

CANADA / JUDGMENT

Utar Scientific Inc. (Bankruptcy of)

2003 BCSC 438

COURT

Supreme Court of British Columbia

DECIDED

24 March 2003

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2003BCSC0438

IN THE SUPREME COURT OF BRITISH COLUMBIA

Citation:

Bankruptcy of Utar Scientific Inc.

2003 BCSC 438

Date: 20030324

Docket: 227721 VA02

Registry: Vancouver

IN THE MATTER OF THE BANKRUPTCY OF

UTAR SCIENTIFIC INC.

Before: The Honourable Mr. Justice McEwan

Reasons for Judgment

Counsel for the Trustee/Respondent:

D.D. Nugent

Counsel for the Appellant/Applicant:

R.J. Argue

Date and Place of Trial/Hearing:

February 27, 2003

Vancouver, B.C.

- [1] This is an appeal from the disallowance by the trustee in Bankruptcy of Utar Scientific Inc. ("Utar") of a portion of a claim made by Commerce Court International Holdings Ltd. ("Commerce Court").
- [2] Commerce Court was the landlord and Utar the tenant under a lease dated April 1, 1999 and later modified. On June 7, 2002, by order of this court, Grant Thornton Ltd. was appointed interim receiver of Utar under the Bankruptcy and Insolvency Act.
- [3] Under the lease Commerce Court was entitled at its option to three month's rent in the event of bankruptcy:

... if the Tenant makes any assignment for the benefit of creditors or any bulk sale or becomes bankrupt or insolvent or takes the benefit of any Act now or hereafter in force for bankrupt or insolvent debtors, or, if the Tenant is a corporation and any order shall be made for the winding-up of the Tenant, or other termination of the corporate existence of the Tenant then in any such case this Lease shall at the option of the Landlord cease and terminate and the Term shall immediately become forfeited and void and the then current month's rent and the next ensuing three months rent shall immediately become due and be paid . . .

There were however a number of provisions purporting to create continuing obligations for the entire term of the lease.

- [4] Section 136(1)(f) of the Bankruptcy and Insolvency Act provides:

136.(1) Subject to the rights of secured creditors, the proceeds realized from the property of a bankrupt shall be applied in priority of payment as follows:

...

- (f) 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;

- [5] It is matched in Section 29(2) of the Commercial Tenancy Act:

Where a receiving order or an assignment is made against or by a lessee under the Bankruptcy and Insolvency Act (Canada), the custodian or trustee, notwithstanding a condition, covenant or agreement in a lease, has the right to hold and retain the leased premises for a period not exceeding 3 months from the date of the receiving order or assignment, or until the expiration of the tenancy whichever happens first, on the same terms and conditions as the lessee might have held the premises had no receiving order or assignment been made.

- [6] Commerce Court filed a form of Proof of Claim December 12, 2002, totalling \$367,957.06. This was its calculation of the total owing by the tenant through what remained of the unexpired term of the lease.
- [7] The trustee disallowed the claim to the extent of \$312,549.98 on the basis that under Sections 136(1)(f) of the Bankruptcy and Insolvency Act and Section 29 of the Commercial Tenancy Act, Commerce Court was limited to a claim for three months accelerated rent, the three month of actual occupation having been paid.

[8] The trustee summarized the claim he was prepared to allow in these terms:

Therefore, we calculate the landlord's claim as follows:

Preferred Claim:

Section 136(1)(f) of the B.I.A. -

Arrears of Rent \$ 0.00

Accelerated Rent \$131,407.08

\$131,407.08

Less Estimated Security Deposit Held

(80,000.00)

Total Section 136(1)(f) claim \$ 51,407.08

[9] The issue presently before this court concerns the deduction of the "Estimated Security Deposit" in the approximate amount of \$80,000.

