

## LANDLORD WAIVERS AND BANK SECURITY

By: Bruce F. Duggan

### Why should secured creditors be concerned about landlord's rights?

The common law gives landlords a right of "distrain": an enforceable lien against the property of a tenant who has failed to pay rent. Distrain allows a landlord to seize a Tenant's property, such as equipment, sell it, and use the proceeds to pay rent arrears. This landlord right creates a challenge for the enforcement of a bank's security interests because the Landlord's right of distrain has priority over the Bank's PPSA registered security. Typically, a tenant who has defaulted its bank loan has probably also defaulted on its lease.

### Exceptions to a Landlord's Priority

There are only a few situations where a landlord's right of distrain will not have priority over a secured creditor:

1. When the landlord acts in a way that terminates the lease, such as changing the locks, the landlord will also terminate the landlord-tenant relationship and the opportunity for distrain. When a tenant is in arrears of rent, a landlord can choose to either terminate the lease or distrain for rent arrears, but it cannot do both (*Bank of Montreal v. Judges*). Where a landlord's actions are such that they are deemed to have terminated the lease, the Bank has priority over the landlord's claim for rent arrears.
2. Trade Fixtures can also be exempt from Landlord distrain (859587 *Ontario Lt. v. Starmark Property Management Ltd.* and section 34 of the PPSA). Trade fixtures, such as a spray paint booth, become part of the premises as a result of their physical attachment and as such can't be the subject of landlord distrain even though trade fixtures can be removed from the premises by the tenant.
3. A landlord's right of distrain will also be invalid once an order for bankruptcy has been made, because possession of the assets of the tenant reverts to the trustee in bankruptcy at the time of bankruptcy. Additionally, in 889267 *Ontario Ltd. v. The Norfinch Group Inc.*, the landlord seized and sold some goods prior to the tenant's bankruptcy, which was held to be a valid exercise of distrain; however, the court stated that a landlord's right of distrain also involves certain obligations, including a duty of care to preserve the property, account for the monies received on its sale and to hold the balance in trust for any secured creditor(s) and the tenant.
4. A landlord can contractually postpone its priority in favour of a bank by signing a consent and waiver.

### Obtaining Bank priority over a Landlord

Landlord waivers are contractual agreements between the Bank and a landlord that provides the Bank with a limited opportunity to remove the Tenant's equipment in priority to the landlord's right of distrain. Waivers can also provide the Bank with an opportunity to take possession of the premises on specified terms.

Landlords are typically uninterested in waiving their rights of priority. Landlords argue, for example, that they may extend the terms of lease payments rather than attempt to enforce a lease and, to some extent, are constrained from removing a tenant's equipment immediately upon a default. As landlords are often in the position of extending credit for rent to a tenant, they will want priority over the tenant's equipment to reflect this risk. Other landlord's are unable to voice a reason for refusing to sign a waiver and they will often just ignore the process. Some landlords will detail objections and require multiple revisions to a proposed landlord waiver that adds many days to a transaction, and even then still decline to sign the revised waiver, or just avoid it. Generally, landlords recognize that there is "nothing in it for them" in signing a waiver and will just avoid surrendering their priority for rent.

The Bank, of course, will argue that without their financing that such equipment would not exist within the leased premises in the first place but, without negotiating leverage, such arguments typically don't get far. The Bank, without a landlord waiver, may never get an early warning that a tenant's lease is headed into default and, as a result, may be faced with many months of rent arrears by its Borrower that are in priority to the Bank. Without a landlord waiver, the Bank cannot quickly or easily enter the Borrower's premises to inspect or seize equipment if there are rent arrears.

There are occasions where the Bank should be able to obtain a landlord's waiver of its right of distraint. These occasions relate to the strength of a borrower/tenant to require its landlord to acquiesce to the Bank's requirements. For example, when a borrower is in the process of negotiating its lease, and the Bank's facilities will be used by the Tenant/Borrower to purchase equipment and leasehold improvements, the Bank should require the Tenant to include in its lease a provision that the landlord postpone any lien in favour of the bank's security. This is a negotiation that occurs between the borrower/tenant and the landlord, but the Bank is directing the tenant's negotiations. This is the single instance where a bank should always be able to obtain a landlord postponement.

In every other situation, if a general landlord waiver is not available, the bank should at least seek a covenant from the Landlord to provide the Bank with early notice of any lease default. While this does not give the bank priority, it at least gives the bank an opportunity to involve itself early in the problem before the rent arrears escalate to a large number.

*Simmons da Silva & Sinton LLP are approved, external counsel to the Bank of Montreal and have been assisting with mid-market and small-medium enterprise transactions for more than 40 years. More recently, Simmons da Silva & Sinton LLP have been representing the Bank of Montreal on CSBFA transactions.*

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