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BARRISTERS & SOLICITORS

"Help - My Tenant Notified Me that it is Granting a Security Interest- What do I do?

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INTRODUCTION

This paper is intended to assist in understanding the implications to a landlord of a tenant's lender taking security in various different types of property that might be owned by the tenant, to be referred to whenever a tenant or secured party notifies the landlord that the tenant's property has been secured, and/or requests the landlord's consent to the granting of a security interest in the tenant's property.

Whenever a landlord receives such a notice or request, it will be important to consider whether there is anything the landlord should do or state in response to the notice or request, in order to preserve whatever priority the landlord may have (under the lease or the general law) with respect to the property that is the subject of the security. Other materials submitted by Stuart LeMesurier and Jennifer Babe in connection with this session of the 1999 ICSC Canadian Law Conference explain in greater detail the priorities that a landlord may have with respect to certain types of property held by the tenant. This paper is geared toward understanding the manner in which a landlord must act in order to maintain its priorities, when the landlord receives a written notice or request for consent from a tenant's lender.

I have structured this paper in three segments:

(1) A general discussion about the various types of security that a tenant may grant and the implications to the landlord of each;

(2) A discussion of the various types of "mere notices" of the lender's security interest that a landlord might receive and the implications to the landlord of each; and

(3) A similar discussion as in (2) above with respect to lenders' requests for consent.

This paper is not intended to be exhaustive nor to provide a pat answer to every question that may arise in the context of a tenant granting security in its property. A notice of the granting of security by a tenant, or a request for the landlord's consent to the granting of security by a tenant, may take a different form, affect a different type or combination of types of property, or describe a different type or types of security than are examined in this paper.

IN WRITING THIS PAPER I HAVE ATTEMPTED TO RECOGNIZE THAT MANY, IF NOT MOST, OF THOSE WHO WILL ACTUALLY READ IT ARE NOT LAWYERS BUT PERHAPS LAW CLERKS OR LEASING MANAGERS FOR VARIOUS CANADIAN LANDLORDS. I HAVE THEREFORE TRIED TO AVOID THE USE OF LEGAL TERMINOLOGY, AS MUCH AS POSSIBLE, AND TO AVOID THE TENDENCY TO ASSUME THAT CERTAIN THINGS ARE KNOWN. AS A RESULT, THIS PAPER IS MORE OF A "BASIC" THAN AN "ADVANCED" VERSION.

TENANTS' SECURED TRANSACTIONS GENERALLY

Tenants require funds to finance their business undertaking. Tenants make financing arrangements both when their business is first launched and throughout the life of the business as its financing needs change. Sooner or later a tenant will find itself before a banker requesting financial backing to carry on its business. Bankers invariably ask the tenant to put up some collateral as security against the tenant defaulting under the loan.

The tenant may offer collateral in the form of inventory, book debts, furniture, equipment, fixtures, leasehold improvements, its title to (the leasehold interest in) the Leased Premises or the Lease, or all or a combination of these items. A landlord does not necessarily approve of having these items collateralized (or "secured" or "encumbered").

The tenant does not own free and clear title to the Leased Premises themselves, or to all the items that have been installed as improvements or fixtures in the Leased Premises. Rather, the Tenant's interest is subject to the interest that the landlord has by virtue of being the owner of the Shopping Centre and as a result of specific terms of the Lease. As a result, any such security interest granted by the tenant to its banker will compete with the landlord's rights. In an ideal world, a landlord would never be concerned with the possibility that a tenant's banker may one day seize from the Leased Premises and sell a piece of HVAC equipment, some plumbing installations, or shelving. Moreover, in an ideal world a landlord would never find itself entangled with a banker who had seized the entire store and business undertaking of the tenant and was continuing to carry on the business with a view to selling the store as a going concern. However, landlords must contend with the real world in which, as a result of tenants' failed financing arrangements, banks routinely assert claims to property in which the landlord claims a higher form of ownership. The landlord must do what it can to protect its property to the maximum extent possible.

The tenant may own free and clear title to items in the Leased Premises that are not in any way affixed to the Shopping Centre (such as furniture and inventory), but the landlord will have a claim to these goods if the tenant fails to pay rent. The landlord's claim consists of the distraint right to seize the tenant's goods and sell them to satisfy any unpaid rent. If the goods to be distrained against represent collateral for a bank loan to the tenant, the landlord's right to distrain will in some cases compete with the bank's right to seize the goods for arrears of loan payments. Again, the landlord must do what it can to protect its rights to the maximum extent possible.

Some forms of security that the tenant may grant to a bank are so strong as to defeat virtually any claim that a landlord may assert. Other forms of security will be strengthened if they are consented to by the landlord, or possibly if the landlord is notified of them and does not communicate any objection. Accordingly, it is important to understand (1) the various types of security that a tenant may grant to a lender, (2) the implications of a landlord receiving notice of the tenant granting security, and (3) the consequences of the landlord consenting, not consenting, or not replying thereto.

I. TYPES OF SECURITY A TENANT MAY GRANT

(a) Security over Leasehold Improvements/Leasehold Interest

The law recognizes that the owner of real property (a landlord) is entitled to claim ownership in anything that is so permanently affixed to the real property as to be a part of it. However, the law also recognizes that lessees of real property have some sort of an interest in the property that they lease, including the items permanently affixed thereto. As a result, owners (landlords) and lessees (tenants) have overlapping property rights with respect to the leased property. Although the landlord's property rights are greater, or higher, than those of the tenant, the tenant's property rights are not inconsequential. A lender may be interested in having a tenant's property rights as collateral for any loan it makes to the tenant, because there may be value in the tenant's property rights. A lender may wish to realize upon (i.e. take unto itself, to enjoy itself or sell to another) those property rights if the tenant defaults under the loan.

In the industry, leasehold improvements are generally regarded as items installed in the Leased Premises that are so permanently affixed as to form a part of the building or property. Leasehold improvements are not readily removable without damage. HVAC equipment, plumbing, electrical service and distribution, most floor coverings, suspended ceilings and built-in lighting, are usually considered to be leasehold improvements. At law, the term "Leasehold Improvements" does not necessarily carry much significance. More about that later. The point is, sometimes lenders wish to have rights to realize on leasehold improvements and so they will seek security in them.

