

Commercial Financing - Securing Interests In Leases And Rents

(Last Revised January, 2005)

The following is intended for general information only, regarding some of the issues relating to businesses operating in Saskatchewan. We advise you to seek specific legal advice prior to making any of the arrangements outlined in this article, as the particular facts of each person's situation will vary, as will the advisability and effectiveness of any particular strategy.

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1. INTRODUCTION

For the most part, commercial mortgage transactions involve properties which are either the actual business location for the borrower or which are occupied by any number of tenants paying rent to the borrower. In the latter case, the commercial lender is interested in securing not only the real property but the leases, and rental payments thereunder, as well. Taking security in leases and rents and enforcing this security raises specific issues relating to registration, priority, notices and court approvals, issues which, although not overly complex, must be understood to ensure enforceable security for the commercial lender. This paper will canvas these issues and hopefully provide some practical insight in order to better protect your lender client.

2. ASSIGNMENTS OF LEASES AND RENTS - THE SECURITY DOCUMENTS

In circumstances where the borrower is a landlord for one or a number of tenants at the mortgaged premises, and the lender wishes to obtain security in the leases and the rents payable by the tenants, a separate assignment of leases and rents document should be obtained from the borrower in addition to the mortgage. Mortgage documents often contain provisions creating assignments of leases and rents in favour of the mortgagee and although this solves the requirement for land titles registration, as will be discussed later, it creates a potential enforcement problem. Section 132(1) of The Land Titles Act, 2000 S.S. 2000, c. L-5.1, provides, among other things, that proceedings may be brought in the Court of Queen's Bench to enforce the payment of money secured by mortgage. Thus, it is arguable that any steps to enforce the assignment of rents provision in a mortgage must be taken at and supervised by the court. Usually, the action of serving notices on tenants requiring the tenants to pay rent to the lender is couched in immediacy and being forced to obtain court approval for such actions would be potentially troublesome

for the lender. A separate assignment document avoids this problem as the scope of section 132 would not extend to a separate assignment.

Which to use - a general assignment of leases and rents or a specific assignment of leases? Most commercial mortgage transactions would dictate a general assignment, even if there is only one tenant. The general assignment document creates an interest in present and future leases and rents. Therefore, if the mortgaged premises are sub-divided so as to create more leased spaces or if tenants leave and new tenants sign on, the lender is protected and has security in these new leases and rents without requiring further documentation from the borrower.

A specific assignment of lease is used where the lender is interested in one particular lease only. Often this arises where the premises have one strong tenant under a long-term lease. In the particular circumstances, a general assignment may appear as overkill to the borrower. It should be remembered that a general assignment and a specific assignment create the same rights in the leases in favour of the lender.

Assignments of either kind will generally include a description of the leases or lease as the case may be. If you are taking a general assignment, the lack of lease descriptions is not fatal; however, it is suggested that descriptions be inserted to ensure both lender and borrower are in agreement as to the lease status of the mortgaged premises at the time of initial registration and funding. The assignment should use "including, but not limited to," language when referencing the lease descriptions, so as to not restrict the effect of the assignment to the described leases. Of course, in a specific assignment scenario, the lease description is absolutely required. Such descriptions would include name of tenant and landlord (if different from the borrower), date of lease, term of lease, any renewal options, and a description of any assignments by landlord or tenant to create a chain of title from the original lease document to the current borrower and tenant.

Finally, the assignment documents for either a specific or general assignment generally contain a provision allowing the borrower to continue to collect the rents under the leases affecting the mortgaged premises until such time as the lender delivers notice to the tenants to pay the rents to the lender. Only in rare circumstances does a lender wish to direct the rents to itself immediately upon the borrower executing the assignment. Presumably if the lender is concerned enough with the borrower to require the direction of rents immediately, then the entire loan program should be questioned. Normally, the borrower is allowed to operate the mortgaged premises in the ordinary course, collect the rents and make the scheduled loan payments to the mortgagee provided in the mortgage, loan agreement or promissory note as the case may be. This is more efficient administratively for the lender.

