YOU ARE NOT ALONE IN A DEFAULT – THIRD PARTY INTERESTS IN COMMERCIAL LEASES

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There has been a lot written regarding a landlord's options and remedies upon the default of a tenant under a commercial lease. This paper explores the considerations to be given specifically to third parties at the time of default and potential termination.

In brief, a landlord's remedies stem from the commercial lease agreement, the *Commercial Tenancies Act, RSO 1990, c L.7* and the *Short Forms of Leases Act, RSO 1990, c. S.11*. As confirmed by the Supreme Court of Canada in *Highway Properties Ltd. v. Kelly, Douglas and Co. Ltd*., [1] following the delivery of any required notice of default provided for in the lease, a landlord's options are as follows:

1. Re-enter and re-let the premises,
2. Distrain against the assets of the tenant and/or sue for damages, or
3. Terminate the lease agreement and sue for damages.

If a landlord elects to distrain and if the completed distraint does not result in arrears of rent being satisfied in full, the landlord can proceed with a termination.

In general, upon exercising its right to terminate following a default, a landlord can demand that the tenant vacate the premises, and notify the tenant that it intends to sue for rent for the unexpired term of the lease.

[1] *Highway Properties Ltd. v. Kelly, Douglas and Co. Ltd*. [1971] S.C.R. 562. ("Highway Properties")

However, once a termination is effected, a landlord can no longer distrain against the assets of the tenant in order to satisfy the tenant's debt to the landlord. A landlord is required to provide the tenant with a reasonable opportunity to remove its assets from the premises.

An important factor to consider when terminating the lease is that a landlord has the duty to mitigate its damages. A landlord's right to sue for the remaining rent obligation is mitigated by a landlord's responsibility to take commercially reasonable efforts to find a new tenant for the premises to recover the loss in rental income. This includes the landlord's obligation to make reasonable expenditures in finding a new tenant such as advertising, repairing the premises, and hiring leasing agents, if necessary. However, the duty to mitigate does permit the landlord to sue the tenant for any months that the premises remain vacant and the landlord has taken reasonable steps to secure a new tenant. As may be further particularized in the lease, the landlord can also sue for the costs it has incurred to make repairs and replacements in the premises, its advertising, brokerage and solicitor costs, and the loss in revenue from any rent-free period inducements. In addition, the tenant will remain liable for any reduction in rent that the landlord obtains from the new tenant.

Quite apart from understanding these general rights which a landlord has against its tenants, different third parties may be impacted by a landlord exercising its rights. It is important to understand these impacts before exercising these remedies.

FRANCHISOR CONSIDERATIONS

Many operating businesses in the retail sector are subject to franchise agreements entered into between the operator and its franchisor granting specific rights to permit the business to operate.

Franchisors utilize various leasing strategies as part of their franchise model. The key consideration in this aspect of the model relates to the amount of "land control" the franchisor believes is important for it to have. Its level of control acceded to by its landlords will directly impact the default remedies available to its landlords. In part, as a result, sophisticated landlords develop their own policies for leasing arrangements they may permit when dealing with franchised businesses.

The most involved franchisor will enter into a head lease directly with the landlord and then either assign the lease to a franchisee or enter into a sublease with the franchisee. Although this strategy maximizes the franchisor's exposure to the landlord, it can maximize its control over the location. Practically speaking, upon a permitted assignment or sublease, the landlord may interact directly with the franchise operator related to the performance of the day to day obligations under the lease, including often in the payment of rent. As a result, franchisors often prescribe a right for them to receive notices of any defaults by their franchisees and to re-possess the premises before a landlord exercises its termination remedies.

A franchisor can take a less involved approach by allowing the franchisee to enter into a lease agreement directly with the landlord. In this event, a franchisor may still attempt to enter into an

option to assume agreement with the landlord that would permit the franchisor to assume the lease in the event of a default by the franchisee of either the lease agreement or the franchise agreement. Absent an option to assume, a franchisor does not have any contractual rights to operate in the leased premises.

It is important for landlords to appreciate that if a franchise agreement is terminated in the absence of a reassignment option or obligation, their tenants may have no right to continue on their businesses in the premises as a result of restrictive covenants in the franchise agreement. It is therefore advisable for a landlord to include as an event of default of the lease, a termination of the franchise agreement.

If a landlord is not comfortable with the franchisee's financial standing or business acumen, it may require that the franchisor guarantee or indemnify the landlord for the lease obligations of the franchisee, in whole or in part, for the whole term or for a period of time.

