

"PPSA – DISTRESS AND LANDLORD WAIVERS"

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PPSA - Distress and Landlord Waivers

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I. OVERVIEW

Most commercial businesses, including those that are operated from leased locations, require financing. Borrowers are invariably asked by their lenders to put up some collateral as security against defaults under the financing terms. They may offer to secure inventory, book debts, furniture, equipment and fixtures; those who are tenants may also offer leasehold improvements, their leasehold interest in their leased premises, or their lease, or all or a combination of them.¹

A landlord of a commercial tenant does not necessarily approve of having any of these items encumbered. In an ideal world, a landlord would never be concerned with the possibility that a tenant's lender may one day remove from the leased premises a piece of HVAC equipment, some plumbing installations, or some other element of the infrastructure of leased premises. A landlord may be slightly less bothered by the possibility that its tenant's freestanding furniture or equipment might be removed from the leased premises by the tenant's unpaid lender (but it would certainly not be pleased by this experience). Moreover, in an ideal world a landlord would never find itself entangled with a lender who claimed a superior right to items of property that the landlord had itself seized, pursuant to its right to distrain for arrears of rent. However, landlords must contend with the real world in which, as a result of tenants' failed

¹ It is beyond the scope of this paper to consider the landlord-tenant-lender issues arising in connection with encumbering leases of / leasehold interests in real property.

financing arrangements, lenders assert claims to property in which the landlord claims an interest.

Let us consider the types of personal property that might be caught in the intersection of secured lender and landlord interests.

II. TYPES OF TENANT PROPERTY THAT MIGHT BE SECURED

At common law, articles placed by a tenant on leased premises fall under one of the following general classifications:

- (1) chattels - articles that are not attached to the realty other than by their own weight; and
- (2) fixtures - articles affixed to the realty in some manner.

While the question whether or not a specific article placed on the leased premises by the tenant has become a fixture depends upon the specific facts, the general principles in Ontario as to when an article becomes a fixture and when a fixture may be removed by a tenant were set forth in *Stack v. T. Eaton Co.*:²

- (1) articles not otherwise attached to the land other than by their own weight are not to be considered as part of the land, unless the circumstances are such as shown that they were intended to be part of the land;
- (2) articles affixed to the land even slightly are to be considered part of the land unless the circumstances are as such as to show that they were intended to continue as chattels;
- (3) the circumstances necessary to be shown to alter the prima facie character of the articles are circumstances which show the degree of annexation and object of such annexation, which are patent to all to see;
- (4) the intention of the person affixing the article to the real property is material only so far as it can be presumed from the degree and object of the annexation; and

² (1902), 4 O.L.R. 335 (C.A.)

(5) even in the case of tenants' fixtures put in for the purposes of trade, they form part of the freehold with the right, however, to the tenant, as between the tenant and his landlord, to bring them back to the state of chattels again by severing them from the soil, and that they pass by a conveyance of the land as part of it, subject to this right of the tenant.

At common law, "tenant's fixtures" are items affixed by the tenant for the purposes of either the tenant's trade or mere ornament or convenience and which, absent any agreement to the contrary, the tenant may remove at the termination of the lease (provided that they may be removed without causing material damage to the leased premises). The common law also recognizes as a category, "landlord fixtures", which are, generally, all other articles that are affixed to the realty (except for tenant fixtures). They may be put up by the landlord before or during the term, or by any previous owner or tenant, or by any other person. Further, any fixtures that the tenant has no right to remove (accordingly to the lease terms) are considered to be landlord's fixtures. Landlord's fixtures constitute part of the real property. The distinction between a tenant's fixture and landlord's fixture is a factual determination. What must be considered is whether the property was affixed in the course of trade and whether it can be removed without causing material or irreparable damage.³ Not surprisingly, some Courts have held certain items to be trade fixtures, while others have held that the same item is a landlord's fixture.

The following items have been classified as tenant or trade fixtures by the Courts: air conditioning units, air compressors, wainscot fixed to the wall by screws, counters, shelving, electric light fixtures, cooking and baking equipment, automotive paint spray

³ Williams & Rhodes, *Canadian Law of Landlord and Tenant*, 6th ed. (Toronto: Carswell, 1988) at 13:3:2.

booth bolted to the floor and vented through the roof, electric signs, mirrors, and hardwood flooring laid by a tenant for roller skating.

