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CUMMER- YONGE - A POST-MORTEM

A discussion of the decision of the Supreme Court of Canada in *Crystalline Investments Ltd. v. Domgroup Ltd.*

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I. INTRODUCTION

I began to write this article prior to the release of the recent decision of the Supreme Court of Canada in *Crystalline Investments Ltd. v. Domgroup Ltd*.[1] I planned to write an article discussing recent cases citing the case of *Cummer-Yonge Investments Ltd. v. Fagot*[2] and my article would have concluded with a lament that has been heard before: the decision in *Cummer-Yonge* is wrong and needs to be overruled. Then *Crystalline* was released and my planned article became moot.

When this happens, the resourceful lawyer does not, of course, pack up all his research and drafts of articles and throw them into the garbage. No, he turns his work into this article, which is essentially a post-mortem on *Cummer-Yonge* and its ilk and a discussion of the *Crystalline* decision.

Cummer-Yonge and *Crystalline* were each cases dealing with the ramifications of the effect of a bankruptcy of a commercial tenant, and the subsequent disclaimer of the tenant's lease. Various issues had arisen before the courts in these two (and other) cases, including the liability of a guarantor for the obligations of the bankrupt tenant, the liability of an indemnitor of such obligations and the liability of the issuer of a letter of credit securing such obligations.

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1 [2004] 1 S.C.R. 60, [2004] S.C.J. 3 (hereinafter "*Crystalline*").

2 (1965), 8 C.B.R. (N.S.) 62, [1965] 2 O.R. 152, 50 D.L.R. (2d) 25 (H.C.); affirmed without written reasons (1965), 8 C.B.R. (N.S.) 62 (Note), [1965] 2 O.R. 157 (Note), 50 D.L.R. (2d) 30 (Note) (C.A.) (hereinafter, "*Cummer-Yonge*").

Prior to *Crystalline*, there was a line of cases in Canada which began with *Cummer-Yonge*, and culminated in recent British Columbia decisions, that held, essentially, that the bankruptcy of a commercial tenant and the disclaimer of the lease by the trustee results in the termination of the obligations of the tenant, which in turn results in any guarantee, security or letter of credit held by the landlord guaranteeing or securing such obligations being unenforceable, since there are no longer any obligations to guarantee or secure. There were also a number of other cases which revealed a tension within the courts in extending the logic of this first line of cases. In some of these other cases, letters of credit, constituting independent obligations between the issuer of the letter of credit and the beneficiary (the landlord), could still be drawn upon by the landlord after the bankruptcy of the tenant for certain obligations of the tenant or certain losses or damages suffered by the landlord. In other cases, the courts had not extended the logic of the *Cummer-Yonge* line of cases to assignor tenants - that is, tenants who had assigned their lease without being released thereunder, then had their assignee go bankrupt. In these cases, the courts had held that, notwithstanding disclaimer of the lease, the obligations of the assignor under the lease continued.[3]

In *Crystalline*, the Supreme Court expressly overruled *Cummer-Yonge* (albeit in *obiter dicta*) and thus rewrote the law in this area. This decision represents a commendable effort by the Supreme Court to clarify an area of law that had become far too complex and a breeding place for bad law. This article attempts to review *Crystalline* in the light of all of the major cases in this area of the law, with a view to seeing whether the decision is a correct one and to see if it puts to rest all of the issues that *Cummer-Yonge* and its ilk had raised.

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[3] See *Transco Mills Ltd. v. Percan Enterprises Ltd.* (1993), 100 D.L.R. (4th) 359, 76 B.C.L.R. (2d) 129, 29 R.P.R. (2d) 235 (B.C.C.A.); *Glenview Corp. v. Lavolpicella* (1997), 12 R.P.R. (3d) 74 (Ont. Gen. Div.).

II. GENERAL FACT SITUATION AND STATUTORY FRAMEWORK

Although the fact situation in *Crystalline* is somewhat different, the general fact situation that will be discussed in this article is as follows. A landlord grants a commercial lease to a tenant. To bolster the covenant of the tenant under the lease, or to secure that covenant, the landlord obtains either a guarantee from a third party (the surety), an indemnity from a third party (the indemnitor) or a letter of credit from the tenant or from a third party (which third party may or may not have executed a guarantee or an indemnity with respect to the obligations of the tenant under the lease). The tenant then goes bankrupt. The tenant's trustee in bankruptcy disclaims the lease.

The question that arises from this fact situation is: may the landlord, with respect to obligations of the tenant under the lease that arose after the date of the bankruptcy and disclaimer, (i) exercise its security from the tenant, (ii) hold the third party to the lease, being the guarantor or indemnitor, responsible for such obligations, including the payment of rent, or (iii) draw down on the letter of credit to reimburse itself for such obligations?

The relevant legislation[4] begins with subsection 71(2) of the *Bankruptcy and Insolvency Act*[5], which provides as follows:

> On a bankruptcy order [formerly a receiving order] being made or an assignment being filed with an official receiver, a bankrupt ceases to have any capacity to dispose of or otherwise deal with their property, which shall, subject to this Act and to the rights of secured creditors, forthwith pass to and vest in the trustee named in the bankruptcy order or assignment, …..

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4 This article will assume that Ontario law governs.

5 *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (hereinafter the "BIA").

On the bankruptcy of the tenant, then, the interest of the tenant in the lease vests in the trustee in bankruptcy. Subsection 30(1)(k) of the BIA provides as follows:

> The trustee may, with the permission of the inspectors, do all or any of the following things:
>
> (k) elect to retain for the whole part of its unexpired term, or to assign, surrender or disclaim any lease of, or other temporary interest in, any property of the bankrupt;….

Section 146 of the BIA states as follows:

> Subject to priority of ranking as provided by section 136, … the rights of landlords shall be determined according to the laws of the province in which the leased premises are situated.

It has been held that subsection 30(1)(k) of the BIA is supplementary to section 146 and that, if provincial law grants the trustee the right to disclaim, then subsection 30(1)(k) grants the trustee the power, with the consent of the inspectors, to exercise that right.[6]

Subsection 136(1) of the BIA gives certain unsecured claims against the bankrupt's estate priority to all other unsecured claims, in a certain order. Subsection 136(1)(f) gives priority, after (a) funeral expenses of a deceased bankrupt, (b) the costs of administration of the bankrupt estate, (c) the Superintendent's levy, (d) certain claims for wages, (d.1) alimony and support payments, and (e) municipal taxes, to:

> the landlord for arrears of rent for a period of three months immediately preceding the bankruptcy and accelerated rent for a period not exceeding three months following the bankruptcy if entitled thereto under the lease, but the total amount so payable shall not exceed the realization from the property on the premises under lease, and any payment made on account of accelerated rent shall be credited against the amount payable by the trustee for occupation rent[.]

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[6] See *Re Palmondon; Marcotte v. Duquette and Rioux* (1959), 38 C.B.R. 200 (Que. S. C.); *Re Security Group N.A.C. Inc.; Raymond, Chabot, Fafard, Gagnon, Inc. v. Hyatt Const. Corp.* (1984), 50 C.B.R. (N.S.) 225, 51 B.C.L.R. 129 (C. A.); *Daltner's Ltd. v. Grobstein* (1948), 30 C.B.R. 28 (Que. S. C.).

The Ontario legislation dealing with the rights of landlords on the bankruptcy of their tenants is contained in sections 38 and 39 of the *Commercial Tenancies* Act[7], which provide as follows[8]:

> 38(1) In case of an assignment for the general benefit of creditors, or…where a receiving order in bankruptcy or authorized assignment has been made by or against a tenant, the preferential lien of the landlord for rent is restricted to the arrears of rent due during the period of three months next preceding, and for three months following the execution of the assignment, and from thence so long as the assignee retains possession of the premises, but any payment to be made to the landlord in respect of accelerated rent shall be credited against the amount payable by the person who is assignee, liquidator or trustee for the period of the person's occupation.
>
> (2) Despite any provision, stipulation or agreement in any lease or agreement or the legal effect thereof, in case of an assignment for the general benefit of creditors, or…where a receiving order in bankruptcy or authorized assignment has been made by or against a tenant, the person who is assignee, liquidator or trustee may at any time within three months thereafter for the purposes of the trust estate and before the person has given notice of intention to surrender possession or disclaim, by notice in writing elect to retain the leased premises for the whole or any portion of the unexpired term and any renewal thereof, upon the terms of the lease and subject to the payment of the rent as provided by the lease or agreement, and the person may, upon payment to the landlord of all arrears of rent, assign the lease with rights of renewal, if any, to any person who will covenant to observe and perform its terms and agree to conduct upon the demised premises a trade or business which is not reasonably of a more objectionable or hazardous nature than that which was thereon conducted by the debtor, and who on application of the assignee, liquidator or trustee, is approved by a judge of the Ontario Court (General Division) as a person fit and proper to be put in possession of the leased premises.
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> 39(1) The person who is assignee, liquidator or trustee has the further right, at any time before so electing, by notice in writing to the landlord, to surrender possession or disclaim any such lease, and the person's entry into possession of the leased premises and their occupation by the person, while required for the purposes of the trust estate, shall not be deemed to be evidence of an intention on the person's part to elect to retain possession under section 38.
>
> (2) Where the assignor, or person or firm against whom a receiving order has been made in bankruptcy, or a winding up order has been made, being a lessee, has, before the making of the assignment or such order demised any premises by way of under-lease, approved or

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[7] R.S.O. 1990, c. L.7.

[8] Subsection 39(3) has been omitted from the quoted sections.

> consented to in writing by the landlord, and the assignee, liquidator or trustee surrenders, disclaims or elects to assign the lease, the under-lessee, if the under-lessee so elects in writing within three months of such assignment or order, stands in the same position with the landlord as though the under-lessee were a direct lessee from the landlord but subject, except as to rental payable, to the same liabilities and obligations as the assignor, bankrupt or insolvent company was subject to under the lease at the date of the assignment or order, but the under-lessee shall in such event be required to covenant to pay to the landlord a rental not less than that payable by the under-lessee to the debtor, and if such last mentioned rental was greater than that payable by the debtor to the said landlord, the under-lessee shall be required to covenant to pay to the landlord the like greater rental.

Further, with respect to guarantees, under the BIA, the bankruptcy of a principal debtor does not affect the liability of a surety for the obligations of that debtor. Section 179 of the BIA states:

> An order of discharge does not release a person who at the date of the bankruptcy was a partner or co-trustee with the bankrupt or was jointly bound or had made a joint contract with him, or a person who was surety or in the nature of a surety for him.

Even before the BIA and its predecessor legislation, at common law this was the case.[9]

This statutory framework has essentially been the same since the equivalents of sections 38 and 39 of the *Commercial Tenancies Act* were enacted in 1924.[10]

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9 See Rowlatt on the Law of Principal and Surety (4th edition, 1982), at page 173.

10 See S.O. 1924, c.42, s.2. The history of the relevant provisions in the *Bankruptcy Act* and the *Landlord and Tenant Act* is somewhat interesting. Prior to the enactment of the *Bankruptcy Act* of 1919, the federal government did not have any legislation relating to the bankruptcy of individuals, notwithstanding that, under the *British North America Act*, only Parliament had the jurisdiction to pass laws in relation to bankruptcy. The provinces had stepped into the breach somewhat with their various *Assignments and Preferences Acts*, but these permitted only voluntary assignments and did not have a petition for a receiving order mechanism. The *Landlord and Tenant Act* of Ontario in 1914, in section 38, dealt with an assignment for the general benefit of creditors and the preferential lien of the landlord for rent rising out of such assignment and only allowed the assignee to retain possession of the lease, not to disclaim it. When the *Bankruptcy Act* was passed in 1919, section 52 contained various rights of a landlord, including to a preferential amount of rent, to retain the premises or to disclaim them. As part of a major amendment of the *Bankruptcy Act* in 1923, section 52 was repealed and the new section substituted therefor was essentially the same as the present section 146; that is, the rights of landlords were to be determined under provincial law (see S.C. 1923, c. 31, s. 31). Promptly after the passage of this legislation by Parliament, the legislature in Ontario passed the *Landlord and Tenant Act* 1924, in which section 38 of the *Landlord and Tenant Act* was repealed. The section that was substituted therefor is essentially what is now found in sections 38 and 39 of the *Commercial Tenancies Act* (see S.O. 1924, c.42). Some of the reasons for this reorganization of authority in 1923 and 1924 can be found in the Parliamentary Report of the Study Committee on Bankruptcy and Insolvency Legislation, 1970 (the Tassé Report).

The other relevant law is that relating to letters of credit.[11] In the case of *Angelica-Whitewear Ltd. v. Bank of Nova Scotia*[12], the Supreme Court of Canada described the "fundamental" principle governing letters of credit as follows:

> The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour a draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued.[13]

This principle is referred to as the autonomy principle. Under this principle, the issuer of the letter of credit, upon receipt of a demand under the letter of credit, together with any other documents that are required under the credit, is obligated to pay the beneficiary notwithstanding any dispute that exists between the beneficiary and the applicant under the underlying contract (which, in our fact situation, is the lease).

The only exception to this principle is as a consequence of fraud. In order to enjoin a beneficiary from drawing down on a letter of credit, an applicant to the court must show a "strong *prima facie* case of fraud" in order to be successful.[14] A "mere allegation of fraud by a plaintiff" will not be sufficient[15] and "fraud" must "import some aspect of impropriety, dishonesty or deceit".[16] The

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11 For a detailed review of the law relating to standby letters of credit see my articles at (1999), 14 B.F.C.R. 505 and (2002), 18 B.F.L.R. 67.

12 [1987] 1 S.C.R. 59.

13 *Ibid*, page 70.

14 *Ibid*, page 84.

15 See *Rosen v. Pullen* (1981), 126 D.L.R. (3d) 62 (Ont. H.C.), at page 69.

courts have also found a demand under a letter of credit to be fraudulent where it was "clearly untrue or false", "utterly without justification", made where the beneficiary had "no right to payment" or was "not even colourable as being valid or have absolutely no basis in fact".[17]

If payment has been made under the letter of credit, the remedy of the applicant (ie. the tenant or its trustee in bankruptcy) is not for an accounting but, instead, if the drawdown breached the provisions of the underlying contract between the applicant and the beneficiary (in this case, the lease), an action for breach of contract or unjust enrichment against the beneficiary.[18]

III. CRYSTALLINE - FACTS AND THE COURT OF APPEAL (PART I)

1. Fact Situation

The facts of *Crystalline* were slightly different from the general facts set out above, and the relevant statutory provisions were also different. The facts were as follows. Crystalline Investments Limited, as landlord, granted a commercial lease in 1979 to Dominion Stores Limited ("Dominion"), as tenant, of premises in the Northumberland Square Shopping Centre in Douglastown, New Brunswick.[19] In 1985, Dominion assigned the lease to Coastal Foods Limited ("Coastal"), a wholly-

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16 *Cineplex Odeon Corp. v. 100 Bloor West General Partner Inc.*, [1993] O.J. No. 112 (Ont. Gen. Div.) [Commercial List]), at para. 30.

