Landlord Mortgage Defaults:

Ensuring Tenants have Security of Tenure and are able to claim any amounts owed by the original landlord. [1]

The Six – Minute Commercial Leasing Lawyer 2021

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1. Introduction - Old Problem, New Circumstances

Commercial tenants may not understand that they can be evicted if the landlord defaults under its mortgage, even if the tenant continues to pay its rent and comply with the terms of the lease. This article will address the circumstances under which a commercial tenant could lose its lease and its right to occupy the premises to a mortgagee in Ontario and how to avoid that result. I will also review the steps that can be taken to ensure the lease will survive a mortgage default, while still retaining all of the accrued rights and remedies which have arisen prior to the mortgage default, intact and enforceable by the tenant.

COVID-19 and the resulting economic crisis have made security of tenure (the prevention of the unilateral termination of the lease and retaking of possession from the tenant) more relevant and default under mortgages more likely to occur as retail tenants struggle to reopen, commercial tenants struggle to pay rent and all tenants try to come to terms with the value proposition of maintaining physical locations for business. Landlords could face higher vacancies, declining cash flow from rents, and demands from lenders to maintain payments on mortgages taken out under different economic circumstances. The result is that some landlords will default under their mortgages.

From the tenant's perspective, security of tenure will become an issue for those who occupy commercial premises if the landlord defaults on its mortgage and the lender steps in (in this article I will refer to the lender as the "mortgagee" assuming the loan is by way of a mortgage/charge on the property). Related issues that I will address include the question of who will carry out the landlord's obligations under the lease and, if the

mortgagee goes into possession of the property or sells it and the tenant remains, will the tenant be able to continue to enforce and rely on any of its accrued rights and all of the terms of its existing lease.

As a lawyer who has a great deal of experience dealing with lease negotiations, drafting and registration issues are very familiar to me. The pure title issues and real estate issues are dealt with less often by me because, as a practical matter, professionals practicing mortgage enforcement do not often involve the leasing professionals when a mortgagee enforces it mortgage. Disputes are often negotiated, the tenant and mortgagee generally come to terms as they often want the same thing – namely, the tenant to stay. The installation of a receiver by the mortgagee or the court to manage the property and facilitate the foreclosure or sale process also avoids many of the pitfalls which are described in the *Goodyear* case and other cases cited herein. There are many good articles addressing the finer real estate issues.

I am going to assume for the purposes of this paper that the registered owner of the property has granted a mortgage to a lender and has also entered into a lease of some or all of the property. If the lease is with a head tenant, as landlord, there may be additional considerations not dealt with in this article. This article does not address residential leases.

2. Right of the Landlord or the Tenant to Terminate the Lease

A commercial lease represents an interest in the property – a “leasehold interest”. As a result, it is governed by the system of registrations and the rules of priority under the *Land Titles Act* (Ontario) or the *Registry Act* (Ontario). The general rule is that the priority of interests in the property are determined by order of registration.

When an owner acquires a property, it registers its deed. The owner (who will be our “landlord”) owns all of the property rights, the “freehold interest”, subject to existing easements and agreements and certain exceptions which I will address later. The freehold interest is superior to a leasehold interest in the property. The landlord then takes out a loan from a mortgagee and grants a charge[3] on its freehold interest in

favour of the mortgagee. The landlord may also be asked to give additional security by way of an assignment of rents and an assignment of leases. The mortgagee registers its mortgage on title and may also make registrations for its assignment of rents and assignment of leases. When a landlord enters into a lease with a commercial tenant the tenant can register that lease on title. If we were to get a copy of the parcel register from the land titles office for this property after the foregoing, we would see the following documents registered on title in the following order:

(a) The Deed;

(b) The Mortgage (and possibly assignment of rents and PPSA notice); and

(c) The Notice of lease (or the lease or a short form of lease).[4]

The way the law of property in Ontario works is that the owner can grant rights to a mortgagee and the tenant and its interest is then subject to the rights of the mortgagee and the tenant. The mortgagee and the tenant can then enforce their mortgage and lease, respectively, against the landlord.

Things get more complicated when it comes to the mortgagee enforcing its mortgage rights against the tenant and the tenant enforcing its rights under the lease against the mortgagee. This becomes an issue when the landlord defaults under the mortgage and the mortgagee pursues its remedies under the mortgage, the assignment of rents and/or an assignment of leases.

The remedies the mortgagee may pursue against the landlord and the property include:

(i) seeking to enter into possession of the property itself or through a receiver; and

(ii) foreclosing and becoming registered owner of the property; or

(iii) selling the property under power of sale to a third party.