The following items have been classified as landlord fixtures by the Courts: baseboard heaters, light switches, hot water heater, sink, electrical service entrance, counter top, toilet, urinals and partitions with door frames; heating system and boiler; kitchen sink and cabinets; electrical fans, custom-made work benches and solvent tank, all built-in as part of building structure and not easily removed; and a mural painted on a wall.⁴

III. LANDLORD'S RIGHT OF DISTRAINT

If the tenant fails to pay rent, the landlord will have a claim to only those items in the leased premises that are not in any way affixed (such as furniture, equipment and inventory). The landlord's claim consists of the lien of distress, which is a common law right that arises upon rent being in arrears⁵. This right of distress (or "distraint") consists of a right to seize the tenant's goods and chattels (personal property) and to sell them to satisfy the unpaid rent (if they are not redeemed by the tenant upon payment of the arrears and the landlord's costs of the distress). The *Personal Property Security Act (Ontario)* (hereinafter, "PPSA")⁶ does not apply to such a claim by the landlord; the landlord's lien does not have to be registered under the PPSA to be valid⁷.

⁴ *Homestar Holdings Ltd. v. Old Country Inn Ltd.* [1986] B.C.J. No. 1152, 8 B.C.L.R. (2d) 211 (B.C.S.C.), provides at paragraph 12 ff. an excellent list of what the Courts have held to be trade/tenant's fixtures. *The automotive paint spray booth ruling is found in Starmark, see infra, note 13.*

⁵ *Commercial Credit Corp. Ltd. v. Harry D. Shields Ltd.* (1991), 29 O.R. (2d) 106 (H.C.J.), aff'd 32 O.R. (2d) 703 (C.A.)

⁶ R.S.O. 1990, c. P.10.

⁷ *Supra*, note 1.

The right to distrain is an incident of a landlord-tenant relationship; the landlord is not a secured creditor by virtue of its right to distrain. The right (or lien) only arises when rent is in arrears.

If the tenant becomes bankrupt when a distraint for rent has not been completed by the landlord, the landlord's right to distrain will not have priority over the tenant's secured creditors. The secured creditors clearly rank ahead of the landlord in that instance, as is set out in Section 136(1) of the *Bankruptcy and Insolvency Act*⁸.

However, prior to bankruptcy, if the tenant's goods, to be distrained against by the landlord, happen to represent collateral under a financing arrangement, a competition may arise between the lender's right (to seize and liquidate the goods to satisfy the financing obligation) and the landlord's right (to seize and liquidate the goods to satisfy the rent arrears). Section 31(2) of the *Commercial Tenancies Act*⁹, which impacts on a landlord's common law right of distraint, prohibits a landlord from distraining for rent on the:

chattels of any person except the tenant or person who is liable for the rent, "... *but this restriction does not apply in favour of a person claiming title under an execution against the tenant, or in favour of a person whose title is derived by ... transfer or assignment from the tenant, whether absolute or in trust, or by way of mortgage or otherwise, nor to the interest of the tenant in any goods or chattels on the premises in the possession of the tenant under a contract for purchase, or by which the tenant may or is to become the owner thereof ...*"

Therefore (prior to bankruptcy), the landlord's right to distrain against chattels that are encumbered by a PPSA security interest is potentially valid. That said, security interests in which title to the property is retained by the secured creditor are a different

⁸ R.S. 1985, c. B-3. Furthermore, even a completed distraint can be "unwound" if bankruptcy occurs. *Warran Whillans Enterprises Inc. (Trustee of) v. Gazzola*, [1989] B.C.J. No. 1073, 60 D.L.R. (4th) 590.

⁹ R.S.O. 1990, c. L.7.

matter than security interests in which title to the property is retained by the borrower. For instance, a borrower under a PMSI may not have any title whatsoever to the secured goods. And a lessee under an equipment lease (which is now recognized as a security interest under the PPSA¹⁰) has no title). But a “conditional sales contract” form of security interest allows the borrower to acquire equity in the item with each financing payment; that equity (but only that equity) can be distrained against by the landlord¹¹. Similarly, chattels that are the subject of a General Security Agreement are susceptible to the landlord's distraint prior to the secured creditor enforcing its rights (although the lender's seizure can itself be a daunting task, as the lender is not likely to be welcomed into the leased premises for that purpose by either its borrower or the landlord, nor does the landlord (absent a Court order or written agreement specifying otherwise) have any obligation to the lender to allow it to gain access).¹²

