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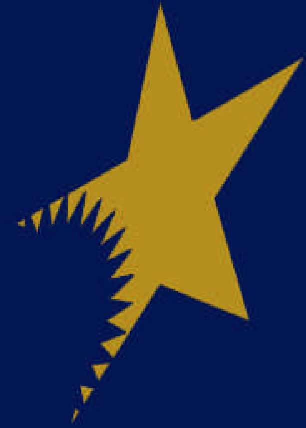

Blaneys on Business

"Business people have several reasons to be concerned about the new (Ontario Limitations) Act."

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

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial group, Alex Mesbur at 416.593.3949 or amesbur@blaney.com.

NEW ONTARIO LIMITATIONS ACT RAISES CONCERNS IN BUSINESS COMMUNITY

Renato Chiaradia

The Ontario legislation that places new and more stringent limitations on the dates by which contracting parties who decide to take legal action are obliged to begin that action raises a number of concerns in the business community.

The date by which one party to a contract may bring an action for breach against the other party is one area that raises particular concern for business people, especially as it relates to representations and warranties made in the contract.

When a business is bought, for example, it is common for the purchaser to demand that the seller represent and warrant that the assets of the business are free of all defects – that the computers are in good working order, for instance, or that the manufacturing facility does not contain asbestos.

Historically, parties to a contract were free to negotiate how long their representations and warranties survived after the deal closed. Different representations and warranties often survived for different lengths of time. Some ran 18 months while others were more commonly set at two years. Others, like corporate tax warranties, survived longer and others yet, such as warranties of title, where sellers warrant that they are, in fact, the legal and beneficial owners of the business, lasted indefinitely.

The new Limitations Act, which took force last January 1, requires parties that want to sue for breach of a representation and warranty to begin legal action within two years of the date that they "discover" – that is, that they know, or ought to have known – that a breach has been committed. Even if the two year basic limitation period has not expired, an ultimate limitation period has been introduced to bar claims from being brought 15 years after the act or omission on which the claim is based took place, even if the claim was not discovered or reasonably discoverable in that 15 year period.

Business people have several reasons to be concerned about the new Act.

First is the relative brevity of the new basic limitation period. Prior to the new legislation, the parties had six years to sue for breach of contract. They now have two.

A second and perhaps more acute concern is that it is no longer open to the parties to negotiate their own limitation period. In the past, if buyers and sellers wanted a limitation period that was longer or shorter than the statutory period, they were free to opt out of the statutory period and negotiate their own time limitations. Under section 22 of the new Act, parties cannot agree to vary or exclude limitation periods prescribed by the Act.

"Section 22 (of the Act) constrains, perhaps inappropriately, the freedom of contract that has become a basic feature of our economic system."

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There has been significant debate among lawyers regarding the effect, if any, of section 22 on survival periods that parties negotiate in their commercial agreements. Members of the legal community are concerned that the courts might interpret section 22 strictly with the effect that an expiry date set out in a representation and warranty will be construed as an indirect attempt to vary or exclude a limitation period. Such an interpretation would have the undesired effect of thwarting the parties' intentions and fundamentally altering the bargain struck at the negotiating table.

This affects the business community deeply for a number of reasons. First, on a philosophical level, it constitutes state intervention in private commercial arrangements that sophisticated buyers and sellers in a free market economy are seeking to make based on their business judgement and for their own business purposes. Section 22 constrains, perhaps inappropriately, the freedom of contract that has become a basic feature of our economic system.

Second, on a practical level, it takes away from both parties' strategic and tactical flexibility to create and manage an agreement, flexibility that could benefit either party, a wider circle of stakeholders, or perhaps even the public.

On an additional practical level, the new Act is also prompting Ontario parties to a deal that has a cross-border element (e.g. an Ontario buyer and a New York State seller) to try to evade Ontario limitations provisions by structuring transactions in ways that would make American law apply to the deal. This could result in significant costs and risks to Ontario businesses.

Third, there is no readily apparent public policy rationale for section 22, and no clear answer to the question of how the public interest is served by the provision. Arguably, the prior legislation was already serving the most obvious grounds for having a limitation period for contractual breaches – to help create greater certainty about commercial obligations.

In that context, the Ontario Bar Association has asked the Attorney General to repeal section 22 or at least limit it to consumer contracts to ensure, for example, that large corporations cannot force desperate consumers to waive a legal right that would protect those consumers. In a written statement to the OBA last December, the Attorney General stated that his Ministry would monitor the new effects of the new law on an ongoing basis. ■

SUPREME COURT BRINGS WELCOME CLARITY TO LEASE GUARANTEE RULES

Steven P. Jeffery

For landlords, tenants and third parties who "guarantee" commercial leases, the Supreme Court of Canada has issued a decision that brings welcome clarity to the rules relating to those guarantees.

At the same time, however, several related questions that the court was not asked explicitly to address remain unanswered and open to future judicial determination.

The Supreme Court decision discussed here involved Crystalline Investments Ltd., the owner of a New Brunswick shopping centre, and Domgroup Ltd., a supermarket chain, over a lease signed originally in 1979.