17 See *Rosen v. Pullen*, *supra,* note 15; *Henderson v. Canadian Imperial Bank of Commerce* (1982), 40 B.C.L.R. 318 (B.C.S.C.); and *Royal Bank of Canada v. Gentra Canada Investments Inc.* (2000), 1 B.L.R. (3d) 170 (Ont. S.C.J.) [Commercial List]), additional reasons at (2000), 2000 Carswell Ont. 2837, affirmed (2001), 15 B.L.R. (3d) 25, 147 O.A.C. 96 (Ont. C.A.).

18 See *Robinson v. Ontario New Home Warranty Program* (1994), 18 O.R. (3d) 269 (Ont. Gen. Div.)

19 *Crystalline* was actually two cases with essentially the same facts (only the landlords and the premises were different). We will, for simplicity, just deal with one of the cases.

owned subsidiary. The consent of the landlord was not required for this assignment and Dominion was not released from its covenant as the original tenant.

Coastal then amalgamated with another corporation and continued as The Food Group Inc. ("Food Group").[20] On February 11, 1994, Food Group filed a notice of intention to make a proposal pursuant to Part III of the BIA. On February 18, 1994, the proposal trustee delivered a notice of repudiation of the lease to Crystalline pursuant to section 65.2 of the BIA, repudiating the lease as of March 31, 1994. Meanwhile, Dominion had become Domgroup Limited.

Under subsection 65.2(1) of the BIA, Food Group was entitled, at any time between the filing of the notice of intention and the filing of its proposal, or on the filing of its proposal, to repudiate any commercial lease under which it was the tenant, on thirty days notice to the landlord. Under subsection 65.2(2), the landlord then has fifteen days to dispute the repudiation by applying to the court.

Subsection 65.2(3) then provides that, upon repudiation, a proposal filed by the tenant must provide for payment to the landlord of an amount equal to six months rent under the lease (or the rent for the remaining term of the lease after the date of repudiation, whichever is less). This is the maximum amount that the landlord can recover after a repudiation under section 65.2.

In *Crystalline*, the landlord did not bring an application under subsection 65.2(2) of the BIA. Instead, the landlord claimed against the original tenant, Domgroup, who resisted, leading to this litigation.

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20 The facts are set out somewhat differently by Carthy, J. A., in the Ontario Court of Appeal, (2002), 58 O.R. (3d) 549, and Major, J. (who wrote the decision of the court) in the Supreme Court.

In the action brought by the landlord, Domgroup brought a motion for summary judgment, dismissing the action.

Domgroup was successful at trial[21]. The landlord appealed. In the Court of Appeal[22] Carthy, J.A. delivered the decision of the court, allowing the appeal and setting aside the summary judgment.

2. Decision of the Ontario Court of Appeal

After outlining the facts, Carthy, J.A. stated that the question before the court was "whether the insolvent assignee's repudiation of the lease pursuant to the scheme [of the BIA proposal provisions] affects the agreement between the landlord and the original lessee".[23] Carthy, J.A. noted "at the outset that it seems counter-intuitive to consider that the original lease is affected and indeed terminated by the repudiation" as this "confers no benefit on the insolvent and does nothing to serve the purpose of the legislation".[24]

After disposing of an argument made to the court about an amendment made in 1995 to section 65.2 of the BIA, changing the word "repudiate" to "disclaim", the court noted that section 65.1 used the word "terminate" to describe what a landlord could not do to the lease once a notice of intention was filed. Thereafter, section 65.2 allows repudiation (or, now, disclaimer) of the lease on

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[21] (2001), 39 R.P.R. (3d) 49, 31 C.B.R. (4th) 216.

[22] (2002), 58 O.R. (3d) 549.

[23] *Ibid*, p. 554.

[24] *Ibid*. Carthy, J.A. may be accused of being somewhat disingenuous here, as the Ontario Court of Appeal has, in the past, as we will see, seen nothing "counter-intuitive" about declaring a lease terminated vis-à-vis third parties after a disclaimer of the lease by the tenant's trustee in bankruptcy

behalf of the tenant, but this "is a statement of position by one party" which "does not…effect a termination". Rather, the rights of the landlord against the insolvent after such repudiation are as set out in section 65.2 "and there is no mention in the statute of termination or consequences affecting others who may have liability to the landlord".[25]

Carthy, J.A., after stating that his view as to the effect of the repudiation "is supported by every authority brought to my attention", then reviewed the authorities. However, the first case referred to by him, *Cummer-Yonge*, did not support his view. As briefly alluded to above, *Cummer-Yonge* is the seminal case in Canada that began the debate (now settled by *Crystalline*) regarding the effect of disclaimer of a lease by a tenant's trustee in bankruptcy (or, in *Crystalline*, proposal trustee). Accordingly, it is appropriate to review this case in some detail before returning to see how Carthy, J.A. dealt with it in *Crystalline*.

IV. THE CUMMER-YONGE CASE

Cummer-Yonge was decided in 1965 by Gale, C.J.H.C. and was, as he stated, "an action on a guarantee". A lease had been entered into between the plaintiff, as landlord, and a corporation, as tenant. Two individuals executed the lease as guarantors. The guarantee clause in the lease read as follows:

> The Guarantors… join… for the purpose of guaranteeing the due performance by the Lessee of all its covenants in this lease including the covenant to pay rent on the part of the Lessee to be performed.

The corporate tenant went bankrupt. The trustee in bankruptcy disclaimed the lease. The plaintiff landlord sued the individual guarantors.

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25 *Ibid*, p. 555.

The individual guarantors took the position "that the bankruptcy of the tenant had the effect in law of terminating the liability of the bankrupt company to pay rent under the lease for the balance of the term, and that consequently the liabilities of the defendants as guarantors were likewise terminated"[26]. In support of this argument, the defendants relied upon subsection 41(5) of the *Bankruptcy Act*[27], which essentially provided the same as the present subsection 71(2) of the BIA[28] and on the definition of "property" in the *Bankruptcy Act*, subsection 2(o)[29], which was in the following terms:

> "property" includes money, goods, things in action, land, and every description of property, whether real or personal, movable or immovable, legal or equitable, and whether situate in Canada or elsewhere and includes obligations, easements and every description of estate, interest and profit, present or future, vested or contingent, in, arising out of, or incident to property. [italics omitted]

The guarantors argued that, because the word "obligations" was included in the definition of "property", the effect of subsection 41(5) of the *Bankruptcy Act* was to vest in the trustee in bankruptcy both the rights and the liabilities of the bankrupt tenant under the lease. When the trustee disclaimed the lease, both the rights and the liabilities were terminated. Since a guarantee is a secondary obligation, once the primary obligation (ie. the liability of the tenant under the lease) was terminated, the guarantee was determined (ie. became of no effect).

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26 *Supra*, note 2, O.R. page 153.

27 R.S.C. 1952, c. 14.

28 The relevant portion of subsection 71(2) of the BIA is set out above in the text after footnote 5.

29 Now in subsection 2(1) of the BIA.

The guarantors were able to cite two English cases to the court in which guarantors had successfully resisted liability under leases disclaimed by trustees in bankruptcy: *Stacey v. Hill*[30] and *D. Morris & Sons, Ltd. v. Jeffreys*[31]. We will discuss these cases further below.

Counsel for the plaintiff was John Honsberger, who knew more than a little bit about insolvency law. He attempted to convince the court that there was a distinction between a surrender of a lease and a disclaimer of a lease, as the trustee in bankruptcy in this case had disclaimed the lease, instead of surrendering possession as he was entitled to do under subsection 38(1) of the *Landlord and Tenant Act*[32]. Honsberger argued that a disclaimer divested only the trustee of the rights and obligations under the lease and had the effect in law of revesting these rights and obligations in the bankrupt tenant. Due to the effect of the *Bankruptcy Act* (now the BIA), these obligations were unenforceable against the tenant, but the liability of the guarantors would continue.

The court was not convinced that a disclaimer of a lease by a trustee in bankruptcy had this effect in law and, even if a disclaimer only divested the trustee of its interest in the lease, it did not follow that the interest reverted to the bankrupt tenant. To the contrary, subsection 41(5) of the *Bankruptcy Act*, referred to above, specifically stated that all property of the bankrupt vests in the trustee upon a filing of an assignment in bankruptcy. Accordingly, the court held that, when the trustee disclaims

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30 [1901] 1 K.B. 660 (C.A.).

31 (1932), 148 L.T. 56 (K.B.).

32 R.S.O. 1960, c. 206 (now the *Commercial Tenancies Act*, R.S.O. 1990, c. L.7, s.39(1)). The provisions of sections 38 and 39 of the *Commercial Tenancies* Act (which are essentially unchanged from the provisions of the *Landlord and Tenant* Act as it was at the time of the *Cummer-Yonge* decision) have been set out above (see text above at note 8).

its interest in the lease, all the rights and obligations that vested in the trustee became wholly at an end. The court concluded, in a finding that would be quoted in many future cases, as follows:

> I therefore find that, upon the bankruptcy of the tenant, all of its rights and obligations under the lease, including its liability to perform the covenant to pay rent, irrevocably passed to the trustee in bankruptcy. After that date, there were no covenants in the lease which the lessee was required to perform, and the defendants' guarantee of "the due performance by the Lessee of all its covenants in this lease" thereupon became inoperative[33].

The action was therefore dismissed against the guarantors for any rent after the date of bankruptcy. The Ontario Court of Appeal affirmed the trial judge's decision without giving reasons.

In short, then, the logical steps followed by the court in the *Cummer-Yonge* decision were as follows:

1. a lease constitutes both rights and obligations to a tenant thereunder;

2. because the definition of "property" in the *Bankruptcy Act* includes "obligations", both the rights and the obligations of the tenant under a lease vest in the trustee in bankruptcy upon the bankruptcy of the tenant; and

3. since a guarantee is a secondary obligation (ie. to do what another has agreed to do if that other does not do it), then upon the primary obligation of the tenant coming to an end (when the obligations under the lease vest in the trustee in bankruptcy), the secondary obligation of the guarantor comes to an end at the time the bankruptcy occurs.

It is to be noted that, notwithstanding the relatively extensive review of the effect of disclaimer on the obligations of the tenant and the guarantor, the court did not base its decision on the fact that

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33 *Supra*, note 2, O.R. at page 157.

the trustee disclaimed the lease.[34] But the court did find that a disclaimer of the lease by the trustee in bankruptcy terminated all of the rights and obligations of the tenant under it.

V. CRYSTALLINE - THE COURT OF APPEAL (PART II)

Now, *Cummer-Yonge* does not support Carthy, J.A.'s contention in *Crystalline*. However, Carthy, J.A., after noting concisely the *ratio* of *Cummer-Yonge*, immediately distinguished it due to the "distinction between the position of a guarantor and one who has primary obligations".[35] However, this did not address the fact that, in *Cummer-Yonge,* Gale, C.J.H.C. held that a disclaimer of a lease by a trustee in bankruptcy of the tenant *terminated* the lease. This finding, logically (as the line of cases referred to at the beginning of this article has found[36]), leads to the termination of the rights of the landlord against all third parties, which could include the original tenant.

However, Carthy, J.A. does not address this. He simply goes on to refer to the British Columbia Court of Appeal case of *Transco Mills Ltd. v. Percan Enterprises Ltd*.[37] which held, on "identical facts" to the *Crystalline* case, that a disclaimer of a lease by a trustee in bankruptcy does not affect the rights

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[34] As was noted by Jeffrey Lem and Stefan Promink in their article "Goodbye "Cummer-Yonge": A review of Modern Developments in the Law Relating to the Liability of Guarantors of Bankrupt Tenants" (1993), 1 D.R.P.L. 419.

[35] *Supra*, note 22, p. 555. Carthy, J.A. cites the Ontario cases of *Andy & Phil Investments Ltd. v. Craig* (1991), 5 O.R. (3d) 656, 9 C.B.R. (3d) 52 (Gen. Div.) and *Glenview Corp. v. Lavolpicella, supra,* note 3, in support of this distinction.

[36] Some of these cases are reviewed below.

[37] *Supra*, note 3.

of the landlord against the original tenant.[38] Carthy, J.A. found this decision "convincing" and allowed the appeal without further discussion.

But what of *Cummer-Yonge*? As it was a guarantee case, it could be distinguished from *Crystalline*. But was it just a "guarantee case"? In fact, *Cummer-Yonge* has been followed in other cases that relate to letters of credit and to security given for the obligations of the tenant. Let us review both the history of *Cummer-Yonge*, which includes some old English cases, and the cases that came after *Cummer-Yonge*, including a recent decision of the English House of Lords, to see why the Supreme Court of Canada found it necessary to hear the appeal of the *Crystalline* case and to expressly overrule *Cummer-Yonge*, even though this overruling must be viewed, technically, as *obiter dicta* by the court.

VI. THE ENGLISH CASES

1. The Old English Cases

Let us start with the English case referred to by the court in *Cummer-Yonge, Stacey v. Hill*.[39] It was decided in 1901 by the English Court of Appeal. The facts of the case were straightforward: Stacey let certain premises to a Chapman, and Hill guaranteed payment of rent under the lease in arrears for twenty-one days, to a sum not exceeding one hundred and forty pounds. Chapman went bankrupt and the trustee in bankruptcy disclaimed the lease. There had not been any sublease or assignment of the lease. Stacey sued Hill for arrears of rent.

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38 Neither the trial court nor the Court of Appeal in the *Transco* case referred to *Cummer-Yonge*.

39 *Supra,* note 30. The other case referred to in *Cummer-Yonge*, *D. Morris & Sons Ltd. v. Jeffreys*, *supra*, note 31, was a case that simply followed *Stacey v. Hill* on similar facts.

The trial judge held that the guarantor was released by the disclaimer of the lease. In the Court of Appeal, the plaintiff referred to subsection 55(2) of the *Bankruptcy Act*, 1883[40] which read as follows:

> The disclaimer shall operate to determine, as from the date of disclaimer, the rights, interests, and liabilities of the bankrupt and his property in or in respect of the property disclaimed, and shall also discharge the trustee from all personal liability in respect of the property disclaimed as from the date when the property vested in him, but shall not, except so far as is necessary for the purpose of releasing the bankrupt and his property and the trustee from liability, affect the rights or liabilities of any other person.

The plaintiff then referred to the cases of *Re Levy; Ex parte Walton*[41], *Harding v. Preece*[42] and *Hill v. East and West India Dock Company*[43].