In the circumstances of (i) above, the tenant will be dealing with the mortgagee until further action is taken by the mortgagee or the landlord puts the mortgage back in good standing ("redeeming" the mortgage) by curing the default or paying off the mortgage. You can see in the circumstances of (ii) and (iii) the tenant will have a new landlord/owner.

The question for the tenant is: what happens to the lease in each of these circumstances?

If we go back to the principle of determining priority by order of registration based on the list above, then the mortgagee has priority over the lease because the mortgage was registered prior to the lease. When the mortgagee entered into its deal with the Landlord, there was no lease. In this situation, the law says that the mortgagee can proceed as if the lease does not bind it and can obtain an order for possession and removal of the tenant. Bad news for the tenant who was hoping to stay in the property and enjoy its lease.

However, the courts have said that a breach of the mortgage, which gives the mortgagee the right to possession and sale, amounts to a breach of quiet possession by the landlord under the lease.[5] As a result, the tenant has the right to terminate the lease, regardless of the independent actions of the mortgagee. This is bad for the mortgagee who wants to succeed to the rights of the landlord and maintain the lease, because losing the tenant could have a serious adverse impact on the value of the mortgagee's security. However, it is good for a tenant who would prefer to terminate the lease.

The reason the tenant and the mortgagee have these problems is because the mortgagee's contract (the mortgage) is with the landlord alone and the tenant's contract (the lease) is with the landlord alone. At this point in the example, there is no written agreement between the mortgagee and the tenant and so the courts have said the parties have no privity of contract (rights as between one another arising under a written contract between them).

Also, the tenant and the mortgagee also have no privity of estate (rights as between one another by virtue of their interest in the property). Both the landlord and tenant can enforce the lease against the other because of their respective interest in the estate. Similarly, if the property is sold by the landlord or the mortgagee (and the lease has not been terminated), the purchaser takes the property subject to the lease and the new owner and the tenant (and its permitted assignees) can enforce the existing lease against one another.[6] Therefore, the courts have so far concluded the mortgagee has no privity of estate with the tenant and cannot enforce the lease under this concept of privity.[7]

Privity of contract exists between the Landlord and mortgagee under the written mortgage and between the landlord and the tenant under the written lease. Let me stop here and remind you that, subject to few exceptions, a lease must be in writing to be enforceable.[8]

There is the possibility that the mortgagee was asked by the landlord and the tenant to consent to the lease at the time it was signed. If such a consent was obtained from the mortgagee, the mortgagee may be estopped from terminating the lease upon default under the mortgage.

The solution to our problem between the mortgagee and the tenant is to have them sign an agreement that addresses the issue of what happens when the mortgagee exercises its remedies in the case of a default under the mortgage by the owner/Landlord.

3. Subordination, Non-Disturbance and Attornment Agreement (“SNDA”), Non-Disturbance Agreement (“NDA”), and Postponement and Non-Disturbance Agreement (“PNDA”)

Often referred to as an “SNDA” or “NDA” (depending on the context which determines what you need), a subordination, non-disturbance and attornment agreement is a separate contract between the tenant and the mortgagee wherein the tenant effectively agrees to “subordinate” (agree that its lease is subordinate in priority

to the mortgage if registered or in existence prior to the mortgage being registered) and "attorn" (agree to stay in the premises and honor the terms of the lease, if the mortgagee wants it to) to the mortgagee. In return, the mortgagee promises to: (i) provide security of tenure and not disturb the tenant's possession (i.e. not evict the tenant), and (ii) assume and honor the landlord's obligations under the lease, as long as the tenant continues to comply with its obligations in the lease. An SNDA is enforceable because there is a direct written agreement between the mortgagee and the tenant and the mortgagee has agreed to assume the obligations of the landlord, resulting in privity of contract.

An SNDA can be entered into at any time, but it is best for the tenant to obtain the agreement at the same time it negotiates the initial lease. I often say that the only time a tenant is going to get a tenant favourable SNDA from a mortgagee is when the tenant makes it a condition of signing the lease. The landlord in that case is motivated to push the mortgagee for what the tenant wants. The most common practice in the industry is for the landlord to undertake under the terms of the lease to make reasonable commercial efforts to obtain an SNDA from present and future lenders on the lender's standard form, subject to reasonable changes requested by the tenant. They may not get it and the terms may not be satisfactory from a tenant point of view. In the *Goodyear* case, the mortgagee and the tenant negotiated the SNDA on and off for 5 years after the lease was signed before abandoning the effort, much to the regret of the mortgagee.

