

Lenders will view this as a significant potential liability when considering extending financing to corporations with defined benefit plans. While *Indalex* applies specifically to Ontario, lenders are considering potential risks elsewhere in Canada and, in particular, provinces with pension legislation that include similar protections for plan members.

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"...know and understand the terms of your contracts and their implications completely, and be sure to comply with those terms strictly."

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The impact of *Indalex* on credit and lending practices may be significant. Lenders will be particularly frugal with borrowers who have significantly underfunded plans. The amount of funds available on loans will undoubtedly be reined in, and interest rates can be expected to rise to mitigate the increased risks brought about by *Indalex*.

With increased risk will also come increased oversight or "big brothering" by lenders. Reporting requirements on loans will become more stringent, particularly with respect to reporting on pension liabilities. Lenders will want to be kept well informed about the status of underfunded pension plans in order to react and plan accordingly.

Other steps lenders may take to protect themselves include insisting on prohibitions on pension fund wind-ups and the creation of any new defined benefit plans. Pending further developments in the law, another form of protection available to lenders is the inclusion of bankruptcy triggers in lending agreements. That is, when certain events occur, the borrower will be required to assign itself, or be assigned, into bankruptcy under the BIA, thereby reversing the super-priority granted to pensions. ■

IMPORTANT ADVICE TO LENDERS:BEWARE OF THE WORDING IN YOUR GUARANTEE

Diane P.L. Brooks

A recent decision of the Supreme Court of British Columbia contains a critical caution for lenders – know and understand the terms of your contracts and their implications completely, and be sure to comply with those terms strictly.

If you do not, you may discover, the hard and expensive way, through litigation, that what you agreed to was not, in fact, what you intended.

The court decision involves three transportation industry companies – Coast Mountain Aviation, Inc., M. Brooks Enterprises Ltd. and A.K.S. Trucking Ltd. – and an operating loan, guaranteed by A.K.S., that Coast Mountain made to Brooks and on which Brooks defaulted.

In the case [*Coast Mountain Aviation Inc. v. M. Brooks Enterprises Ltd.* (2012 BCSC 1440)], due to an inadvertent error on the part of the lender (Coast Mountain) and its lawyers, the guarantee taken by Coast Mountain to support Brooks's borrowings was held invalid and the guarantor (A.K.S.) was relieved of its obligation to cover the default.

Coast Mountain agreed to lend $1,096,000 to Brooks. As security for the loan, Coast Mountain required a mortgage on land owned by Brooks. Coast Mountain also required a guarantee from A.K.S. (A.K.S. was not related

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"An accommodation guarantee is one that is given to accommodate a borrower and for which the guarantor receives no compensation."

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to Brooks but did a substantial amount of business with it) and a mortgage from A.K.S. on a condominium that A.K.S owned.

When signed, the guarantee document contained a proviso that the mortgage was not to be registered against title to the real property unless and until default was made under the loan by Brooks and five days prior written notice to A.K.S. was given. The court held that the giving of the guarantee was conditional upon this proviso and that because the lender registered the mortgage immediately upon receiving it (and before the borrower defaulted and written notice to the guarantor was issued), A.K.S. was relieved of its obligation to pay the lender.

The lender maintained that the insertion of the condition in the guarantee was never the intention of the parties. As evidence of this, it offered that the mortgage to be granted by Brooks was prepared on the same registration document as the mortgage to be granted by A.K.S.

Therefore, the two mortgages had to be registered at the same time. Given that they were contained in one document, there was no way to register the mortgage against the Brooks property without also registering the mortgage against A.K.S.'s property.

As there was no evidence that the Brooks mortgage couldn't be registered right away, the lender argued that the parties could not have intended to condition AKS's guarantee. However, the court found that the lender did not provide sufficient evidence of a different oral agreement between itself and A.K.S. which would negate the condition in the guarantee.

The written decision makes for interesting reading on the history of guarantees and the court reviews much of the case law to distinguish an "accommodation guarantee" from a "compensation guarantee", a distinction not often referred to in the present day.

An accommodation guarantee is one that is given to accommodate a borrower and for which the guarantor receives no compensation. A compensation guarantee is one in which the guarantor receives a fee for giving of the guarantee, as one might see in the construction bonding industry.

The court found that A.K.S was an accommodation guarantor, notwithstanding that it derived some benefit from the borrowings. (Coast Mountain had insisted that part of the loan proceeds to Brooks be paid to satisfy arrears of property tax on A.K.S.'s condominium property and to satisfy a previous judgement against A.K.S. that had clouded title to the property.)

The court determined, however, that the payment of these charges was done primarily to protect the lender's interest and not for the exclusive benefit of A.K.S. as compensation for the company's guarantee. As an accommodation guarantee, the guarantee was held to a

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"Almost every commercial lease contains restrictions on assigning, subletting or otherwise transferring the leased premises to another party."

