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LEGAL BYTES

THE LETTER OF CREDIT

Aubie J. Herscovitch

A letter of credit constitutes an interesting alternative to the payment for a deposit upon the execution of a commercial lease.

A tenant may guarantee the payment of rent and/or other obligations under a lease by way of letter of credit. It constitutes a guarantee of payment of the amount stipulated upon simple presentation to the tenant's financial institution. This form of guarantee has the essential characteristic of being completely autonomous from the lease it is guaranteeing

In principal, a letter of credit involves three parties, the beneficiary, the issuer and the applicant. In the event of a default on the part of the applicant, the beneficiary of the letter of credit, in this case the landlord, may request payment from the issuer, the applicant's bank.

The letter of credit generally takes the form of a short document in which standard clauses are inserted in order to ensure execution.

Reciprocally, a letter of credit may also be obtained by a tenant from a landlord in order to ensure landlord's contractual obligations towards the tenant such as the payment of a tenant's allowance or the reimbursement of amounts expended by a tenant to fixture the leased premises.

Traditionally, a financial institution will deduct from the tenant or landlord's line of credit the maximum amount it may be required to pay under the letter of

credit. It is remunerated for this service by interest on the amount of the letter of credit at the applicable interest rate on the total sums advanced under the line of credit, as if the amount of the letter of credit had been advanced. The line of credit, which is an operational credit different from the term-financing, is itself generally secured by a movable hypothec on accounts receivable and inventory.

ADVANTAGES AND DISADVANTAGES OF LETTERS OF CREDIT FOR LANDLORDS AND TENANTS

a. Advantages to Landlord

i. Protection from bankruptcy or insolvency

In the event of the tenant's bankruptcy or insolvency, the landlord is especially vulnerable. Letters of credit are not considered to be the tenant's property and therefore are not affected by the tenant's bankruptcy or insolvency. In cases where the landlord's security is not a letter of credit, the sole landlord's recourse for recovery is to act as a debtor in the bankruptcy process.

ii. Timing issues for landlord

The letter of credit can be draw by the landlord at time and an act of default in the lease in not necessary for the landlord to draw upon the letter of credit. The sole presentation of the documents outlined in the letter of credit is sufficient to force the issuing bank to pay. The ability to decide when to draw upon the letter of credit provides the landlord with additional leverage over the tenant.

b. Advantages to both landlord and tenant

iii. Possibility of increased security amounts available with a letter of credit

Will allow the landlord to demand larger security amounts that they can rely upon should the tenant default. If the letter of credit is large enough, the landlord will be more inclined to enter into a lease with a tenant that the landlord might otherwise have refused, due to the tenant's lack of creditworthiness.

c. Disadvantages of a letter of credit

i. Potential for fraud

The obligation of the bank to pay the landlord is independent of default under the lease. The potential for the landlord to commit fraud is at its highest where the breach of the lease to which payment relates is at the subjective determination of the landlord. From the perspective of the landlord, if there is a question about the tenant's performance under the lease, it may be easier for the landlord to draw upon the letter of credit first and ask questions later. If the lease obligations are eventually found to have been properly performed by the tenant, the tenant will then have to attempt to recover the cash advanced under the letter of credit.

ii. The tenant and the bank

The issuance of letters of credit tends to increase the dependency of the tenant upon its bank.

CONCLUDING REMARKS

The beneficiary of the letter of credit should devote the necessary time and effort such that both the lease and letter of credit are clearly drafted to ensure that there may be no misinterpretation under either or both documents as to when the sums payable under the leader of credit may be paid.

Thus, a letter of credit is a useful alternative security for landlords and tenants to use in lieu of cash security. Properly drafted, it will provide to the landlord the same protection as a cash security.

INSURANCE – YOU HAD BETTER BE HONEST !

Melvin S. Schiff

Everyone has, at one time or another, purchased an insurance policy. Whether it was life insurance, car insurance or property insurance, insurance is an integral part of our lives.

Some of us, in arranging for insurance, are inclined to be less than honest and forthcoming in terms of the information provided to our broker or the insurance carrier. Do-

ing so, however, can create a great risk.

The insurance company, in issuing the policy or setting the premium, relies on the information provided by the applicant. Generally, it will not undertake any independent investigation of the facts contained in the application. The law, however, permits insurance carriers to refuse payment under a policy of insurance if it can be proven that the insured or the owner of the policy misrepresented or concealed relevant facts.

Articles 2410 and 2411 of the *Civil Code of Quebec* provide as follows:

Art. 2410: *Subject to the provisions on statement of age and risk, any misrepresentation or concealment of relevant facts by either the client or the insured nullifies the contract at the instance of the insurer, even in respect of losses not connected with the risks so misrepresented or concealed.*

Art. 2411: *In damage insurance, unless the bad faith of the client is established or unless it is established that the insurer would not have covered the risk if he had known the true facts, the insurer remains liable towards the insured for such proportion of the indemnity as the premium he collected bears to the premium he should have collected.*

Additional articles including *Article 2420* of the *Civil Code of Quebec* are to the same effect.

For these reasons, it is imperative that in applying for a policy of insurance, you do not conceal anything and represent the facts fully and accurately.

Insurance companies, upon receipt of a claim, will thoroughly investigate the factual background of the application before settling the claim. Through their adjusters and investigators, they will establish that the applicant who confirmed that he had stopped smoking ten (10) years ago still smokes, from time to time, that the building which was represented to be in use has been vacant for two (2) years and that the severe back injury that prevents you from working mysteriously heals every Thursday night permitting you to play hockey with your friends at the local arena.