Like any contract, an SNDA will only solve your problem if the terms address the problem and provide for a solution. So, let's review the issues and possible solutions that can be canvassed while negotiating an SNDA.

I start with a caution to get an SNDA and deal with the equities and state of accounts issues. However, sometimes the tenant does not have the leverage or budget to obtain an SNDA. How does the tenant assess the risk? Some of these considerations include:

(a) The identity and financial strength of the landlord – e.g. institutional landlord vs stand alone building owned by a private landlord;

(b) The identity of the lender – e.g. institutional lender vs private lender;

(c) The location and type of property – is it a large regional mall, a smaller strip plaza, a large office building or stand-alone industrial premises?

(d) What does the tenant have to lose in the circumstances – has the tenant spent a lot on improvements to the property, is it a long term with options to extend, and is the location key to the business?

(e) As I point out elsewhere, it is often in the mortgagee's and the tenant's mutual best interests that the tenant remain in the premises under the current lease.

For instance, a tenant may decide not to obtain an SNDA in circumstances where it occupies a smaller space in a large regional mall, owned and financed by a one or more large institutions. On the other hand, a tenant may be more inclined to obtain an SNDA if it is leasing a stand-alone building to which they will make significant improvements, in a great location, at favourable rental rates, and where the property is owned by a private owner.

4. Issues to address in an SNDA

From the mortgagee's perspective, a mortgagee will generally be amenable to providing a SNDA because it is possible that the value of the property is attributable to: the rental income, the strength of the tenant covenant and the term of the lease. It often does not make sense for the mortgagee to terminate the lease when the landlord defaults under the mortgage. Consequently, the mortgagee wants to be sure the tenant does not terminate either. However, if the lease was registered before the mortgage, then the mortgagee does not have the same concern because in that case the tenant does not have the option to terminate the lease.[9]

From the tenant's perspective, the tenant wants an SNDA so that they can continue to occupy the premises under the terms of their lease following the landlord's default under the mortgage.

In the negotiation of the terms of the SNDA it may be helpful to keep in mind and to distinguish between (i) those issues directly related to the lease - rent and repair for instance, (ii) those matters of which the tenant can give the mortgagee notice during the term and a chance to remedy - breaches by the landlord entitling the tenant to terminate for instance, and (iii) issues not related directly to the lease - punitive damages, amounts owed to the tenant by the landlord.

One purpose of this article is to address how to preserve the equities that have accrued between the landlord and the tenant before the default under the mortgage. I will therefore address that issue and a few others to explain how the drafting of the SNDA tries to fix the problems identified so far, but this discussion is not a comprehensive list of issues and options that may arise when you negotiate an SNDA.[10]

(a) Security of tenure: The tenant wants to ensure that if the mortgagee goes into possession, forecloses or sells the property the tenant can stay in the premises.

(b) Estoppel: The landlord wants to tenant to confirm at the time of signing the SNDA that, among other things, there is no prepaid rent, there are no tenant allowances owing to it from the landlord, there are no free rent periods, options to extend or early termination rights (to which the tenant will add "other than as expressly provided in the lease"), and "to the knowledge of the tenant" the landlord is not in breach of the lease.

(c) Attornment: The Mortgagee wants privity of contract with tenant and wants the tenant to agree to attorn to the mortgagee so it will be able to enforce the terms of the lease and keep the tenant in the premises. This is in addition to the attornment clause in the lease.

(d) Changes to the Lease: The mortgagee is agreeing to respect the lease in the current form as of the date of signing and therefore wants a prohibition on future changes to the lease or, as a step down position, it does not want to be bound by

changes it did not consent to. This last point is problematic for a tenant and how it is resolved will have a big impact on which terms of the lease (and any future amendments) can be relied upon by the tenant in the future following the mortgagee taking possession.

(e) Payment of rent to the mortgagee: The tenant will want the agreement to say it does not have to pay rent to the mortgagee until the mortgagee has succeeded to the interest of the landlord and taken possession of the property. This has consequences to the discussion around assignment of rents below. The tenant may also ask the landlord to be a party to the SNDA to acknowledge the right of the tenant to act on the notice to pay rent to the mortgagee.

(f) Special covenants that impact the lease terms: A prohibition on changes to the lease is what I refer to as an example of a special covenant. The tenant does not want to add new covenants with the mortgagee which qualify or add to the obligations already negotiated under the lease. At the very least, it can cause an administrative problem as the tenant will have to keep in mind the terms of the SNDA when it is negotiating amendments to the lease or dealing with issues with the landlord over the years of the term. At the very worst, the tenant may agree to amend the lease in the future with the landlord and the terms of the amendment will not bind the mortgagee in possession.

