

ICSC Canadian Shopping Centre Law Conference

**A PRACTICAL GUIDE: TENANT FINANCING PROVISIONS
IN THE COMMERCIAL LEASE**

MAY 1, 2018

CORY SHERMAN & CATERINA WHITE

Sherman♦Brown
—BARRISTERS & SOLICITORS—

A PRACTICAL GUIDE: TENANT FINANCING PROVISIONS IN THE COMMERCIAL LEASE

INTRODUCTION

A tenant's ability to finance its business operations and to enter into security agreements, chattel mortgages and other similar arrangements in order to secure the purchase of its trade fixtures and to create security upon other personal property, is often strictly prohibited or otherwise restricted by the landlord in its lease negotiations with the tenant. This is particularly true given the reality of the Canadian leasing market, which is suffering from the loss of traditional "bricks and mortar" stores (most recently Sears and Toys "R" Us) in the face of robust online sales.

Landlords are hesitant to facilitate tenant financing, when funds may be used to bolster the tenant's online presence, rather than the viability of its physical locations. Conversely, landlords are becoming increasingly eager to stake claims to the tenant's property, as they look to reinforce their security in a leasing market which is characterized by growing uncertainty. The lease provisions which relate to tenant financing and the landlord's security interest in the tenant's property will become the subject of increased scrutiny and perhaps, more engaged, thoughtful negotiation, as both the landlord and the tenant attempt to navigate an ever-changing, modern leasing market.

1. The Lease Provision: Registration Against Title to the Shopping Centre

Landlord Position: The landlord's standard form of lease will typically include a provision which prohibits the tenant from registering (or allowing registration on its behalf) of any encumbrance against the landlord's fee interest in the shopping centre

Tenant Position: While this is generally acceptable to the tenant, there may be instances where, in order to secure its financing, the tenant's lender will insist upon registering a charge against all of the tenant's *leasehold* interests across the country

- This usually arises in negotiations where the tenant is a large, chain operation with a significant number of locations in Canada

Compromise Position: The landlord may permit the tenant's lender to register a security interest against the tenant's *leasehold* interest in the premises, but only so long as all three parties (i.e. the lender, the landlord and the tenant) execute a consent and acknowledgement agreement (for the purposes of this discussion, a "**Tri-Party Agreement**"), or other similar agreement, whereby the landlord consents to and acknowledges the lender's priority against the tenant's leasehold interest in the premises and the tenant's property that is located therein

- ***The landlord, however, will not generally allow the lender to register its charge against the landlord's fee interest in the shopping centre***
- In the event of tenant default (thereby permitting the lender to take possession of the premises), the Tri-Party Agreement should set out additional restrictions on the lender's rights such as:
 - *Notice:* The lender's right to enter the premises cannot be enforced without first providing notice to the landlord

- *Remedy of Default*: The landlord will generally require that the lender pay all arrears of rent and remedy any existing default under the lease before it is permitted to enter into or occupy the premises
- *Assignment*: The landlord may impose restrictions on the lender's ability to the assign the lease to a replacement tenant
 - The landlord may stipulate, among others, net worth and permitted use requirements, which must be satisfied by any proposed tenant
 - The landlord may also insist that the lender remain liable following any such assignment (the lender will always resist)

2. **The Lease Provision: Definition of "Transfer"**

Landlord Position: The definition of "Transfer" in the landlord's standard form of lease often includes reference to a mortgage, charge, lien or other encumbrance of the lease or the premises or of the tenant's personal property (i.e. trade fixtures, inventory, equipment and furniture) therein

- "Transfers", such as the one described above, will require landlord consent before initiating
- What this means is that the tenant will not be permitted to encumber its leasehold interest or personal property in the premises without first obtaining the landlord's approval

Tenant Position: The tenant will reject the landlord's attempt to control its ability to secure financing

- Without the landlord's consent to a leasehold mortgage, or the waiver of the landlord's right of distraint in respect of a general security agreement ("**GSA**") the Tenant may not be able to secure financing in respect of the costs associated with the development and construction of the premises.

