JUNE 2004

WeirFoulds LLP
BARRISTERS & SOLICITORS

clientbulletin

COMMERCIAL LEASING

Inside this Issue:

The Financing Triangle: The Top Five Practical Considerations in Negotiating Tenant Financing Rights and "Landlord Waivers"
Angela Mockford

Operating Costs Audits and the Role of the New Consultants-A Landlord's Perspective
Lisa Borsook

The Swan Lake of Cummer-Yonge, sub. nom. Goodbye Cummer-Yonge, Again
Deborah R. Rogers

The Financing Triangle: The Top Five Practical Considerations in Negotiating Tenant Financing Rights and "Landlord Waivers"

Angela Mockford

When a typical franchisee in the food service industry seeks to open a business in a shopping centre, it usually obtains a commitment from its lender to provide financing for the purchase of the furnishings, fixtures, inventory and equipment. Normally, the lender requires the tenant to provide security over all of the items purchased, as well as over the business' receivables. More and more often, the lender also requires the tenant to obtain a waiver of rights from the tenant's landlord. But what if the landlord is paying a leasehold improvement allowance? What if the tenant's franchisor also wants rights in case of tenant default (in which case your already-complicated triangle becomes a square)? How do you draft a lease clause or waiver document that all of these parties will approve?

Consideration No. 1 There's a Conflict Here!

The landlord wants to preserve its rights and priority in the tenant's personal property, and also to make sure the leasehold improvements are not encumbered or removed—the question of what is a "leasehold improvement", or a "fixture", or a "trade fixture" is a murky one. The tenant needs its financing, and has to sign a lease (otherwise, there's a chance both landlord and lender will refuse to fund)—it is therefore trapped among the other three players. The lender seeks first right in the collateral for the loan (and that collateral may include items that the landlord considers "leasehold improvements"), as well as re-possession, removal and access rights. The franchisor also wants rights to take over the space and run the business. Now that we recognize the competing interests, the question is, how can these interests be reconciled in time to get the restaurant open for business?

Consideration No. 2 It's Mine! No, It's Mine!

The most important part of a financing clause or waiver document is the description of the property in which the landlord agrees to give up, waive, or postpone, its interest in favour of the lender's security therein. While the landlord will probably agree that the lender may have first right to unaffixed, movable chattels, "personal property", "equipment" and "trade fixtures" (because it wants the tenant to open and pay rent, hardly ever distrains anymore due to the change in the tax laws—it can't distrain on fixtures anyway, and knows the lender can ultimately bankrupt the tenant), it's going to have an issue with "leasehold improvements". And what do these terms mean in any event? For example, is a walk-in freezer a "trade fixture" that is removable, or a "leasehold improvement" that becomes part of the property permanently?

Consideration No.3 The Limits and Scope of the Clause/Waiver

A sharp landlord will endeavour not to "waive" its rights, but rather to postpone them, and then only do so to a *bona fide* lender (chartered bank, insurance company, credit union, etc.). The tenant, however, might need flexibility in the source of its financing (individuals, shareholders, or any other non-traditional lenders (including the franchisor), and should ask for concession from the landlord with respect to certain identifiable lenders, and for the right to be transferable for the purposes of sublease or assignment (and in general, sale of the business). For a franchisee, it's especially important to remember to obtain rights to transfer to the franchisor or a replacement franchisee.

Consideration No. 4 I Have to Get in There! Lender's Access Rights

Whether the lender has taken security over the goods, has retained ownership of them, or intends to the assume the premises under the provisions of a leasehold mortgage, it will require access to the premises in the event of a default by the tenant. In most financing clauses, a default by the tenant under either of the lease and the loan agreement gives rise to the lender's and landlord's rights.