Insurance has been described, juridically, as a contract of absolute trust and transparency between the parties. It is therefore imperative that you *"tell the truth and nothing but the truth"* and represent every fact of any consequence.

Rather than merely signing the application prepared by

your broker, you should take the time to carefully review the application to ensure that what you are attesting to is accurate in all respects. The broker may not realize that you had asthma when you were a youth or that you suffer from high blood pressure. It is incumbent upon you to carefully review the application and, if necessary, to disclose facts that are relevant to the insurance company.

Your failure to do so may result in the insurance company denying coverage when a claim is filed.

CHARACTERIZATION OF ELIGIBLE VS. NON-ELIGIBLE DIVIDENDS HOWARD NEMEROFF

As attorney for many corporate clients, we often receive instructions to prepare resolutions authorizing the preparation of dividend declarations which more often than not come from the clients' accountants. Many times, the accountants ask us to describe the dividend in the resolution as either an eligible or ineligible dividend.

An eligible dividend is one which is traceable to the company's GRIP (i.e. general rate income pool) while an ineligible dividend is one which is traceable to a company's LRIP (i.e. low rate income pool – being the after-tax pool of earnings taxed at the small business rate). An eligible dividend has a more generous gross up and tax credit treatment than does an ineligible dividend. However, if a dividend is not properly characterized, it is considered to be ineligible by default. Unfortunately, merely describing the dividend as being eligible or ineligible in the resolutions is not sufficient by itself to properly characterize the dividend.

From a tax point of view, it is irrelevant whether the resolution authorizing the dividend describes the dividend as being eligible or non-eligible. What really counts is notifying the shareholder entitled to the dividend of the characterization of the dividend. The only exception to this statement applies where the recipients of the dividends, i.e. the shareholders, are one and the same as the directors who are authorizing the dividend. It should be pointed out that a director's spouse or holding company is not "one and the same" as the director himself.

Whenever we receive a request from a company's accountants to prepare papers in order to authorize the declaration of a dividend which the accountant has described as either eligible or non-eligible, we contact the accountant to explain that he cannot rely solely on the text of the authorizing resolution to characterize the dividend as either eligible or non-eligible, as the case may be, (except in the limited exception described above). In order that the characterization be effective, the company must issue a letter to the recipient shareholder or must designate on the cheque, if any, in payment of the dividend, that the dividend in question is an

eligible or non-eligible dividend, as the case may be.

If, after this explanation, the accountant still wants the authorizing resolution to characterize the dividend as eligible or non-eligible, we will, of course, accommodate and insert the desired characterization, but in forwarding the resolution to the client for signature, we will point out the need for the company to send out a letter to the shareholder recipient or to put a statement on the dividend cheque, if any, which expressly declares the characterization of the dividend in question.

THREE YEARS PRESCRIPTION AND REIMBURSEMENT OF OVERCHARGES UNDER COMMERCIAL LEASES

Léa Bénitah-Bouchard, Student-at-Law

A careful tenant must always double-check amounts claimed by its landlord under the lease, and ensure that they reflect the terms of said lease and result from correctly performed calculations. If the landlord provides relevant financial information, such as periodical operating statements, it is imperative that the tenant thoroughly looks into the numbers and ensures that it is not paying undue rent increases, taxes, expenses, etc. If the landlord is not obliged under the lease to provide relevant financial documentation on a regular basis, the tenant must require access to these documents so that it may make its own verifications.

But what happens to a tenant who realizes, years later, that it has been overpaying rent, taxes or other charges? Is it entitled to claim reimbursements from the landlord and if yes, how far back is it allowed to do so under prescription rules?

Suspension of prescription

A claim generally prescribes by 3 years (article 2925 of the Civil Code of Quebec). In the case of an obligation which is performed successively, the starting point is the day on which the obligation becomes due (article 2932 of the Civil Code).

Where a tenant has been overcharged and could not find out about it (rather than did not), it may raise impossibility to act and suspension of the prescription. Article 2904 of the Civil Code provides:

2904. Prescription does not run against persons if it is impossible in fact for them to act by themselves or to be represented by others.

The debtor's fault

Jurisprudence and doctrine recognize that ignorance of facts which are a source of legal rights, especially when a result of the debtor's fault, is an "impossibilité en fait d'agir" falling under article 2904 of the Civil Code.

The *debtor's fault*, however, is a more demanding criteria than one would expect. Suspension of prescription only occurs where the creditor is in a situation of absolute impossibility towards finding out that is being misled by the other party.

The Courts have ruled that a party who wishes to invoke impossibility to act must first establish that it has not been negligent.

For example, the Superior Court of Quebec concluded that having been defrauded by the other party did not in itself constitute impossibility to act. If the exactitude of the amounts due can be verified by reviewing available information, a party may not later complain that it did not, at the time, consider useful to perform such review. The Court has indicated that the criteria for impossibility to act are met if, and only if, a party is being defrauded in a way that it cannot reasonably find out about it.

Impossibility to act between landlords and tenants

In 2006, the Superior Court adjudicated a case against a tenant who did not review in due time the operating statements it was receiving from its landlord on a regular basis. The tenant was a sophisticated retailer with extensive resources to perform such review. The Court ruled that the tenant had been negligent in not properly verifying the operating statements and could not claim reimbursements for any unduly paid sum prior to the last 3 years.

However, in a previous case with slightly different facts, the Superior Court rendered a decision in favor of the tenant. Said tenant had never received financial statements which the landlord was obliged to provide under the lease, and had therefore not had the chance to verify its bills against these documents. Because the landlord had an obligation to provide financial statements, the Court concluded that prescription had been suspended until fulfillment by the landlord of its obligation of information.



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