(i) <u>The Tenant's Leasehold Interest</u>

Even though the tenant is not the "owner" (in lay terms) of the Leased Premises, the tenancy created by the Lease entitles the tenant to certain property rights which import certain legal rights and obligations. The owner of the Shopping Centre owns what has historically been referred to in law as a "freehold interest" in the lands and all the buildings and improvements erected on the lands which together comprise the Shopping Centre. The tenant of a part of the Shopping Centre owns what is referred to in law as a "leasehold interest" in the part leased. The Leased Premises include the boundaries of the Leased Premises and everything that is so permanently affixed thereto as not to be readily removable without damage (i.e. the Leasehold Improvements).

In other words, the tenant owns a leasehold interest in the Leased Premises, which are comprised of the outer shell of the Leased Premises and the Leasehold Improvements. The landlord owns a freehold interest in the Shopping Centre, including the Leased Premises and the Leasehold Improvements. The landlord's and tenant's property interests overlap, with the Landlord having the greater, or higher, set of property rights over the tenant.

The tenant's leasehold interest arises under the Lease. The tenant may agree to secure either its leasehold interest in the Leased Premises, or the Lease itself, in favour of its lender. For all intents and purposes, these two concepts are identical.

The most typical scenario for a tenant securing its leasehold interest in leased premises is one where the tenant owns a large chain of stores and it seeks credit from its lender. The lender will agree to advance the funds with a scheduled repayment plan on the condition that the lender acquires the right to take over the tenant's stores if it fails to make the scheduled repayment to the lender as required. Thus, the tenant grants security over its leasehold interest in the Leased Premises to its lender. (This transaction is essentially the same thing as assigning the Lease to the lender on the condition that the lender cannot actually take possession of the Leased Premises and enjoy the tenant's rights and obligations under the Lease unless and until the tenant defaults under its loan from the lender.) While it is common that this type of arrangement is entered into by large chain retailers, it can also be put in place for a single location.

The landlord has cause for concern if this type of arrangement is made, because the existence of the lender's security subjects the landlord to the possibility that the lender might one day take over the Leased Premises and assume the rights and obligations of the tenant under the Lease. Since the Landlord carefully hand-selects its tenants to ensure that it has a proper tenant mix in its Shopping Centre, and ensures that each lease contains a tightly-worded Transfer clause designed to protect the landlord from tenants assigning their leases to operators who lack the necessary qualifications to be in the Shopping Centre, the landlord will generally be displeased with the prospect of having a lender carrying on the Tenant's business in the Leased Premises. "After all", the landlord's leasing representatives and mall managers will say, "what does a bank know about running a retail operation?"

While it may be true that a lender in the business of providing financial assistance to businesses does not always have the necessary qualifications to operate a business which it has financed, sophisticated Canadian banks usually appoint sophisticated receiver/managers to operate businesses that they seize to satisfy unpaid loans. More often than not the presence of the receiver/manager in the Leased Premises can be an improvement over the shoddy operation that caused the tenant to default on its loan arrangements.

However, it is also possible that a lender will realize upon the security it holds (which in all likelihood includes not only the Leased Premises but also all of the contents - i.e. inventory, furniture, equipment), with a view to carrying on a liquidation sale to clear out as much merchandise as possible for cash, and then abandoning the Leased Premises.

Or, on the other hand, a lender may seize the Leased Premises and carry on the business for awhile with a view to selling the business as a going concern. This would entail yet another operator of the business entering the Leased Premises, and the landlord may or may not get a real opportunity to consider whether it approves of the new operator.

A lender's loan/security agreement with the tenant/borrower may contradict the terms of the Lease. For instance, the loan agreement may provide that after seizing it, the lender may sell the business carried on in the Leased Premises to whomever it sees fit, whereas the Lease will provide that no Transfer of the tenant's business may take place without the landlord's prior approval. Or, the Lease may provide that each party has the necessary authority to enter into the Lease and any amending agreements, but unbeknownst to the landlord, the security agreement may restrict the tenant from modifying the terms of the Lease in any way without obtaining the prior approval of its lender.

During a lender's occupation of the Leased Premises, it may decide not to pay rent or observe or perform other covenants of the tenant under the Lease, such as the obligation not to conduct a liquidation sale.

All of this could have a very harmful effect on the landlord and the other tenants of the Shopping Centre.

A lender is under no obligation to give a mere notice to a landlord of its security over the Lease or the tenant's leasehold interest in the Leased Premises. The tenant, on the other hand, is usually required under the terms of a typical commercial lease to notify the landlord, since such a transaction usually constitutes a Transfer within the meaning of the Transfer provisions of the Lease. Many landlords' standard lease forms do not permit the tenant's leasehold interest in the Leased Premises, or the Lease itself, to be encumbered. Moreover, if a lender enforces its rights under the security agreement and takes possession of the Leased Premises, most typical commercial leases will deem the tenant to be in default, and the landlord may terminate the Lease immediately.

As a result, lenders will often combine forces with their borrowers (the tenants) and together they will notify the landlord of the lender's taking of security in a tenant's leasehold interest or in the Lease itself. Lenders and tenants will ask for the landlord's consent to the security, and lenders will seek assurances that if they exercise their rights to realize upon their security by taking possession of the Leased Premises, the landlord will not take any action to disturb their possession, nor will the landlord stand in the way of the lender's attempts to find a buyer for the business in the Leased Premises.

(ii) Leasehold Improvements

Sometimes a tenant will grant security over all of the Leasehold Improvements instead of over its leasehold interest in the Leased Premises (of which, as was mentioned above, the Leasehold Improvements form a part). The tenant may have spent a considerable amount of money in improving its store, and its lender may wish to have the improvements as security for a loan since they may be of great value (this is especially true of restaurants). The lender may not be interested in having security over the tenant's leasehold interest in the entire Leased Premises since it may have decided that it will never want to take possession of the Leased Premises and carry on the business until it can be sold as a going

concern. Although the sale of the business as a going concern would usually bring the greatest return, it will require the lender to incur some expense in operating the business and, if the leasehold improvements alone are very valuable, the lender may be content to have the right to remove them from the Leased Premises and then sell them.