Whether the franchisor is the head tenant, an assignor, a guarantor or indemnifier of the lease or has assignment rights, the landlord will likely be required to provide a notice to the franchisor at the same time as it provides a notice to the franchisee of a default under the lease. As directed by the court in *Highway Properties*, the notice should provide a detail of the default and a time period, as specified in the particular lease documents to rectify same, and comply with section 19(2) of the *Commercial Tenancies Act*, where required. It should also stipulate that the failure to rectify the default may result in the landlord exercising its right to terminate the lease and sue for

damages incurred. Those damages may include unpaid rent to date, the cost to repair any damages, and the rent for the unexpired term.

Assuming that appropriate notice periods were provided and that no steps were taken to remedy the default, the landlord still has to consider the agreements it has entered into with the franchisor and franchisee before terminating the lease.

If the franchisor is a guarantor or indemnifier to the lease, the landlord should review the clauses in the lease and/or the guarantee or indemnity agreement that it has entered into with the franchisor. It is common for a landlord to insert a clause that, at the landlord's option, would require the franchisor to assume the tenant obligations under the lease or upon the landlord's termination of the original lease agreement, to enter into a new lease agreement. This clause ensures that the obligations of the franchisor survive the termination of the franchisee's interests in the premises.

If such a clause or agreement exists, the landlord will need to provide appropriate notice to both the franchisee, as tenant, and the franchisor, as the guarantor or indemnifier, pursuant to the lease and/or guarantee or indemnity agreement. The notice should include the potential recourse that the landlord will pursue against the franchisee and franchisor.

Franchisors will often try to negotiate provisions which will allow them a certain period of time to introduce a new franchisee into the leasing equation without being in default of any continuous use obligations.

Some franchisors have adopted a "tripartite" form of agreement to contain all of the obligations of all three parties in a single document. Those agreements can also provide for included or separate guarantee or indemnity obligations.

Upon terminating the lease, a landlord should not exercise remedies that are contrary to its agreements with the franchisor and franchisee. For example, if a landlord intends on enforcing a covenant in the guarantee or indemnity agreement requiring the franchisor to enter into a new lease agreement, the landlord should not take immediate possession and/or attempt to re-lease the premises to a third party. The British Columbia Court of Appeal in *365175 B.C. Ltd. v. Malamute Recreations Ltd. et al* [2] commented that if the landlord seeks remedies that are inconsistent with the remedies available to it in the guarantee agreement, it could serve to negate the guarantor's obligations under the guarantee agreement.

If the franchisor has terminated its franchise agreement, where the franchisee is the head tenant or assigned tenant, and the franchisor seeks a remedy available to it in any lease agreement to possess the premises, it would be advisable for the landlord to have originally obtained an indemnity from the franchisor for any claims that the franchisee may bring with respect to the possession of the premises and assets at the premises.

FRANCHISEE CONSIDERATIONS

As discussed above, a more involved franchisor will likely be the head tenant to a lease and will enter into a lease assignment or sublease with the franchisee. As part of this process, the landlord

[2] *365175 B.C. Ltd. v. Malamute Recreations Ltd. et al* 200 BCCA 293

will enter into a consent to the assignment or sublease. This consent creates a privity of contract between the landlord and franchisee.

A landlord should review the clauses in the consent document to ensure that it follows the appropriate default notice and termination steps. A landlord will likely be required to provide a notice to the franchisee at the same time that it provides a notice to the franchisor regarding defaults under the lease, as the franchisee may be entitled to remedy the defaults. A landlord will also likely be required to provide the franchisee with the notice of termination.

A landlord may also require the principal of a franchisee corporation to personally guarantee or indemnify in respect of the franchisor's obligations in a direct head lease scenario. The guarantee or indemnity agreement should prescribe what notices need to be given to the guarantor or indemnifier. Similar to our discussion above, if the guarantor or indemnifier has any residual rights upon default, the landlord should be careful to provide the notices to the guarantor or indemnifier and ensure that it does not pursue remedies that are contrary to those rights.

Franchisees have rights to rescind their agreements with their franchisors for certain breaches of the *Arthur Wishart Act (Franchise Disclosure), 2000* [3] and similar provincial legislation. Franchisees which exercise a rescission right against their franchisors nevertheless remain bound by their agreements with third parties, including landlords. A franchisee which rescinds its franchise agreement may seek to abandon its leased premises with impunity. Landlords should appreciate that notwithstanding the franchisee's exercise of their right of rescission, they may pursue their remedies against the franchisee. The franchisee will seek compensation from its

[3] *Arthur Wishart Act (Franchise Disclosure), 2000*, SO 2000, c3

franchisor for its exposure to the landlord and may seek to tie the landlord up while the landlord is seeking to enforce its remedies against the franchisee. A rescinding franchisee wants to ensure that its franchisor is the party that is ultimately responsible for the landlord's claims but the landlord may have no reason to want to await the resolution of any dispute between the franchisor and franchisee to realize on its remedies.