In the *India Dock Co.* case, the assignee of a lease became bankrupt, his trustee disclaimed and the House of Lords held that, notwithstanding the disclaimer, the original lessee remained liable upon his covenant. The relevant legislation at that time was section 23 of the *Bankruptcy Act*, 1869[44], which provided as follows:

> When any property of the bankrupt acquired by the trustee under this Act consists of land of any tenure burdened with onerous covenants…or of any other property that is unsaleable, or not readily saleable, by reason of its binding the possessor thereof to the performance of any onerous act, or to the payment of any sum of money, the trustee… may, by writing under his hand, disclaim such property, and upon the execution of such disclaimer the property disclaimed shall, …if the same is a lease be deemed to have been surrendered… . Any

40 46 & 47 Vict., c.52.

41 (1881), 17 Ch.D. 746; [1881-5] All E.R. 548 (C.A.).

42 (1882), 9 Q.B.D. 281.

43 (1884), 9 App. Cas. 448 (House of Lords) (hereinafter "*India Dock Co.*").

44 32 & 33 Vict., c.71.

> person interested in any disclaimed property may apply to the Court, and the Court may…order possession of the disclaimed property to be delivered up to him, or make such other order as to the possession thereof as may be just…

This section was first examined by the courts in *Smyth v. North*[45] which had the same facts as in *India Dock Co.* Two of the three Barons on the Exchequer Court panel in *Smyth v. North* were of the view that section 23 "only affects the relations between the bankrupt and his trustee"[46] and that "when [the bankrupt] is the assignee of a lease, the relation of the lessor and the original lessee is not disturbed".[47]

The third Baron, Bramwell, B., agreed in the result, but disagreed with the other two Barons as to the effect of section 23. In his view, the use of the word "surrender" in the section led to the conclusion that the lease was determined vis-à-vis all persons. Otherwise, the "absurdity follows that [the landlord] has… both the land and the rent", since the land must, on the surrender, revert to the landlord and the landlord retained, on the plaintiff's submission, the ability to claim the rent from the original tenant. However, Bramwell, B. chose to ignore the closing words of section 23, which allowed any person interested in the disclaimed property to apply to the court for possession of it. This did not escape the attention of Pigott, B., who noted that "the [original] lessee must seek his remedy in the clauses at the end of the section, which give the Court power to make orders for the delivery of possession of the disclaimed property to persons interested in it".[48]

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45 (1872), L.R. 7 Ex. 242 (Exch. Ct).

46 *Ibid*, per Martin, B.

47 *Ibid*, per Pigott, B.

48 *Ibid*.

In the *India Dock Co.* case, the House of Lords essentially agreed with the decision in *Smyth v. North*. Interestingly, Lord Bramwell (as Bramwell, B. had become) was also on the panel in the *India Dock Co.* case, and he dissented. But the other three Law Lords agreed. Earl Cairns delivered the main decision for the majority. He started by saying that, if the legislature had wanted, in section 23, to put an end to a disclaimed lease for all purposes, then the section would have to be very clear in saying so. For, otherwise, the legislature would be proposing to interfere with the agreement of the original tenant - who presumably was still solvent - to continue to be liable for the obligations of the tenant after the assignment by him of the lease - an agreement that was made "with his eyes open".

Earl Cairns admitted that it was possible to read section 23 this way. But this was not the only way that the section could be interpreted. In interpreting the section, the court must keep the object of the section in mind, and the object of this section, and of the *Bankruptcy Act*, in his view, was to "clear and discharge the bankrupt", "to facilitate as early as possible the distribution of the property …among the creditors" and "protect the trustee from any liability". The interpretation of the section urged by Lord Bramwell destroyed the rights of third persons and did not accomplish any "beneficial object" for the purpose of the bankruptcy.

Earl Cairns then referred to the judgment of James, L. J. in *Re Levy; Ex parte Walton*[49] in order to decide between the two competing interpretations of section 23. In that case, a lease was entered into between the Waltons, as landlords, and the Levys, as tenants. The Levys sublet the premises to one Michaelson. The Levys then went bankrupt and the trustee sought to disclaim the lease. The Registrar in Bankruptcy agreed that the trustee could disclaim and the landlords appealed.

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49 *Supra*, note 41.

The Court of Appeal held that the disclaimer did not affect the rights of third parties, and the lease therefore continued in respect of the sub-tenant. In construing section 23 of the *Bankruptcy Act,* James L. J. said:[50]

> … when the statute says that a lease which was never surrendered in fact (a true surrender requiring the consent of both parties, the one giving up and the other taking) is to be deemed to have been surrendered, it must be understood as saying so with the following qualification, which is absolutely necessary to prevent the most grievous injustice, and the most revolting absurdity - 'shall, as between the lessor on the one hand and the bankrupt, his trustee and estate, on the other hand, be deemed to have been surrendered'.

The absurdity to which James, L. J. referred was to take away from the landlord his remedies *in rem* under the lease and to release the sub-tenant from the liabilities to which the property was subject under the lease. If the original tenant had simply died insolvent, "the lessor's remedies as against the estate itself, and the sub-lessee's liability to distress and forfeiture would remain."[51]

James, L. J. also posed a rhetorical question with respect to the position of a surety of a disclaimed lease, as follows:

> Take the case of a lease with a surety for the payment of rent. Could it ever have been intended that the bankruptcy of the lessee was to release the surety?[52]

It was clear that James, L. J. believed that the bankruptcy of the lessee was not to release the surety, even if the lease was disclaimed by the trustee and the disclaimer was deemed under the 1869 Act to

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50 *Ibid*, All E.R., page 553.

51 *Ibid*, page 552.

52 *Ibid*.

be a surrender of the lease. In fact, in *Harding v. Preece*[53], the court held that both the original tenant and the surety for a bankrupt assignee of a lease remained liable for the rent under the lease after it had been disclaimed.

Jessel, M. R. interpreted section 23 as follows:

> That section, in my opinion, means that the property is to be disclaimed *inter se*, so as not to interfere with the rights of third parties, and so as only to benefit the bankrupt and his estate, and to put an end to the obligations of the bankrupt so far as they created rights and liabilities as between the trustee and the persons entitled to the benefit of them. It is only to free such bankrupt and his trustee and the estate from liability, on the one hand and on the other, to protect persons whose direct rights against the bankrupt may be interfered with by the disclaimer.[54]

In *India Dock Co.*, Earl Cairns agreed with the interpretation of James, L. J. in *Re Levy,* and also noted that all the cases on section 23, including *Smyth v. North*, agreed with this interpretation. He therefore dismissed the appeal.

Lord Blackburn agreed that the construction that James, L. J. had put on section 23 was correct. In his view, the words "shall be deemed to have been surrendered" meant "shall be surrendered so far as is necessary to effectuate the purposes of the [Bankruptcy] Act and no further". To allow the original tenant to be released "would be to go far beyond the purposes of the Act, and to work a cruel hardship on all persons who have a solvent security for their rent". In *India Dock Co.*, the "absurdity" that the majority of the Law Lords saw was the taking away from the landlord of the covenant of the original tenant as a consequence of the insolvency of the original tenant's assignee.

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53 (1882), 9 Q.B.D. 281 (Div. Ct.).

54 *Supra,* note 41, pp. 551-2 All E.R. The Chancery Division Report of this decision quotes these words of Jessel, M.R., differently. In particular, the last phrase is set out there as follows: "so far only as is necessary in order to relieve the bankrupt and his estate and the trustee from liability".

As Lord Blackburn put it, using the same reasoning as James, L. J. in *Re Levy*, if "the assignee had died insolvent…there would have been no doubt that the [landlord] could have had recourse against [the original tenant]." It did not make sense to change this simply because the assignee went bankrupt, as this did nothing to further the object of the *Bankruptcy Act*.

Lord Bramwell, in dissenting, repeated the absurdity on the other side that he saw: that the original tenant would continue to be liable for the rent under the lease, but would not have any benefit of the lease. In *India Dock Co.*, Lord Bramwell went on to deal with the closing words of section 23, allowing any person interested in the disclaimed property to apply to the court for possession of it. In his view, these words did not assist the original tenant. He said:[55]

> Is [the original tenant] interested in the disclaimed property? Certainly not. He has parted with all his interest in it. His only interest in it is that unpleasant one of having a duty in respect of it. It seems to me that if he were to apply to the Court, it would be impossible that the Court would grant him possession of it.

These, then, were the cases put to the Court of Appeal in *Stacey v. Hill*. The words at the end of subsection 55(2) of the 1883 *Bankruptcy Act* ("but shall not, except so far as is necessary for the purpose of releasing the bankrupt and his property and the trustee from liability, affect the rights or liabilities of any other person") appeared to be based on the decision of Jessel, M.R. in *Re Levy*[56] and to therefore make it even clearer than it had been under the 1869 Act, that in the case of a bankrupt assignee of a lessee, the original lessee was not released by the deemed surrender under the statute. Did these words not make it equally clear that a guarantor of the bankrupt was not released? In the view of the three judges of the English Court of Appeal in *Stacey v. Hill*, those words did not mean

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55 *Supra*, note 43, page 468.

56 See the wording in note 54.

that the guarantor remained liable. In their view, since a guarantor who pays under a guarantee has a right of indemnity from the principal debtor, and this would result in the guarantor having a claim against the bankrupt, it was necessary for the purpose of completely releasing the bankrupt that the guarantor also be released. The judges did not discuss the question that arose from this reasoning in situations such as in the *India Dock Co.* case. That is, whether, if an original lessee paid rent under the lease disclaimed by the assignee bankrupt's trustee, would the original lessee have a claim against the bankrupt under the original contract of assignment between the original lessee and the bankrupt?

2. The Hindcastle Case

Ninety-five years after the decision in *Stacey v. Hill*, the House of Lords, in *Hindcastle Ltd. v. Barbara Attenborough Associates Ltd.*,[57] heard a case that brought to the attention of the court the issue as to whether *Stacey v. Hill* was correctly decided. In *Hindcastle*, the plaintiff landlord granted a sublease to the first defendant. The tenant assigned this sublease to the second defendant, with the landlord's consent, without releasing the assignor, and the third defendant guaranteed the obligations of the assignee under the sublease. The assignee later assigned the sublease again to a third person. The third person then went into liquidation under the English *Insolvency Act, 1986* and the liquidator disclaimed the sublease. The plaintiff landlord sued the three defendants. The issues were whether the liquidator's disclaimer released the original tenant, the assignee of the original tenant and the guarantor of such assignee.

57 [1996] 1 All E.R. 737 (H.L.) (hereinafter, "*Hindcastle*").

Lord Nicholls, in the primary decision in the House of Lords, fully reviewed the history of the relevant English legislation. As Canadian bankruptcy legislation was originally based on the English legislation, this review is relevant to Canada.

Before 1869, the court noted that the relevant statute in England discharged the tenant from its liability to pay the rent under a lease if, after a bankruptcy, the trustee in bankruptcy elected to accept the lease (ie. elected to assume the lease for its own account). Notwithstanding this discharge of the tenant, a surety for the tenant remained liable to the landlord.

As we have seen, the *Bankruptcy Act* of 1869 introduced provisions enabling the trustee to disclaim leases and other onerous property. In the cases we have reviewed (*Smyth v. North, Re Levy*, *India Dock Co.*) the courts interpreted the provisions of the *Bankruptcy Act* 1869 such that a disclaimer by the trustee in bankruptcy was effective only as between the bankrupt tenant and the landlord, and did not affect third parties.

In 1883, the *Bankruptcy Act* was again amended and subsection 55(2) was added, stating that the disclaimer of the lease "…shall not, except so far as is necessary for the purpose of releasing the bankrupt and his property and the trustee from liability, affect the rights or liabilities of any other person". This wording has continued to the present day in essentially the same form, with subsection 178(4) of the *Insolvency Act*, 1986 providing as follows:

> a disclaimer under this section (a) operates so as to determine, as from the date of the disclaimer, the rights, interest and liabilities of the company in or in respect of the property disclaimed; but (b) does not, except so far as is necessary for the purpose of releasing the company from any liability, affect the rights or liabilities of any other person.

This brought Lord Nicholls to *Stacey v. Hill*. Lord Nicholls reviewed the four grounds that had been put forward to support the decision in *Stacey v. Hill*:

1. "on disclaimer the lease determines and no rent can subsequently become due under it".[58] (The court in *Cummer-Yonge* made this finding.) Lord Nicholls responded to this point by noting that it "flies in the face of the plain language of the statute". As set out above, subsection 178(4)(b) of the English *Insolvency Act, 1986*, specifically provides that a disclaimer does not affect the rights or liabilities of any other person, which would include a guarantor of the obligations of the tenant, except so far as is necessary for the purpose of releasing the company from any liability. For purposes of Ontario law, this wording is not present in subsection 39(1) of the *Commercial Tenancies Act* of Ontario. The question in Ontario therefore becomes: how is the disclaimer language in the *Commercial Tenancies Act* to be interpreted by the courts? Does it release only the tenant from all rights and liabilities under the lease, or does it release all other persons, including any original tenant (if the bankrupt tenant is an assignee) and any guarantor? If it releases third persons, can a distinction be made between third persons who are primarily liable (assignors, indemnitors) and those who are secondarily liable (guarantors)?

2. "the release of a debtor discharges his guarantor".[59] As stated by Collins, L. J. in *Stacey v. Hill*: "the liabilities of a surety are in law dependent upon those of the principal debtor". In other words, since the obligation of a surety is a secondary obligation, the termination of the primary obligation determines any liability of the secondary obligor. However, again, the wording of subsection 178(4)(b) of the English *Insolvency Act* foreclosed this argument. And,

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58 *Ibid*, page 751.

59 *Ibid*, page 752.

in Canada, section 179 of the *Bankruptcy and Insolvency Act* codifies the common law in providing that a discharge of a bankrupt does not release a person who was a surety for him. If a discharge from bankruptcy does not release a surety, then the mere fact of a bankruptcy does not release the surety. However, this does not complete the analysis, because in addition to the bankruptcy of the tenant, there has also been a disclaimer of the lease. Does the disclaimer of a lease release the surety? This takes us back to the first point above.

3. "the exception built into paragraph (b) [of subsection 178(4) of the *Insolvency Act*] applies in the case of a guarantor".[60] In other words, it is necessary for the purpose of releasing the bankrupt from any liability under the lease that the guarantor also be released. This is because a guarantor has a right of indemnity from the tenant. Accordingly, it does not effectively release the tenant if the lease comes to an end but the guarantor must nonetheless satisfy the obligations of the tenant under the lease, resulting in the guarantor claiming indemnification from the tenant. The tenant will still be obliged to perform the obligations under the lease, in the sense that it will be obligated to indemnify the guarantor who performed such obligations. However, Lord Nicholls did not have difficulty in holding that subsection 178(4)(a) of the *Insolvency Act* operated to determine the liabilities of the bankrupt under the obligation of indemnity that it owed to its guarantor. In other words, the right of indemnification was also determined.[61] For purposes of Ontario law, this does not assist us, as the Ontario legislation does not contain this wording. Thus, *prima facie*, the entitlement of

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[60] *Ibid*.