Even if the tenant installed all of the leasehold improvements at its expense, most standard forms of shopping centre leases provide that upon their affixation to the Leased Premises, leasehold improvements become a part of the real property and thus they are part of the landlord's freehold. Even as a matter of general law (if there is no signed lease), items that are permanently affixed to the Leased Premises (legally known as "fixtures") become part of the realty upon affixation. The result is that all that the tenant owns with respect to the Leasehold Improvements is a leasehold interest therein. Although technically and conceptually the Leasehold Improvements and the tenant's leasehold interest are distinct and represent different forms of collateral for a bank, in practical terms the differences may have no impact on the issues confronting the landlord.

Technically, the difference is that if a tenant grants security over the Leasehold Improvements (even though it can only secure its leasehold interest in those Leasehold Improvements, because that is all that it owns), then all that the lender may ultimately realize upon in the event the tenant defaults under the loan agreement is the Leasehold Improvements (subject to the Landlord's freehold interest therein). What this means is that if the tenant defaults under the loan agreement, the lender may seek to take possession of the Leasehold Improvements. But the lender would not have any right to be in possession of the Leased Premises, since that right arises under the Lease and without having secured that right (i.e. the tenant's leasehold interest in the whole of the Leased Premises), the lender would not be able to "seize" it. It would simply be seizing the Leasehold Improvements. (By the same token, the lender realizing upon leasehold improvements only and not the tenant's leasehold interest in the Leased Premises would not by doing so take on any corresponding obligation to perform the tenant's covenants under the Lease.)

In other words, a security interest in the Leased Premises (or in the tenant's interest therein or in the Lease itself) is a charge over the tenant's leasehold interest in the Leased Premises and, when realized upon by the lender, will permit the lender to possess the Leased Premises (including the Leasehold Improvements) as if it were the tenant. A security interest in the Leasehold Improvements alone will not carry with it that right to take possession of the Leased Premises, but will only permit the lender to seize the Leasehold Improvements themselves.

Most landlords are just as concerned with security over the Leasehold Improvements being granted, since upon affixation, they become the property of the landlord. The tenant enjoys only a leasehold interest in the Leasehold Improvements. At the end of the Term of the Lease, the tenant is required to vacate the Leased Premises and leave the Leasehold Improvements behind. Clearly, a landlord would not want to permit the tenant's lenders to remove HVAC equipment, plumbing and electrical service and distribution, floor coverings,

suspended ceilings, or built-in lighting from the Leased Premises at any time. That would be particularly offensive in a situation where the landlord provided turn-key premises, or paid the tenant a construction allowance in order to build its store. Moreover, a landlord would not wish to terminate the lease for a rent or other default by the tenant and then be subjected to a claim by the tenant's lender that the Leasehold Improvements were not permitted to be leased in connection with a new lease by the landlord to a new tenant, because the lender as a secured party enjoyed a higher right than the landlord's with respect to the Leasehold Improvements.

A lender is under no obligation to give a mere notice to a landlord of its security over leasehold improvements. The tenant, on the other hand, will usually have to give some form of notice to the landlord since the Lease may not permit Leasehold Improvements to be encumbered. Some lenders do make it a practice to notify landlords of their taking of security in respect of a tenant's leasehold improvements. Lenders and tenants will often ask for the landlord's consent to the security, or for the Landlord to subordinate any rights it may have in the Leasehold Improvements to the lender's rights to realize upon them. The next discussion concerning security interests in fixtures, explains why.

(b) Charge on Fixtures, Equipment, Furniture, Inventory

Many of the other items installed, kept or used by a tenant in the Leased Premises will also have value and be of interest to a lender seeking to encumber property as collateral for its loan to the tenant/borrower.

(i) Fixtures

Usually, a tenant will have installed a point-of-purchase counter, some display counters, shelving, wall racks or units, suspended or wall-mounted light fixtures, and/or other items which it requires in order to carry on its trade. These items, since they require some degree of affixation, are referred to as "fixtures". In the industry and jurisprudence, the term "fixtures" is often divided into two types of fixtures: those that are now most commonly referred to as Leasehold Improvements, and those that are now most commonly referred to as "trade fixtures". Trade fixtures are generally considered to be fixtures that are not so permanently affixed as to become part of the land. They are distinguished from fixtures/Leasehold Improvements by virtue of the fact that they may be readily removed from the Leased Premises without damage. Recent case law (addressed in Jennifer Babe's paper) has all but done away with this distinction for the purposes of considering a landlord's and tenant's lender's competing claims to fixtures within Leased Premises, but the terminology is still used in lease arrangements and in three-party agreements between landlords, tenants and their lenders.

If a tenant or its lender were to contact a landlord and request its consent to a charge over the tenant's "fixtures", and the landlord consented, the implications could be far-reaching. Section 34(1)(b) of the Personal Property Security Act (Ontario) has the effect of giving a

tenant's lender priority over a landlord's right to ownership of fixtures installed by the tenant, where (1) the tenant first installed the fixtures and then granted a security interest to its lender and (2) the landlord consented to the security being granted.

A lender is under no obligation to give a mere notice to a landlord of its security over a tenant's fixtures. Some lenders nevertheless make it a practice to notify landlords of their taking of security in respect of a tenant's fixtures. However, lenders will often ask for the Landlord's consent to the security in order to obtain the priority offered by Section 34(1)(b) of the PPSA.

(ii) Equipment

Equipment owned and used by a tenant in connection with its business is very likely to be secured in one way or another. Unless the equipment is in some way affixed to the Leased Premises (in which case the equipment would be characterized as a fixture), it is simply property of the Tenant in respect of which the Landlord has a right to distrain if the Tenant falls into arrears of rent.

There are certain types of security agreements which provide that the title to (or ownership of) the equipment does not pass to the tenant until the loan is paid in full. In those cases it is possible that the landlord will not enjoy a right to distrain against the equipment until the day it becomes the property of the tenant. It may, however, have a right to distrain against the tenant's equity in the equipment.