(g) Maintenance and repair of the property: The tenant wants the mortgagee to assume the obligations of the Landlord for maintaining, repairing and replacing the premises and the property under the terms of the lease if it goes into possession. This can be achieved by the mortgagee agreeing to be bound, as landlord, under the lease.

(h) Enforce the existing rights or equities: Tenant wants to be able to enforce all of its rights under the lease including its personal rights (as opposed to just those rights that “run with the land”). [11]

The mortgagee does not want to be liable for the equities or state of accounts between the landlord and tenant during the term of the lease accrued before the

mortgagee takes possession, as the mortgagee had nothing to do with it. The mortgagee will want to (i) exclude any liability for any act or omission of the landlord, (ii) not be subject to any set off or defence which the tenant might have against the landlord, or (iii) not be bound by any minimum rent, percentage rent or additional rent which the tenant has paid to the landlord for more than the current month.[12] The tenant will want the mortgagee to assume the obligations of the landlord under the lease whenever arising and subject to all of the equities which may have accrued in favour of the tenant.

What must be addressed in the SNDA depends on the circumstances. I am proceeding on the basis of the tenant seeking a SNDA at the time of entering into the lease with the existing mortgagee. The lease will also hopefully provide that an SNDA will be obtained from future mortgagees as a condition of agreeing to subordinate and attorn to them under the lease.

It is the practice of some lenders to send tenants an acknowledgment of attornment by the tenant in favour of the mortgagee to sign in connection with new financings. This can be combined in the estoppel certificate. This is an attempt to overcome the privity of contract issue, however, on its own, it does not address the tenant's many other possible concerns.

5. The TDL Group Case

In the Ontario Court of Appeal case *473807 Ontario Ltd. V TDL Group Ltd.* ("*TDL Group*"), the mortgagee and the tenant ("TDL") signed an SNDA (which the court referred to as a "PNDA") at the time the landlord entered into the mortgage agreement. The landlord subsequently went into default under the mortgage and the mortgagee took possession. The SNDA provided for TDL's agreement to postpone its lease to the mortgage (that is to give the mortgage priority over the lease) in return for the mortgagee's agreement to give TDL security of tenure. As long as TDL paid the rent required by the lease, the mortgagee would not disturb TDL's possession of the premises. The postponement provision of the SNDA reordered priorities. The other rights and obligations were dependant on other terms of the SNDA, which provided that

when the mortgagee went into possession, it would step into the landlord's shoes and assume the landlord's obligations under the lease. TDL was to be no worse off in a tenancy relationship with the mortgagee than it was under its tenancy with the landlord.[13]

The problem in the TDL Group case was that the tenant had obtained a judgment against the Landlord before the mortgage went into default. The amount of the judgment ($700,000) could be set off against the rent due under the lease, resulting in the tenant not having to pay any further rent for many years. That was the scenario under which the mortgagee took possession of the property. When the mortgagee discovered the tenant had no intention of paying any rent, they took the matter to court.

The case is instructive not only to privity but is also as a summary of the issues to be addressed in a well drafted SNDA. The court stated:

1. A mortgagee who has a mortgage registered before the lease cannot enforce the lease when it goes into possession. If it accepts rent, a new lease is created as set out in *Goodyear*. By their conduct the mortgagee and the tenant adjusted their legal rights.

2. In the case in 1, the mortgagee has not agreed to assume any obligations of the landlord under the original lease.

3. A mortgagee who signed a PNDA with the tenant has now created privity of contract that was absent in 1. In the TDL case, the PNDA was determinative as it said the mortgagee would "*become the mortgagee's tenant under the Lease*", "*upon all terms and conditions of the Lease*," if it "s*ucceeded to the interest of the landlord under the Lease*". [14]

4. By the assignment of rents and the PNDA, the mortgagee became the landlord's assignee, or at least assumed a position identical to that of an assignee and so it was subject to the equities and state of accounts between the landlord and the tenant.

5. An attornment clause alone in the lease does not create privity between the mortgagee and the tenant. [15]

6. Where one of two innocent parties, the mortgagee and the tenant, must suffer for the default of the assignor, the law will protect the obligor (tenant), subject to any direct agreement otherwise.[16]

The case provides that under an SNDA the tenant will be protected and the state of accounts and equities accrued under the lease will be enforceable against the mortgagee **unless the parties agree otherwise in the SNDA**. The court cited references which suggested that set-offs are usually excluded by mortgagees in SNDA's and estoppel certificates are regularly obtained before taking possession as a matter of commercial practice, but the mortgagee did neither in this case.