3. REGISTRATION AND PRIORITY

Section 144 of The Land Titles Act, 2000, provides that for the purposes of determining priority among successive holders of rights in rents, an interest that arises pursuant to an assignment of rents is deemed to be an interest in land and may be registered. Priority is, therefore, governed by The Land Titles Act, 2000, thus requiring registration under the land titles system. A general assignment of leases and rents or

a specific assignment of lease is to be registered against title to the mortgaged premises by way of application for registration of an interest. Subject to the comments made earlier relating to enforcement, an assignment of rents provision in a mortgage, in all likelihood, meets the land titles registration requirement once the mortgage itself is registered.¹

If you search a particular title and do not find an interest registration protecting an assignment of rents, remember to also check the wording of any prior registered mortgage for a provision creating an assignment of rents. It would be unfortunate to assume "no interest registration, no assignment" only to later discover the clause in the registered first mortgage to which your client would lose its presumed priority in the rents.

4. REVIEWING LEASES FOR LENDERS

When you receive instructions to act on a commercial mortgage transaction, those instructions may include the request to review the existing leases relating to the mortgaged premises for the lender. Some lenders undertake this review themselves, obtaining copies of the leases directly from the borrower or through lender's counsel. Other lenders place that task with their counsel as part of the security preparation and registration retainer. What interests lenders in the leases and what can be obtained from the tenants to provide additional comfort to lenders?

As may be obvious, lenders are primarily interested in who the tenant is, the term of the lease and the rent payable. Tenants of a "national" character (i.e., oil companies, department stores, convenience store chains), and the provincial government are considered strong tenants. The covenant to pay rent, and, therefore, provide cash flow to the borrower, can be viewed with more stability when tenants of this nature are involved. If the tenant is unknown to the lender, you can provide information which may be on file at the Corporations Branch, for example, in an effort to better identify such a tenant. Related to this issue is whether the lease is supported by any guarantees. The existence of guarantees helps to bolster the covenant of the tenant, perhaps to a level acceptable to the lender.

With respect to term, it is preferable if all, or at least the major tenant leases, expire after the maturity of the loan in question. If such leases expire prior to maturity, the borrower could suffer a cash crunch if replacement tenants are not found. The lender is desirous of ensuring security of rent flow for the entire term of the loan. Where the property involves a number of leases (such as a shopping centre), the leases should preferably have staggered expiry dates, again to protect against a sudden loss of cash flow during the term of the loan.

The amount of rent payable by the tenants should be reviewed and, in doing so, percentage rent can be ignored. Concentrate on base rent as percentage rent is an unknown quantity. Lenders wish to ensure that the amount of rent being paid by the tenants reflects market rents that are being charged elsewhere for similar premises. If the lender is from out of province, you may wish to obtain market rent information to assist in the review.

Related to the payment of rent are two other issues of note. First, does the lease allow the tenant to prepay rents? As you can appreciate, prepayment of rent is a potential nightmare for lenders when enforcement measures are taken. On occasion the lender will find the rent all prepaid and the assignment of no practical effect. Secondly, the nature of the lease (i.e., net to the landlord or gross) should be reviewed. If the lease is not a "net" lease, the financial obligations on the part of the borrower/landlord contained in the lease may affect its ability to service the loan repayment.

Tenant rights (in addition to the right to prepay rent) are also of interest to lenders. Does the tenant possess the right to terminate or surrender the lease without the consent of the borrower/landlord? If so, the risk of losing a tenant is increased, perhaps to an unacceptable level from the lender's perspective. It is preferable for the lease to allow damages and specific performance as remedies for tenants as compared to termination. Similarly, rights of set-off and rent abatement can affect rent flow, especially the former. If the event which gives rise to the right of set-off appears likely to occur, this should be brought to the attention of the lender.

Other issues which may be of some interest to a lender:

1. Insurance - are lease terms sufficiently onerous to create adequate funds to repair the building in a prompt manner, thus limiting the rent abatement period?;
2. Are the landlord covenants reasonable as the lender will be subject to such covenants in a foreclosure or receivership scenario?;
3. Assignment and sub-letting - how easy is it for a tenant to transfer its interest, perhaps to a less desirable tenant? Leases requiring the landlord to financially approve any assignee or sub-lessee provide comfort on this issue; and
4. Subordination, attornment and non-disturbance - do these provisions create an unreasonable burden on the landlord and the lender? (This issue will be discussed in more detail later in this paper.)

Having considered many if not all of these issues on behalf of your lender client, it always must be remembered that location can overcome a number of these problems if they exist. If the mortgaged premises are naturally rentable, tenants at market rent on reasonable lease terms can probably be found. Your lender client will be the ultimate judge of this issue.