[61] *Ibid*, page 747g, h.

a guarantor to indemnification continues and any court in Ontario considering the question posed in the first point above - what is the effect of a disclaimer? - must take into account the practical effect, described above, of allowing landlords to pursue guarantors of the lease.

In this context, Lord Nicholls also discussed what John Honsberger had attempted to deal with in the *Cummer-Yonge* case: namely, what happens to the lease if it is disclaimed *vis-à-vis* the tenant but survives *vis-à-vis* the guarantor? Lord Nicholls mentioned three possibilities: "the lease vests in the Crown as *bona vacantia*, or that it remains in being but without an owner, or that it remains vested in the tenant but in an emasculated form".[62] Lord Nicholls answered this question by referring to section 181(2) of the *Insolvency Act*, which allowed any person who claimed an interest in the disclaimed property or who is under any liability in respect of the disclaimed property, not being a liability discharged by the disclaimer,[63] to apply for an order vesting the disclaimed property in the applicant. In other words, a guarantor with a continuing liability could apply to have the lease vested in the guarantor. Since the legislation thus contemplated the possibility of the lease continuing and a third person performing the tenant's covenants thereunder after it had been disclaimed, any legal analysis had to take this into account. In his view "the best answer seems to be that the statute takes effect as a deeming provision so far as other persons' preserved rights and obligations are concerned. …Thus when the lease is disclaimed it is determined and the

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[62] *Ibid,* page 748.

[63] Note that this latter language, allowing a person who is merely under a liability to apply for a vesting order, is language that was apparently added to deal with Lord Bramwell's objection to the language that merely stated that a person "interested" in the disclaimed property could apply for a vesting order.

reversion accelerated but the rights and liabilities of others, such as guarantors and original tenants, are to remain *as though* the lease had continued and not been determined".[64]

4. "a guarantor's right to be indemnified by the principal debtor is inherent in the relationship between them… and is to be regarded as inseparable from it".[65] In other words, depriving a surety of his right of indemnity while leaving his liability under the guarantee unimpaired would constitute such a change in the obligation undertaken by the guarantor as would, under the law of guarantee, release him. Lord Nicholls acknowledged that "the law, more specifically equity, has traditionally shown a tender regard for guarantors". However, he recognized that, under section 281(1) and (7) of the English *Insolvency Act*, "the discharge of a bankrupt releases him from all his bankruptcy debt, but this does not release a guarantor for the bankrupt". This is, as we have seen, also the case under the BIA. He concluded that the "very object of giving and taking a guarantee would be defeated if the position were otherwise".[66] When the guarantor executed the guarantee, he or she expected that he or she might have to satisfy the obligations of the tenant under the lease. Ordinarily, a guarantor would not expect this to change due to the bankruptcy of the tenant. If there is any value left in the lease, the *Insolvency Act* enabled the guarantor to apply for a vesting order to have the lease vested in him or her.

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64 *Supra*, note 57, page 748.

65 *Ibid*, page 752.

66 *Ibid*, page 753.

Lord Nicholls acknowledged that it was "the difficult part of the appeal" to overrule *Stacey v. Hill*, which had stood for 90 years and "been acted upon frequently". Nonetheless, Lord Nicholls and the other Law Lords unanimously overruled *Stacey v. Hill*. Lord Nicholls noted that, in England, the correctness of the decision in *Stacey v. Hill* was always in doubt.[67] What persuaded Lord Nicholls to overrule *Stacey v. Hill* was, he said, to avoid "the frankly absurd results produced if *Stacey v. Hill* and *Hill v. East and West India Dock Co.* were left standing uneasily side by side."[68] This would be the equivalent of *Cummer-Yonge* and the Court of Appeal's decision in *Crystalline* standing side by side.

As Lord Nicholls continued, there were two sets of absurd results. Firstly, "in practical terms, an original tenant guarantees that the tenants for the time being will perform their obligations. There is no practical justification for distinguishing his position from that of a formal guarantor".[69]

Secondly, Lord Nicholls noted that, under *Stacey v. Hill*, if there was an assignment of the lease, only the guarantor of the bankrupt assignee lessee would be released by disclaimer of the lease, but not any guarantor of the original lessee. This was in fact the case in *Hindcastle*. As Lord Nicholls put it: "What sort of law would this be?"[70]

VII. THE CANADIAN CASES FOLLOWING CUMMER-YONGE

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67 See Rowlatt on the Law of Principal and Surety (4th ed., 1982), at page 174, note 98, where the author states that the decision in *Stacey v. Hill* "seems difficult to reconcile either with the terms of the *Bankruptcy Act* 1883 s.55, now re-enacted by the *Bankruptcy Act* 1914, s.54 or with the decisions on previous Acts" [citations omitted], and see the other examples of criticisms set out in Lord Nicholl's decision, *ibid*, at pages 753j-754a.

68 Supra, note 57, page 754.

69 *Ibid*.

70 *Ibid*.

In England, then, the issues surrounding the effect of bankruptcy and disclaimer of a lease had been raised 100 years before *Cummer-Yonge*, and the English courts had come up with decisions (*Stacey v. Hill* and *Hill v. East and West India Dock Co.*) that were as logically contradictory as *Cummer-Yonge* and the decision of the Ontario Court of Appeal in *Crystalline*. Before we review how the Supreme Court of Canada in *Crystalline* handled this contradiction, let us survey the major Canadian cases that followed *Cummer-Yonge*, to see the affect of that case in Canada.

(i) *Targa Holdings Ltd. v. Whyte*

The first Canadian case after *Cummer-Yonge* that we will consider is the Alberta Court of Appeal case of *Targa Holdings Ltd. v. Whyte*[71], which is also a case of a guarantee executed under a lease. In that case, Targa Holdings Ltd., as landlord, leased a building to Colray Manufacturing & Distributing Ltd., as tenant. By a separate guarantee, three individual appellants guaranteed "the due payment and discharge of all liabilities to you of [the tenant] howsoever incurred without limitation thereto for a period of five (5) years". The tenant went bankrupt several months later. A receiver which had been appointed under a court order prior to the bankruptcy remained in possession for a period of approximately two and a half months after the bankruptcy, when the premises were vacated. They then remained vacant for another five and a half months, when the landlord sold the premises. The landlord sued for the rent for the period of vacancy.

There was no evidence as to whether the trustee in bankruptcy disclaimed or surrendered the lease. Under sections 3 and 4 of the *Landlord's Rights on Bankruptcy Act*[72], the trustee was to pay to the

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71 (1974), 21 C.B.R. (N.S.) 54, 44 D.L.R. (3d) 209 (Alta. C.A.) (hereinafter, "*Targa Holdings*").

72 R.S.A. 1970, c. 201.

landlord, in priority to all other debts, three months rent accrued before the date of the receiving order and the tenant was a debtor to the landlord for all other rent accrued due at the date of the receiving order and for any accelerated rent to which the landlord may be entitled under the lease, but not exceeding an amount equal to three months' rent. Under section 5, except for the aforesaid claims, the landlord had no right to claim as a debt any money due to him from the tenant for any portion of the unexpired term of the lease. Under section 6, the trustee in bankruptcy was entitled to occupy the premises and for any period when in occupation, was to pay the landlord occupation rent calculated on the basis of the lease. Any payment made in respect of accelerated rent was to be credited against any such occupation rent paid.

The trial judge awarded judgment against the guarantors. They appealed. The Alberta Supreme Court, Appellate Division, allowed the appeal and dismissed the claim against the guarantors. The three justices of the Alberta Supreme Court, Appellate Division, gave three separate judgments. McDermid, J. A., and Clement, J.A., agreed in allowing the appeal. Prowse, J.A. dissented. The judgments are difficult and I do not propose to analyze them in depth, but what is interesting is the treatment of *Cummer-Yonge*.

McDermid, J. A. merely noted that *Cummer-Yonge* supported his decision to allow the appeal and dismiss the action against the guarantors.

Clement, J. A., after reaching the same decision, stated that he was "happy" that his conclusion was in agreement with *Cummer-Yonge*, although their conclusions were not reached by the same

approach.[73] He then went on to comment on one aspect of the divergence in the approaches of the courts, and that was the attribution by Gale, C.J.H.C. in *Cummer-Yonge* of a meaning to the word "obligations" in the statutory definition of "property" with respect to which Clement, J. A. was unable to agree. He stated:

> To me it ["property"] means, by every canon of construction, an asset owing *to* the bankrupt as an obligee, not a liability on his part as an obligor to pay. While liability arises out of a contract requiring future performance, it can only become a liability of the trustee when he, as distinct from the bankrupt personally, becomes bound in law to perform.[74]

However, notwithstanding that this attribution of meaning to the word "property" was logically important to the decision reached in *Cummer-Yonge,* Clement, J.A. does not comment further on that case.

Prowse, J.A., in dissent, reviewed the arguments of the appellants based on *Cummer-Yonge*. The first argument related to the definition of the word "property" in the *Bankruptcy Act* and Gale, C.J.H.C.'s conclusion that the use of the word "obligations" in that definition resulted in the obligations of the tenant under a lease passing to the trustee in bankruptcy, freeing the tenant of all obligations under the lease and, as a result, releasing a guarantor of those obligations. Prowse, J. A. noted section 149 of the *Bankruptcy Act* (now section 179) and concluded that he would be "reluctant" to conclude that the vesting of the property of the bankrupt in the trustee had the effect of releasing the guarantor in the chain of reasoning used by Gale, C.J.H.C. Prowse, J. A. stated he was unable to adopt the meaning given to the word "obligations" by Gale, C.J.H.C. In his view, "obligations" was used in

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73 Note that, as Lem and Promiuk point out in their article, *supra*, note 34, at pages 433-4, the majority in *Targa Holdings* agrees with the court in *Cummer-Yonge* that it is the bankruptcy of the tenant that releases the guarantor, not any subsequent disclaimer of the lease by the trustee.

74 *Supra*, note 71, page 71.

the definition of "property" "in the sense of assets that may have some value and does not include liabilities of the bankrupt". He then stated:

> Vesting of the lease in the trustee creates privity of estate between the trustee and the landlord that does not however discharge the bankrupt from the liability on the express covenants in the lease.[75]

He then continued:

> It is the bankrupt's liability arising from privity of contract that does not vest in the trustee as it does not fall within the definition of property set out in the Act. The liability may be unenforceable but the bankrupt is not released from it… until an order of discharge is granted.[76]

There was no evidence of disclaimer of the lease and Prowse, J. A. therefore concluded that the lease continued in existence and the tenant's obligations continued. Therefore, the guarantors remained liable on the guarantee. It appears that he would have concluded differently if the lease had been disclaimed.

(ii) *Titan Warehouse Club Inc. (Trustee of) v. Glenview Corp.*

The next case is the Ontario case of *Titan Warehouse Club Inc. (Trustee of) v. Glenview Corp.,*[77] which is the first case involving a letter of credit. In this case, Titan, as tenant, entered into a lease with Glenview, as landlord. Under the lease, Titan agreed to provide Glenview with a letter of credit,

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75 *Ibid*, page 77.

76 *Ibid*, page 78.

77 (1988), 67 C.B.R. (N.S.) 204 (S.C.O.).

which is stated by the lease "to guarantee to the Landlord the payment by the Tenant of the Rent and Additional Rent payable pursuant to the Lease".

Within a few months, Titan's bank had appointed a receiver and manager for Titan and, within a couple of days after that, Titan was adjudged a bankrupt. The trustee in bankruptcy disclaimed the lease and brought an application to the court seeking a declaration that the landlord, Glenview, was not entitled to make any draw under the letter of credit. The applicant argued that "upon disclaimer of the lease by the trustee in bankruptcy, any obligations pursuant to the lease came to a complete end as if the lease was surrendered with the consent of the landlord". There was therefore no rent owing beyond the date of the disclaimer, with respect to which a draw down under the letter of credit could be made.

The applicant cited the passage from *Cummer-Yonge* quoted above. It submitted that, as there was no rent owing, and the letter of credit guaranteed the payment of rent, Glenview was not in a position to execute a statutory declaration declaring that it was entitled to draw down under the letter of credit. Any such statutory declaration would be false and this would defeat the autonomy of the letter of credit.

The landlord submitted that the letter of credit was an autonomous instrument as between the landlord and the issuer and that, so long as the landlord provided the issuer with documents that appeared on their face to be regular and in accordance with the provisions of the letter of credit, the issuer had to pay under the letter of credit. The landlord relied on the Supreme Court of Canada case of *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*[78].

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78 *Supra*, note 12 (hereinafter, *"Angelica-Whitewear"*).

After noting that the court in *Angelica-Whitewear* had stated that the fraud exception "should extend to any act of the beneficiary of a credit the effect of which would be to permit the beneficiary to obtain the benefit of the credit as a result of fraud", the court concluded that *Cummer-Yonge* disposed of the application and that the landlord was afforded protection by the letter of credit only for rent owing up to the date of disclaimer but not thereafter.

The landlord appealed, but, in a short judgment, the Court of Appeal dismissed the appeal, stating as follows:

> In our opinion, the letter of credit incorporated the terms of the lease by reference. Clause 22.00 thereof states that the letter of credit was intended to guarantee to the landlord payment of the rent by the tenant. In our view, the words making the letter of credit payable "in the event of the bankruptcy of the tenant", read in the context of the clause as a whole, must be related to the stated purpose of the letter of credit. In addition, the payment of the letter of credit cannot be obtained except upon proof that the tenant was in arrears of payment of rent, an event which was precluded by the disclaimer by the trustee.

This is somewhat unclear. The first sentence states that "the letter of credit incorporated the terms of the lease by reference". It is difficult to see that this correct. In fact, so far as we can tell from the reported decisions, the letter of credit referred to the lease only in stating that, in order to draw down on the letter of credit, the beneficiary had to provide a statutory declaration specifying the amount claimed and "stating that you are entitled to the amount drawn hereof in accordance with the terms of a lease agreement dated June 1987 entered into between [the parties]". Article 3 of the Uniforms Customs and Practice for Documentary Credits[79] states that letters of credit "are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way

[79] International Chamber of Commerce publication no. 400 (1984) and no. 500 (1993).

concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit".

The next two sentences of the court's decision appear to conclude that, notwithstanding that the letter of credit expressly stated that it was payable in the event of bankruptcy, since the letter of credit was a "guarantee", it was subject to the decision in *Cummer-Yonge*.