However, a charge or encumbrance over the tenant's equipment is not something the Landlord can realistically prevent, and in any event (apart from such "title retention" security agreements), if the Tenant fails to pay rent and the Landlord wishes to distrain against the Tenant's equipment, it may in certain cases gain priority over a lender holding a security interest in the equipment by exercising its right to distrain.

A lender is under no obligation to give a mere notice to a landlord of its security over a tenant's equipment. Some lenders nevertheless make it a practice to notify landlords of their taking of security in respect of a tenant's equipment.

(iii) Furniture

Usually furniture is not in any way affixed to the Leased Premises and the landlord can be fairly sure that a lender's proposal to secure the tenant's furniture in the Leased Premises will not entail any sort of analysis as to whether the furniture comprises any sort of "fixtures". Furniture owned by the tenant is almost always a chattel, and if the tenant encumbers it in favour of a lender then the same considerations apply as are expressed above regarding equipment.

The landlord's only concern will be as to the nature of the security agreement. If the security is in the form of a "title retention" agreement, then the landlord will not enjoy a right to distrain against the furniture until the tenant has fully repaid the loan, although it may be entitled to distrain against the Tenant's equity in the furniture. If the security agreement is not in the form of a "title retention" agreement (e.g. it is in the form of a chattel mortgage or a general security agreement), then the landlord will be entitled to distrain against it; if it does so before the lender seizes the furniture pursuant to the security agreement, it will defeat the lender's claim (unless a bankruptcy of the tenant subsequently ensues within one year). (Note that in Saskatchewan the landlord-and-tenant legislation takes a different approach and protects lenders who have taken Purchase Money Security Interests (PMSI's) in chattels from a landlord's distraint right.)

A lender is under no obligation to give a mere notice to a landlord of its security over furniture owned by a tenant. Some lenders nevertheless make it a practice to notify landlords of their taking of security in respect of a tenant's furniture.

(iv) Inventory

Inventory (also known as stock-in-trade in some security agreements) is a chattel located in the Leased Premises, and the landlord's right to distrain should not be affected by a charge over inventory granted by the tenant in favour of a lender. Under the Execution Act (Ontario), inventory may be exempt from distress. However, most sophisticated commercial lease forms state that the tenant waives the exemption and that none of the tenant's inventory is exempt from distress.

As a result, the landlord's greatest concern will be as to the nature of the security over the inventory. Generally speaking, unless security over inventory is taken by a lender as part of a package of security provided by the tenant/borrower (which would include any or all of the Lease, the tenant's leasehold interest in the Leased Premises or the tenant's fixtures, equipment and furniture), most often a lender taking security over inventory alone is a bank taking security pursuant to Section 427 of the Bank Act. Sometimes, but rarely, a consignment of inventory is the route a secured creditor will take and consigned goods clearly do not belong to the tenant and cannot be distrained against by a landlord.

In sum, the landlord's rights will generally depend on the nature of the security over the inventory. Unless the security is in the form of a Section 427 Bank Act security, or is actually a consignment, the general rule of "race to the swiftest" applies to the priorities as between a landlord's right to distrain and a secured creditor's right to realize upon its security. If the landlord distrains on the inventory before the lender realizes upon its security, the landlord will defeat the lender's claim (unless the tenant's bankruptcy ensues within one year).

A lender is under no obligation to give a mere notice to a landlord of its security over inventory. Some lenders nevertheless make it a practice to notify landlords of their taking

of security in respect of a Tenant's inventory, especially when the security is granted under Section 427 of the Bank Act (which is more commonly done in Quebec financing arrangements than in the common law provinces).

(c) Section 427 Bank Act Security

This type of security applies only to inventory and its packaging. It may also cover accounts receivable generated from the secured property. It does not apply to fixtures, equipment or furniture, or the Leased Premises themselves. The granting of a S.427 Bank Act security interest does not give the bank any interest in the Lease, the Leased Premises or any fixtures, equipment or furniture, nor does it give the bank any right to occupy the Leased Premises.

If the tenant defaults under its loan agreement with the bank and fails to pay rent under its lease with the landlord, then the priority as between the landlord and the bank will automatically be that the landlord's distress right will have priority over the bank's Section 427 security to the extent only of the arrears of rent which existed on the day the Bank Act security was given. The bank's security will automatically take priority over the landlord's distress right for all arrears of rent accruing after the Bank Act security was given.

As a result, if the arrears existing as of the date the Bank security is granted are ultimately paid up by the tenant, then the landlord will thereafter have no right to distrain against any of the tenant's inventory unless and until the Section 427 Bank Act Security no longer applies.

Any bank that obtains Section 427 security must file a notice of the security with the Bank of Canada. In so doing it automatically protects its priority over any landlord of the tenant with respect to the secured property for arrears of rent accruing after the security is given.

The bank is under no obligation to give notice to a landlord of its Section 427 security. Many banks nevertheless make it a practice to notify landlords of their taking of a Section 427security in respect of a tenant's property.

II. TYPES OF NOTICES A LANDLORD MAY RECEIVE

(a) Notice of Security over Leasehold Improvements (a.k.a. Fixtures) / Leasehold Interest

As mentioned earlier, a lender holding security over the Lease or the tenant's leasehold interest in the Leased Premises or the Leasehold Improvements is under no obligation to give notice to the landlord of its security. However, sometimes a lender may give such notice in connection with a request for the landlord to subordinate its rights to the lender, or together with a request for consent to the granting of security, or it may even give a notice purporting to assert rights that would prevail over the landlord. In this section of my paper, the discussion is confined to the implications of receiving only a notice, and not a request for the Landlord's consent.