The Landlord may require that, in the event of either type of default, the lender must pay any arrears of the tenant prior to obtaining access but the parties are more likely to settle on payment of a type of "occupation rent" by the lender. The landlord will certainly insist that the lender make good any damage caused by the lender or its agents in removing the goods from the premises (including damage to parts of the shopping centre other than the premises such as freight elevators, loading docks and shared walls), and will hold both the lender and the tenant responsible for such costs. In addition, the landlord will extract from the tenant its consent to the granting of such access, and its acknowledgement that the landlord need not inquire into the validity of the lender's claim, the lender's access, and the lender's removal of the collateral. This is not to say that the landlord will not also require the lender to satisfy the landlord that the lender has

A broadly-worded indemnity from the lender is also often sought by the landlord, even though other provisions of the lease may arguably address this issue.

complied with all statutory and contractual requirements (such as the requirement to give notice) before granting access to the lender. A broadly-worded indemnity from the lender is also often sought by the landlord, even though other provisions of the lease (e.g., the tenant's obligation to insure the contents of the premises and the right of the landlord's insurer to subrogate against the tenant) may arguably address this issue. Any indemnity will usually be the subject of significant negotiation with the lender. Finally, if the landlord has terminated the lease, and the lender is entitled only to access to the premises for the purposes of removing the collateral, the landlord may permit access by the lender only for a certain period of time.

Consideration No. 5 Am I Missing Anyone?

A sharp landlord will require any indemnifier or guarantor under the lease to confirm its acceptance of the financing arrangement and rights given to the lender (including by signing any waiver or mortgage consent form directly) because such arrangements could, arguably, constitute a 'material' change in the risk assumed by the indemnifier. The tenant and lender are not likely to argue.

In addition, the franchisor may be asked to sign the waiver for the purpose of acknowledging that its rights (if it has any to take over the lease, or cure defaults) are subordinate to the rights of the lender. Some franchisors have standing agreements with major lenders to do just that.

In the case in which the financing is being obtained by an entity who is not the tenant (but is a related corporation or a subtenant), the recitals should make the transaction clear and the appropriate covenants or acknowledgments will likely be extracted by the landlord.

Wrap-up

Affording at least some consideration to these issues puts you, as tenant, landlord, lender or franchisor, well on the way to preparing a well-crafted financing clause that marries common sense and legal necessity. The ultimate goal of a financing clause or waiver is to provide the parties with some comfort and certainty that if "something goes wrong", the parties will have a written agreement to turn to —hopefully without resorting to the complex web of priorities legislation, and the cloudy definitions of the common law.

But in the event the lender opts to pursue the bankruptcy of the borrower anyway…

Angela Mockford is an Associate and a member of the Commercial Leasing Practice Group. Angela works exclusively in the commercial leasing field, negotiating and drafting lease documentation. She can be reached at 416-947-5096 or by e-mail at mockford@weirfoulds.com. In her absence, please contact David Thompson at 416-947-5093 or by e-mail at dthompson@weirfoulds.com.

Operating Costs Audits and the Role of the New Consultants-A Landlord's Perspective

Lisa Borsook

What is the role of the new consultants? That one is easy. To make landlord's lives miserable. Any comparison to a Revenue Canada audit isn't entirely appropriate, Revenue Canada audits are by and large preferable. As far as I understand it, Revenue Canada auditors are not compensated in relation to how much grief they can cause. Second, they generally have read the Income Tax Act and are trying to apply some of its principles to the facts with which they are dealing. Suffice to say, I would be more comfortable dealing with operating cost consultants if they worked on a flat rate or hourly basis like the rest of us.

But let me try and give you a practical response to landlord's questions of how to deal with an op cost consultant when they come calling. The first issue is pretty easy-confirm that its treatment of op costs has been fair and in accordance with the provisions of the lease. You can test the answer later, but it sure doesn't hurt to know at the outset whether you can withstand this sort of inquiry with head held high or not.