CANADA REVENUE AGENCY CONSIDERATIONS

In addition to considering the rights and responsibilities of the tenant and the special case of franchisors and franchisees, the landlord should consider the position of the Canada Revenue Agency (the "CRA"). If the tenant or subtenant is not paying its rent to the landlord, it may be the case that it is also not making the appropriate remittances to the CRA. For example, an operator is required to make remittances for amounts withheld from employees for income tax, employment insurance, and Canada pension plan contributions, in addition to sales taxes collected from customers.

If the operator fails to make these remittances, the CRA may have a claim against the assets in the leased premises. As previously mentioned, one of the remedies available to the landlord would be to distrain against the assets of the tenant. The problem with this remedy is that there is no guarantee that the CRA will not seek to recover the tenant's debt through the proceeds from the sale of the tenant's assets. According to the Ontario Superior Court in *The Attorney General of Canada v. Community Expansion Inc. et al.,* [4] in the event of a debt owed by the tenant to the federal government, the sale proceeds are considered to be held by the landlord in trust for the

[4] *The Attorney General of Canada v. Community Expansion Inc. et al.,* [2004] O.J. No. 5493, 136 A.C.W.S. (3d) 567 appeal dismissed by Ontario Court of Appeal [2005] O.J. No. 186, 137 A.C.W.S. (3d) 1241

federal government. This is further complicated by the fact that the court has stated that the CRA does not have to claim the debt owed prior to the asset sale for the trust to attach to the sale proceeds. Since the introduction of the HST, the federal government does not provide information to landlords for amounts owing by tenants.

As a result, it may not be worthwhile for the Landlord to go through the effort to distrain against the tenant's or subtenant's assets. The landlord may therefore find it preferable to proceed instead with the termination of the lease. As previously mentioned, the landlord is not entitled to the tenant's assets upon a termination of the lease. However, it should provide a notice to the CRA that assets of the tenant remain at the premises, and provide an opportunity for the CRA to collect the assets in satisfaction of any debts.

It is not uncommon for a landlord to want to terminate a lease in circumstances where it has a replacement tenant that would take the premises as is, in part, because of the leasehold improvements and assets of the tenant that may be situated in the premises. The landlord may find it in its interests to try to negotiate with a third party secured creditor of the tenant to secure the assets free and clear to enable it to convey those assets to a prospective tenant. In these circumstances, it is critical for the landlord to first ascertain if there are any outstanding liabilities of the tenant to CRA, as CRA would retain an interest in the assets notwithstanding the intended conveyance. It should be noted that any prospective new tenant in this situation will also be concerned by the possible outstanding debt to CRA as CRA often takes the position that a replacement tenant which effectively carries on the business of the previous tenant is somehow liable for the CRA debt of the previous tenant. This is a particular problem in the franchise

context where a franchisor seeks to install a replacement franchisee utilizing the assets of the former franchisee.

TRUSTEE IN BANKRUPTCY CONSIDERATIONS

If a tenant declares bankruptcy, it will limit the remedies available to the landlord. Upon the declaration of bankruptcy, the trustee in bankruptcy may seize control of the leased premises and the assets within, and assign the lease to a third party, despite any clauses in the lease agreement to the contrary. If this occurs, the landlord does not have the recourses against the tenant to either terminate the lease or distrain against its assets.[5] It only has a preferred claim for up to three months rent owing and up to three months rent due in the future (only if there is an accelerated rent clause). Further, the trustee in bankruptcy has three months to decide whether it intends to walk away from the lease agreement, or retain the lease for the whole or any portion of the unexpired term and/or assign to a third party.[6]

According to section 38(2) of the *Commercial Tenancies Act*, in exercising its right to assign the lease, the trustee is not obligated to honour any restrictive use clauses in the lease agreement.[7] However, the Ontario High Court of Justice in *Micro Cooking Centres (Canada) Inc. (Trustee of) v. Cambridge Leaseholds Ltd.*,[8] opined that the restrictive uses clauses are fundamental to shopping centre leases, where merchandise mix is important. As such, a landlord of a shopping centre may have reasonable grounds to deny an assignment to a particular third party if the