In order to deal with some of the main issues raised above, and to provide greater protection to the lender, the security documents should include notices to tenants and tenant acknowledgments. (Examples of each document are attached to this paper.) The former document is a notice signed by the lender and provided to the tenant advising the tenant of the assignment of rents and putting the tenant on notice as to certain matters to which the landlord/borrower cannot agree without the lender's consent. The latter document (also known as an estoppel certificate) is provided by the tenant to the lender. It contains a confirmation of the present lease status, it acknowledges receipt of the notice from the lender, and it includes covenants on the tenant's part not to prepay rents, amend the lease or terminate or surrender the lease without the approval of the lender. The acknowledgment will serve to identify any existing landlord/tenant disputes or the prepayment of rent which would be of concern to a lender. As a practical

note, it is preferable to put these notices and acknowledgments into the hands of the tenants (usually through the borrower's counsel) as soon as possible as tenants can be slow to return the acknowledgments. In the case of major tenant leases, funding should not proceed without the acknowledgments having been received.

Leases often contain provisions relating to subordination and attornment in favour of the landlord's lender and occasionally deal specifically with non-disturbance agreements. A subordination clause confirms the priority position of the lender over the particular lease which puts the lender in the position of being able to terminate this lease in the event of a foreclosure. The tenant agrees to formally register a postponement of any caveat in favour of the lender's mortgage. The attornment provision recognizes the lender as the landlord in the event of foreclosure and the tenant agrees to continue to be bound by the terms of the lease in such circumstances. Without anything further, these clauses place the lender in the most desired position from the point of view of control of the mortgaged premises.

In circumstances where the tenant has provided a subordination and attornment in favour of the lender, this tenant has a desire to ensure that its lease, and the occupancy of the mortgaged premises, will not be affected by any foreclosure proceedings. Often a substantial investment has been made by the tenant in leasehold improvements and the tenant wishes to fulfil the terms of the lease. Further, depending on the tenant, the lender itself may have an interest in ensuring that the lease continues as the mortgaged premises may be more marketable to potential purchasers with certain leases in place. The result is the execution of a non-disturbance agreement between the lender and the particular tenant. The lease review may reveal a provision requiring the landlord to obtain a non-disturbance agreement from any lender in favour of the particular tenant. Again, the acceptability of this provision to the lender may very well depend on the nature of the tenant. At the very least, if such a lease provision is acceptable to the lender, the form of non-disturbance agreement should be controlled by the lender.

Acknowledgment is given to "A Lender's View of Shopping Centre Leases" by Ray E. Lawson and Herbert B. McNally, Q.C. and "Subordination and Attornment" by Lionel B. White and Harold Spring, both found in Shopping Centre Leases, Harvey M. Haber, Editor, Canada Law Book Limited, 1976.)

5. ENFORCEMENT OF ASSIGNMENTS OF RENTS

As discussed above, an assignment of rents allows the borrower to collect the rents until the lender notifies the tenants otherwise. If default has occurred under the main loan documentation (usually in the form of non-payment of principal and/or interest), the lender will want to take control of the rents pursuant to the assignment as soon as possible. If a separate assignment document exists, section 132(1) of The Land Titles Act, 2000 will not operate so as to require court approval for the rental enforcement measures. Notices must be provided to the tenants to pay future rents to the lender. There is no statutory form for such a notice; however, it should be sufficiently detailed to avoid any confusion on the part of the tenant. Circumstances often dictate that these notices be served immediately in order to catch the next rental payment date or to thwart the efforts of the borrower in making special arrangements with tenants. Personal service of the notices, even with the use of a bailiff, is recommended to guarantee receipt by the

tenants. Once the notice is served, the lender collects the rents and enforces the lease in the place of the borrower as provided in the assignment document.