The legal analysis is also actually relatively straightforward. First, and I know that you have heard this before, look at the lease. What does it say about the Tenant's right to audit the landlord's books and records? What are the pre-requisites to the tenant exercising such a right? What are the limitations? Anticipating a fairly standard landlord's form of lease, the tenant may have no audit rights. That pretty much can shut down the problem, subject to more practical considerations which I will canvas shortly. If it has a right, that right may limit the extent of its investigation in a variety of ways. For instance, the tenant may only be able to look at certain types of records, and only at certain times. The tenant's right to do so may be limited, or may be limited to certain categories of persons, like the tenant's accountants. Recent landlord's leases have specifically provided that % based audits by commission hungry agents are not permitted-I don't think that is the exact wording, but that would be gist of it. Don't hesitate to look at the person's qualifications before you let them in. Is there a confidentiality requirement? Does the landlord have the right to impose requirements-like the obligation to sign a confidentiality agreement, or to use their information solely for the purpose of their client, the named tenant? Timing may be a factor-the time within which the tenant can exercise the right may have passed The number of years of investigation may be specifically limited by the terms of the lease. All of that information may limit the terms of their investigations and set the parameters within which the investigation can proceed.

The first issue is pretty easy-confirm that its treatment of op costs has been fair and in accordance with the provisions of the lease.

The second analysis is what happens after the investigation has occurred, and the consultant has commenced to question the propriety of various items in the operating cost statements. The first point I want to make here, is that the consultants' analysis may be wrong. They may have asked for adjustments without reference to the terms of the lease-carving out exclusions that the tenant may want to get, but for which it did not bargain. The most common request is to delete any management or administration fees, structural costs, capital costs, depreciation, or by their analysis of what the tenant's proportionate share should be, reduce the amount payable altogether. In my experience, they are just not necessarily right. Understanding how proportionate share is calculated is often a big problem.

The third point-the fact that they are dead wrong on their request for a particular adjustment- doesn't mean that the consultant will cede the point. In my experience, and taking into consideration that their compensation may be a percentage of the amount they are able to recoup for the tenant, they may press the point nonetheless, and there is something to say for the nuisance factor, although making concessions may have long term implications, or even significantly greater implications than the landlord originally imagined. For instance, a concession made in one year, without justification, will invariably come back to haunt the landlord. And the consultant may also assume that if the landlord made a concession for this tenant, it will make it for other tenants in the development. So-they will then go to other tenants and describe their success in dealing with the landlord, and before you know it, the landlord has a tenant revolt on its hands. Suffice to say, concessions without justification are not a good idea, and are to be avoided. Short term gain; long term pain.

Now some landlords will tell you that this analysis doesn't get them anywhere-the tenant is too big and significant in the grand scheme of the centre for the landlord not to be somewhat conciliatory-for the sake of preserving the relationship with the tenant in the future. And there may be other factors which affect how the landlord, for the sake of expediency, has to

A concession made in one year, without justification, will invariably come back to haunt the landlord.

deal with the consultants' requests. For example, the failure to resolve the issue with the consultant may impact on the landlord's ability to dispose of the centre to a purchaser. The tenant is going to allege that there is an outstanding dispute, and depending on the size of the adjustment, the period of time for which it is claimed, and the future implications, the impact of that allegations can be disastrous in terms of the sale, and the sale price. The landlord may be in the process of obtaining financing, and the mortgagee is looking for a clean estoppel certificate. Same problem.

What are some of the other legal principles that a landlord might want to consider in analyzing a tenant's request for an adjustment-and this analysis is relevant regardless of whether or not a consultant is involved?

The issue may not be whether or not the amount is chargeable at all, but what the charge should be-that is its quantum.

First of all, there are cases which make it quite clear what a landlord can and cannot charge. For instance, the case law is relatively clear that when the lease is silent, or not specific, a landlord can't pass through capital taxes or management and administration fees. But a landlord shouldn't just dismiss the right to charge certain amounts, because of the case law. It may be distinguishable. The issue may not be whether or not the amount is chargeable at all, but what the charge should be-that is its quantum. That is a lot easier to deal with, from a landlord's point of view, than having the charge eliminated altogether. Second, a landlord should consider what exactly is the tenant's right to compel the landlord to make the readjustment-does the lease permit any kind of right of set-off, and if so, in this particular circumstance? If the tenant has a right of set-off that is a big hammer-right or wrong on the issue as to whether or not the adjustment claimed is a correct one.