From the perspective of the commercial lawyer working with PPSA interests in commercial lending transactions, it is important to note that all manner of security interests are defined under Section 1(y) of the PPSA as “security interest”; there is no distinction to be found in the PPSA based on form or the passing of title. But since the landlord's distraint right does not require PPSA registration, if it happens that a borrower tenant owes both rent to its landlord *and* financing payments to its lender, the task of sorting out priority will be, at least initially, a guess. The outcome of some of that competition is characterized as a “race to the swiftest”, depending on the nature of the security interest as to the locus/extent of title. At the very least, he who seizes first will

¹⁰ *Ministry of Government Services Consumer Protection and Service Modernization Act, 2006*, S.O. 2006, c.34, Sch. E.

¹¹ *J.R. Auto Brokers Ltd. v. Hillcrest Auto Lease Ltd.*, [1968] 2 O.R. 532 (H.C.)

¹² 889267 Ontario Ltd. v. The Norfinch Group Inc., [1998], O.J. No. 3850 (Gen. Div.)

hold the goods subject to a later determination as to the quality and rank of any competing claims. Accordingly, a landlord who cautiously opts to conduct a PPSA search prior to deciding to distrain will find that it will not thereby gain much insight into whether the tenant's chattels are encumbered to a degree that would measurably impact on the value of any completed distraint. Likewise, a secured lender who contacts a landlord who completed a distraint may have an uphill battle proving that its claim is prior to the landlord's.

IV. NO RIGHT OF DISTRAINT ON FIXTURES

A tenant may grant security over all types of property. But a landlord has no right to distrain over fixtures. In a fairly recent decision¹³, the Ontario Court of Appeal noted a distinction between fixtures that are "immovable" and those that are "trade fixtures", stating:

It has long been established that immovable fixtures are not distrainable at common law. Trade fixtures are different from immovable fixtures in that they can be restored to the status of chattels at the option of the tenant. Despite that difference, trade fixtures have been treated, certainly in this province, as true fixtures as long as they are attached to and part of the land. The strong weight of authority supports the position that as long as trade fixtures are fixtures, they are no more subject to distraint than immovable fixtures. The complaint that this position makes the landlord's right to distrain depend, in some cases, on matters as inconsequential as a few screws or nails has validity, but is not a new complaint: see *Crossley Brothers Ltd. v. Lee, supra*. Although the landlord and tenant relationship is now closely regulated by statute, the Legislature has not seen fit to abandon the common law distinction between fixtures and other goods and chattels of the tenant for the purpose of determining the landlord's right of distraint. Nor has the Legislature altered the common law definition of fixture applicable to the law of distraint. As long as the common law prevails, the manner in which the property is attached to the land will be a significant consideration when deciding whether property is subject to distraint. ... The present law as to the nature of trade fixtures has been settled in this province for over 90 years.

¹³ 859587 Ontario Ltd. v. Starmark Property Management Ltd. (1998), 40 O.R. (3d) 481 (C.A.)

Even though landlords have no distraint right over fixtures, lenders taking security in fixtures must nevertheless reckon with landlords. Most leases stipulate that fixtures are not to be removed during the Term. Most leases also give the landlord the option to require the tenant to remove fixtures/improvements at the end of the Term. Further, many standard forms of commercial leases provide that upon affixation, improvements and alterations to the leased premises, as well as trade fixtures, become property of the landlord. Moreover, as a matter of general law, fixtures become part of the realty upon affixation.¹⁴

Clearly, a landlord would not like to face a claim that any floor coverings, wall or ceiling treatment or electrical or mechanical facilities (eg. HVAC, plumbing) were subject to removal by the tenant's lender (as a secured party having a higher rank or claim than the landlord's right). This would seriously undermine the landlord's intended flexibility. At the same time, most lenders generally don't intend to rip out many improvements in the event their borrower fails to make payments. They may intend to remove certain fixture-type equipment that is more readily detachable (eg. an oven or a walk-in freezer), but this is a glossy statement that becomes parsed once each specific fixture is evaluated for its post-detachment marketability. Merely having the right to realize on the improvements (or fixtures) may serve as a bargaining chip - which may, ultimately, be all that is realistically intended.