In the last sentence quoted above, the court offers an additional reason for its decision, referring to "proof" being required that the tenant was in arrears of payment of rent before payment under the letter of credit could be obtained. However, the law on this matter was actually correctly stated by the applicant before the trial judge, when it said that, so long as it provided a statutory declaration to the issuer in the form required by the letter of credit, the issuer was required to pay.[80] There was no "proof" required that the tenant was, in fact, in arrears. We can only assume that the Court of Appeal was actually agreeing with the trial judge in holding that executing such a statutory declaration in the circumstances would be fraudulent.

However, what the Court of Appeal does appear to be saying is that it was the disclaimer of the lease by the trustee that brought all rent payments under the lease to an end. Since the letter of credit was given in order to guarantee the payment of rent, and since after disclaimer of the lease there was no rent to be paid, the landlord was not entitled to draw down on the letter of credit for any amounts owing under the lease after its disclaimer. This appears to be adding a gloss to *Cummer-Yonge*.

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[80] This is simply a restatement of the autonomy principle: see the quoted words from the *Angelica-Whitewear* case at note 13.

(iii) *Andy & Phil Investments Ltd. v. Craig*

The next case is *Andy & Phil Investments Ltd. v. Craig*,[81] a case cited by the Ontario Court of Appeal in *Crystalline*. This was a case of a guarantee, but a guarantee that had apparently been drafted with *Cummer-Yonge* in mind.

The plaintiff was the landlord under a commercial lease. The defendant was described in the lease as a guarantor. The tenant under the lease went bankrupt and the trustee disclaimed the lease. The landlord sued the guarantor and brought a motion for summary judgment.

The lease contained, in section 16.15, a provision in which the guarantor covenanted "as principal and not as surety" that the tenants under the lease would perform and observe their obligations thereunder and that:

> (b) The Guarantor is jointly and severally bound with the Tenants for the fulfilment of all covenants, obligations and agreements of the Tenants under the Lease. In the enforcement of its rights under this guarantee the Landlord may proceed against the Guarantors as if the Guarantors were named as Tenants under this Lease.
>
> (e) In the event of termination of the Lease…or in the event of disclaimer of the Lease pursuant to any statute, then, at the option of the Landlord to be exercised at any time within six (6) months thereafter the Guarantors shall execute and deliver a new lease of the premises demised by the Lease between the Landlord as landlord and the Guarantors as Tenants for a term equal in duration to the residue of the term of the Lease remaining unexpired at the date of such termination or such disclaimer….

The guarantor submitted that, as a guarantor, his obligations ended with the disclaimer of the lease, and he cited *Cummer-Yonge* and the *Titan* cases in support of this submission. The court, in reviewing

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81 *Supra*, note 35.

Cummer-Yonge, found that Gale, C.J.H.C. in that case had found that the guarantors had a "secondary obligation". The court then stated:[82]

> "The obligation of [the guarantor] in the present case is not secondary. It is clear from the language of clause 16.15 that [he] signed "as principal and not as surety". Clause 16.15, set out above, makes [the guarantor] a tenant to all intents and purposes. [The guarantor] not having gone bankrupt, there has been no suspension of the landlord's rights to proceed against [him] as tenant or principal."

The court concluded that, "because of the difference in language between the lease in the present case and the lease in *Cummer-Yonge*, *Cummer-Yonge* is of no relevance or application to the present situation". This conclusion is difficult to argue with, as the guarantor had agreed to enter into a new lease. So, even if it could be argued that, as a guarantor who was "jointly and severally" liable with the tenant, the obligations of the guarantor, together with those of the tenant, ended on the disclaimer, the landlord was entitled to a new lease on the same terms, and any failure of the guarantor to sign such a lease would lead to damages equal to the damages suffered by the original default of the original tenant.

The court then stated that, if it were incorrect in this conclusion, then "I should note that I prefer the analysis of the word "obligation" by Clement and Prowse, JJ.A. in [the *Targa Holdings* case], and of McFadyen J. in *Commerce Leasing Ltd. v. Baergen*… to that of Gale C.J.H.C. in *Cummer-Yonge*."[83] The court does not expand further on this point, but it appears that the defendant had argued that his

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82 *Ibid*, page 658.

83 *Ibid*, page 659. I have omitted the citation for the *Commerce Leasing* case, which was (1984) 35 Alta. L. R. (2d) 200, 54 C.B.R. (N.S.) 268 (Q.B.). That case was a chattel lease case, in which the issue was whether the bankruptcy of the lessee under the lease terminated the lease and thereby released any guarantors. The court approved of the opinions of Clement and Prowse, JJ.A. in the *Targa Holdings* case that the definition of "obligation" in the BIA did not include obligations to be performed by the bankrupt and, therefore, the court held that the bankruptcy of the lessee alone did not terminate the lease (this being a chattel lease, there was no disclaimer of the lease by the trustee).

obligations were brought to an end by the bankruptcy of the tenant, not by the disclaimer of the lease by the trustee. This follows from the decisions in *Cummer-Yonge* and *Targa Holdings*. By disagreeing with the argument that "obligations" includes the obligations to be performed by the bankrupt, the court in *Andy & Phil* is essentially declining to follow *Cummer-Yonge*, but without dealing with the further issue of whether the disclaimer of the lease terminated the obligations of the tenants and of any guarantors. As we have seen in *Titan*, and as we will further see, *Cummer-Yonge* has been followed as authority for the proposition that the disclaimer of the lease terminates the lease and, thereby, the obligations of any guarantor of the lease, even though Gale, C.J.H.C. actually went further and held that the bankruptcy itself terminated the obligations of the tenant under the lease.

As all landlord and tenant lawyers in Canada know, *Cummer-Yonge*, combined with *Andy & Phil*, lead to a practice of lawyers producing "indemnities" instead of "guarantees" from third parties to bolster covenants of tenants under commercial leases, which indemnities would inevitably contain an obligation on the indemnifying party to execute a new lease on the termination or disclaimer of the existing lease.

(iv) *885676 Ontario Ltd. v. Frasmet Holdings Ltd.*

The next case is *885676 Ontario Ltd. v. Frasmet Holdings Ltd.,*[84] another letter of credit case. In this case, 885676 Ontario Limited, as tenant, entered into a lease with Frasmet Holdings Limited, as landlord. The lease required the tenant provide an irrevocable letter of credit "to secure the tenant's obligations under the lease".

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[84] (1993), 17 C.B.R. (3d) 64 (hereinafter "*Frasmet*").

The tenant went bankrupt and the landlord sought to draw down under the letter of credit. The trustee in bankruptcy disclaimed the lease and brought this application to prevent the honouring of the letter of credit.

The court, in reviewing the law, reviewed the *Cummer-Yonge* decision, including citing the passage quoted above[85]. Counsel for the landlord argued that *Cummer-Yonge* was wrongly decided, in that the conclusion of the court in *Cummer-Yonge* that the word "obligations" in the definition of "property" in the *Bankruptcy Act* included obligations of the bankrupt was incorrect. In the context of the definition of "property" which was "property of the bankrupt", he submitted that "obligations" must mean obligations *owing to* the bankrupt not obligations *owing by* the bankrupt to others. He cited the *Targa Holdings* case in support of this argument.

In *Frasmet*, Blair, J. was tempted by this argument, but felt himself obliged to follow *Cummer-Yonge*, as it was a Court of Appeal decision. He continued, "[t]he question with which I must grapple, however, is whether I am dealing with the same issue as [was decided in *Cummer-Yonge*]". In Blair, J.'s view, he was not, as *Cummer-Yonge* was a guarantee case, whereas this was a case involving a letter of credit.

This brought Blair, J. to *Titan*, since it was a letter of credit case in which the Ontario Court of Appeal appeared to state that a letter of credit issue *was* the same as the issue decided by *Cummer-Yonge*. Blair, J. noted that, in *Titan*, the lease stated that the letter of credit was provided "to guarantee to the Landlord the payment by the Tenant of the Rent", whereas, in this case, the lease stated that the letter of credit was "to secure the tenant's obligations under the lease". In Blair, J.'s

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85 See the text at note 33.

view, "there is to my mind a very material distinction between a "guarantee" and a "security", particularly when that security is to be in the form of a letter of credit".

Blair, J. reviewed the autonomy principle, quoting the usual words from *Angelica-Whitewear*. He noted again that a letter of credit "is a creature quite different from a simple guarantee". He noted that the only exception to the autonomy principle is the fraud exception. He then noted that the basis of the decision of Montgomery, J. in the trial decision in *Titan* was the fraud exception, since Montgomery, J. found that the draw down of the letter of credit in the *Titan* case for payment of rent would have constituted a fraud, as "such an event was precluded [by *Cummer-Yonge*] by the bankruptcy of the tenant and the disclaimer of the trustee".

In this case, however, there were amounts owing in addition to rent, namely certain amounts expended by the landlord on construction at the premises and the three months accelerated rent permitted under the *Bankruptcy and Insolvency Act*. Blair, J. then stated:

> While the bankruptcy of Stanford [the tenant] and the subsequent disclaimer of the Lease by the Trustee may release the Tenant and its Trustee from those obligations [ie. to pay rent], they cannot, in my opinion, deprive the Landlord from having resort to the security for which it bargained in order to protect itself in the case of the very kind of eventuality which has occurred. Nor can they relieve the Bank of its obligations, under its contract with the beneficiary of the Letter of Credit, to pay upon being presented with the appropriate certificate (in the language of the letter of credit)…".[86]

In Blair, J.'s view, there was no fraud in this case in presenting such a certificate to the bank. The landlord was only entitled to draw down under the letter of credit to the extent that it was owed money under the lease and, if any excess amount was drawn down, the landlord would have to account to the debtor for the excess. The distinctions that Blair, J. raised in distinguishing *Frasmet*

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86 *Supra*, note 84, page 74.

from *Cummer-Yonge* and *Titan* have been called "tortuous"[87] and some of the logical difficulties with Blair, J.'s decision were exposed in the next case we will review.

(v) *Peat Marwick Thorne Inc. v. Natco Trading Corp.*

The next case is *Peat Marwick Thorne Inc. v. Natco Trading Corp.*[88] In this case, a tenant executed a security agreement in favour of the landlord, which agreement recited that it was given "to secure the payment of all rent and any other obligations of the tenant under the lease". The security agreement granted a security interest in certain equipment. The tenant subsequently went bankrupt and the landlord sought to enforce its security. The trustee in bankruptcy sought the advice and direction of the court. The court held that, on the bankruptcy, the obligations of the tenant under the lease ceased and thus there was no debt with respect to which the security could be enforced.

The court cited the case of *Cummer-Yonge*, quoting the passage quoted above. The court also referred to the earlier case of *Re Mussens Ltd.*[89], which case decided that, upon disclaimer, the tenant is in the same position as if the lease had been surrendered with the consent of the landlord. After concluding this, the court in that case continued:

> In England the statute with which sec. 38 of the Landlord and Tenant Act more or less corresponds, contains the provision that any person injured by the operation of the section (i.e., by the disclaimer or surrender) shall be deemed a creditor of the bankrupt to the extent of such injury and may accordingly prove the same as a debt under the bankruptcy; but the Ontario statute contains no similar saving of the rights of the lessor, and the result is that in

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87 Lem and Promiuk, *supra*, note 34, page 436.

88 (1995), 22 O.R. (3d) 727 (Gen. Div.) (hereinafter "*Natco*").

89 [1933] O.W.N. 459. This case was also referred to in *Cummer-Yonge*.

> Ontario the liquidator has been given a statutory right to commit a breach of the insolvent's covenant, and that no right of compensation for the statutory breach having been given to the covenantee no damages can be recovered.[90]

The court in *Natco* then cited *Re Vrablik*[91] which had held that, under the BIA, a claim for rent after bankruptcy and disclaimer of the lease is restricted to the statutory three months next following the execution of the assignment in bankruptcy or for so long as the trustee elects to retain possession of the property.

The court, after citing the *Titan* case and referring to the fact that the landlord sought to rely on the *Frasmet* case, then stated:

> With great respect to the decision of Blair J., in my view if a security taken by the landlord secures *the obligations of the tenant* under the lease, then when those obligations end, the security can no longer be enforced in respect of obligations yet to be performed. The result is the same as with a guarantee, if it is a guarantee of the obligations of the tenant. If the obligations of the tenant are released once the lease is disclaimed, then the guarantor of those obligations is no longer guaranteeing performance by the tenant.[92]

The court acknowledged that a guarantee or letter of credit or other security could be drafted to survive termination of the lease, including by the bankruptcy of the tenant. However, in the case of security for the obligations of the tenant, once the tenant has gone bankrupt, no further obligations of the tenant existed to be secured. Accordingly, the landlord was not entitled to enforce its security.

There is a certain logical simplicity and certainty to the *Cummer-Yonge* decision as supplemented by *Titan*: once the tenant under a lease has gone bankrupt and the lease in question has been disclaimed,

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90 *Ibid*, p. 461.

91 (1993), 17 C.B.R. (3d) 152 (Ont. Gen. Div.).

92 *Supra*, note 88, pages 731-2.

all of the obligations under the lease terminate, with the result that any guarantee (*Cummer-Yonge*), security (*Natco*) or letter of credit (*Titan*) is of no further effect with respect to obligations arising after the disclaimer. If this logic is extended to the facts in *Crystalline*, as the trial judge in that case extended it, then surely certainty in the law is achieved. Essentially, all third parties with obligations under or arising out of the lease are released by the disclaimer. On the other hand, as more than one judge has noted (including Lord Nicholls in *Hindcastle* and Blair, J. in *Frasmet*), why should bankruptcy and disclaimer deprive the landlord of its rights against third parties, such as guarantors or issuers of letters of credit, when the guarantee or letter of credit was obtained for just this eventuality? Further, as the courts in some of these cases have been careful to note, it is possible to draft around these problems, as was done in *Andy & Phil*. Is it good law to base decisions on whether a person is labelled a "guarantor" or an "indemnitor" or a "secondary obligor" or a "primary obligor", rather than on the fact that their obligations are essentially the same? Let us proceed with our review of the cases to see how these questions were addressed by the courts.

(vi) *Dunlop Construction Products Inc. (Receiver of) v. Flavelle Holdings Inc.*

Dunlop Construction Products Inc. (Receiver of) v. Flavelle Holdings Inc.[93] is also a letter of credit case. Flavelle Holdings Inc., as landlord, leased a building to Dunlop Construction Products Inc., as tenant. The tenant provided a letter of credit to the landlord which, by its terms, was "intended to secure the obligations of Dunlop, as tenant, to [the landlord] under the Lease".