Keep in mind the obligation to perform contractual obligations in good faith. That works both ways-the tenant shouldn't assume that the landlord is trying to fleece it-there are plenty of perfectly good consultants and auditors who don't know how to read a lease. Tenant's have obligations of good faith too-like to pay rent without setoff, and if they don't perform their obligation, they may find themselves on the wrong side of a locksmith. In any event, the notion of a party's obligation of fulfill its contractual obligations in good faith is an evolving one, and I for one can't say with certainty how a court would interpret the parties' respective obligations in any given situation.

Then there is the notion of proprietary estoppel,-the notion that a party cannot insist on its strict legal rights if to enforce those rights would be inequitable having regard to the dealings between the parties. In other cases, a slightly different variation of the principle is argued as detrimental reliance-where one party acts to his detriment on the reasonable reliance of the representations of the other, thereby disentitling the other from going back on those representations. The legal argument may also be framed as waiver –which is a voluntary concession granted by one party, upon the faith of which another shapes their conduct and which waiver will remain effective until it is made clear by notice or otherwise that the waiver is to be withdrawn and the strict position under the contract restored. Which of those arguments will apply in the circumstances depends on intention, and a clear review

---

Waiver is a voluntary concession granted by one party, upon the faith of which another shapes their conduct

---

of the facts of the case. And of course, let's not ignore real estoppel-like the tenant signing an estoppel certificate in which it stated that the lease was in good standing, and it had no claims against the landlord. If a landlord finds one of those in its file, it can go a long way toward shutting the tenant down.

Finally, and this is very complicated, there is the question of limitations. Generally speaking, the tenant has to commence its action within six years, based on the *Real Property Limitations Act*, which probably applies. Ten years if the lease is a specialty, which is

another big thorny issue, depending on whether or not the document is under seal. So, the tenant shouldn't be able to go back farther than that in its investigation. But I for one always find limitations confusing, so my warning here is that in the particular circumstances, you have to consider the issue and have someone work their way through it to see whether or not the tenant's claim is statute barred.

My most important point in all of this-I know that in one context or another I repeat the same thing over and over-what is the landlord's bargaining position? Who needs each other more, the landlord or the tenant? Who has the bigger hammer? What are the prevailing circumstances? Are the landlord's op costs competitive with op costs in the vicinity?. Because lease terms or no lease terms, rights of set-off or no rights of set-off, proprietary estoppel or no reliance issue, none of it matters if the landlord wants to close a sale, finish the financing, or this is the landlord's biggest tenant, or the landlord is facing a combined tenant revolt and the landlord still has to pay its mortgage. The advice you receive has to be informed, but realistic in the circumstances. And finally think about time. How much time does the landlord want to devote to this problem? Consultants have all the time in the world. Landlords are notoriously short of it. And lawyers are billing based on time-which can make the costs of dealing with the problem, large or small, seem disproportionate to the problem. Time-that is a factor which you have to think about in dealing with these issues.

Lisa Borsook is a partner in the firm of WeirFoulds LLP. She is the Chair of the firm's Commercial Leasing Practice Group. Over the past three years, WeirFoulds LLP was mentioned in the Canadian Legal Directory by Lexpert® as a leading property leasing firm in Toronto, and Lisa was named as a leading practitioner in property leasing. Lisa can be reached at 416-947-5003, and by e-mail at lborsook@weirfoulds.com.

The Swan Lake of Cummer-Yonge, sub. nom. Goodbye Cummer-Yonge, Again

Deborah R. Rogers

For almost forty years, the case of *Cummer-Yonge Investments Ltd. v Fagot et al* ("***Cummer-Yonge***") has presented a significant thorn for commercial leasing lawyers. The challenge is creating guarantees, indemnities or security (collectively referred to in this article as "***Third Party Assurances***") for the protection of landlord clients that would survive after the tenant's bankruptcy.