(i) The Tenant's Leasehold Interest

If a landlord receives a notice from a lender or a tenant of the recent or future granting of security over the Lease or the tenant's leasehold interest in the Leased Premises, no legal advantage to the lender or the tenant results. However, the notice should not be ignored or simply filed away. The first step is to review the Lease to ascertain whether such a grant is permitted. If the Lease has been amended to provide that the Tenant may grant such security, then it may not be necessary to provide any response. On the other hand, it may be an appropriate response to the notice to inquire as to whether any pre-conditions to the granting of such security without consent (which pre-conditions would be expressed in the Lease) have been satisfied. In other words, it may be necessary to seek more information as to the details of the transaction in order to ensure that the type of transaction taking place is indeed one which the Lease permits. The Lease may provide that such an encumbrance is permitted, but only if it is in connection with a bona fide financing transaction of the whole of the tenant's business undertaking, and/or only if it takes place with a particular financing institution or type of financing institution. The Lease may provide that the form of the financing documentation is subject to the Landlord's approval, although the entering into of the transaction is in itself permitted. The appropriate response in any of these cases would be to write to the lender or the tenant, as the case may be, acknowledging receipt of the notice and stating that, in accordance with the provisions of the Lease permitting the granting of the security, there are certain requirements to be fulfilled on the part of the tenant. The letter should then reiterate the requirements and ask that proof of their satisfaction be provided by a specified date, failing which the landlord shall be entitled to treat the transaction as if it were prohibited under the terms of the Lease.

If the encumbrance is not permitted under the terms of the Lease, then the appropriate response would be to advise the tenant (and the lender) of the fact that the entering into of the transaction constitutes a default under the Lease. Thereafter, the landlord should consider what remedies or disciplinary action under the Lease or at law it might wish to pursue.

(ii) Leasehold Improvements/Fixtures

If a landlord receives a notice from its tenant or the tenant's lender that security over the tenant's Leasehold Improvements or fixtures has been granted, the landlord should again first review the Lease to ascertain whether the encumbrance is expressly permitted thereunder. If it is permitted, then any pre-conditions to such permission should be closely examined and inquiries should be made of the tenant and the lender in order to determine whether the conditions have been satisfied. If there is any doubt, the landlord should ask for satisfactory proof that the encumbrance falls within the meaning of the relevant provisions of the Lease.

If the Lease prohibits the collateralizing of the Leasehold Improvements or fixtures, or states that such a disposition constitutes an event of default, then the landlord may wish to give the tenant notice of its default under the Lease (and for extra measure provide a copy of the notice to the tenant's lender), and then consider and choose from the various remedies available to the landlord under the Lease and at law for the occurrence of an event of default.

(b) Notice of a Charge on Equipment, Furniture, Inventory

(i) Equipment

If a landlord receives notice of the encumbering of certain equipment to be used by the tenant, which equipment is not in the nature of a fixture, then the notice may simply be filed away, as there is nothing to be gained by any response. Although it is also true that nothing should be lost by acknowledging receipt of the notice, it would be prudent not to provide any acknowledgment in case the lender were to one day produce the acknowledgment and argue that it evidences an agreement by the landlord to subordinate its rights to the lender. The landlord is not obligated to provide any such acknowledgment, unless otherwise specified in the Lease.

In the event that the form of security taken by the lender is a "title-retention" type of encumbrance, then the priorities may be altered and as a result, it would be advisable to inquire (broadly) into the nature of the security being granted. This information could prove useful in any future attempt by the landlord to levy distress on the tenant's equipment in the Leased Premises.

(ii) Furniture

A landlord's greatest concern if it receives a mere notice of the encumbering of a tenant's furniture is as to the nature of the encumbrance. In most cases furniture is not a fixture but is personal property (i.e., a chattel), and notice of the granting of a security interest therein is simply informative and does not carry with it any legal significance vis-a-vis the landlord.

However, the landlord might wish to determine whether the security is in the form of a "title retention" agreement, so that it can know in advance whether its right to distrain against the furniture might be affected. Otherwise, the notice may simply be filed away and a response is neither warranted nor recommended.

(iii) Inventory

Since inventory can never be a Leasehold Improvement or any sort of fixture, if a landlord receives notice of a tenant's granting of security over its inventory, there is nothing the landlord should do or agree to do in the way of responding to the notice. Inventory is, with a few exceptions (appliances, jewellery), not often the most valuable source of return in a liquidation. Although the landlord might wish to determine whether the encumbrance on the inventory is in some form of a "title-retention" security agreement (in order to evaluate its right to distrain against the inventory), otherwise it need not do anything but file the notice and take note of the security.

In the case of a Section 427 Bank Act security over inventory, different considerations apply.

(c) Notice of Section 427 Bank Act Security

Since the granting of a Section 427 Bank Act security does not give the lender (a bank) any interest in the Lease, the Leased Premises or the Leasehold Improvements, nor does it give the bank any right to occupy the Leased Premises, no concern along these lines is raised by receipt of a notice of the granting of such security.

This type of security will only affect (insofar as the landlord is concerned) inventory and its packaging and if it is granted, the notice from the bank will specify the date upon which it was granted. Since there is nothing the landlord can do to alter the fact that the bank will automatically enjoy priority over the landlord's right to distrain over the secured goods (except to the extent of the arrears of rent which existed on the day the security was given), all that the landlord need do is record the date of the granting of the security and check the tenant's rental accounts as of that date to determine whether there are any arrears (and if so, in what amount). That information must be noted in the event the landlord ever wishes to consider a possible distraint against the tenant's inventory. To the extent of those arrears only (and to the extent they remain outstanding), the landlord may distrain against the tenant's inventory without regard for the bank's security.

Despite the practice of many banks to request the landlord's acknowledgment of receipt of the notice of Section 427 Bank Act Security, there is no requirement for such an acknowledgment and no significance to providing one. Accordingly, no acknowledgment is required or recommended.

However, if it is determined that there are arrears of rent as of the date the Section 427 Bank Act Security is given, then (although there is no legal requirement for such a reply) the landlord may wish to put the bank on notice of such arrears.

III. TYPES OF REQUESTS FOR CONSENT A LANDLORD MAY RECEIVE

(a) Consent to Security over Leasehold Improvements/Leasehold Interest

Unless the Lease provides that consent is not required for, or the landlord may not withhold consent to, the tenant's granting of security over the Lease, the tenant's leasehold interest in the Leased Premises or the Leasehold Improvements, landlords are well advised not to consent to the granting of any such security.

(i) The Tenant's Leasehold Interest

A request from either a tenant or its lender for the Landlord's consent to the granting of security over the Lease or the Tenant's leasehold interest in the Leased Premises may take several forms. Often such a request will appear to be more of a notice, but will contain some language requesting that the landlord acknowledge receipt of the notice by signing it back and returning it to the tenant. The acknowledgment wording may include language to the effect that the Landlord consents to the security being granted and will permit notice of it to be registered on title to the Shopping Centre lands.

