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SECURITY DEPOSITS: WHAT SECURITY DO THEY PROVIDE LANDLORDS?

Richards Buell Sutton Commercial Leasing Newsletter

Introduction

Deposit provisions in leases are a valuable mechanism for landlords to address lease security. Through a deposit, landlords are able to protect themselves from potential losses arising from a tenant's failure to perform its obligations under the lease. Regardless of the characterization of the deposit as prepaid rent, liquidated damages or security for tenant performance, landlords are often under the assumption that they have priority to the deposit if the tenant defaults under the lease.

However, earlier this year, the judgement in *Alignvest Private Debt Ltd v Surefire Industries Ltd*, 2015 ABQB 148 ("*Alignvest*") cast doubt on whether this understanding is accurate in all circumstances.

To understand this more clearly, below is a brief summary of *Alignvest*.

Facts

The case involved a sale-and-leaseback transaction between Surefire Industries Ltd. ("Surefire"), as seller/tenant, and York Realty Ltd. ("York"), as purchaser/landlord. The lease included a \$3,187,500 deposit, which was not paid in cash but instead was paid to York by way of an adjustment to the purchase price for the property.

The dispute arose when Surefire was declared bankrupt. Surefire's secured creditor, Alignvest Private Debt Ltd ("*Alignvest*"), had a registered security interest in the assets of Surefire and York, having not registered its security interest in the deposit under the *Personal Property and Security Act (Alberta)*, acknowledged the priority of Alignvest's interest in Surefire's personal property. As a result, Alignvest claimed that York's interest in the deposit was subordinated to Alignvest's perfected security interest while York claimed that the deposit was not part of Surefire's personal property as it had been paid to York on the closing of the sale-and-leaseback transaction and therefore was properly York's property.

Consequently, the Court was tasked with determining whether the deposit was security for the performance of obligations under the lease or prepaid rent. York argued that a non-refundable deposit that is applied to



rent payments or remedying tenant defaults is prepaid rent and therefore the property of York. Alignvest argued that the deposit was security for the tenant's performance of its obligations under the lease, meaning the deposit was the property of Surefire and was therefore subject to Alignvest's security interests.

Analysis

The Court stated that it "must look to the wording of the lease to determine the intention of the parties with respect to the deposit, whether it should be characterized as pre-paid rent, liquidated damages or security and whether it would be non-refundable in the hands of the tenant..."

The deposit provision was drafted as follows:

"6. Security Deposit/Rent Credit

(a) The Tenant will pay to the Landlord ... a deposit of ... \$3,187,500 plus goods and services tax (the Security Deposit"), which Security Deposit is to be held without interest by the Landlord as security for the performance by the Tenant of its obligations under the Lease ... Subject to the foregoing, the Security Deposit will, provided that the Tenant has paid all amounts due to the Landlord under this Lease and is not otherwise in default..., be applied during the term as follows:

[applied to monthly rent commencing on the 13th month of the term, and certain following months during the term of the tenancy]

(b) The Tenant shall be credited ... \$5000,000.00 ...towards its Rent obligations during the first two months of the Term..."

The Court determined that the deposit was security for the performance of Surefire's obligations under the lease and not prepaid rent or a non-refundable deposit based on the following key factors:

(a) there were two parts to the deposit provision: the first part was "security for the performance by the Tenant of its obligations under the Lease" and the second part was a prepaid rent credit;

(b) York did not exercise its right to retain the Security Deposit when rental payments were late by a few days;

(c) the deposit was not immediately applied to the rent owing for the specific future months as it was only applied to future rents if the tenant was not otherwise in default and once the future rent became due; and



(d) the deposit was repayable to the tenant if the landlord exercised its early termination rights under the lease if the tenant was not then in default of the lease.

Consequently, it was determined that York held a security interest in the deposit and because York did not register its security interest in the deposit, this interest in the deposit was subordinate to Alignvest's perfected interest.

Conclusion and Best Practices

Landlords should be mindful of the consequences of the deposit provisions in leases and whether or not they need to take steps to protect their interest in the deposit. Careful drafting of deposit clauses in a lease can help avoid the unintentional creation of a security interest over the deposit.

If a landlord intends to have a security interest in a deposit, it should take appropriate steps to perfect the security interest.

For existing leases, landlords should consider the potential ramifications of not immediately retaining the security deposit for its own use in the event that a tenant fails to meet its obligations under the lease, as a delay in doing so may jeopardize their priority to the deposit.