The *Cummer-Yonge* case examined the liability of a guarantor for a tenant's lack of performance under a lease after the bankruptcy of the tenant. The court held that a guarantor's liability for a tenant's obligations

> *One of the significant effects of* Cummer-Yonge *has been the inspired creativity and gymnastics of the leasing bar to circumvent the consequences of* Cummer-Yonge.

under the lease is extinguished on the disclaimer of the lease by the tenant's trustee in bankruptcy. In short, since the tenant no longer has any obligations under the lease, there is no obligation outstanding for the guarantor to guarantee. In the result, when the guarantee is needed most, that is on the bankruptcy of the tenant, the guarantor is released.

One of the significant effects of *Cummer-Yonge* has been the inspired creativity and gymnastics of the leasing bar to circumvent the consequences of *Cummer-Yonge*. Landlord's lawyers have been encouraged in this endeavour by numerous decisions in which the judge, after holding that the Third Party Assurance would not survive the tenant's bankruptcy, has reasoned that if the Third Party Assurance had been drafted differently or structured differently, it may have survived the tenant's bankruptcy to respond to the landlord's claim.

As further case law emerged, some dealing with interpreting Third Party Assurances with improved language, the decisions were still inconsistent and, in many cases the Third Party Assurances were still found by the courts to be ineffectual upon the disclaimer of lease by the tenant's trustee in bankruptcy.

Against this backdrop of confusion and uncertainty enters the long awaited decision of *Crystalline Investments Limited v. Domgroup Ltd* ("***Crystalline***"), a breath of fresh air for landlords seeking to rely on Third Party Assurances surviving their tenant's bankruptcy.

In the Crystalline case, a grocery store tenant under two shopping centre leases assigned the lease to a tenant who became insolvent and filed a Proposal under Section 65.2 of the *Bankruptcy and Insolvency Act* (the 1992 version) (the "**Act**").

As part of the Proposal, the subject leases were to be repudiated. The landlord did not challenge the repudiation and accepted statutory compensation for their damages, being the equivalent of six months rent.

The Court approved the Proposal and ordered termination of the leases. The landlord claimed against the original tenant for the balance of the arrears of rent and other damages for the loss of the tenancy. The lease between the original tenant and the landlord stated that the tenant would remain fully liable under the lease notwithstanding an assignment.

The legal issue to be determined by the Court as formulated by Trafford, J. in the lower Court and repeated in this case at paragraph 22, was stated as follows: "Is a landlord, following the court approved termination of a commercial lease under Section 65.2 of the 1992 *Act*, and following acceptance of the compensation provided for by the statutory code, entitled to arrears of rent or for damages in respect of the unexpired term of the terminated lease as against the pre-proposal assignor of the lease?"

The Supreme Court of Canada to which the case was ultimately appealed, examined the construction of Section 65.2 of the *Act* to determine whether the obligations between the landlord and the original tenant were brought to an end when the leases were repudiated.

The Supreme Court of Canada agreed with the Ontario Court of Appeal that the insolvency of the assignee tenant and the repudiation of the lease under the *Act* did not affect the landlord, who could continue to look to the original tenant for enforcement of the leases. The court stated that "Section 65.2 relates to the repudiation of leases by insolvent commercial tenants. It is not concerned with the effect of that repudiation on third parties, such as assignors and guarantors."

The Court reasoned that the purpose of Section 65.2 is as follows:

> [to] free an insolvent from the obligations of a commercial lease that have become too onerous, compensate the landlord for early determination of the lease, and to allow the insolvent to resume viable operations as best it can. *Nothing in Section 65.2, or any part of the Act protects third parties (i.e., guarantors, assignors, or others) from the consequences of an insolvent's repudiation of a commercial lease. That is to say that they remain liable when the party on whose behalf they acted becomes insolvent.* (emphasis added)

The Court explained the legal theory behind the continued liability of an original tenant after an assignment of lease. That being, when a lease is finalized, the landlord and tenant have privity of contract and privity of estate. When the lease is assigned to a new tenant, the landlord continues to have privity of contract with the assignor, but the privity of estate comes to an end. The original tenant remains liable to the landlord on his covenant. The estate or an interest in the tenancy transfers to the assignee, who, by being entitled to possession of the leased premises, is obliged to pay rent, but the original tenant remains liable should the assignee tenant not perform.