The tenant went bankrupt and the trustee in bankruptcy disclaimed the lease. After the petition in bankruptcy was filed, but before the receiving order was made, the landlord demanded payment

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93 (1996), 31 O.R. (3d) 58 (C.A.).

under the letter of credit for arrears of rent then existing and three months accelerated rent. The issuing bank paid. After the receiving order was made and the disclaimer of the lease, the landlord demanded on the issuer for the balance of the money under the letter of credit. The landlord relied on the covenant of the tenant in the lease to keep the premises in good repair and alleged that the premises were in a state of disrepair and the cost of repair would exceed the balance outstanding under the letter of credit. The landlord therefore alleged that it was entitled to the balance of the monies under the letter of credit. The bank refused to pay and these proceedings followed.

At first instance, the court declared that the bank was not liable to pay. The court focused on a certain provision in the lease which stated that the tenant would repair after notice in writing from the landlord to make repairs had been given. The court noted that no notice had been given and that therefore there was no obligation on the tenant to repair. Therefore the landlord had no right to payment of any costs of repair and any draw down under the letter of credit for such costs would be fraudulent.

In the Court of Appeal, the court noted that, in fact, there was another provision in the lease which generally required the tenant to repair the premises. Under many cases cited by the Court of Appeal, a landlord has been awarded damages for breach of the tenant's repair covenant based on the estimated cost of repair, despite the fact that the landlord had not effected the repairs and despite the fact that the landlord was never going to effect the repairs. Therefore, there was an amount of damages owing to the landlord and any demand by the landlord under the letter of credit would not be fraudulent.

Counsel for the bank then attempted to rely on *Cummer-Yonge* to the effect that, on the disclaimer of the lease, all obligations thereunder ceased to have any effect. However, the court held that "the letter of credit clearly afforded protection to the landlord with respect to obligations outstanding at

the date of the disclaimer", which included the damages for not repairing. The court therefore concluded that the landlord was entitled to draw down on the letter of credit for the balance of the money thereunder and allowed the appeal.

(vii) *Westshore Ventures Ltd. v. K. P. N. Holding Ltd.*

Westshore Ventures Ltd. v. K.P.N. Holding Ltd.[94] is a British Columbia case that also involved a letter of credit. In this case, K.P.N. Holding Ltd., as assignee of the original landlord, was party to a lease of premises with Doppler Industries Ltd., as tenant. Westshore Ventures Ltd. was a related company to Doppler and it secured the obtaining of a letter of credit that was required under the lease "as security for the obligations of the Lessee under this Lease". K.P.N. made demand on the letter of credit and, on the same day that the issuer paid under the letter of credit, Doppler was adjudged a bankrupt. Westshore sought recovery from K.P.N. of that portion of the amount paid under the letter of credit that was not due under the lease. The trustee in bankruptcy subsequently disclaimed the lease. K.P.N. refused to return any amount received by it under the letter of credit and these proceedings followed.

After disposing of an initial question as to whether Westshore had standing to bring this action, the trial judge held that the landlord was only entitled to retain the amount paid under the letter of credit that represented amounts actually owing under the lease and directed an accounting to determine the expenses, unrelated to rent, which were recoverable under the lease by the landlord from the tenant. If the amount drawn down under the letter of credit exceeded this amount, then the excess was to be returned. The court reviewed all of the relevant cases, commencing with *Cummer-Yonge* and then

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94 [1999] B.C.J. No. 1227; affirmed and cross-appeal allowed [2001] B.C.J. No. 713; application for leave to appeal dismissed [2001] S.C.C.A. No. 302 (hereinafter, "*Westshore*").

proceeding with *Titan*, *Re Vrablik, Frasmet* and *Natco.* The court quoted at length from *Frasmet*, and then noted the disagreement with the decision in *Frasmet* of the court in *Natco*. The court then stated: "In my respectful view, the decision in *Natco* fails to adequately appreciate the clear distinction drawn in *Frasmet* between letters of credit and guarantees". The court found that a letter of credit was different from a guarantee and that "the case at bar is indistinguishable from the decision in *Frasmet*".

With respect to rent, the court stated:

> The obligations of Doppler for payment of rent under the lease are, by reason of the combined effect of the bankruptcy, the trustee's disclaimer of the lease, and the operation of sections 29(6) and (7) of the *Commercial Tenancy Act* [R.S.B.C., c.57], limited to three months' rent. The other obligations of Doppler under the lease continued to survive as they are secured by the letter of credit.[95]

Subsections 29(6) and (7) of the British Columbia *Commercial Tenancy Act* provide:

> (6) The landlord may prove as a general creditor for (a) all surplus rent accrued due at the date of the receiving order or assignment; and (b) any accelerated rent to which he or she may be entitled under his or her lease, not exceeding an amount equal to three months' rent.
>
> (7) Except as aforesaid, the landlord is not entitled to prove as a creditor for rent for any portion of the unexpired term of the lease, but the trustee shall pay to the landlord for the period during which the trustee or the custodian actually occupies the premises from and after the date of the receiving order or assignment a rental calculated on the basis of the lease and payable in accordance with its terms…

Note that these provisions only prevent the landlord from proving as a general creditor for rent in the bankruptcy of the tenant. They do not refer to claims that the landlord may have against other parties, including guarantors and issuers of letters of credit.

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95 *Ibid*, [1999] B.C.J., para. 44.

In the British Columbia Court of Appeal, Westshore's claim was put in terms of unjust enrichment. Lambert and Saunders, J.J.A., delivering the majority decision, noted that the lease stated that it could be drawn down "for the full amount of monies represented thereby as pre-paid rent and or fulfilment of the other obligations of the Lessee in respect of this lease". With respect to "pre-paid rent", the majority held that a claim for pre-paid rent, otherwise known as accelerated rent, was limited to three months under subsection 136(1)(f) of the BIA. Further, any occupation rent paid by the trustee was to be credited against this amount owing. Since the trustee had paid occupation rent for three months, no pre-paid rent was owing.

This brought Lambert and Saunders, J.J.A., to "the other obligations of the Lessee in respect of the lease". The majority held that the effect of the surrender of the lease by the trustee[96] was set out in subsection 29(3) of the *Commercial Tenancy Act*, which was that "the tenancy shall terminate". They then stated:

> Once the tenancy has terminated, there cannot be any further obligations of the tenant under the lease, nor do we think that any rights or obligations of the landlord could survive, except perhaps in relation to consequential delivery of real or personal property which cannot justly be retained when the tenancy comes to an end.[97]

Since, up to the date of surrender, the landlord had not incurred any expenditures, nor had it suffered any losses, any expenditures after that date or losses suffered after that date were not amounts that could be recovered by drawing down under the letter of credit.

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96 Note that, although the Court of Appeal specifically noted in paragraph 11 of its decision that the trustee in bankruptcy had disclaimed the lease, the court stated here that the trustee in bankruptcy surrendered possession of the premises and, thereafter, the court's decision refers to a "surrender" or "surrender of possession" instead of a "disclaimer". It can only be assumed that the court would have found that a disclaimer or the effect of a disclaimer was the same as a surrender or the effect of a surrender.

97 *Supra*, note 94, [2001] B.C.J., para. 33.

The majority cited *Cummer-Yonge*, *Natco* and a third case[98] in support of the proposition that the effect of subsection 29(3) of the *Commercial Tenancy Act* was to end all obligations of the tenant under the lease. They then asked "whether a primary obligation owed directly by a person who is not a party to the lease, such as an obligation under a letter of credit, is distinguishable from the cases of secondary obligation, such as a guarantee, an indemnity, or the granting of a security interest in equipment by a tenant"?[99] The majority noted the decisions in *Titan* and *Frasmet*, and preferred the decision of Madame Justice Feldman in *Natco* to the decision of Mr. Justice Blair in *Frasmet*. They stated:

> The feature which distinguishes the cases where the security for the tenant's obligations continues is not whether the security is a primary security, like a letter of credit, or a secondary security, like a guarantee. Rather, the key question is: "What obligations are secured?" If the obligations secured are the obligations of the tenant under the lease then the security is no longer security for anything when the obligations of the tenant under the lease come to an end. But where the obligations secured are obligations, perhaps independent obligations, to make good the loss suffered by the landlord by reason of the tenant's bankruptcy or other default, which might well include damages for loss of rent over the duration of the tenancy, then those separate obligations might well survive the bankruptcy of the tenant.[100]

The majority concluded that, since "there were no obligations of any kind secured by the letter of credit after the trustee in bankruptcy surrendered possession and terminated the tenancy", the landlord had no right to draw down under the letter of credit. Since the lease specifically contained a provision requiring the lessor to repay any amounts drawn on the letter of credit that were not owing, the full amount of the letter of credit had to be repaid by the landlord to Westshore.

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98 *Crown Pacific Development Inc. v. Ferster* (1991), 7 C.B.R. (3d) 91 (B.C.S.C.).

99 *Supra*, note 94, [2001] B.C.J., para. 35.

100 *Ibid*, para. 36.

Hall, J. A. dissented in part. In his view, the basis behind the relevant legislation was that, in a bankruptcy, the interest of creditors will not be adversely affected by the actions of the landlord. If a landlord is permitted to draw down under a letter of credit that is issued by its tenant, then presumably the bank that issued the letter of credit will then enforce its security for the amount drawn down, and the other creditors of the bankrupt will suffer. Thus, in this case, where Westshore, a third party, was responsible for obtaining the letter of credit, there was no harm to be done to the bankrupt's estate by drawing down on the letter of credit. In these circumstances, Hall, J. A. was prepared to allow the landlord to draw down under the letter of credit an amount equal to the expenses paid by the landlord in refurbishing and re-leasing the premises after the bankruptcy of the tenant.

(viii) *Lava Systems Inc. (Receiver and Manager of) v. Clarica Life Insurance Company ("Lava Systems")*

The last case that we will consider is *Lava Systems*,[101] an Ontario decision also involving a letter of credit. Lava Systems Inc. entered into a lease, as tenant, with Clarica Life Insurance Company, as landlord. The landlord agreed to pay a substantial amount in tenant inducements to the tenant. The tenant agreed to provide an irrevocable letter of credit to the landlord "as security for the faithful performance by the Tenant of all the terms, covenants and conditions of this Lease for which the Tenant is responsible". Under the lease, the landlord was entitled to "draw upon the Letter of Credit in whole or in part as may be necessary to compensate the Landlord for any loss or damage sustained due to the Tenant's breach of its obligations".

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101 [2002] O.J. No. 2526 (C.A.), revg. (2001), 31 C.B.R. (4th) 284.

The letter of credit itself stated that drafts drawn by the beneficiary "should be accompanied by your statement that the amount drawn is in connection with the indebtedness of [Lava] with respect to the demised premises".

A year and several months later, Lava failed to pay rent and the landlord drew down under the letter of credit to pay for two months rent. Lava was then put into receivership by its bank. Three days after the receiver was appointed, the landlord drew down the entire remaining balance under the letter of credit. Some weeks later, Lava was adjudged a bankrupt. The trustee in bankruptcy disclaimed the lease.

The receiver brought this action requesting an accounting from the landlord for the funds drawn under the letter of credit and demanding the return of the funds, it being the receiver's view "that no amounts are owing by Lava under the Lease after deducting the Occupation Rent paid to the Landlord by the Receiver".

Before the trial judge, the receiver argued that the disclaimer of the lease terminated the lease and, therefore, after the disclaimer, there was no right in the landlord to recover future rent or damages for lost rent. The receiver cited *Re Mussens Ltd.*[102] Further, as a result of subsection 38(1) of the *Commercial Tenancies Act*[103], since the trustee had been in occupation and paid occupation rent for the three month period, there was no money owing under the lease after the disclaimer with respect to which the landlord could draw down under the letter of credit.

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102 *Supra*, note 89.

103 *Supra*, note 7, and see the text at note 8.

The landlord argued that the letter of credit stood as security for all of the obligations of the tenant under the lease, including the covenant to leave in good repair and repay the tenant inducements. The landlord relied on *Frasmet*.

The trial judge first considered the *Cummer-Yonge* case, which he took to stand for the proposition that "when the trustee in bankruptcy disclaimed the leasehold interest, all the rights and obligations which it inherited from the bankrupt are at an end". The court cited the *Titan* case, and then noted the *Frasmet* case, in which Blair, J. had distinguished the case before him from *Titan* on the basis that the letter of credit in *Frasmet* was stated in the lease "to secure the tenant's obligations under [the] lease". The court quoted the words of Blair, J. in *Frasmet* set out above.[104] The court also noted that *Frasmet* was not followed in *Natco*.

On the basis of these authorities, the trial judge concluded that "[a] surrender or disclaimer of the lease by the trustee in bankruptcy terminates the whole lease and all obligations newly arising under it, as if the landlord had consented to the surrender. …[t]he only right of the landlord surviving the termination is the preferential lien provided in [the *Commercial Tenancies Act*] s.38 and BIA s.136(1)(f) for rent for the periods therein provided".[105]

The court pointed out that the letter of credit was an "autonomous contract" between the issuer and the beneficiary. However, the court noted that the inducements the landlord was seeking to recover were not set out in any collateral agreement or separately in any way, but were included in the rent payable under the lease. Since all obligations under the lease had ceased on the disclaimer of the

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104 See text at note 86.

105 *Supra,* note 101, C.B.R. page 295.

lease, the landlord was not entitled to draw on the letter of credit, since there was no "indebtedness" of the tenant owing under the lease. The court stated: "In blending repayment of the Inducements with rent payable under the Lease, the Landlord assumed the risk of bankruptcy's effect on the Lease, a risk not present in a separate loan agreement".[106] The court thus held that the landlord must account to the trustee and the receiver for any realization under the letter of credit in excess of the obligations under the lease secured by the letter of credit.

The trial judge's decision was reversed on appeal. The Court of Appeal's decision was based on the law of letters of credit. The court agreed with the trial judge's holding that a "letter of credit is independent of any agreement or the equities between the beneficiary and the issuer's customer or the issuer and its customer". The only exception to this was fraud. In this case, "whether [the landlord] was entitled to draw on the letter of credit, and, if so, in what amount, is a matter between it and the bank that issued the letter of credit". The funds that were paid to the landlord were the bank's funds, not the funds of the tenant. Had the draw down under the letter of credit not occurred, the trustee or receiver would not have had any claim against these funds. The court noted that there was no evidence that the receiver had received an assignment of the bank's rights against the tenant for indemnity upon a draw down under the letter of credit. There was no right in the tenant or its receiver to require that the landlord account for the amount drawn down on the letter of credit.

The Court of Appeal noted that the judge had dealt with this issue in his reasons. The trial judge had concluded his analysis by stating the following (which was quoted by the Court of Appeal):

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106 *Ibid,* page 297.