[10] Clause 3.2 of the March 1, 1999 [sic] Modification of Lease provides:

Forthwith upon the parties reaching agreement as to the Tenant Improvement matters contemplated by Clause 3.3, and as a pre-condition of the enforceability of this Lease, the Tenant shall deposit with the Landlord the sum of ONE HUNDRED NINETY-ONE THOUSAND SEVEN HUNDRED SIXTY DOLLARS (\$191,760.00) in the form of an irrevocable standby Letter of Credit (the "Letter of Credit") as security for the performance of its obligations under the lease, in a form and substance satisfactory to the Landlord, acting reasonably.

[11] The Hong Kong Bank of Canada issued an irrevocable standby letter of credit naming Commerce Court the beneficiary. It was expressed to be:

Security for the performance of the Applicant's obligations under the Lease dated April 1, 1999 and made between Commerce Court International Holdings Ltd. and 3552225 Canada Inc. as amended by the Modification of Lease dated March 1, 1999 and made between the same parties (collectively the "Lease").

[emphasis added]

- [12] On or about June 12, 2002 Commerce Court demanded the balance of about \$79,000 remaining under the letter of credit. The bank was prepared to pay this sum out on June 24, 2002. On July 2, 2002, however, the interim receiver agreed with counsel for Commerce Court that the \$79,000 would be held in trust.
- [13] On July 24, 2002 the interim receiver assigned Utar into bankruptcy.
- [14] On October 23, 2002 the trustee disclaimed any and all interest in the lease pursuant to Section 29 of the Commercial Tenancy Act. A month later the trustee sent a further Notice of Disallowance:

Take notice that as trustee acting in the matter of the bankruptcy of UTAR Scientific Inc., pursuant to subsection 135(2) of the Act, we have disallowed your claim for amounts in excess of your entitlement under the Commercial Tenancy Act ("CTA") and the Bankruptcy and Insolvency Act ("BIA") for the following reasons:

1. Section 29(2) of the CTA provides that the landlord is not entitled to prove as a creditor for any portion of the unexpired term of the lease.
2. The entitlement for a landlord's preferred claim is covered by Section 136(1)(f), BIA, and provides:

"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,"

And further take notice that if you are dissatisfied with our decision in disallowing your claim in whole or in part you may appeal to the court within the 30-day period after the day on which this notice is served, or within such other period as the court may on application made within the same 30-day period allow.

- [15] The trustee's position is briefly stated in ¶26 of the affidavit of Greg Ibbott:

It is the Trustee's position that the Landlord is only entitled to a position as a preferred creditor for the amounts owed by the bankrupt pursuant to the terms of the Lease. It is further the Trustee's position that as the Landlord has already received approximately \$80,000.00 towards payment of the Bankrupt's obligations under the Lease, that the Landlord's preferred rent claim must take this payment into account.

- [16] Commerce Court takes the position that the letter of credit is a contract between it and the Bank, independent of any relationship between Commerce Court and Utar or Utar and the Bank. It relies on *Lava Systems Inc. (Receiver and Manager of) v. Clarica Life Insurance Co.*, [2002] O.J. No. 2526 (O.C.A). In that case the trustee of the bankrupt applied to the court for directions as to whether the landlord of the bankrupt was obliged to account for money

drawn under a letter of credit in excess of statutory rights under the Commercial Tenancy Act and the Bankruptcy Act, following the trustee's disclaimer of the lease. The motions court found that the landlord was required to account to the trustee for the excess. In reversing this decision Mr. Justice Borins of the Ontario Court of Appeal made the following observations:

¶4 My decision turns on the law that applies to the autonomy of documentary letters of credit as explained by LeDain J. In *Bank of Nova Scotia v. Angelica - Whitewear Ltd.*, [1987] 1 S.C.R. 59 at 70-85. See, also, *885676 Ontario Ltd. (Trustee of) v. Frasmet Holdings Ltd.* (1993), 17 C.B.R. (3d) 64 at 71-73 (Ont. Gen. Div.). Relying on these authorities, the application judge at p. 295 of his reasons, corrected summarized the legal principles governing letters of credit.