Alternatively, the request may be accompanied with a three-party agreement issued by the tenant's lender. The request might state that the transaction has already taken place, or will take place on a future date, and that in connection with the transaction the lender (on behalf of itself and the tenant) requests that the Landlord execute the three-party agreement. The three-party agreement might recite a few details describing the transaction to be entered into between the Tenant and the lender and it might then provide for certain agreements to be observed as between the tenant, the lender and the landlord in the event the tenant defaults under its loan agreement with the lender or under the Lease. Many landlords have their own form of such a three-party agreement. (Such three-party agreements are sometimes called "comfort letters", because they are intended to provide some comfort to both the lender and the landlord that neither the tenancy nor the security will be seized or extinguished by either party without ample prior notice and other safeguards being provided to the other party.)

Most landlords do not wish to allow their tenants to encumber the Lease or the tenant's leasehold interest in the Leased Premises. This policy is usually reflected in the Transfer provisions of the landlord's standard lease form. However, before issuing standard negative response to a request for consent to such a transaction, the Lease must be reviewed to determine whether the landlord's position is tenable. The Lease may not require the landlord's consent to the transaction. Or the Lease may provide that although the landlord's consent is not required, the form of documentation between the tenant and the lender must be approved by the landlord. In either of these cases, a negative response would be inappropriate.

In addition, although most landlords' stated policy is to not permit encumbrances on the Lease or the tenant's leasehold interest in the Leased Premises, situations may arise which

call for a departure from the rule. The landlord might contrast the option of refusing consent against the possibility that the tenant may either fail to obtain funding (e.g. Small Business Improvement Loan) or go bankrupt, and consider it appropriate to permit the security to be granted. A form of three-party agreement setting out the terms and conditions to be observed by the tenant, its lender and the landlord in connection with the lender's security is appended to this paper as Exhibit "A". The purpose of the agreement is to protect and clarify the landlord's rights and the rights and obligations of the lender so that if there is a default by the tenant under the loan agreement or under the Lease, the responsibilities of the parties are clearly spelled out. If the landlord wishes to permit an encumbrance of the tenant's leasehold interest, it might reply to the request for consent by stipulating that it will consent on the terms of the Agreement set out in Exhibit "A". Note that Exhibit "A" presumes that the tenant's business is a chain of retail stores, and the lender is taking security in more than just the tenant's leasehold interest in the Leased Premises.

(ii) Leasehold Improvements

If a landlord receives a request for its consent to the granting of a security interest by its tenant in favour of the tenant's lender over any of the Leasehold Improvements located in the Leased Premises, a reply in the negative would normally be issued by most landlords. As mentioned earlier, the rationale for refusing to consent is that according to the law and most leases, immediately upon affixation of the Leasehold Improvements they become the property of the landlord, so the landlord is not willing to allow a lender to have the right to seize them when the lender is not paid by its borrower/the tenant.

However, in some circumstances the consent of the landlord to the granting of security over Leasehold Improvements is given. Consent will usually not be given where the landlord has granted the tenant a sizeable Tenant Allowance in order to construct its store and install the Leasehold Improvements. In fact, in those circumstances often landlords will consider taking a security interest of their own.

The landlord must, of course, grant its consent where the Lease has been amended to provide for it. Ideally, the Lease will not completely dispense with the requirement for the landlord's consent but will state that although the transaction itself is permitted, the form of documentation is subject to the landlord's approval. In that case (and in every other case where consent will be given, regardless of whether the landlord is entitled to impose any conditions on its consent) it would be preferable for the landlord to prescribe some terms and conditions governing the lender's ability to enter into the Leased Premises and seize the Leasehold Improvements. In some cases, a form of three-party agreement (between the tenant, its lender and the landlord) setting out the terms and conditions to be observed by the parties in connection with the lender's security may have been attached to the Lease as a Schedule. If so, then that agreement must be used. Otherwise, the agreement set out in Exhibit "A" might be a good starting point for a draft, with serious consideration required to be given by the landlord to the rights permitted to the lender to occupy the Leased Premises.

It should be noted that even if a landlord refuses to give its consent to the granting of security over Leasehold Improvements, many tenants will simply ignore the refusal and proceed with granting the security. If the landlord is not prepared to enforce its rights under the Lease and at law in the face of the tenant's default, it may be preferable for the landlord to acknowledge that reality at the outset and approach the situation with a view to consenting to the security if an acceptable three-party agreement can be made.

There are also instances where it is agreed by the landlord and a tenant's lender that the priorities as between them with respect to certain fixtures should be set out in an agreement which may, for example, set out a maximum value of the tenant's fixtures over which first-rank priority shall be reserved for the lender, and further provide that for any value in excess of the stated figure, the landlord is to enjoy the higher priority. Such agreements are more complex. No standard form of such agreement is attached as an Exhibit since each situation will give rise to a different form of agreement.

(b) Consent to Charge over Equipment, Furniture, Inventory

(i) Equipment

If the equipment to be encumbered is not a fixture, then although there is nothing to be gained or lost by the tenant, its lender or the landlord if the landlord consents to the encumbrance, there is no reason for the landlord to provide its consent to the transaction. Accordingly, most landlords adopt a policy that they will not under any circumstances provide any such consent. If such a request for consent is received, it should nevertheless be filed so that in the future, if distress is an option, the landlord will be aware of the potential for competing claims or seizures. If the tenant or its lender asks for an explanation from the landlord as to why it will not grant its consent, the simple answer to be given (verbally) is that the consent is not required.

If by any chance there is a prohibition in the Lease against such a charge, then the landlord should not only go on record as refusing to consent but should also give notice that such a charge will constitute a default under the Lease. If the tenant goes ahead with the charge despite the notice, then the landlord must determine whether prepared to act on its rights. Alternatively, the landlord may determine that it is willing to allow the tenant's equipment to be encumbered, although in all likelihood the tenant's lender will in that case produce a document requesting that the landlord waive its right to distrain against the equipment. The lender's consent document should be closely examined to ensure that it does not achieve more than the landlord intended. A typical "SBIL" consent agreement with respect to a lender's security over movable equipment as appended to this paper as Exhibit "B".

