Focus REAL PROPERTY

Landlords insecure after ruling

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A recent Alberta case will be alarming to many landlords and their counsel. Landlords regard the security deposit as a "pot of money" available to be applied towards performance of the tenant's obligations if needed. Most times, there is no filing or registration by the landlord. A trustee in bankruptcy looks upon the security deposit as an asset of the estate of bankrupt. Personal property security legislation (including in Alberta and B.C.) commonly provides that a security interest in collateral is not effective against a trustee in bankruptcy if the security interest is unperfected at the date of the bankruptcy. Is the landlord's claim to the security deposit perfected by "possession" of the "pot of money?"

Briefly stated, the facts of the case in *Alignvest Private Debt Ltd. v. Surefire Industries Ltd.* [2015] A.J. No. 316 are that a sale and lease-back transaction occurred in February 2013 between York Realty Ltd. as purchaser/landlord and Surefire Industries Ltd. as seller/tenant. The lease provided for a security deposit of $3.1875 million. Alignvest Private Debt Ltd. held a registered general security agreement granted by Surefire in March 2013 over the assets of Surefire, which was declared bankrupt in December 2013. Alignvest claimed priority to the security deposit against York. This was supported by an agreement entered into by York in favour of Alignvest whereby York acknowledged the validity of Alignvest's security and York subordinated its interest until Surefire's obligations to Alignvest were paid in full. The trustee in bankruptcy took the position that the security deposit was intangible personal property (i.e. a monetary credit due to Surefire) to which Alignvest's security attached. Implicit in the trustee's position and the court's decision is that in order to be protected against the trustee, the landlord's claim to the security deposit would have to have been registered under Alberta's *Personal Property Security Act* and that the security deposit was not perfected by possession. The court held that "the deposit is security for obligations under the lease and not prepaid rent. It does not fall under an exclusion to the provisions of the PPSA, and as a security interest should have been perfected by registration. As it was not, it is subject to Alignvest's perfected security interest."

This ruling does not bode well for landlords holding security deposits. If a tenant stays solvent and keeps its creditors at bay, the security deposit can serve its purpose as intended. But landlords can be unpleasantly surprised to find that "when it is needed most, it is not there."

Note that the court commented that the "characterization of the deposit under this lease should not be taken as determinative of the characterization of deposits under other forms of lease, and is limited to this specific lease and the intervention of a secured creditor with a perfected security interest."

Clearly, the court is signaling that the language of each lease should be considered independently. Even so, in my assessment, based on the reasoning of the case, the outcome would be the same even if the lease stated that the security deposit was "prepaid rent."

If a landlord holds a security deposit of the size in this case of $3.1875 million, then clearly the landlord would be well advised to register under applicable personal property security legislation. A single-tenant landlord might choose to do the same, rather than take any risk. Commercial landlords of multiple tenancies will want to consider an overall approach taking into account overall costs and administration. Unfortunately, the practical alternatives are not appealing. Among the possibilities for commercial landlords to consider are:

- The landlord could routinely file under personal property security legislation for all leases with a security deposit, but that entails cost and administrative hassle (including increased requests for priority by tenants' lenders, and requests for discharges long after the tenant has vacated the premises);
- A letter of credit is an alternative, but letters of credit have their own legal foibles and administrative issues (which are best left as a separate topic); and
- The landlord's argument will be improved by using an alternative approach framing the "deposit" as an up-front payment (akin to rent paid up front under a prepaid lease) instead of a security deposit — but this alternative approach (if implemented as stridently as would be required) can be cumbersome to present and explain to tenants, and is not assured of being successful.

The takeaway points for landlords are:

- Landlords must appreciate that security deposits have limitations and vulnerabilities;
- On a case-by-case basis, landlords should consider whether to register under applicable personal property security legislation; and
- If the creditors are circling, landlords should consider applying the security deposit right away (if the tenant is in arrears) and/or taking steps to shore up their position (e.g. belatedly filing under the personal property security legislation might be helpful) before an insolvency filing occurs or the trustee in bankruptcy or creditors take enforcement action.

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