Compromise Position: Leasehold Mortgage

- See "Compromise Position" in Section 1 above – *parties to enter into a Tri-Party Agreement*
- In exchange for its concession, and in addition to requiring the parties to enter into a Tri-Party Agreement, the landlord may demand additional consideration from the tenant – i.e. a security deposit or a letter of credit
- The landlord may hesitate in the delivery of its consent, but may ultimately recognize the leasehold mortgage as a means by which to sustain a viable tenant in an otherwise competitive and insecure market

Compromise Position: Chattel Mortgage

- This usually takes the form of a GSA granted in favour of the tenant's lender
- This will require that the landlord waive its right to distraint against the tenant's personal property
 - The landlord will prefer to postpone, rather than to completely waive its right of distress, thereby allowing it to seize the remaining tenant property following satisfaction of the lender's debt
- The landlord may agree to waive its right of distraint, but only so long as the lender agrees:
 - the lender's security interest will be limited to the tenant's personal property, and will not apply in respect of leasehold improvements (which, depending on their degree of affixation, may be considered landlord property);
 - the landlord will assume no responsibility in respect of the tenant's personal property – i.e. it will be the lender's obligation to ensure that the existence and value of same is protected; and
 - should the lender enter the premises in order to seize the tenant's property, certain conditions will apply – i.e. the period of occupancy will be defined explicitly, the lender must pay all arrears and all rent for the period during which it occupies the premises, and

the lender must agree to remedy any damage caused to the premises or to the shopping centre as a result of its occupancy thereof

Lease Amendment:

“Notwithstanding anything to the contrary contained elsewhere in this Lease, the Tenant may, without the Landlord's prior consent, but upon prior written notice to the Landlord...execute and deliver a mortgage, deed of trust, pledge and or collateral assignment of this Lease (a "Security Agreement") in favour of a bank, trust company, insurance company or other bona fide third party lender (a "Financier") as security for any indebtedness in any form whatsoever. The Landlord, however, shall not be required to subordinate its fee simple interest in the Leased Premises to any such Financier. In the event that the Tenant shall execute and deliver a Security Agreement, and if the Financier notifies the Landlord of the execution of such Security Agreement, and the name and place for service of notices upon such Financier, then and in such event, the Landlord hereby agrees for the benefit of the Tenant and such Financier from time to time:

- 1. that the Landlord will give to any Financier simultaneously with service on the Tenant a duplicate of any and all notices or demands given by the Landlord to the Tenant and no such notice shall be effective unless a copy is so served upon Financier.*
- 2. the Landlord shall not terminate this Lease or the Tenant's right of possession for any default of the Tenant if, within a period of fifteen (15) days after the expiration of the period of time within which the Tenant might cure such default, such default is cured or caused to be cured by Financier.”*

3. The Lease Provision: General Security Agreement (Granted in Favour of Landlord)

Landlord Position: The landlord's standard form of lease may also include a GSA provision, which gives *the landlord* (not the lender, as discussed in Section 2 above) a security interest in respect of the tenant's personal property located within the premises

- Typically, this provision will allow the landlord to seize and sell the tenant's personal property in the event of default under the lease
- Initially, at least, the landlord will insist upon the inclusion of the GSA provision as it purports to provide the landlord with an interest in the tenant's personal property should the tenant file for bankruptcy or otherwise engage in an insolvency process
- The landlord may take the position that this action confers on it the status of a secured creditor thereby increasing its chance of obtaining compensation in the event of tenant default

Tenant Position: The tenant will reject the inclusion of the GSA provision, as it will inhibit the tenant's ability to secure financing

- In order to obtain financing for its operations from a third party lender, the tenant will likely be required to grant the lender a first charge in respect of its personal property which will be registered under the *Personal Property Security Act* (the “*PPSA*”) and therefore have priority (and effectively render fruitless) the landlord's interest in that same property
- Furthermore, any agreement entered into between the tenant and the lender in respect of said financing will likely prohibit the tenant from granting any additional security interest in its personal property, without the lender's prior approval

Compromise Position

- See “Compromise Position” in Section 2 above – *Chattel Mortgage*
- The lender may agree to allow the tenant to grant the landlord a security interest in its personal property, but only so long as the landlord agrees:
 - not to register its interest under the *PPSA*;
 - to postpone its interest in the tenant’s property to any GSA granted in favour of the lender; and
 - to ensure that all documentation required to be executed in respect of any such financing remain subject to the lender’s approval

Example:

“The Tenant hereby grants to the Landlord a security interest (the “**Security Interest**”) in all inventory, fixtures, equipment, furniture and chattels of the Tenant situate on or about the Leased Premises from time to time (the “**Collateral**”) to secure the payment of all Rent payable pursuant to this Lease and the fulfillment of the other obligations of the Tenant under this Lease. The Tenant confirms and agrees that the Security Interest is complete and valid without the necessity of any other or further documentation in respect thereof and is intended to constitute a security agreement as defined in the Personal Property Security Act (Ontario), as amended (the “**Act**”). This security agreement is separate from and shall survive the termination, expiry, repudiation, disaffirmance or disclaimer of this Lease. Upon default by the Tenant of its obligations pursuant to this Lease, the Landlord shall be entitled at its sole option (and without any obligation so to do), to exercise any remedies available to it as a secured party under the Act in respect of the Collateral. The Security Interest is given in addition to, and not as an alternative to, and the rights and remedies afforded to the Landlord thereunder may be exercised by the Landlord without prejudice to any of the Landlord’s other rights and remedies under this Lease and at law including, without limitation, the Landlord’s right of distress. The Tenant covenants and agrees that all Collateral located on the Leased Premises from time to time shall be owned by the Tenant and except in the ordinary course of the Tenant’s business, the Tenant shall not at any time without the prior written consent of the Landlord, such consent not to be unreasonably withheld, dispose of all or any part of the Collateral.”