At this point in the article I feel I have covered the subject matter of the initial issues:

(a) How does a tenant avoid the lease being terminated in the event of a default by the landlord under a mortgage?

i. register a notice of lease on title to the property;

ii. get an SNDA signed with the existing mortgagee(s); and

iii. make the subordination and attornment provisions of the lease subject to the tenant obtaining an SNDA from future mortgagees.

(b) How does a tenant preserve the accrued rights and all of the lease terms going forward following a mortgage default?

i. Get the mortgagee to agree in the SNDA to be bound by all of the terms of the existing lease and the equities and statement of accounts between the landlord and the tenant up to the time of the mortgagee going into possession (or perhaps just don't let them be excluded).

However, if the notice of lease is not registered and/or the SNDA is not in place, it becomes more complicated. Besides being governed by the agreements of the parties, the results may also be governed by the terms of the lease, the conduct of the parties and other agreements. Therefore, I would like to delve into some of the cases and legal issues that result in the conclusions I have relied upon above. I have not discussed them in detail thus far as I felt it would overly complicate the points I wanted to make. However, some of the following points provide further insight as to why it is best to address the issues by written agreement.

I would also like to review some of the terms of the lease that may be addressed at the time the lease is entered into that relate to maintaining security of tenure.

6. Goodyear – It is possible to have two leases at once

I have referred to the Ontario Court of Appeal case of *Goodyear Canada Inc. v. Burnhamthorpe Square Inc*. ("*Goodyear*")[17] in the text above. It is the law of Ontario when it comes to the priority between a prior registered mortgage and a lease. It is a remarkable case for a number of reasons, but there are a couple of things in particular I want to point out.

The first is that it was the tenant who took the opportunity to terminate a long-term lease when the mortgagee went in possession. In my experience, it is the tenant who would like to stay and that is the approach and assumption I have proceeded on for this article. Changing economic circumstances and downward pressure on rental rates could makes this a more common approach.

The second remarkable thing is the concept that once a mortgagee accepts rent and takes possession there are in fact two leases existing simultaneously – one between the tenant and the mortgagee, as well as the original lease between the tenant and the landlord. The lease with the mortgagee is a year-to-year lease, terminable upon six months' notice on "*such terms of the old lease as are consistent with a year to year tenancy*".[18] Also, it may be that personal rights of the tenant and collateral promises of the former landlord, such as a right of first refusal, would not be enforceable

under this new lease.[19] Additionally, *"the former lease between the mortgagor/landlord and the subordinate tenant is not terminated, per se. Instead, it remains operative "in the background" to be, in effect, rejuvenated if the mortgagor/landlord subsequently redeems or otherwise re-acquires possession of the mortgaged property from the mortgagee*."[20]

One other thing is that the case confirms the law that a default under the mortgage is the trigger for a breach of the covenant of quiet possession under the lease, which entitles the tenant to terminate its lease.[21]

This last point is relevant not only for the rights of the tenant under the lease, but also in the event that the mortgagee seeks to have the tenant pay rent to the mortgagee under its assignment of rents, prior to taking possession of the premises. The first time the tenant may become aware of a problem is when it receives a demand for payment under an assignment of rents. A mortgagee can take the rent and reserve the right to terminate the lease. An assignment of rents is not an interest in real property, it is an interest in the rent under the lease. In an assignment of rents, the assignor (the landlord) assigns its interest in the rental payments to a lender (the mortgagee) as collateral security to its mortgage. In the case of a default under the mortgage, the agreement permits the assignee to ask the tenant, who is obliged to pay the rent to the landlord under the lease, to pay it instead to the assignee/mortgagee.

The tenant is obliged to pay the mortgagee under a proper assignment of rents. If it does not and pays the rent to the landlord then it could be liable to pay twice. That is separate from the choice the tenant has to make about whether it wants to treat the lease as continuing or run the risk of a new lease with the mortgagee being formed by paying the rent. As a solution, the tenant may enter into an agreement with the mortgagee respecting the payments and whether the mortgagee has assumed possession. However, before the mortgagee forecloses on the property the terms the mortgagee can agree to regarding the lease or a new lease are constrained by the extent of the mortgagee's interest in the property at that time, which is subject to the right of the mortgagor to redeem.