The Supreme Court of Canada dealt, secondly, with the argument that if the original tenant remains liable under the leases, the common law right of indemnification would operate to frustrate the scheme

of the bankruptcy and insolvency legislation. That is, if the landlord was entitled to collect rent and damages under the lease from the original tenant, the original tenant could seek indemnification from the bankrupt assignee, claiming as an unsecured creditor. In the result the bankrupt assignee could face an additional claim in excess of the preferred claim of the landlord under Section 65.2, thereby frustrating the objectives of the *Act* to free the tenant from a lease that has become too onerous.

The Court did not agree that this result would frustrate the objective of the *Act*. Firstly, the Court noted that the assignor is no different from other alternative debtors, none of which are released from liability under the *Act*, nor denied their common law right of indemnification. Secondly, there is nothing in the scheme of the *Act* that disallows an original tenant from seeking indemnification on a contingent claim, provided it is provable and not disallowed. The assignor would simply join the other unsecured creditors in the proceedings. The Court reasoned that if such a claim is proved, it cannot satisfy and at the same time frustrate the *Act*. In other words, it is not inconsistent with the *Act* for an original tenant to seek indemnity against the insolvent assignee and to join the line with other unsecured creditors. It is consistent, in fact, with the rights available to other alternative covenantors.

> *"Section 65.2 relates to the repudiation of leases by insolvent commercial tenants. It is not concerned with the effect of that repudiation on third parties, such as assignors and guarantors."*

To this point, the case was not much of a surprise to the leasing bar. However, the judicial gift to landlords was the discussion that followed in obiter regarding the continued efficacy of *Cummer-Yonge*.

The Court questioned whether there was any justification for distinguishing between a guarantor and an assignor post disclaimer in terms of their continued liability to a landlord after the bankruptcy of an assignee tenant.

The Court cited the case of *Stacey v. Hill*, a case of the English Court of Appeal which had the same result as *Cummer-Yonge*. Noting that the House of Lords overruled this case, the Supreme Court of Canada made the following long awaited statement at paragraph 42:

> The House of Lords went on to overrule *Stacey v. Hill*. In my opinion, *Cummer-Yonge* should meet the same fate. Post disclaimer, assignors and guarantors ought to be treated the same with respect to liability. The disclaimer alone should not relieve either from their contractual obligations.

No doubt the Supreme Court of Canada's decision in *Crystalline* will be hailed more for its *obiter* than its *ratio*.

The pronouncement of the Supreme Court of Canada that *Cummer-Yonge* is no longer the law, reflects the commercial reality driving most landlords to seek Third Party Assurances in the first place. If the tenant cannot perform its lease obligations, the landlord wants to look to someone or something that will compensate for the tenants non-performance. It would surely be the very unusual case where the landlord would not want a Third Party Assurance to continue in the face of a tenant's bankruptcy.

While stated in *obiter*, the overturning of *Cummer-Yonge* must be viewed in the context of a Court purposefully and thoroughly examining a troubled area of the law.

In light of the efforts of our highest court to over-rule *Cummer-Yonge*, landlords and their lawyers will take some comfort that Third Party Assurances given to secure lease obligations should survive post disclaimer in a tenant's bankruptcy. The defence mounted by third parties seeking to avoid landlord's claims in the face of a bankrupt tenant, will likely shift from focussing on the fact that the assurance is released on the bankruptcy of the tenant, to dissecting the actual wording of the assurance given. I suspect that drafting will continue to matter a great deal, but at least the *pas de deux* will proceed on a more commercially reasonable point.

Deborah Rogers was a partner with WeirFoulds LLP until May 2004. Presently, she is General Counsel of Brookfield Properties. Any questions about this article should be directed to Lisa Borsook at 416-947-5003.

If you prefer to receive this publication by e-mail, please let us know by sending us a message at: publications@weirfoulds.com