If possible, in any discussions with the tenant or its lender pertaining to the request for the landlord's consent to the charge over equipment, it would be valuable to ascertain the nature of the charge (i.e. "title-retention" or otherwise).

(ii) Furniture

Since furniture will rarely, if ever, be a fixture, and there is no prohibition in most leases against the tenant encumbering its furniture, it is rare that a landlord is ever approached for its consent to the granting of such security. Most landlords do not consent to such a charge, since the consent is unnecessary. The same consideration as expressed above, with respect to equipment that is not a fixture, apply in this context.

(iii) Inventory

Almost all tenants grant security over inventory to their lenders. It is very unusual that a landlord is ever asked to consent to a charge over inventory. If such a request is made, the landlord's simply answer should be that it will not provide the consent since it is not legally required to do so.

(c) Consent to Section 427 Bank Act Security

Many banks routinely request the Landlord's acknowledgment of receipt of notice of a Section 427 Bank Act security. Such an acknowledgment would be tantamount to a consent, which is not required under most leases or at law. There is no reason for the landlord to provide any acknowledgment or other form of consent to a Section 427 Bank Act security.

EXHIBIT "A"

CONSENT AGREEMENT

THIS AGREEMENT dated as of the * day of *, 19*.

A M O N G:

*
(the "Lender")

OF THE FIRST PART;

- and -

*
(the "Borrower")

OF THE SECOND PART;

- and -

*
(the "Landlord")

OF THE THIRD PART.

WHEREAS:

A. The Landlord is the landlord (or for the purpose of this Agreement is the agent of the landlord) under the leases (the "Leases") identified on Schedule "A" which is attached to and forms part of this agreement and the Borrower is the Tenant under each of the Leases either as the original tenant or as the result of an assignment;

B. This Agreement is to be construed as though it were entered into by its parties (the "Parties") separately in respect of each of the Leases, and "Lease" is to be construed accordingly;

C. "Lease" will also be construed, in each case as including any amendments of the Lease that are identified on Schedule "A";

D. The Tenant wishes to obtain the consent of the Landlord in respect of certain security to be granted, by the Tenant in favour of the Lender (the "Mortgage"), pursuant to which all of the Tenant's right, title and interest in and to the Leases, and the Tenant's inventory, chattels, equipment, and fixtures situated on the Premises are to be assigned, mortgaged, pledged and charged to secure, the obligations of the Tenant under or in respect of certain credit facilities.

E. Capitalized terms that are not defined in this Agreement have the same meanings as in the Lease, but the term "Leased Premises" where it appears in a Lease is referred to in this Agreement as the "Premises", and references in this agreement to the "Tenant" are references to the Borrower.

NOW THEREFORE in consideration of good and valuable consideration (the receipt and sufficiency of which is acknowledged) the parties to this Agreement (the "Parties") agree as follows:

Consent

1. (a) The Landlord consents to the Mortgage, subject however to the terms and conditions of this Agreement.

(b) Neither the Mortgage, nor any part of it, or any notice, caveat, caution, or other document pertaining to it will be registered on title to the Shopping Centre in respect of any particular Lease.

(c) The Tenant covenants that so long as the Mortgage affects the Lease, or the Premises, or any part of them, it will not further assign, sublet, transfer, dispose of, or otherwise deal with the Lease, the Premises, or any part of them without the Landlord's consent which consent may be unreasonably withheld.

(d) This consent will not be considered as a waiver of the requirement for consent in respect of any further or subsequent mortgage, transfer, assignment, subletting or other dealing with the Premises or the Lease (collectively a "Transfer") and all requirements of the Lease pertaining to the conditions under which consent would be given by the Landlord in respect of a Transfer, will continue to apply. It is acknowledged, that there will not be any increase in the Minimum Rent payable under the Lease directly as a consequence of the Mortgage and the Lender is not required to enter into an agreement with the Landlord to perform the obligations of the Tenant under the Lease. However, on any Transfer effected by the Lender, all of the requirements of the Lease must be complied with including any requirement that Rent be increased, and any requirement that an agreement be entered into

with the Landlord by the Person to whom the Transfer is made, to perform the Tenant's obligations under the Lease.

Reservation of Remedies by Landlord

2. The Landlord specifically reserves, (and the Lender and the Tenant acknowledge that reservation), its right, to exercise its remedies in relation to any default under the Lease. Its consent to the Mortgage is given on the basis that should the Tenant, or the Lender, or any party claiming by, through or under the Lender in enforcing its remedies under the Mortgage, do anything or fail to do anything that would constitute a default under the Lease, the Landlord will retain its rights to enforce its remedies in respect of that default and will not be considered to have waived any such rights or remedies. For example, if a receiver is appointed, if or any other event described as an "event of default" or a default occurs the Landlord will be entitled to enforce the remedies provided under the Lease, the Landlord and Tenant legislation of the Province, and the applicable laws of the Province.

Right to Remedy

3. The Landlord will, prior to exercising any right to terminate a Lease, notify the Lender of the Tenant's default by written notice (the "Landlord's Notice") and the Lender will have the same length of time to remedy the default after the Landlord's Notice is given to the Lender, as is required under the Lease to be given to the Tenant to remedy the default.

Fixtures - Priorities

4. The Lender confirms that despite the provisions of any Personal Property Security or similar legislation of the Province, and despite the Landlord's consent to the Mortgage, the Landlord's interest in any fixtures (other than trade fixtures) situated from time to time on the Premises will remain prior to that of the Lender and the Lender agrees to subordinate any claim for a security interest or, lien, or similar right in respect of those fixtures (that are not trade fixtures) in favour of the Landlord's claim and that of any mortgagee of the Landlord or any successor or assign of the Landlord, as the case may be.

Certain Remedies

5. The rights and privileges in favour of the Lender by virtue of this Agreement:

(a) will not in any way be considered to alter, affect, extend or prejudice any of the rights and remedies available to the Landlord against the Tenant; and

(b) are in substitution for and to the exclusion of any rights at law or in equity of the Lender as subtenant or tenant of the Premises. The Parties acknowledge that this Agreement represents a fair and equitable balancing of the competing interests of the Lender, the Receiver, the Landlord, and the Tenant, and the Lender acknowledges

that it would be inequitable for it to obtain relief, inconsistent with this Agreement, under Sections 21, and 39(2) of the Landlord and Tenant Act of Ontario, or similar statutes of other provinces.