¹⁴ The distinction between "landlord fixtures" and "tenant fixtures", referred to earlier, becomes relevant here. There tends to be some confusion in the commercial realm, regarding the use of terms such as "leasehold improvements", "fixtures" and "trade fixtures". This stems partly from the fact that in common law these terms have different meanings in different contexts, and under various statutes (e.g. income tax) there may be different meanings again for the terms "fixtures" and "leasehold improvements". To further complicate matters, in general usage by businesspeople, the terms are often used casually without regard for legal meanings.

V. PRIORITY AGREEMENTS/WAIVERS OF DISTRESS/CONSENTS

As the reader will appreciate from the comments above, in many borrowing arrangements, it is commonplace for a lender to require that its borrower obtain an agreement from their landlord: (1) waiving the right to distrain against the property that is to be the subject of a security interest in favour of the lender and/or (2) waiving or subordinating in favour of the lender any claim the landlord may have to certain fixtures in the leased premises.

Likewise, since many commercial leases contain terms prohibiting the tenant from encumbering some or all of its personal property, it is sometimes a condition of financing that the borrower obtain written consent to the security from its landlord(s), to overcome any lease provisions to the contrary.

The approach taken (waiver and/or consent) will vary with the type of security interest sought, the nature of the goods to be secured, and the terms of the lease. The various types of landlord consents/waivers that come up in commercial transactions involving the granting of a PPSA interest can be examined by category of collateral.

Fixtures

Generally speaking, a lender is under no obligation to give a mere notice to a landlord of its security over improvements. Some lenders nevertheless make it their practice to notify landlords of their taking of security over their borrower tenant's improvements. Mere notification will not confer any additional status upon the lender absent a lease provision to that effect. However, since commercial leases often do not allow the tenant to encumber any improvements, landlords may find themselves in a

position to note their tenant in default upon receiving such notification. Some tenants are pro-active on this front, negotiating into the lease a right to encumber fixtures/improvements without landlord interference. Where that has not been achieved, typically lenders/borrower tenants seek the landlord's consent to the security and/or ask the landlord to subordinate its rights to the collateral to the lender's rights.

If a landlord were to consent to a charge over fixtures, the implications could be far-reaching. Section 34(1) of the Personal Property Security Act (Ontario) states:

- "A security interest in goods that attached,
- (a) before the goods became a fixture, has priority as to the fixture over the claim of any person who has an interest in the real property; or
 - (b) after the goods became a fixture, has priority as to the fixture over the claim of any person who subsequently acquired an interest in the real property, *but not over any person who had a registered interest in the real property at the time the security interest in the goods attached and who has not consented in writing to the security interest or disclaimed an interest in the fixture.*"

This provision has the effect of giving a tenant's lender priority over a landlord's right to ownership of fixtures installed by the tenant, where the security interest attached prior to the goods becoming a fixture (eg. a PMSI). It also gives the lender priority 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. Lenders often seek the landlord's consent to the security in order to obtain the priority offered by Section 34(1)(b). Where the Lease requires the landlord to consent, the outcome as to priority is pre-ordained. Where the lease does not so limit the landlord, yet the landlord is willing to allow the encumbrance, it may seek to condition its consent on terms requiring the lender to (i) notify the landlord of its intent to realize on the fixture(s), (ii) comply with any rules and regulations of the landlord concerning the method and timing of

removal; (iii) repair damage caused by installation and/or renewal; (iv) pay occupation rent for the period required to carry out the removal; (v) reimburse the landlord for any costs of security, supervision and/or inspection incurred by it in connection with the removal; and/or (vi) indemnify the landlord from claims by any other party in relation to the goods and/or their removal.

Notably, even when a landlord withholds consent to the granting of security over improvements/fixtures, many tenants and their lenders simply ignore the refusal and proceed regardless.

In other instances, the landlord and the tenant's lender agree on a maximum value over which the lender shall have first-rank priority, with the landlord to enjoy priority over the remainder.

Axiomatically, waivers of distress are inappropriate/unnecessary in a priority agreement dealing with fixtures (because a landlord has no right to distrain over fixtures).

Inventory, Furniture and Unaffixed Equipment

Inventory, furniture and unaffixed equipment is very likely to be secured in one way or another; this is property in respect of which the landlord has a right to distrain if the tenant falls into arrears of rent. Most leases do not explicitly prohibit such an encumbrance although some will define as an event of default as a situation where there does not exist, at the leased premises, "property, free and clear of any encumbrance, sufficient to satisfy the landlord's right of distraint for a period of X months". In the case of a lease containing such a term, a tenant may be wise to seek the landlord's consent, so as to avoid committing the event of default.