Prior to this case, the ramifications of a commercial tenant going bankrupt and the trustee in bankruptcy's subsequent disclaimer of the tenant's lease (that is, the trustee's exercise of its legal right to give up the leased premises and

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effectively terminate the lease) had proved troublesome for the courts. Various issues had arisen before the courts, 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.

The usual fact situation in lease guarantee cases is as follows. A landlord grants a commercial lease to a tenant. To back up the tenant's agreement that he will pay the rent and meet the other terms of the lease, the landlord obtains either a guarantee from a third party (the surety), security from the tenant or a third party, or a letter of credit from the tenant or a third party.

The tenant then goes bankrupt. The tenant's trustee in bankruptcy disclaims the lease.

Prior to the *Crystalline* case, there was a line of Canadian cases beginning with a 1965 Ontario case, *Cummer-Yonge Investments Ltd. v. Fagot*, that held, essentially, that a tenant's bankruptcy and the subsequent disclaimer of the lease results in the termination of all of the obligations of the tenant.

This, in turn, means any guarantee, security or letter of credit held by the landlord guaranteeing or securing such obligations cannot be enforced, since there are no longer any obligations to guarantee or secure.

In the *Crystalline* case, a slightly different fact situation arose and it tested the logical limits of the *Cummer-Yonge* line of cases. Here, Crystalline, as landlord, granted a commercial lease to Dominion Stores, as tenant, of premises in a New Brunswick shopping centre. Later, Dominion assigned the lease to Coastal Foods, a wholly-owned subsidiary. Crystalline's consent was not required and Dominion was not released from its covenant as the original tenant.

After some corporate machinations, Coastal Foods became The Food Group Inc. In 1994, Food Group filed a notice under the federal *Bankruptcy and Insolvency Act* (the "BIA") that it intended to make a proposal for resolving its outstanding obligations to its creditors.

The proposal trustee then delivered a notice under the BIA to Crystalline, repudiating the lease. Meanwhile, Dominion had become Domgroup Limited.

This repudiation amounted to the same thing as a disclaimer by a trustee in bankruptcy. Under the *Cummer-Yonge* case, this would have meant that the obligations of the tenant under the lease were terminated. Accordingly, when Crystalline brought an action against its original tenant, Domgroup, Domgroup's defence was that the lease had terminated and that, therefore, there were no obligations left for it to perform.

Domgroup was successful at trial. Crystalline appealed and the Ontario Court of Appeal rejected Domgroup's argument. Domgroup then appealed to the Supreme Court of Canada. Normally, the Supreme Court would be loath to hear a commercial case with such a narrow issue, but the notoriety of *Cummer-Yonge* and a recent decision of the English House of Lords in a similar case no doubt were on the mind of the court when it agreed to hear the appeal.

The Supreme Court's decision was unanimous. It noted that the trial 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".

It held that when a lease is repudiated under the BIA, the result is that the insolvent tenant (in their case, Food Group), and only the insolvent tenant, is relieved of its obligations. The purposes

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of the BIA are, first, to free an insolvent from the obligations under a commercial lease that have become too onerous; second, to compensate the landlord for the early termination of the lease and, third, to allow the insolvent to resume viable operations as best it can. Third parties, such as guarantors and assignors, remain liable, because nothing in the BIA protects them.

The court held that Domgroup's assignment of the lease to Food Group did not convert Domgroup into a guarantor of the Food Group and that while the bankruptcy of the Food Group may have impaired Domgroup's right to require Food Group to perform its obligations under the lease, that did not affect Domgroup's primary liability to the landlord for those obligations.

This decision raised the ultimate question: if a third party such as the original tenant was not affected by the bankruptcy and disclaimer, why was a third party guarantor released under *Cummer-Yonge*?

The court noted that *Cummer-Yonge* had created uncertainty in the law relating to leasing and bankruptcy, leading to a distinction between guarantors as having secondary obligations that disappear when a lease is disclaimed by a trustee in bankruptcy, and assignors (or indemnitors) as having primary obligations that survive a disclaimer.

The Supreme Court, referring to a recent similar decision of the English House of Lords, decided that *Cummer-Yonge* should be overruled. In other words, after a 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.

With *Cummer-Yonge* overruled, landlords should now be free to obtain guarantees of their tenants' obligations, together with security and letters of credit, from third parties.

Having said that, there are still unanswered questions relating to security and letters of credit that are obtained from the tenant itself.

The letter of credit issue is particularly tricky. If a disclaimer results in the termination of a lease (which the Supreme Court appears to agree with), then if the letter of credit has been provided by the tenant, how can the landlord enforce the letter of credit when the lease "no longer exists"?

On the other hand, a letter of credit involves a third party (the bank that issued the credit) – since the obligations of a third party are not affected by the disclaimer (as the Supreme Court held in *Crystalline*), should the landlord not be able to demand payment from the bank under the letter of credit?

These issues and others must still be settled, but there is no doubt that the Supreme Court has clarified the law for the better in its decision in *Crystalline*. ■

Blaneys on Business is a publication of the Business Law Department of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

We welcome your comments. Address changes, mailing instructions or requests for additional copies should be directed to Chris Jones at 416 593.7221 ext. 3030 or by email to cjones@blaney.com.Legal questions should be addressed to the specified author.

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