> Assuming the Bank was entitled to recover full reimbursement from Lava, the Landlord, having drawn more than was secured by the Letter of Credit and knowing from the Letter of Credit that it was for the account of Lava, must account to the Trustee and Receiver for any realization under the Letter of Credit in excess of the obligations under the Lease secured by the Letter of Credit arising prior to termination.[107]

The Court of Appeal did not agree with this conclusion. It found the trial judge's assumption that the bank was entitled to recover full reimbursement from Lava was unsupported by the record. The Court of Appeal stated that the trial judge's conclusion "implicitly assumes that the bank had assigned to [the receiver] its claim to recover full reimbursement from Lava for the amount it paid to Clarica in excess of Clarica's statutory entitlement".[108]

The court concluded that there would only be two situations in which the receiver would have a right against the landlord. The first would be if the bank assigned to the receiver any claim that it had against the landlord. The court correctly states that, to succeed, any such claim would have to prove that the landlord acted fraudulently. The second situation would have arisen if the tenant had reimbursed the bank for the amount drawn by the landlord on the letter of credit. In this situation, the tenant, or its receiver, might have a claim against the landlord for breach of the terms of the lease, on the basis that the landlord had drawn more under the letter of credit than it was entitled to do under the lease. Since neither of these situations obtained, the receiver had no legal right to the relief requested. The court therefore allowed the appeal and dismissed the claim of the receiver.

In my submission, although the Court of Appeal's judgment is short and the reasoning summary, the court has correctly applied the key principles of letter of credit law. However, the reasoning of

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107 *Supra*, note 101, O.J. para. 8.

108 *Ibid.*

the Court of Appeal is somewhat troubling. First of all, the court states that the assumption of the trial judge that the bank was entitled to recover full reimbursement from the tenant was "unsupported by the record". However, under letter of credit law, assuming that the issuer complied with the terms of the letter of credit, the issuer is entitled to indemnification from the applicant for any amounts drawn down under the letter of credit.[109] Thus, the bank was, in fact, entitled to recover full reimbursement from the tenant for the amounts drawn under the letter of credit. Secondly, the court does not address the question of whether the tenant or its receiver had an action against the landlord for breach of the lease, i.e., by drawing down under the letter of credit when it was not entitled to do so under the lease, whether or not the tenant or receiver reimbursed the bank for the amount drawn by the landlord under the letter of credit. As well, the court did not expressly address the question of whether the tenant or its receiver or trustee in bankruptcy would have an action against the landlord as a result of *Cummer-Yonge* and *Titan*: since the lease had terminated and no future amounts under the lease could be claimed, the landlord was not entitled to the amount that it drew down under the letter of credit.

VIII. SUMMARY - THE CANADIAN PRE-CRYSTALLINE POSITION

These, then, were the primary cases in Canada before the *Crystalline* case made its way to the Supreme Court of Canada. On the one hand, despite the questions raised by two judges in the *Targa Holdings* case, the decision in *Andy & Phil* and the submissions of counsel in the *Frasmet* case, *Cummer-Yonge* was followed in *Targa Holdings, Titan, Natco* and *Westshore*[110] and stands for the

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[109] See H. C. Gutteridge and M. Megrah "The Law of Bankers' Commercial Credits" (7th ed., 1984), Europa Publications Limited, London, England, p. 58. This is not free of doubt - see my article on Standby Letters of Credit (1999), 14 B.F.L.R. 505, p. 518, note 48 - but, I submit, is a safe assumption for the court here to make.

[110] "Followed" may be putting it too strongly in the case of *Targa*.

proposition, as a judge in another case put it, "that when a trustee in bankruptcy disclaims a lease held by a bankrupt lessee, the effect is to terminate [a guarantor's] obligation to honour the lessee's covenants under the lease".[111] The Courts of Appeal of Ontario and British Columbia had extended the logic of this proposition to letters of credit in the *Titan* and *Westshore* cases, holding, effectively, that a letter of credit that "guaranteed" the obligations of the tenant could not be drawn down after a disclaimer, since there were no obligation remaining to be "guaranteed" after the disclaimer.

Clearly, *Cummer-Yonge's* actual holding, that a guarantor's obligations under a lease terminated on bankruptcy, had not been followed, except in *Targa Holdings*. Rather, the courts following *Cummer-Yonge* focussed on the disclaimer of the lease (see *Titan, Natco,* and *Westshore).* Really, the question that arises is the one that was before the English courts in *Re Levy* and *India Dock Co.*: what is the effect of the disclaimer of the lease vis-à-vis third persons such as guarantors, indemnitors, issuers of letters of credit, and original tenants who had assigned their leases?

In approaching this simple question, the Supreme Court of Canada in *Crystalline* had, in contrast to *Cummer-Yonge* and related cases, the decisions in *Andy & Phil, Frasmet*, *Flavelle* and *Lava Systems*, none of which appeared to follow *Cummer-Yonge*, and the decision of the House of Lords in *Hindcastle*. These cases served to highlight the following problems with the decision in *Cummer-Yonge*:

1. the decision ignores section 179 of the BIA, which specifically states that sureties are not released by a bankruptcy;

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[111] See *KKBL No. 297 Ventures Ltd. v. Ikon Office Solutions, Inc.*, [2003] B.C.J. No. 2426 (S.C.).

2. the case applies the English Court of Appeal case of *Stacey v. Hill*, a case which many questioned whether it had been correctly decided and which was ultimately (after the decision in *Cummer-Yonge*) overruled by *Hindcastle*; and

3. the case states that it is the bankruptcy of the tenant, not the disclaimer of the lease by the trustee in bankruptcy, that releases the tenant and any guarantors.

The decision referred to in the third point set out above was reached in *Cummer-Yonge* by the court's holding that "obligations" owed by a person constitute "property" of that person. As we have seen, other courts have noted that this does not make sense. It appears to be more correct to say that the "obligations" referred to in the definition of "property" in the BIA are obligations *owed to* the bankrupt, not obligations *owing by* the bankrupt. Thus, the whole argument of any guarantor that the obligations of the tenant under the lease pass to the trustee in bankruptcy and therefore there are no obligations for the tenant or the guarantor to perform, falls. The interpretation made by Gale, C.J.H.C. in *Cummer-Yonge* of the definition of "obligations" has been defended: one commentator (Jeffrey Carhart) states that it is "entirely consistent with, for example, subsection 30(1)(c) of the BIA which gives the trustee the ability to carry on the bankrupt's business". In Carhart's view, how can a trustee carry on the business of the debtor if it "does not have the ability to discharge the obligations of the bankrupt"?[112]

However, in my submission, this argument does not make much sense in the context of the BIA. While subsection 71(2) of the BIA makes it clear that the property of the bankrupt passes to the

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[112] Jeffrey C. Carhart "Cummer-Yonge Revisited: The Effect of the Bankruptcy of a Commercial Tenant on Guarantees, Indemnity Agreements and Letters of Credit pertaining to the Lease Obligations" (1993), 19 C.B.R. (3d) 170, at 173.

trustee, there is no similar provision dealing with the liabilities of the bankrupt (unless, of course, one construes "property" to include obligations or liabilities owing by the bankrupt). The scheme of the BIA, I submit, makes it clear that the liabilities of the bankrupt remain with the bankrupt, but the rights of the unsecured creditors against the bankrupt with respect to those liabilities are stayed.[113] Secured creditors, on the other hand, are not affected by the bankruptcy and may pursue their rights under their security. In doing so, clearly the secured creditor is applying the proceeds realized from the enforcement of its security to the debts of the bankrupt, which are still owing by the bankrupt to the secured creditor. Further, there would be no need for the Act to provide for a "discharge" of the liabilities of the bankrupt if those liabilities, in fact, passed to the trustee in bankruptcy. However, as we know, the Act does specifically provide for a discharge of the bankrupt.[114] In my submission, these provisions, and many others in the Act, are consistent with the proposition that the liabilities of the bankrupt remain with the bankrupt.[115]

Thus, in looking afresh at *Cummer-Yonge*, the Supreme Court presumably came to question whether the decision was correct, given that, if the decision were made today, any court examining the three points listed above would probably decide each of them differently from Gale, C.J.H.C.'s holdings in *Cummer-Yonge*.

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113 See, for example, section 69.3 of the BIA.

114 See section 172 of the BIA.

115 See the words of Jessel, M.R., in the *Re Levy* case, *supra*, note 41, at page 500 All E.R., where he notes (in 1881) that "[n]o man would accept the office of trustee if he were made subject to all the personal liabilities attaching in respect of the property of the bankrupt which has vested in the trustee". And see the discussion in Lem and Proniuk's article, *supra*, note 34, page 433.

Having said this, however, a court today would also have to note that the lease situation is unique in that the trustee in bankruptcy is given the right to disclaim the lease, which right in Ontario is granted under subsection 39(1) of the *Commercial Tenancies Act*. Historically, the courts in England interpreted this right as being one between the trustee and the landlord only; that is, it did not affect the rights and liabilities of third parties such as guarantors or assignors of the lease. This interpretation by the English courts has been codified in section 178(4)(b) of the English *Insolvency Act*. However, the wording of the *Commercial Tenancies Act* of Ontario does not contain the same wording as section 178(4)(b) of the English *Insolvency Act*. Subsection 39(2) of the *Commercial Tenancies Act* does provide that, in the event of a disclaimer of a lease, any under-lessee or sublessee of the bankrupt tenant may elect to stand in the same position with the landlord as though the under-lessee were a direct lessee from the landlord (subject to the under-lessee paying rent equal to the greater of the rent payable under the sublease and the rent payable under the head-lease). This codifies the *Re Levy* decision. However, this wording does not suggest in any way that the lease entered into by the bankrupt survives *vis-à-vis* third parties.

The question then becomes whether the *Commercial Tenancies Act* provision is to be interpreted in the same way that the English Court of Appeal in *Re Levy* interpreted the English *Bankruptcy Act* of 1869, when that Act provided simply that a trustee could disclaim a lease and, if disclaimed, it was "deemed to have been surrendered"? This interpretation of the court in *Re Levy*[116] was approved by the House of Lords in *Hill v. East & West India Dock Company*.[117] However, in that case, Lord

[116] *Supra*, note 41.

[117] *Supra*, note 43.

Bramwell dissented[118] on the basis that, if the bankrupt was an assignee of the original tenant, and the original tenant was, by this interpretation of the *Bankruptcy Act* 1869, to remain liable for the obligations under the lease, this would be oppressive on the original tenant, as it had no means of getting back the benefits of the lease. In England, amendments were made to the legislation in the *Bankruptcy Act* 1883, adding the ability of an interested person or a person with a liability relating to the lease, such as the original tenant or a guarantor, to apply for a vesting order to have the lease vested in him. However, there is no similar provision in the Canadian legislation. How are the duelling "absurdities" (as the judges in the old English cases called them) to be reconciled in Canada?

IX. THE SUPREME COURT OF CANADA DECISION IN CRYSTALLINE

These are the issues that the Supreme Court of Canada presumably felt should be addressed when it agreed to hear the appeal of the tenant in the *Crystalline* case. The judgment of the court was delivered by Major, J. He sets the stage early: after a short review of the facts, he notes that the original motions judge relied on *Cummer-Yonge* in deciding that "since the leases no longer existed, the liabilities that would have been owed by the original tenant to the landlords also disappeared".[119] He then expressed his agreement with the decision of the Ontario Court of Appeal.

Major, J. then reviewed the facts in more detail, set out the relevant statutory provisions, namely section 65.2 of the BIA, and briefly examined the decisions of the motions judge and the Court of Appeal.

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118 "Vigorously" states Lord Nicholls in the *Hindcastle* case.

119 *Supra*, note 1, [2004] S.C.J., para. 7.

Major, J. then set out the issue as follows: "should s. 65.2 be interpreted to bring all the obligations between the appellant [original tenant] and respondents [landlord] to an end when the leases were repudiated by the insolvent, Food Group?"[120] He answers the question quickly by stating that "the repudiation must be construed as benefiting only the insolvent."[121] In his view, the purposes of s. 65.2 are, firstly, "to free an insolvent from the obligations under a commercial lease that have become too onerous", secondly, "to compensate the landlord for the early determination of the lease", and thirdly, "to allow the insolvent to resume viable operations as best it can".[122] Third parties, such as guarantors and assignors, remain liable, as nothing in s. 65.2 protects them. Major, J. agreed with the Court of Appeal that s. 65.2 is to be read narrowly. Major, J. thus adopted the approach of the courts in England in cases such as *Re Levy* and *India Dock Co.*

Major, J. reviewed the position of the original tenant, noting that privity of contract between the original tenant and the landlord survives assignment of the lease by the tenant, that such assignment does not convert the original tenant into a guarantor of its assignee, and that the bankruptcy of the tenant's assignee may impair the original tenant's right to require the assignee to perform the obligations of the tenant under the lease but does not affect the primary liability of the original tenant for those obligations. He cited the *Transco Mills* case[123] and the English case of *Warnford*

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[120] *Ibid*, para. 26.

[121] *Ibid*, para. 27.

[122] *Ibid*, para. 28.

[123] *Supra*, note 22.

Investments Ltd. v. Duckworth[124] in support of these propositions. In fact, there is at least one other Canadian case besides the *Transco Mills* case that holds that the original tenant remains liable after the bankruptcy of its assignee.[125] In other words, it was clearly the law already that the bankruptcy of an assignee and disclaimer of the lease by its trustee did not affect the liability of the original tenant. The question, of course, was: if a third party such as the original tenant was not affected by the bankruptcy and disclaimer, why was a third party guarantor?

Major, J. then dealt with the issue raised in *Stacey v. Hill* and discussed by Lord Nicholls in *Hindcastle*: does the right of indemnification in the original tenant (or guarantor) against its assignee frustrate the objectives of the BIA? Major, J. had no difficulty disposing of this argument. Firstly, he noted that an assignor is no different from other "alternative debtors", none of whom is excused under the BIA: he refers to section 179 and its preservation of the liabilities of partners, co-trustees, joint debtors and sureties of the bankrupt and to section 62(3) and its preservation, in the context of a proposal, of the liabilities of third parties not specifically released by the discharge of the debtor. These third parties still have their rights of indemnification against the bankrupt.

Secondly, in Major, J.'s view, if the original tenant has a provable claim in the bankruptcy of its assignee due to a right of indemnification against the assignee, this does not frustrate the BIA. However, it is worth noting that this question of the "frustration" of the BIA arises more in the context of the words of the English *Insolvency Act*, which specifically states that third parties are not

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124 [1978] 2 All E.R. 517 (Ch. D.).

125 See note 3.

released except where necessary to release the bankrupt, than under the BIA, which does not contain this wording.