[5] *Peat Marwich Thorne Inc. v. Natco Trading Corp. (1995),* 22 O.R. (3d) 727, 31 C.B.R. (3d) 119
[6] *Commercial Tenancies Act*, RSO 1990, c L.7 s. 38, 39
[7] *Commercial Tenancies Act*, RSO 1990, c L.7 s. 38
[8] *Micro Cooking Centres (Canada) Inc. (Trustee of) v. Cambridge Leaseholds Ltd. (1988*), 68 C.B.R. (N.S.) 60 referred to in *Dylex Ltd. (Trustee of) v. Westwood Mall (Mississauga) Ltd.,* [2001] O.J. No. 5021 (Ont. H.C.J.).

intended use by the third party is contrary to the restrictive use clause in the lease. Further, a lease can only be assigned if the landlord is paid up to date on rent.

According to the *Bankruptcy and Insolvency Act* (the "*BIA*"), a tenant on the cusp of bankruptcy may elect to retain a trustee in bankruptcy to submit a proposal or a notice of the tenant's intention to submit a proposal.[9] A proposal is a compromise offered to the tenant's creditors for the satisfaction of the tenant's debts. By submitting a proposal or an intention to submit a proposal, the tenant benefits from a temporary stay of proceedings, preventing any creditor from initiating further proceedings against the tenant. [10] This temporary stay of proceedings includes the right of the landlord to terminate the lease agreement.[11]

In the course of a proposal, the tenant may disclaim a lease upon providing 30 days' notice to the landlord.[12] The landlord has the option to object to a proposed disclaimer by applying for a court declaration that the lease is not to be disclaimed. The court will grant the declaration unless it is established that the declaration would affect the debtor's ability to make a viable proposal to its creditors.[13] If the tenant successfully disclaims the lease, the landlord is not entitled to accelerated rent. However, the landlord will be entitled to compensation according to the terms of the proposal, which is prescribed in the *BIA*.[14]

[9] *Bankruptcy and Insolvency Act,* RSC 1985, c B-3 s. 50
[10] *Bankruptcy and Insolvency Act,* RSC 1985, c B-3 s. 69
[11] *Bankruptcy and Insolvency Act,* RSC 1985, c B-3 s. 65.1 (2)
[12] *Bankruptcy and Insolvency Act,* RSC 1985, c B-3 s. 65.2
[13] *Bankruptcy and Insolvency Act,* RSC 1985, c B-3 s. 65.2
[14] *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 s. 65.2 (4)

If a landlord believes that a tenant is on the cusp of bankruptcy, and it has defaulted under the lease agreement, it may be prudent to take steps to terminate the lease agreement immediately. However it must be careful to consider the rights of a subtenant. For example, if the tenant becomes insolvent, section 39 (2) of the *Commercial Tenancies Act* would permit the subtenant to take the place of the head tenant.[15] This would only apply if the landlord has originally approved or provided its consent in writing to the sublease. In this case, the landlord does not have the option to terminate the lease upon the insolvency of the tenant. In exercising this right, the subtenant must make the landlord whole in respect of any defaults by the tenant.[16]

Landlords often seek as an inducement to enter into an agreement with a tenant, a security over the assets of the tenant to secure the tenant's obligations under the lease. In the event of the tenant's bankruptcy and subsequent disclaimer of the lease, landlords are not able to enforce their security interests over the tenant's assets for claims that they will have against the tenant. As a result, landlords often obtain guarantee or indemnity agreements from third parties, securing the tenant's obligations under the lease. It is preferable for a landlord to enter into an indemnity agreement as opposed to a guarantee agreement. The courts have found that a guarantor is liable for the obligations of a tenant existing at the time that the lease is disclaimed but not after. By contrast, an indemnifier is liable for all rent obligations existing after the lease is disclaimed.

[15] *Commercial Tenancies Act,* RSO 1990, c L.7 s. 39
[16] *Golden Griddle Corp. v. Toronto (City), 1997* 33 O.R. (3d) 545

COMPANIES CREDITORS ARRANGEMENTS ACT PROCEEDINGS

An insolvent tenant may elect to proceed under the *Companies Creditors Arrangements Act*.[17] This election is available to debtors which have at least $5 million in debt. Similar to the proposal in the *BIA*, it creates a stay of proceedings against the debtor's creditors.[18] In this case, the tenant with the assistance of a court appointed monitor, presents a plan of arrangement to its creditors in satisfaction of its debts.[19]

