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What to do when your lessee declares bankruptcy?

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A commercial lease does not end on the sole basis that the lessee declares bankruptcy; to the contrary, the Bankruptcy and Insolvency Act (“BIA”) provides that the property of the bankrupt, including the lease, is vested in the trustee. In fact, the terms of the lease are what make it possible for the lessor to terminate the lease should the lessee declare bankruptcy.

Once the lease is terminated, the lessor has priority to recover three months of rent due as at the date of bankruptcy; however, if the lessor is entitled to advance rent under the lease, he will also be able to recover three months of upcoming rent. The priority granted to the lessor applies only to rent and does not include any amount related to damage caused by the lessee, for which the lessor can make an ordinary claim.

Although granting the lessor priority may seem an efficient way to recover rent in a bankruptcy, the relative import of this must be kept in mind, since the preferential debt payable to the lessor can only be paid from the net equity value of the movable property, or goods, located on the leased premises, i.e., the value after the secured creditors who had rights on the goods have been paid. If the value of the goods is low, the priority granted to the lessor can be altogether worthless. Faced with this reality, can the lessor improve his position by means of collateral securities?

There are other means by which lessors can ensure the payment of rent, such as movable hypothec, security deposits, letters of credit, surety bonds, etc.

Without elaborating on the debates in this regard, the movable hypothec the lessor has over the lessee’s goods is useless in a bankruptcy, because the federal law (BIA) takes precedence over the provincial law. The same situation exists with regard to a security deposit since, as a security, the deposit is still considered the property of the lessee and therefore is vested in the trustee at the time of bankruptcy; however, this does not apply to rent paid in advance, since it would be considered the property of the lessor and therefore cannot be claimed by the trustee.

Third-party endorsements of rent payment, such as a surety bond or bank letter of credit, are by far the most efficient means to adequately compensate the lessor in the event that the lessee declares bankruptcy, since the bankruptcy is immaterial to the third-party agreements.

In conclusion, make sure that the lease binding you to your lessee expressly provides for (i) termination of the lease should the lessee declare bankruptcy; (ii) the possibility of recovering three months of advance rent and not only the three months of rent due as prescribed in the BIA; and (iii) if a deposit is paid, that it is rent paid in advance and not just a security.

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DID YOU KNOW ?

“Entering into a contract with the limited partner of a limited partnership cannot be equated with entering into a contract with the limited partnership; only the general partner can bind a limited partnership.”

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