A matter to consider when providing the notice to tenants is the potential application of the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3. First, if a receiver is being appointed over rents, issues and profits, the requirements governing receivers contained in Part XI of the Bankruptcy and Insolvency Act must be followed. Secondly, section 244(1) of the Bankruptcy and Insolvency Act may govern the circumstances. Under that provision, a secured creditor which intends to enforce security on all or substantially all of the accounts receivable of an insolvent person, used in relation to a business carried on by the insolvent person, is to serve notice of intention to enforce that security. Each enforcement scenario will turn on its own facts as to whether section 244 will apply. For example, if the borrower holds multiple revenue properties, acting on an assignment of rents with respect to one such property will not trigger the notice of intention. If the mortgaged premises are the only such property held by the borrower, then arguably the rents are all or substantially all of the accounts receivable of the borrower and the rental property is a business. Serving a section 244 notice of intention would be prudent. Further, if the borrower is not "insolvent" as defined in section 2(1) of the Bankruptcy and Insolvency Act, the notice of intention need not be served. Does the failure to make mortgage payments result in insolvency? Perhaps not in and of itself, however, the question may not be answerable, being based on property valuations and other criteria, until long after the rents have been steered to the lender. Again caution would suggest serving the notice of intention where at least the "all or substantially all of the accounts receivable" test has been met.

One aspect to rent collection and lender remedies which does require court approval is the ability of a lender to enter into new leases of the mortgaged premises. Section 132 of The Land Titles Act, 2000 states that the court may authorize a lender, whether in possession of the mortgaged premises or not, to lease the subject property, or part thereof, with the restriction that such leases shall not extend beyond five years. An assignment of rents document does not create the right to lease in favour of the lender - court approval pursuant to section 132 is the only route.

In making such an order, the court will look to issues such as whether the mortgaged premises are vacant, in disrepair or subject to neglect by the borrower, whether the presence of the lender is needed to preserve the value of the mortgaged premises, and whether the borrower has acted so as to collect rents but not maintain utilities and taxes. (See Royal Trust Corporation of Canada v. Orient Trading Company Limited, et al, [1993] S.J. No. 116 (Sask Q.B.), Touche Ross Limited v. Galaxy Investments Inc. et al (1986), 49 Sask R. 122 (Sask Q.B.), and Co-operative Trust Company of Canada v. Target 21 Industries Ltd. et al (1984), 36 Sask R. 287 (Sask Q.B.)) Each of these decisions recognize that granting an order of possession of the mortgaged premises prior to completion of the foreclosure proceedings is unusual; however, if some or all of the tests described above are met, an order can be issued allowing the lender to control and lease the premises.

6. Contacting a Lawyer on This Subject

For more information on this subject or specific legal advice, contact Robertson Stromberg Pedersen LLP at (306) 652-7575.

¹ It should be noted that section 144 of The Land Titles Act, 2000, does not apply where **all** of the competing interests arose prior to April 1, 1995. Prior to April 1, 1995, priorities with respect to assignments of rents were deemed under s. 4(f) of The Personal Property Security Act, S.S. 1979-80, c. P-6.1 (repealed) (the “old PPSA”) to be interests in personal property and therefore governed by the personal property security regime. On April 1, 1995, s. 124.3 of The Land Titles Act, R.S.S. 1978, c. L-5 (repealed) (the “old Land Titles Act”) (the predecessor legislation to The Land Titles Act, 2000) came into force to deem assignments of rents to be interests in land and to have priority governed by the land titles regime. There was a transitional provision such that s. 124.3 of the old Land Titles Act did not apply where all of the competing interests in assignments of rents arose prior to April 1, 1995 or where there was a conflict between an interest that arose prior to coming into force of s. 124.3 and an interest that arose within 6 months of the coming into force of s. 124.3. Where s. 124.3 of the old Land Titles Act did not apply, priorities with respect to competing interests in assignments of rents were governed by the old PPSA. Thus for example, if all of the competing interests in assignments of rents arose prior to April 1, 1995, the old PPSA governed. By way of further example, if there were two competing interests with one arising before April 1, 1995 and the second within six months following April 1, 1995, the old PPSA governed. However, if the second competing interest arose more than six months after April 1, 1995, then the old Land Titles Act governed. The practical effect of this was to force existing holders of assignments of rents as at April 1, 1995, to register their interests under the old Land Titles Act. The old Land Titles Act has been repealed and replaced by The Land Titles Act, 2000. As already noted, s. 144 of The Land Titles Act, 2000 simply provides that the section does not apply where **all** of the competing interests arose prior to April 1, 1995. As a practical matter, most lenders as at April 1, 1995 who had taken an assignment of rents prior to that date will by now have registered under the land titles regime. If they have not done so, then they should do so as soon as possible.