Notices

6. Any demand or notice to be given by any Party to any other Party will be in writing and may be given by personal delivery or by prepaid registered mail addressed as follows:

(a) to the Tenant at:

the address or addresses provided for in the Lease.

(b) to the Lender at: *

(c) to the Landlord at: *

and if given by registered mail will be considered to have been received by the Party to whom it is addressed on the date following four (4) business days (excluding Saturdays, Sundays and statutory holidays) following the date upon which it is sent by registered mail with postage and cost of registration prepaid (unless at the time of mailing or within four (4) business days after which there is a strike, interruption or lockout in the postal service, in which case the notice will be given by personal delivery, telegram or telecopy) and if personally delivered to an adult person during normal business hours, when so delivered. Any Party may change the address designated from time to time, by notice in writing to the other Parties.

Execution of this Agreement

7. This Agreement will not be considered to have any force and effect until it has been executed by all of its Parties.

No Assumption by Lender

8. The Lender will not be liable under the Lease and will not be considered in possession of the Premises as the result of its security in the Lease or this consent.

Legal Fees

9. The Tenant agrees that it will be responsible for payment of the Landlord's legal fees in connection with the negotiation and preparation of this Agreement and that those fees will be payable as Additional Rent.

Enurement

10. This agreement is binding upon, and enures to the benefit of its Parties and their respective successors and permitted assigns.

Language Clause

11. The Parties have required that this Agreement and all notices, deeds, documents and other instruments to be given pursuant to this Agreement be drawn in the English Language. Les parties ont exige que la presente entente ainsi que tous les avis et autres documents a etre donnes ou executes en vertu des presentes soient rediges en langue anglaise.

IN WITNESS WHEREOF the Parties have executed this Agreement under their respective seals by their proper officers duly authorized for that purpose.

***

(Lender)

Per:_____

Per:_____

***

(Borrower)

Per:_____

Per:_____

***

(Landlord)

Per:_____

Per:_____

SCHEDULE "A"

LIST OF LEASES

EXHIBIT "B"

CONSENT AND ACKNOWLEDGMENT AGREEMENT

TO: _____ (the "Bank")

The undersigned (the "Landlord") is advised that (a) the Bank has provided certain financing to _____ (the "Tenant") which has leased certain premises (the "Premises") identified as Unit #____ situated in the Shopping Centre known as " _____" from the Landlord under a lease dated the _____ day of _____, 19__, as the same may be amended, superseded or replaced from time to time (the "Lease"), and (b) the Tenant has given, or intends to give to the Bank, a Personal Property Security Interest (the "Bank's Security") in certain tangible assets situated, or to be situated, on the Premises.

In consideration of the Bank's acknowledgement set out in Part B, below; and the sum of One Dollar ($1.00) the Landlord, agrees as follows:

Part A

1. The Landlord consents to the Bank's Security;

2. The Landlord acknowledges that the Lease is a valid and subsisting lease in full force and effect and in good standing;

3. If any default occurs under the Lease, in respect of which the Landlord intends to exercise a right to terminate or forfeit the Lease, the Landlord will give the Bank at the address set out below, notice in writing of the default but it will have no liability to the Bank, nor will its rights referred to below, in this agreement be prejudiced, should it fail to do so.

   The Bank's address for notice is:

   _____
   _____
   _____
   _____

4. So long as the Lease remains in full force and effect, if there is a default by the Tenant under its financing with the Bank, the Landlord agrees, upon receiving written notice from the Bank, to permit the Bank to enter onto the Premises to remove the inventory, equipment, chattels and trade fixtures (the "Removable

Property") of the Tenant that are subject to the Bank's Security. However, this does not imply a waiver on the part of the Landlord of any of its rights of distraint or any other rights under the Common Law or any Landlord and Tenant legislation in force in the Province of Ontario.

Part B

1. The Bank acknowledges that the Bank's Security does not apply to the Lease or to the Tenant's interest in the Lease or to the leasehold improvements that are not Removable Property and confirms that the Bank's Security does not affect tangible property situated on the Premises except the Removable Property.

2. The Landlord, the Bank, and the Tenant agree that all Removable Property will be considered as chattels for the purposes of the Lease and this agreement.

3. The Bank confirms that the Tenant is not in default under any material obligation of the Tenant for which the Bank holds the Bank's Security.

4. The Bank will follow all reasonable directions of the manager of the Shopping Centre to minimize disruption and to maximize safety in effecting removal of items from the Premises; will restore promptly all damage caused in connection with the removal; will indemnify the Landlord against all claims arising in connection with the Bank's removal of the Removable Property and releases the Landlord the Owners of, and any manager of the Shopping Centre (as well as their respective officers, directors, employees, agents and contractors) from all claims for damage or loss to the Removable Property regardless of how the damage or loss occurs.

5. The Bank will not register any notice of the Bank's Security on the title to the Shopping Centre.

6. The Landlord's consent is conditional upon the Bank signing the enclosed copy of this agreement to confirm its acknowledgement and agreement concerning what is set out above.

Part C

1. The Tenant has executed this Consent and Acknowledgement Agreement to confirm what is stated above and to confirm that the Landlord does not, in signing this Consent and Acknowledgement Agreement, waive, release, amend, or derogate from its rights under the Lease as between the Landlord and the Tenant.

Part D

1. The Party (if any) that signs this agreement below as the "Indemnifier" confirms that the obligations of the Indemnifier under any Indemnity Agreement entered into by it in respect of the Lease remain in full force and will not be reduced or derogated from by virtue of any provision of this agreement or any action or failure to act on the part of the Landlord as contemplated by this agreement.

The Parties have executed this agreement.

_____
(insert name of Landlord)

Per:_____

Per:_____

Confirmed and agreed this_____ day of _____, 19___.

_____
(insert name of Bank)

Per:_____

_____
(insert name of Tenant)

Per:_____

_____
(insert name of Indemnifier)

Per:_____