The landlord's main concern here is as to the nature of the security interest. If the security is in the form of a title retention agreement, then the landlord will not enjoy a right to distrain against the chattels until title has passed to the tenant, although it may be entitled to distrain against the tenant's equity. Since most leases do not prohibit encumbrances on ordinary chattels, and landlords typically have nothing to gain by consenting, most landlords adopt a policy of not consenting. Likewise, most landlords will not agree to waive or subordinate their right to distrain.

Inventory (also known as stock-in-trade in some security agreements) may be exempt from distress under the *Execution Act* (Ontario)¹⁵. Perishable goods are also exempt from distress.¹⁶ However, most sophisticated commercial lease forms state that the tenant waives all such exemptions and that none of the tenant's inventory is exempt from distress. Once again, the landlord's chief concern is as to the nature of security over inventory. Generally speaking, unless security over inventory is taken by a lender as part of a package of security provided by the tenant/borrower (eg. the Lease, the tenant's leasehold interest in the Leased Premises, the tenant's fixtures, equipment and furniture and all inventory), most often a lender taking security over inventory alone is a bank taking security pursuant to Section 427 of the Bank Act¹⁷. This type of security has

¹⁵ R.S.O. 1990, c. E.24, s.2.

¹⁶ *Simpson v. Hartopp* (1744), 125 ER 1295, [1558-1774] All ER Rep 453.

¹⁷ S.C. 1991, c. 46. 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. 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 427 security in respect of a tenant's property.

fallen out of favour in Ontario (although it is still in use in Quebec). Sometimes, but rarely, a consignment of inventory is the route a secured creditor will take (because consigned goods clearly do not belong to the tenant, therefore they cannot be distrained against by a landlord).

In sum, the landlord's rights to inventory will generally lead to a "race to the swiftest" as between the landlord and the secured creditor, yet priority agreements in relation to inventory are seldom encountered.

Sample Agreement

Attached as Exhibit A is an example of a priority agreement.

**CONSENT AND
ACKNOWLEDGEMENT AGREEMENT**

TO: _____ (the "Lender")

The undersigned (the "Landlord") is advised that (a) the Lender has provided certain financing to _____ (the "Tenant") which has leased certain premises (the "Premises") identified as Unit #___ situated in the property located at _____ from the Landlord under a lease dated the __ day of _____, 20__, 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 Lender, a Personal Property Security Interest (the "Lender's Security") in certain tangible assets situated, or to be situated, on the Premises.

In consideration of the Lender'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 Lender'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 Lender at the address set out below, notice in writing of the default but it will have no liability to the Lender, nor will its rights referred to below, in this agreement be prejudiced, should it fail to do so.

The Lender'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 Lender, the Landlord agrees, upon receiving written notice from the Lender, to permit the Lender to enter onto the Premises to remove the equipment, chattels and trade fixtures, as more particularly set out in Schedule "A" attached hereto (the "Removable Property"), of the Tenant that are subject to the Lender'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 which the Landlord may have at law or pursuant to the *Commercial Tenancies Act*. {OR:

The Landlord hereby postpones in favour of the Lender any rights of distraint which the Landlord may have at law or pursuant to the *Commercial Tenancies Act.*}

Part B

1. The Lender acknowledges that the Lender's Security does not apply to the Lease or to the Tenant's interest in the Lease or to the improvements in the Premises that are not Removable Property and confirms that the Lender's Security does not affect any property situated on the Premises other than the Removable Property.
2. The Landlord, the Lender, and the Tenant agree that all Removable Property will be considered as chattels for the purposes of the Lease and this agreement.
3. The Lender confirms that the Tenant is not in default under any material obligation of the Tenant for which the Lender holds the Lender's Security.
4. The Lender will follow all reasonable directions of the Landlord 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 Lender's removal of the Removable Property and releases the Landlord and its 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 Lender will not register any notice of the Lender's Security on the title to the lands.
6. The Landlord's consent is conditional upon the Lender 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: _____

I/We have authority to bind the corporation.

Confirmed and agreed this _____ day of _____, 20__.

(insert name of Lender)

Per: _____

Per: _____

I/We have authority to bind the corporation.

(insert name of Tenant)

Per: _____

Per: _____

I/We have authority to bind the corporation.

(insert name of Indemnifier)

Per: _____

Per: _____

I/We have authority to bind the corporation.

SCHEDULE "A"
REMOVABLE PROPERTY