Other considerations to note are that the landlord may try to step in and prevent the rent from being diverted to the mortgagee. As well, there may be other mortgagees with a superior claim to that of the mortgagee who sent the demand. It is also open to the mortgagee to seek to appoint, or have the court appoint, a receiver to take control of the property to avoid an unanticipated "taking of possession" and to preserve the property and the lease.[22] In the case of where the assignment is disputed or any conflicting claims arise, the tenant/debtor can pay the money to the Superior Court of Justice.[23]

A final remedy of the tenant to preserve the security of tenure may be to redeem the mortgage itself in a foreclosure action. [24]

7. Exceptions to the Rules of Priority: Unregistered Leasehold Interests

If the lease is registered before the mortgage, then the lease has priority over the mortgage. In such a case, the tenant cannot terminate the lease by reason of the mortgagee going into possession of the property.

The general rule is that any unregistered interest in property is void against a subsequent purchaser or mortgagee unless (i) the purchaser or mortgagee has actual notice of the interest, or (ii) it falls under one of the statutory exceptions for limited term leases.

(a) Common Law Constructive Notice: If the lease is registered before the mortgage, any rights of the mortgagee will be subject to the leasehold interest. However, if the Landlord has entered into a lease with a tenant prior to granting the mortgage or selling the property, the lease has not been registered, and the mortgagee or purchaser has actual or constructive notice of the unregistered lease, any interest the mortgagee or purchaser obtains in the property will be subject to the leasehold interest of the Tenant.[25]

(b) Statutory Exceptions:

(i) Section 44 (1) 4. of the *Land Titles Act* (Ontario) provides that all registered land is subject to ….*any lease or agreement to lease, for a period* ***yet to run*** *that does not exceed three years, where there is actual occupation under it*. [26]

(ii) Also, section 70(2) of the *Registry Act* (Ontario) says the rules of priority respecting registration and effect do not apply to a lease for a **term not exceeding seven years** where the actual possession goes along with the lease. [27]

8. Civil Code for Comparison Purposes

Sometimes our clients sign a lease in Quebec. I find it interesting to compare what happens in that Civil Code jurisdiction. It is my understanding that under the Quebec Civil Code, you must register notice of your Quebec lease (and any amendments) to preserve the tenant's rights and avoid termination of the lease (or the amendment) by a mortgagee or a purchaser of the property. Subordination provisions under the lease to future mortgagees should be made subject to rights acquired by your registration of the lease, as well as conditional on getting an SNDA. There is no concept of attornment in Quebec. As well, the Quebec Court of Appeal confirmed in 2013 that as long as the Tenant registers its notice of lease it does not need to include non-disturbance provisions in the lease or negotiate a SNDA with the Landlord's existing mortgagee, provided the mortgagee has not registered notice of the exercise of its hypothecary rights.[28] If your lease is with a head tenant, I understand it is still prudent practice to get a SNDA from the owner and the existing mortgagee. Please be sure to get advice from a lawyer in Quebec with respect to agreements to which Quebec law will apply.

9. Who will maintain and operate the Property?

If a landlord is in financial trouble, one concern a tenant may have is who will maintain the property and carry out the landlord's obligations under the lease? A strong self-help clause under the lease combined with a set-off right in favour of the tenant is

one step. Generally, a landlord will remain in possession of the premises and is empowered to manage the premises unless: the mortgagee becomes a mortgagee-in-possession, a receiver is appointed, or the landlord becomes bankrupt and a trustee in bankruptcy is appointed.

If a mortgagee is in possession, the mortgagee must act as a prudent owner and keep the property in a reasonable state if they are receiving a surplus of rents. In Falconbridge on Mortgages (4th Ed. 1977), it states that:

"...*a mortgagee in possession ought to do such repairs as he can repay by the rents of the estate after his interest paid, but he need not rebuild or lay out large sums beyond the rent for that would be to lend more principal money, upon, perhaps, a deficient security*."[29]

As well, a mortgagee is entitled to reimbursement if the expenditure was a reasonable one, which increased the selling value of the property or was necessary to keep the property in a proper state of repair.[30]

If a mortgagee is not in possession, it seems the same responsibilities are not required of the mortgagee to keep the property in good repair. It has been suggested that; "*if the mortgagee is receiving a surplus of rents beyond what is necessary to satisfy its debt, it could be reasonably assumed that this surplus should be put toward maintaining the property*".[31]

10. Terms of the Lease which impact Security of Tenure and the Equities

I would like to review some lease provisions that may impact the issues discussed so far, including the rights vis a vis the mortgagee, the right to register and preserve the priority of the leasehold interest of the tenant, the ability of the tenant to effectively operate if a landlord is in financial difficulties, and preserving some remedy against the landlord in the case where a tenant needs to sue for damages by reason of failure to provide quiet possession in the case of a mortgage default.