In this process, the tenant has the ability to disclaim its lease agreements.[20] However, while it remains in occupation of the leased premises, it is obligated to continue with its rent obligations under the lease. In addition, the insolvent tenant cannot assign the lease unless the terms of the lease agreement permit an assignment. Likely this will mean that an insolvent tenant will have to be in good standing with the landlord, including being current on the payment of rent, before the landlord will consent to an assignment. Generally in the course of restructuring, the insolvent tenant cannot amend any of the terms in the lease and operate in a fashion that is inconsistent with the terms of the lease.[21]

LENDER AND SECURED SUPPLIER CONSIDERATIONS

As mentioned previously, one of the options available to a landlord upon the default of a tenant is to distrain against the assets of the tenant located at the premises, instead of terminating the lease. Section 31 (2) of the *Commercial Tenancies Act* stipulates that a landlord can distrain

[17] *Companies' Creditors Arrangement Act*, RSC 1985, c C-36
[18] *Companies' Creditors Arrangement Act,* RSC 1985, c C-36 s.11.02
[19] *Companies' Creditors Arrangement Act,* RSC 1985, c C-36 s. 4 and 5
[20] *Companies' Creditors Arrangement Act,* RSC 1985, c C-36 s. 32
[21] *Re T. Eaton Co. (1999),* 12 C.B.R. (4th) 130 (Ont. S.C.J.).

against the goods and chattels of any person who is liable for the rent, being either the tenant (including an occupier with the tenant's consent), the subtenant or guarantor.

However, this section further states that the landlord has the right to distrain against assets even when certain third parties have an interest in the assets.[22] This list includes an execution creditor, a person whose title to the assets is derived from a transfer or assignment from the tenant, a chattel mortgagee, a secured party, a debenture holder, a conditional sales vendor, and any relative of the tenant. [23]

While the tenant remains solvent, the landlord has a priority over the assets held by the tenant at the premises. However, should a secured creditor such as a bank, chattel mortgagee, franchisor or supplier that has registered a security interest in the tenant's assets, realize that the landlord is considering or is in the course of levying distress against the tenant's assets, the secured creditor may put the tenant into bankruptcy. Upon bankruptcy, the rights of the parties are reversed and the secured creditors have priority over the landlord unless the distress was previously completed.

SUPPLIER CONSIDERATIONS

A tenant may have assets at the leased premises that are subject to conditional sales contracts. This means that a supplier has provided assets or goods to a tenant, whereby title does not pass to the tenant until the goods are paid in full. The landlord has the right to distrain against those goods but only to the extent that the tenant has paid for those goods. If the tenant has paid for

[22] *Commercial Tenancies Act,* RSO 1990, c L.7 s. 31 (2)
[23] *Commercial Tenancies Act,* RSO 1990, c L.7 s. 31 (2)

half of the purchase price, the landlord has the right to distrain to a value of half of the goods (if that is an option) or in the alternative, distrain against the entirety of the goods upon first paying the balance of the amount owing to the supplier. If the landlord pays for the balance to the supplier, it may add this amount to its claim for rent arrears.

A tenant may also enter into leases for its equipment at the premises. There is one type of equipment lease whereby the owner leases the equipment to the tenant for a specified term but the tenant does not have the option to purchase or acquire the equipment at the end of the term. The landlord does not have the option to distrain against this type of equipment and the owner of the equipment (the "equipment lessor") is not required to register a security interest in the equipment. The second type of equipment lease permits the tenant to purchase the equipment for a fixed price at the end of the lease term. The equipment lessor is required to register a security interest in this type of equipment in order to protect its interest. The landlord may distrain against this type of equipment to the extent of the tenant's equity in the equipment. However, before the landlord sells the equipment, it must first assume the lease payments or pay off the balance of the amount owing.

An issue that arises upon distraint is the distinguishing features between these two types of leases. It may not be evident that the equipment is in fact leased or what type of leasing arrangement the tenant entered into with the equipment lessor. The landlord takes a risk upon distraining on equipment that it will receive a claim from an equipment lessor that the sale of the equipment to a third party was improperly taken.

With respect to bankruptcy, a supplier has a preferred claim for the goods supplied to the tenant. This claim is superior to the claims of third parties, including the landlord. In order for a supplier to have a preferred claim, the supplied goods must have been delivered within 30 days prior to the tenant's bankruptcy, must not have been comingled with the tenant's other goods, must be in the same state as upon delivery, and not have been sold to an arm's length third person. The supplier has 15 days to deliver the required notice to the trustee in bankruptcy.

CONCLUSION

The remedies provided for in a commercial lease or the *Commercial Tenancies Act* upon default of a tenant must always be exercised with an assessment of which third parties exist, what interest they may have in the premises or the assets upon the premises, where their interests rank in priority depending on the course of action adopted and what steps they may likely pursue to protect those interests.