A letter of credit is a specialized form of commercial credit. It is an autonomous contract between the issuer, normally a bank, and the beneficiary, normally a supplier, customer with a possible warranty claim, or creditor of the bank's customer. The issuer's customer is not a party to the letter of credit. The letter of credit is independent of any agreement or the equities between the beneficiary and the issuer's customer of the issuer and its customer. Subject to fraud, the letter of credit is payable by the issuer in accordance with its terms, independent of the performance of the underlying contract for which the credit was issued. The funds paid are those of the issuer, not its customer

¶5 On the basis of these principles, whether Clarica 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. In making payment pursuant to Clarica's demand, the bank adhered to its obligations under the letter of credit. The funds which it paid to Clarica were its property, not that of Lava. Had Clarica not drawn on the letter of credit, the balance remaining available to Clarica under the letter of credit would continue to be the property of the bank. In such circumstances, neither Lava's receiver and manger, not its trustee in bankruptcy, would have any claim on the undrawn portion of the security represented by the letter of credit. In my view, the fact that Clarica had obtained these funds as a result of its demand under the letter of credit places Richter in no better position than it would have been had Clarica not issued its demand. This is because the funds available as security under the letter of credit at all times were the property of the bank.

¶6 As I have noted, the bank was not a party to the proceedings. No doubt the bank received some form of consideration from Lava for issuing the letter of credit. However, the record is silent on the assignment of the bank's rights against Lava sufficient to give it the legal right to recover the funds advanced under the letter of credit. The receiver does not stand in the shoes of the bank. Applying the principles that pertain to the autonomy of letters of credit, there is no reason why Clarica is required to account to the receiver, Richter, for the \$677,979.24, which it drew on the letter of credit.

[17] As is evident from this passage the court endorsed the law as stated in *885676 Ontario Ltd. (Trustee of) v. Frasmet Holdings Ltd.* (1993), 17 C.B.R. (3d) 64.

[18] In British Columbia, the Court of Appeal in *West Shore Ventures Ltd. v. K.P.N. Holding Ltd.*, [2001] B.C.J. No. 713, (decided a year before *Lava Systems Inc.* (supra)) explicitly departed from the 885676 Ontario Ltd decision and followed a different Ontario case, *Peat Marwick & Thorne Inc. v. Natco Trading Corp. et al* (1995), 22 O.R. (3d) 727 (Ont. Gen. Div.).

¶36 In our respectful opinion, Madam Justice Feldman correctly analyzed the cases in *Peat, Marwick & Thorne Inc. v. Natco Trading Corp.* 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 losses 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.

¶37 Madam Justice Feldman put the point this way in the *Natco* case:

With great respect to the decision of Blair J., in my view if 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. That was the result in *Cummer-Yonge*. In recent cases courts in Ontario have held that a lease can be drafted wherein the obligation of the guarantor survives the termination of the lease including by the bankruptcy of the tenant: *Andy & Phil Investments Ltd., v. Craig* (1991), 5 O.R. (3d) 656, 9 C.B.R. (3d) 52 (Gen.Div.); *Sifton Properties Ltd. v. Dodson* (1994), 28 C.B.R. (d) 151, 41 R.P.R. (2d) 38 (Gen.Div). It follows that a letter of credit or other security could be drafted to secure an obligation that survives the bankruptcy.

[19] In the present case the letter of credit is said to be "security for the performance of the applicant's obligations under the lease . . .". As such this case apparently falls within the *West Shore* decision insofar as the obligations covered by the letter of credit are concerned.

[20] There is another question, however. In *West Shore* the respondent, *K.P.N. Holding Ltd.*, was the landlord and a company called *Doppler* was the tenant. The Bank of Montreal issued a letter of credit in favour of *K.P.N.*, on the basis of a commitment for reimbursement from *West Shore*. *West Shore* was an independent, but related, company to *Doppler*. *Doppler* went bankrupt.