In past articles I have referred to the seven deadly words a landlord does not want to hear in a lease negotiation. They are “abatement”, “termination”, “set-off”, “allowance”, “reimbursement”, “self-help” and “the-landlord-shall”. These should be kept in mind in the circumstances we are discussing here.

(a) Subordination and Attornment:

Many leases include the subordination and attornment clauses, often found in consecutive paragraphs near the end of the lease document.

The purpose of the subordination clause is to ensure that, notwithstanding the priorities created by the order of the registration of the mortgage and the lease, a present or future mortgage has priority. As we have seen, if the mortgage has priority over the lease, there exists the possibility that the lease will be terminated or effectively amended upon the mortgagee taking possession of the property.

Attornment refers to a situation when a landlord/mortgagor defaults on its mortgage, and the mortgagee realizes on the mortgaged property and asks the tenants to attorn to it as the landlord. In a lease, it is a legal device that attempts to act as an assignment where, by paying rent to the mortgagee, the tenant accepts the mortgagee as the new landlord.[32]

The tenant should insist that the subordination and attornment provisions are not effective unless an SNDA is provided, upon terms that are satisfactory to the tenant, by all present and future mortgagees. It is not clear to me, based on the cases and commentaries, that the subordination or attornment in the lease can be enforced by the mortgagee in the case of a default under the mortgage due to lack of privity.

(b) Registration:

Leases may be registered on title to the property of the landlord. However, some leases provide that the tenant will not register the lease or notice of the lease. Be sure to amend this provision to allow the tenant to be able to register a notice of the lease or

short form of lease. If the lease is not registered, the priority of the lease will be impacted.

(c) Who is the owner?

Always check title to the property on which the leased premises is located. It may be that you need a non-disturbance agreement from a co-owner who is not signing the lease, or an owner in the case where you are leasing the premises from a head tenant. In the case of large projects, the lease is often signed by a bare trustee. You want to be sure that you have the covenant of the beneficial owner or at least a non-disturbance agreement.

(d) Transfer by the Landlord:

The tenant will often spend a lot of time negotiating the right to assign or sublet the premises. However, you should also spend some time on the clause that allows the landlord to assign the lease. The law respecting assignment provides that a landlord may assign the lease, but upon doing so it is not released from the obligations under the lease to the tenant. The clause permitting the landlord to assign the lease will likely provide that upon giving notice of assignment to the tenant, the landlord is released completely from all accrued and future liabilities. At the very least, this should be revised to preserve a claim against the landlord for all accrued equities and accounts between landlord and tenant up to the date of assumption of the lease by the assignee. As well, the tenant should add that the assignment is not effective until the assignee has assumed all of the landlord's accrued and future obligations under the lease, in writing, and having given notice to the tenant. Keep in mind that an assignment of lease to which this refers to is different from an assignment of rents.

(e) Waiver re insurance proceeds:

While you are talking to the mortgagee, ask them to waive their entitlement to retain insurance proceeds in the event of damage and destruction so the money can be used by the landlord to rebuild. The lease often provides, in the damage and destruction clause, that the landlord's obligation to rebuild is subject to its receipt of the proceeds of

the insurance policies. Under the *Mortgages Act* (Ontario) mortgagees have a choice to retain the proceeds of insurance.[33] You can also make it a condition of the lease that the landlord obtain such a waiver.

(f) Operational issues during an interim period: Set-off

If a landlord runs short of cash and is not paying the mortgage, then it is likely the maintenance and repair of the property has fallen behind as well. As a result, the tenant will want to include the right to self-help in the case of a default by the landlord. This will provide that the tenant can complete the repairs or maintain the services the landlord is responsible for and charge it back to the landlord or set it off against future rent.

The tenant can also ask for the right to pay the property taxes directly to the taxing authority if the tenant leases the entire property or the taxes on the premises are separately assessed.

(g) Financial Condition of the Landlord:

It is always a good idea that the tenant do its due diligence on the landlord and, prior to signing the lease, determine if: the landlord has a strong financial covenant, a history of good operations, and whether the property has any mortgages, easements or liens registered against it. The results of those investigations will determine which issues must be addressed and help to assess the risk of the decisions being made, such as the decision to forego registering the lease or getting an SNDA.