4. The Lease Provision: Construction Liens

Landlord Position: The lease provision dealing with construction liens in the landlord’s standard form of lease is often especially broad

- The landlord may draft this provision so that it not only restricts the registration of a construction lien but also restricts the registration of a charge or similar encumbrance against the tenant’s leasehold interest in the premises

Tenant Position: The tenant should be aware of this possibility and should negotiate specific exemptions from this restriction

Compromise Position: The tenant should be permitted to encumber its leasehold interest in the premises so long as, for instance, it is the tenant named in the lease and is not then in default under the lease beyond any applicable notice and cure period

- Both the landlord and the tenant should also be careful to ensure that the construction lien provision does not contemplate the registration of a lien against the landlord’s fee interest in the shopping centre
 - Construction liens, if registered at all, should encumber only the tenant’s leasehold interest in the premises

Example:

“Tenant to Discharge all Liens

The Tenant will ensure that no construction or other lien or charge, or notice thereof, is registered or filed against:

- (a) the Retail Component or any part of it;*
- (b) any interest in all or part of the Retail Component of the Landlord, the Mortgagee or the Head Landlord; or*
- (c) the Tenant's interest in the Leased Premises or any of the leasehold improvements in the Leased Premises;*

by any person claiming by, through, under or against the Tenant or its contractors or subcontractors. If such a lien or charge or notice thereof is registered or filed and the Tenant fails to discharge it within ten (10) days after written notice from the Landlord, the Landlord may discharge it by paying the amount claimed to be due into court or directly to the claimant and the Tenant will pay to the Landlord as Additional Rent on demand all reasonable costs (including reasonable legal fees) incurred by the Landlord in connection therewith, together with an administrative overhead charge of fifteen percent (15%) thereon.

So long as the Tenant is [insert legal name of Tenant] or a Permitted Transferee and is not in default under this Lease beyond any applicable notice and cure period herein contained, then notwithstanding anything to the contrary contained herein, except for any interest in this Lease, the Tenant shall be entitled to pledge, mortgage or otherwise encumber its assets in favour of a financial or other lending institution for the purpose of obtaining funds to be used to construct and/or carry on its business from the Leased Premises, provided such pledge, mortgage or other encumbrance does not derogate from the Landlord's rights under this Lease.”

5. The Lease Provision: Non-Disturbance Agreement

Landlord Position: Many commercial properties are encumbered by mortgages, and may become subject to subsequent mortgages, as the landlord finances the operation and continued development of its property

- When the landlord then enters into a lease with the tenant, the registered mortgage will have priority over the tenant’s leasehold interest in the premises
- The landlord’s standard form of lease will generally include a provision which acknowledges this arrangement, and requires the tenant to subordinate its leasehold interest in the premises to any present or future mortgage granted by the landlord, if required

Tenant Position: The tenant will have invested significant capital in establishing its business within the premises, and will want an assurance against possible eviction should the landlord default under its mortgage with the lender

- Accordingly, and before the tenant will agree to subordinate its leasehold interest in the premises, the tenant will request that the landlord obtain a non-disturbance agreement from the lender

Compromise Position: Most lenders will agree to enter into a non-disturbance agreement with the tenant

- The non-disturbance agreement, at a minimum, should provide that the lender will not disturb the tenant's possession and quiet enjoyment of the premises following any landlord default under the mortgage, but only so long as the tenant is not itself in default under the terms and conditions contained in the lease

CONCLUSION

The facilitation of tenant financing, while ensuring that the landlord's interest in the premises and the tenant's personal property remain intact, will evolve with greater ease where both the landlord and the tenant appreciate the needs and concerns of the other. The parties should be aware of the various constraints discussed above when negotiating the lease, and should utilize this knowledge to devise a compromise position which satisfies all stakeholders. Information which may not form part of the lease itself, such as an assurance as to where the funds obtained through tenant financing will be invested, may also be relevant when negotiating these provisions and should be communicated between the parties to the extent possible.