At this point, Major, J. has made his decision. But, in *obiter dicta*, he then went on to discuss *Cummer-Yonge*. He opened by questioning "whether there is any justification for distinguishing between a guarantor and an assignor post-disclaimer".[126] Major, J. briefly set out the facts of *Cummer-Yonge*, then noted that Gale, C.J.H.C. in that case followed *Stacey v. Hill*. He stated:

> *Cummer-Yonge* has created uncertainty in leasing and bankruptcy.
>
> …
>
> Despite the division over *Cummer-Yonge*, the distinction between guarantors as having secondary obligations that disappear when a lease is disclaimed by a trustee in bankruptcy, and assignors as having primary obligations that survive a disclaimer, thrives in Canadian law.[127]

This situation, Major, J. noted, also existed in England with *Stacey v. Hill*. He then referred to *Hindcastle*, where Lord Nicholls noted the legal and commercial absurdity of a distinction that meant that guarantors of an assignor would not be liable if the assignor went bankrupt but would continue to be liable if the assignee of the assignor became bankrupt. Major, J. then stated:

> The House of Lords went on to overrule *Stacey v. Hill*. In my opinion, *Cummer-Yonge* should meet the same fate. Post-disclaimer, assignors and guarantors ought to be treated the same with respect to liability. The disclaimer alone should not relieve either from their contractual obligations.

The appellant raised the fact that the English *Insolvency Act* specifically states that the liability of third parties is not affected by the disclaimer, while the relevant Canadian legislation says nothing. But

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126 *Ibid*, para. 37.

127 *Ibid*, paras. 39 and 40.

Major, J. stated simply that "the English wording affirms the ordinary construction of the statute" and "explicit statutory language is required to divest persons of rights they otherwise enjoy at law".[128] In other words, he agreed with the court in *Re Levy*.

Major, J. states that he agrees with Carthy, J.A.'s observation in the Court of Appeal that the lease may have real value to the original tenant, whose rights cannot be abrogated in its absence. Does this mean that the original tenant has some rights under the lease, which lease it assigned (ie. gave up all of its rights to another) and which lease has been repudiated? I do not believe that the original tenant has any rights remaining.

X. DISCUSSION AND REMAINING ISSUES

First Principles

Let us go back, now, to the question that we have been circling throughout this article: what would be wrong with a rule that said "upon the disclaimer of a lease by a trustee in bankruptcy, the tenant and all third parties liable under or in respect of the lease are released"? Is this not a simple rule that would promote certainty in the law? Legally, this rule could be justified based on the existing legislation: a disclaimer of the lease is, essentially, a surrender of the lease.[129] And a surrender, being an agreement between landlord and tenant that the lease is at an end, releases everyone in respect of

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128 *Ibid*, para. 43.

129 See Williams & Rhodes Canadian Law of Landlord and Tenant (6th ed., looseleaf) (Carswell), p. 12-11, where it states: "However, the practical effect when the trustee invokes s. 39(1) of the Ontario Landlord and Tenant Act…is much the same whether the giving up of the tenancy is called a disclaimer or a surrender. In either event the obligations of the tenant are at an end."

the future obligations arising under the lease.[130] There is no need to resort to the reasoning employed by Gale, C.J.H.C. in *Cummer-Yonge* or by the majority of *Targa Holdings*.

The problems with this rule are as follows. Firstly, the practical problem: why is a landlord to be prevented from protecting itself against the bankruptcy of its tenant? Further, why is the landlord who crafts a guarantee from a third party in language such as that used in *Andy & Phil* to be protected and not the landlord who takes a simple guarantee? If semantics are to divide the protected landlord from the unprotected one, are we not actually encouraging a lack of certainty in the law and more expensive litigation?

Secondly, the "simple and certain" argument can just as easily be raised to apply to the rule set out over 100 years ago in the English cases that "a disclaimer of a lease by a trustee in bankruptcy is effective only between the trustee and the landlord and not vis-à-vis any third parties".

Thirdly, the proposed rule clashes with the rule - decided at common law before the BIA and codified in the BIA - that a guarantor is not released by a bankruptcy.

Fourthly, although I have previously put this as a question regarding "battling absurdities", what this issue arises from is more basically a question of the interpretation of a statute, the BIA. At the time of *Re Levy* and *India Dock Co.*, interpretation of statutes was based on the "plain meaning rule", under which "a court is obliged to stick to the literal meaning of the legislative text in so far as that meaning is clear"[131] and the "golden rule", "which permits courts to depart from the ordinary

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[130] *Ibid*,p. 12-7, where it states: "Where a lease is validly surrendered, the lease is gone and the rent is also gone, and this principle is not affected by the fact that the lessee remains liable for breaches of covenant committed prior to the surrender."

[131] *Sullivan and Driedger* on the Construction of Statutes (4th ed., 2002) (Butterworths), p. 5.

meaning of a text to avoid absurd consequences".[132] Unfortunately, these rules, as we have seen from the comments of Lord Bramwell in *India Dock Co.*, simply lead one to different "absurdities". Today, the modern principle of statutory construction would lead one to look at not only the words of the statute, but the scheme and object of the statute and the intention of Parliament. On this basis, as set out by Major, J. in *Crystalline*, the presumptions that "the legislature does not intend to change existing law or depart from established principles, policies or practices"[133] and that "the legislature does not intend to abolish, limit or otherwise interfere with the rights of subjects"[134] leads one to agree with Major, J. that the effect of a disclaimer, since it is not expressly set out in the BIA, is to be limited to being between the trustee and the bankrupt's estate, on the one hand, and the landlord, on the other hand. The other interpretation would clearly interfere with the rights of the landlord against numerous third parties - guarantors, indemnitors, issuers of letters of credit. And this interference would not promote the object of the BIA - also set out by Major, J. in *Crystalline* in the context of a proposal, and set out by the courts in *Re Levy* and other English cases (which still apply in Canada today).

In short, in principle, it appears that the decision of the Supreme Court in *Crystalline* is to be preferred over the decision in *Cummer-Yonge*.

As a question of fairness, the decision in *Crystalline* leaves unanswered the "absurdity" that Lord Bramwell saw in this situation over 100 years ago: the landlord has both the premises and the rent.

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[132] *Ibid*, p. 6.

[133] *Ibid*, p. 395.

[134] *Ibid,* p. 399

The original tenant has no right to "get the lease back". In essence, as Lord Nicholls noted in *Hindcastle*, the original tenant in a fact situation such as *Crystalline* has rights and obligations similar to those of a guarantor of the assignee: if the assignee defaults and goes bankrupt, and the assignee's trustee in bankruptcy disclaims the lease, the original tenant, like the guarantor, will be liable for the obligations of the tenant under the lease, but will not have any rights under the lease and will not have any indemnity rights against the bankrupt (other than the right to claim in the bankruptcy). In England, the legislature dealt with this by enacting the provisions of the *Insolvency Act* which allowed third persons such as the original tenant to seek to have the lease vested in them. In addition, the English legislature recently passed the *Landlord and Tenant (Covenants) Act 1995*, which specifically releases a tenant who assigns its lease. This Act was noted by Major, J. in *Crystalline*, but, as he also notes, in order to protect third persons in this manner in Canada, similar legislation would have to be passed in Canada. I would suggest that such legislation should be passed in Canada to protect third parties.

Security For Tenant's Obligations

How does *Crystalline* affect the decision of the court in the *Natco* case? In that case, the landlord took security from the tenant to secure the tenant's obligations under the lease. Under *Crystalline*, the bankruptcy of the tenant and the disclaimer of the lease by the tenant's trustee in bankruptcy results in the termination of the lease as between the landlord and the tenant. Presumably, since the lease is terminated, the security cannot be enforced for any obligations that arise after the date of the disclaimer, since these obligations have terminated. The decision in *Natco* does not appear to be affected by *Crystalline*.

Letters of Credit

What about letters of credit? If a letter of credit is obtained from a third party guarantor or indemnifier in order to secure the obligations of such third party, then clearly, under *Crystalline*, the letter of credit may be draw down by the landlord if the guarantor or indemnifier does not fulfil its obligations, since those obligations survive the bankruptcy of the tenant and the disclaimer of the lease. However, if the landlord obtained (as is more usual) a letter of credit directly from the tenant, has *Crystalline* clarified this situation at all?

Under *Crystalline*, the obligations of the tenant under the lease have terminated after the disclaimer. How, then, can the landlord claim to the issuer of the letter of credit that it is owed anything under the lease? On the other hand, *Crystalline* states that third parties are not affected by the bankruptcy and disclaimer, so how can the issuer of the letter of credit claim that it is no longer liable to pay when the landlord/beneficiary requests a draw down under the letter of credit? *Crystalline* does not assist in resolving these issues.

Although the *Lava Systems* case dealt with these issues, it did not do so in a manner that was complete. In my submission, this type of case must still be reviewed satisfactorily by a court. The courts must apply letter of credit law to the facts. As a result of *Crystalline*, it can now be definitively stated that, upon the bankruptcy of a tenant and a disclaimer of the lease, the lease terminates as between the landlord and the tenant. If the landlord is holding a letter of credit that it obtained from the tenant to secure all of the tenant's obligations under the lease, can the landlord draw down on that letter of credit for obligations under the lease arising after the disclaimer?

Under letter of credit law, the issuer of a letter of credit must pay when the beneficiary demands payment, provided that the beneficiary presents the proper documents and provided there is no

fraud.[135] In this type of case, the "proper documents" normally will consist simply of a certificate from the beneficiary stating that, under the relevant agreement between the beneficiary and the applicant (the tenant), ie. the lease, the landlord is owed money and is therefore entitled to draw down under the letter of credit. But can the landlord make this statement? If the lease has terminated, then in fact there is nothing owing to the landlord for post-disclaimer obligations under the lease. Let us assume that the landlord nevertheless presents the issuer with a certificate stating that the landlord is owed money under the lease for post-disclaimer obligations - the only exception to the issuer's obligation to pay (which arises upon receipt by the issuer of the beneficiary's demand for payment and certificate) is fraud. Is it fraudulent of the landlord to make the statement that it does in this certificate?

"Fraud" has been interpreted fairly broadly in Canada in letter of credit cases. Normally, it will imply some sort of dishonestly or deceit, but in some letter of credit cases, fraud has been equated with "clearly untrue or false", "utterly without justification", having "no right to payment" or where the beneficiary's rights were "not even colourable as being valid or have absolutely no basis in fact", without any need to show subjective dishonesty on the part of the beneficiary.[136] That is, in some cases, fraud has been found as a result of the circumstances of the case, where the request for

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135 See, *supra*, note 13.

136 See, *supra*, note 17.

payment was made without any apparent right in the beneficiary to payment, although the subjective state of mind of the beneficiary in making the request was not reviewed.[137]

In the facts under discussion, clearly the landlord has "no right to payment" of any post-disclaimer obligations under the lease. There is no doubt that the landlord has suffered a loss (unless rents have gone up since the lease was signed, in which case the landlord may not have suffered any loss) and it could be argued that it has a "colour of right" to claim such loss from the issuer of the letter of credit. But, I submit that it would be reasonable for a court to decide, based on the existing case law, that it would be fraudulent for the landlord to request such amounts.[138] If an issuer receives such a request, it would therefore be within its rights to refuse payment, on the basis that fraud exists. Of course, an issuer will not normally know the circumstances surrounding any request for a draw down under a letter of credit. This will present difficulties for issuers in determining whether to pay or not. On the one hand, the issuer is obliged to pay quickly.[139] On the other hand, since the letter of credit was issued to secure the obligations of a tenant, any request for payment under the letter of credit means that the tenant has defaulted, and the issuer may therefore wish to determine, before it pays, whether that default has lead to, or includes, the bankruptcy of the tenant. No one will volunteer this information to the issuer, as they have no economic reason to do so - the trustee in bankruptcy is not concerned, since the monies paid by the issuer are the issuer's monies, and the issuer will only be able to claim in the bankruptcy for such monies.

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[137] However, the concept of "equitable fraud", which implies that there is no need to find dishonesty or deceit, has not been found by the courts to justify non-payment under a letter of credit. The cases do not refer to equitable fraud at all.

[138] See the recent case of *Re New Home Warranty of British Columbia Inc.* (2004), 238 D.L.R. (4th) 13, [2004] 6 W.W.R. 419, 33 C.L.R. (3d) 146, 50 C.B.R. (4th) 224, 46 B.L.R. (3d) 105 (B.C.C.A.).

[139] See ICC Uniform Customs and Practice for Documentary Credits (No. 500, 1993), Article 13(b).

The answer for the landlord is again a formal one to avoid uncertain legal results: the landlord who wishes to obtain a letter of credit to secure the obligations of a tenant must ensure that the letter of credit is issued under an entirely separate agreement between the tenant and the landlord (ie. an agreement that cannot be "disclaimed" on bankruptcy) or, better still, on the application of a third person, who could be a guarantor or indemnifier of the obligations of the tenant under the lease. With respect to a letter of credit from a third person, upon the bankruptcy of the tenant and the disclaimer of the lease, the obligations of the third person will not be affected, and the landlord will be entitled to draw down on the letter of credit if the third person does not perform its obligations under its guarantee or indemnity. If a third party (for example, the principal shareholder of a corporate tenant) is unwilling to guarantee the tenant's liability, but will provide a letter of credit (which at least has the benefit of being in a known and finite amount), then the guarantee could be structured to be a limited recourse guarantee of such principal, with recourse under the guarantee limited to the letter of credit.

XI. CONCLUSION

There is no doubt that the decision of the Supreme Court of Canada in *Crystalline* has clarified the law. The decision follows principles that were laid down by the English courts over 100 years ago. Those principles appear to be correct - that is, there is no reason why provisions of the BIA and other legislation which interfere with the contractual rights and obligations of the bankrupt should be deemed to also interfere with the contractual obligations and rights of third persons. As well, it seems unfair not to allow a landlord to protect itself against the bankruptcy of its tenant by getting a guarantee from a third person. After all, since bankruptcy law was originally put in place, the courts have held that bankruptcy does not affect the obligations of a surety. The mere fact that a disclaimer of the underlying contract has taken place under the BIA - which disclaimer mechanism was

originally put in place to protect and benefit the estate of the bankrupt against onerous contracts - should not affect the principle that sureties are not released.

So now landlords can take guarantees from third persons without having to be too concerned with the wording of the guarantee. A general guarantee of all of the obligations of the tenant under the lease should be enforceable. As well, landlords can consent to assignments and keep the original tenants "on the hook" without being overly concerned with the wording of the consent. A simple covenant of the original tenant that it is not released by the assignment and remains jointly and severally liable with the assignee for the obligations of the tenant under the lease should be sufficient.

But landlords must still be careful when taking letters of credit to secure the obligations of their tenants. In my submission, these letters of credit should always come from third party guarantors or indemnifiers, and not directly from the tenant. As well, taking security from the tenant will not protect the landlord in a bankruptcy scenario.

Crystalline will be the subject of much analysis over the next while, and it may be that lawyers and parties to leases will discover other unanswered issues. But it is always good to see the Supreme Court step into an area of commercial law that has become murky and succeed, as I submit the Supreme Court has succeeded here, in bringing some clarity and light to it.