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higher scrutiny; a breach by the lender of a term of the guarantee would relieve the guarantor from liability.

What may have been in the forefront of the court's mind was the fact that it was the lender's draft of the guarantee that included the condition. The Latin term, *contra proferentem*, means interpretation against the draftsman. In contract law, it is used to interpret contracts that are ambiguous. If a clause in a contract appears to be ambiguous, it is interpreted against the person who drafted the clause. While the condition in this particular guarantee was not ambiguous, the origins of how it got into the guarantee may have swayed the court to find against the lender.

Nonetheless, the lesson for lenders is always to abide by the terms of your written contract, particularly when you have drafted it. ■

GETTING FULL VALUE FOR YOUR BUSINESS; MAKE SURE YOUR LEASE CAN'T GET IN THE WAY

John Brunt

You own a business. You operate from rented premises. You work hard, take the risks, take the lumps, and have a successful enterprise. One day, for whatever reason, you may want to sell. Are you going to realize full value?

Maybe not. You may find that your lease stands in the way. If it does, now is the time to ensure that it will contain a reasonable balance between your interests and your landlord's so that you can realize full value if and when the time comes to sell your business.

This is especially important when a meaningful portion of the goodwill that your business is developing depends on its specific location or where it has multiple establishments or high relocation costs.

As a business owner, you strive to build value by ensuring that all of the factors that contribute to success are in place. Location is often vital to this success. Oftentimes, customers appreciate the convenience of a location or simply become used to obtaining products or services at it.

When combined with the other factors that generate the goodwill associated with your business, location has much to do with the inherent value of the business. Likewise, with multiple establishments or high relocation costs, a specific location, once selected, can be significant.

So, if you are unable to ensure that you can transfer your business' premises to a new owner when you sell, you may find yourself unable to realize upon your years of hard work building the business.

Almost every commercial lease contains restrictions on assigning, subletting or otherwise transferring the leased premises to another party. These restrictions are necessary and reasonable from a landlord's perspective. Your landlord obviously has a right to ensure that

"Landlords and tenants must, from the outset, find a balance of their respective interests in order to ensure that difficulties don't arise... in the future."

any successor of your business, or of your lease, has a reasonable chance of being able to continue to pay the rent.

Such restrictions often go far beyond simply obtaining the reasonable consent of the landlord, however, and may, in rare cases, allow for that consent to be withheld arbitrarily. These additional restrictions are what can cause impediments to the sale of a business and deprive you of the full value that you have earned.

A determination of what is, and what is not, a reasonable basis for a landlord to withhold consent to the assignment, subletting or transfer of a lease may often be dealt with specifically by the terms of the lease, but can also be a subject of dispute, delay and uncertainty. While the onus may lie with the landlord to prove it is being reasonable, by the time any final determination is made, the deal in question may be long gone.

Furthermore, commercial leases contain provisions which provide that when the tenant is a corporation, any change to the ownership of the shares of the tenant or to the farther-reaching "effective voting control" constitutes a transfer to which the assignment and subletting provisions, including obtaining the landlord's consent, will apply.

These restrictions, again, are, reasonable in concept from the perspective of the landlord, so as not to have tenants circumvent landlord control of the premises. However, a review of the specific provisions is required before the lease is entered into to ensure that landlord-control provisions are not unreasonable.

Any failure to negotiate reasonable assignment, subletting and change of control provisions in a lease before a business' value increases as a result of its premises can lead to difficulty in obtaining the benefit of these rights later on.

Some landlords also require that any portion of any payment allocated to the leased premises be paid over to it as part of the terms of its consent. This can lead to differences of opinion as to what, if any, portion of the purchase price of a business is allocated to leased premises. Landlords are sometimes entitled to increase the rent which, in the case of a sublet, a tenant might otherwise be able to realize.

A final remedy that may be available to a landlord in the event of a request for assignment or subletting is the right to terminate the lease. For those businesses with customers for which the location is convenient or established, the risk of having a landlord use these additional rights to obtain additional compensation arising out of the transaction is unacceptable.

Landlords and tenants must, from the outset, find a balance of their respective interests in order to ensure that difficulties don't arise in the context of a contemplated transaction by the tenant at some point in the future.

Landlords need the ability to control the premises, ensure all rents are paid and generally realize the value of the real property which it owns.

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"...a partial cure of a default will not be enough to bring a mortgage into good standing."

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Tenants, on the other hand, need the ability to ensure the transferability of their business without overly onerous restrictions. In the event that a business owner has complete control of its premises, such an owner would be in a position to negotiate freely any transfer or further leasing of the business premises as it negotiated the sale of the business.

Unless care is taken to ensure that an appropriate landlord-tenant balance is negotiated at the time that the lease is entered, a business owner may be giving control of the business' premises to the landlord beyond what is in the tenant's best interest and what is reasonably required.