- [21] In the present case there is a corporate entity named Jaymount Holdings Ltd. which posted the security underpinning the Hong Kong Bank's letter of credit. It has filed a proof of claim in the bankruptcy for \$112,479.55 advanced to Commerce Court under the letter of credit in March 2002, and further for \$79,280.45, the sum presently held in trust. That amount has been debited by the Bank against Jaymount's account.
- [22] In *West Shore* (where *West Shore* was in the position of *Jaymount*), the court considered the issue of standing in the following terms:
- ¶24 *West Shore* and *K.P.N.* were brought into legal relationship by the lease between *K.P.N.*, originally *Zephyr*, and *Doppler*, and by the letter of credit required to be furnished by *Doppler* under the lease, which was in fact facilitated by *West Shore* giving the Bank of Montreal full security for the amount of the letter of credit.
- ¶25 There was no privity of contract at any time between *West Shore* and *K.P.N.* But they were drawn into a system of legal relationships by *Doppler* becoming the tenant under the lease, and by *Doppler* prevailing on *West Shore* to carry into effect the financial commitment that *Doppler* had undertaken to *K.P.N.* with respect to the letter of credit. The scope of that financial commitment by *Doppler*, discharged by *West Shore*, and the reciprocal commitment by *K.P.N.*, are dependent on the terms of the lease and the terms of the letter of credit which together brought *West Shore* and *K.P.N.* into a commercial relationship with each other, with a mutuality of obligations, but without privity of contract.
- ¶26 A similar relationship of obligations, brought into being by contract, but without privity of contract, founded a claim for unjust enrichment in a commercial context in *Altas Cabinets & Furniture Ltd. v. Nat. Trust Co.* (1990), 45 B.C.L.R. (2d) 99 (B.C.C.A.). In our opinion the relationship between *West Shore* and *K.P.N.*, in the circumstances we have described, is in the same way as in *Atlas*, sufficient to give *West Shore* standing to bring its claim in unjust enrichment for restitution or for another appropriate remedy.
- [23] Here the trustee stands in a direct relationship with Commerce Court through its lease with the bankrupt *Utar* and according to the terms that govern that relationship under the Bankruptcy and Insolvency Act and the Commercial Tenancy Act. But *Jaymount* is not joined in the way *West Shore* was in the *West Shore* case. *Jaymount* is not even a party. In this case the court is being urged by the trustee to adopt its view of the meaning of a clause in a contract to which the trustee is a stranger.
- [24] The trustee points out that *Jaymount* has made a claim against *Utar* in the bankruptcy. In my view that does not, however, give the trustee the right to assert *Jaymount's* position indirectly, by disallowing Commerce Court's claim within the bankruptcy. While it appears on the face of the lease that the operative clause falls within the principle stated in *West Shore*, the meaning of that clause cannot be finally determined except in an action among the parties to it or by a party in a proximate legal relationship (as in *West Shore*). If Commerce Court realized a "windfall" or a form of double recovery, the question among the parties to the letter of credit transactions should be whether the terms of the lease

contemplate indemnity beyond the limitations imposed by the bankruptcy. If not, that issue should be sorted out among Commerce Court and the Bank (if it matters to the Bank) and the underwriter Jaymount.

- [25] I do not see how the trustee can enforce an interpretation of the letter of credit that, in effect, takes the part of Jaymount, when Jaymount has made no issue of it. In West Shore West Shore was at least a party, which I think is a crucial distinction.
- [26] Commerce Court's application is therefore allowed. The trustee was not, as between the bankrupt and Commerce Court, entitled to deduct the second advance of some \$79,280.45 under the letter of credit.
- [27] I accept the trustee's submission as to costs. Costs will be allowable out of the estate. There was a justifiable doubt and I think the trustee reasonably took the most cautious approach (see: *In Re Sauder and Warren Ross Lumber Company* (1958), 37 C.B.R. 68 (Ont. S.C.).

"T.M. McEwan, J."

The Honourable Mr. Justice T.M. McEwan

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Prepared on 28 October 2026 · Esheria