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Who Bears the Loss for Converted Security Deposits?

By Jonnette Watson Hamilton

Cases Considered:

Equitable Trust Company v Lougheed Block Inc., 2012 ABCA 87

This judgment is one of several arising as a result of foreclosure proceedings taken with respect to the historic Lougheed Building at 604 – 1 Street S.W. in Calgary. In this March 2012 decision by the Court of Appeal the focus is on the security deposits that the former owner of the building had converted to its own use. Because neither the foreclosing mortgage company — Equitable Trust Company — nor the court-approved purchaser of the building — the aptly named 604 - 1 Street S.W. Inc. — received the tenants' security deposits from the former owner/landlord, the issue was a classic in commercial law, a "battle of innocents." Who would be out the more than $340,000 in security deposits, the mortgagee or the purchaser? The Chambers judge, R.G. Stevens, had let the loss lie where it fell, on the purchaser who would become the landlord to whom the tenants would look for their security deposits. A unanimous Court of Appeal — Madam Justice Marina Paperny, Mr. Justice J.D. Bruce McDonald and Mr. Justice Brian O'Ferrall — allowed the purchaser's appeal and shifted the loss to the foreclosing mortgagee. While many of the grounds for allowing the appeal were based on the particular terms of the specific contract of purchase and sale between these individual parties, some of the grounds are more generalizable and therefore of broader interest.

The precise issue was whether the purchaser should receive a credit, in the form of an adjustment to the purchase price, for security deposits paid by the Lougheed Building's tenants to the former owner of the building. There was no provision in the agreement for purchase and sale that expressly dealt with the security deposits. Each security deposit was security for a tenant's performance of the covenants in its leases, but if a tenant did perform its covenants then its security deposit was to be applied to the tenant's last two months' rent.

The purchaser's argument was based on two provisions of the agreement. First, the purchase price was "subject to the usual adjustments". The purchaser argued, without calling any evidence, that a usual adjustment on the sale of an office building was an adjustment for tenants' security deposits. Because "usual adjustments" was not a defined term in the agreement and because the purchaser had not offered any evidence, the Chambers judge was not persuaded. The second provision that the purchaser relied upon was one that provided that "all items of income and expense, including but not limited to rents, operating costs, taxes and utilities but specifically excluding: i. any tenant improvement allowances owing to Tenants; ii. any landlord's work required pursuant to any Leases, and, iii. any real estate commissions remaining unpaid" were to be adjusted. So were "all prepaid rents actually received by the Vendor prior to the Closing Date." The Chambers judge decided that security deposits were not like the specified

"rents, operating costs, taxes and utilities"; in order to be included, they should have been expressly mentioned.

The Court of Appeal took a different tack. On the purchaser's first argument, it held (at para 27) that, even without any evidence as to what constituted "usual adjustments," effect had to be given to the parties' intentions as expressed in the words of their agreement. In other words — and this is one of the generalizable points — the meaning of "usual adjustments" was not dependent upon empirical evidence about practices in the commercial real estate market in Calgary.

In determining the intentions of the parties as expressed in the words "usual adjustments," the Court of Appeal considered (at paras 28-29) a provision that required the purchaser to assume all of the obligations of the landlord under the leases. With respect to the security deposits, two different scenarios were possible. If a tenant did not perform its covenants, then the security deposit would be forfeited to the landlord and the tenant would have to pay the last two months' rent. If a tenant did perform its covenants, then at the end of the third last month of the lease the landlord would be obliged to credit the security deposit against the last two months' rent. In either event, the purchaser would have to come up with money, either to defray the costs incurred as a result of a defaulting tenant or to pay the last two months' rent. Because it did not have the security deposits, the purchaser would be looking at an item of expenses. And the parties had agreed that "all items of income and expense" were to be adjusted. The Chambers judge had held that in order for the security deposits to be included as items of income and expense, it was up to the purchaser to see that they were explicitly included. The Court of Appeal held (at para 31) the opposite, namely, that in order for the security deposits to be excluded as items of income and expense, it was up to the mortgagee to see that they were explicitly excluded.

Alternatively, the Court of Appeal was willing to see the security deposits as items of income — as "rent" or "prepaid rent" — and the parties had agreed to adjust "all items of income and expense. " The security deposits would become prepaid rent if the tenants performed their covenants under their leases. The mortgagee argued that the fact it had never actually received the security deposits meant that the security deposits were not "prepaid rents actually received by the Vendor prior to the Closing Date." However, because only the mortgagee would know that it had not actually received the security deposits, the mortgagee was obliged to expressly exclude the security deposits if it did not want them adjusted as prepaid rent.

The information disparity between the purchaser and the mortgagee was key to how the Court of Appeal resolved the issues — and its role is another generalizable point. The mortgagee relied on the fact that the purchaser's offer had been conditional upon the purchaser receiving satisfactory answers to its "off-title enquiries" and upon the purchaser being satisfied that its proposed purchase was economically viable. And in order to help satisfy these conditions, the purchaser was entitled to receive whatever it needed to conduct whatever inquiries it deemed necessary or advisable. As well, the purchaser was entitled to contact any or all tenants in the building to determine lease terms and the state of their accounts with the landlord. However, the Court of Appeal noted (at para 34) that the state of the accounts between the foreclosing mortgagee and the former owner were not subject to inspection by the purchaser and only those accounts would have disclosed that the mortgagee did not have the security deposits. Therefore, the Court of Appeal held the mortgagee had to expressly exclude the security deposits if it did not want to have them included in items to be adjusted.

In other words, the mortgagee knew that the former owner had converted the security deposits and the purchaser did not know and this disparity is significant. The purchaser's lack of knowledge is mentioned early (at para 5); the mortgagee's knowledge that it had not recovered the security deposits figured prominently at the end of the decision (at paras 31, 34 and 36). The decision to shift the loss to the mortgagee is therefore responsive to fairness concerns. A purchaser of foreclosed-upon property is often buying a proverbial "pig in a poke". The fact the mortgagee did not have the security deposits should have been disclosed, the Court concludes (at para 36).

The Court of Appeal also mentions twice (at paras 31 and 36) that the mortgagee "stepped into the shoes of its mortgagor which did receive the security deposits." It uses this idea to hold that the mortgagee had to expressly exclude the security deposits if it did not want to adjust them (at para 31) and to find that the mortgagee had a duty to disclose (as vendor). If either party had to bear the loss caused by the mortgagor, it appears to have struck the Court as fairer that it be the mortgagee who had the relationship with the former landlord who converted the security deposits to its own use. In the "battle of innocents," the mortgagee was less innocent.

The final generalizable point is therefore that the Court of Appeal is always a court of equity and that fairness concerns will affect the way that ambiguous contract provisions are interpreted. (Or, as I repeatedly tell my Property Law students —seemingly to no avail — it is better to have the facts on your side than the law.)

(For a previous post on a different aspect of this case, see "Perennial Problem of Section 8 of the Interest Act.")