Commercial leases tend to be viewed as long and onerous documents which, when signed, need not be looked at again so long as the tenant pays the rent and is able to operate from the premises. Such leases, however, contain significant provisions that become applicable in many specific circumstances, which are often unlikely to occur.

In such circumstances where such provisions do become relevant, however, it is imperative that a party's rights have been clearly protected from the onset to the greatest extent possible. The time and effort spent now ensuring that satisfactory leasing arrangements are entered into can be more than justified by potential savings, should one of those circumstances arise.

While landlords are reluctant to accept modifications to their "standard" form leases, particularly in the case of smaller tenants, if one long-term possibility or goal is the sale of your business, you need to consider the assignment clauses carefully. ■

SUBSEQUENT MORTGAGEE'S RIGHTS: CURING A DEFAULT AND THE IMPORTANCE OF BREACHED COVENANTS

Kym Stasiuk

A recent decision of the Ontario Court of Appeal serves as a reminder to subordinate lenders looking to take control over the sale of a property in a mortgage enforcement scenario that a partial cure of a default will not be enough to bring a mortgage into good standing.

In the case of *Business Development Bank of Canada v. Pine Tree Resorts Inc.*, Pine Tree and 1212360 Ontario Limited, the owners and operators of the Delawana Inn in the Georgian Bay community of Honey Harbour, Ontario, defaulted on their loan obligations to both the Business Development Bank of Canada (BDC) and Romspen Investment Corporation.

BDC's security had first position with respect to Pine Tree's indebtedness. BDC applied for a court-appointed receiver, which Pine Tree and Romspen opposed. All parties agreed that the property had to be sold immediately. But, while Romspen wanted to re-open the inn for the upcoming summer season and try to sell it on a going-concern basis, BDC did not.

BDC was successful in its application for a receiver. Pine Tree and Romspen then

"...the exercise of granting leave to appeal is discretionary and must be exercised in a flexible and contextual way..."

appealed. At issue was whether an appeal was Pine Tree's and Romspen's right under section 193 of the *Bankruptcy and Insolvency Act* (BIA) and, if it was their right, whether the order should be stayed pending the appeal.

Before the application judge and on this motion, Romspen's central argument was that it was entitled to exercise its rights as a subsequent mortgagee under section 22 of Ontario's *Mortgages Act* to put BDC's mortgage in good standing and take over the sale of the property.

Romspen proposed to do so by paying all arrears and outstanding costs -- except approximately $250,000 in HST arrears.

These arrears constituted a breach of a covenant under the BDC security and therefore was a default.

Romspen argued, however, that the arrears did not jeopardize BDC's security because they were a subsequent encumbrance.

Therefore, Romspen asserted, it was not necessary for Romspen to comply with that covenant in order to be able to take advantage of a subsequent mortgagee's rights under section 22.

The legal issue to be decided by the Court, therefore, was whether the application judge erred by relying on a covenant default that could not prejudice BDC or erode its first-ranking security as the basis for her conclusion that Romspen had not complied with the requirements for the exercise of a subsequent mortgagee's rights under section 22. In other words, was Romspen required to cure the default by performing the breached covenant involving the tax arrears in order to be able to exercise its section 22 rights?

The Court of Appeal concluded that an appeal was not as of right in this case and that leave to appeal was required.

The court then examined whether leave to appeal should be granted pursuant to section 193(e) of the BIA.

In deciding this, the court first consolidated and clarified two articulations of the test for granting leave to appeal under section 193(e) that have emerged in the jurisprudence and brought the criteria in line with the criteria used to grant leave in restructuring proceedings under the *Companies' Creditors Arrangement Act* of Canada.

Beginning with the overriding proposition that the exercise of granting leave to appeal is discretionary and must be exercised in a flexible and contextual way, the court will look to whether the proposed appeal:

a) raises an issue that is of general importance to the practice of bankruptcy/insolvency matters or to the administration of justice as a whole, and is one that the court should therefore consider and address;

b) is *prima facie* meritorious, and

c) would unduly hinder the progress of the bankruptcy/insolvency proceedings.

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Applying those tests, the court concluded that the facts in this case did not meet the *prima facie* meritorious threshold. Romspen's offer to bring BDC's mortgage into good standing would have left a $250,000 covenant unperformed.

The court said that for Romspen to succeed on appeal would require a very creative interpretation of section 22 and one that would potentially create an undesirable element of uncertainty in the field of mortgage enforcement because no one would know which covenants could be left unperformed and which could not, without litigating the issue in each case.

The conclusion is that, if a subsequent mortgagee wishes to enforce its rights under section 22 in bringing a mortgage into good standing, it will have to not only tender the arrears but will also have to perform any covenant in default.

Subordinate lenders should therefore be mindful of the covenants contained in the security documents of any prior-ranking lender and know the impact that a breach of any of those covenants will have on its rights in a mortgage enforcement situation. ■

EXPECT THE BEST

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