(h) Security from the Landlord:

If your investigations of the landlord lead you to be concerned about its financial covenant you may not want to rely on self-help and set-off alone. You can ask the landlord for security by way of a letter of credit. You could also ask for a grant of security interest in assets of the landlord in writing (which would make the tenant a secured creditor in an insolvency proceeding), and/or cross guarantees from companies related to the landlord. Besides guaranteeing the obligations of the landlord while the

lease is intact, if the lease was terminated by a mortgagee there would still be an entitlement to seek damages from the landlord and any indemnifier.

(i) Limitation on Remedies of the Tenant:

In some leases I have seen the tenant's remedies being limited to enforcing judgments for claims that have been finally determined in court and enforceable only against the landlord's interest in the property or, in some cases, the rents coming from the property. A tenant will want to delete or amend such provisions and reconcile them with the self-help rights and set-off rights it has negotiated.

(j) Security deposit and Prepaid Rent:

The tenant will probably lose the security deposit and prepaid rent in the case of an insolvency of the landlord, unless it held separated and in trust with the tenant as owner of the funds. If the tenant has concerns about the landlord then limit the amounts paid in advance.

(k) Personal Rights:

As discussed earlier in this article, personal rights negotiated in the lease may not survive a new lease with the mortgagee. Rights of first refusal, the option to lease additional space, and the option to purchase the property are some examples of what may be at risk. This is another reason why a tenant should get a strong SNDA and also register a notice of lease which includes reference to these rights.

(l) Abatement:

The possibility of reduced occupancy levels, breach of quiet enjoyment, and redevelopment of the project following this economic crisis are possibilities. A tenant should address these possibilities by adding the remedy of abating the rent in whole or in part in appropriate circumstances.[34]

(m) "Landlord shall"

I suggest tenants pay attention to the drafting of the landlord's covenants in landlord standard form leases and make sure they start with the words: "the Landlord shall". The obligations the tenant seeks to enforce must be drafted as obligations if it wants to rely upon them.

11. Conclusion:

No-one knows what will happen when the current economic crisis, brought on by the COVID-19 pandemic, ends. It will impact different projects in different ways and that justifies brushing the dust off of some of these cases and considering what might happen in order to provide the tenant with some protection for its security of tenure and its accrued rights and equities with the current landlord.

Dennis J. Tobin - February 2021

Footnotes

[1] I would like to thank and acknowledge Jacqueline Hicks, student-at-Law at Blaney McMurtry LLP for her assistance in researching this topic and editing of this article. Also, when preparing this article I sought the input of a number of lawyers at both my firm and other law firms. I want to thank them for their generosity, patience and input. Needless to say, any misstatement or errors are mine alone. This article is not intended to be legal advice. The application of the legal principles to your factual circumstances is a complex legal task and you should seek legal advice before acting on what you have read.

[2] Dennis J. Tobin is a lawyer and partner at Blaney McMurtry LLP in Toronto, Ontario with more than 30 years of experience representing landlords and tenants.

[3] Section 1 of the Land Registration Reform Act, R.S.O (1990) c. L.4 defines a charge as "a charge on land given for the purpose of securing the payment of a debt or the performance of an obligation, and includes a charge under the *Land Titles Act* and a mortgage, but does not include a rent charge; ("charge")"

[4] *Land Titles Act,* R.S.O. 1990, c. L.5, s. 38; *Registry Act,* R.S.O. 1990, c. R.20, s. 22(7). Provisions regarding what can be registered in respect of a lease.

[5] *Goodyear Canada Inc. v Burnhamthorpe Square Inc.*, (1998) 166 DLR (4th) 625, 41 OR (3d) 321 (Ont. C.A.), at para 64 [*Goodyear*]. The case references English Court of Appeal decision in Corbett v. Plowden (1884), 25 Ch. D. 678 (Eng. Ch. Div.).

[6] *Commercial Tenancies Act*, R.S.O. 1990, c. L.7, s. 7 and 8.

[7] *Goodyear, supra* note 5, paras 48-50; J. W. Lem, "A Case Commentary on Goodyear Canada Inc. v. Burnhamthorpe Square Inc." (1999) 21 R.P.R. (3d) 38, at p. 2.

[8] *Statute of Frauds,* R.S.O. 1990, c. S.19, sections 1-4;

[9] *Goodyear, supra* note 5, paras 75-78.

[10] See J. W. Lem and H. Blaikie, "Subordination and Attornment" in Harvey M. Haber, *Tenant's Rights and Remedies in a Commercial Lease: A Practical Guide,* (Aurora: Canada Law Book, 1998).

[11] Harvey M. Haber, Q.C, LSM, *The Commercial Lease: A Practical Guide*, 4th ed. (Aurora: Canada Law Book, 2004), at pp. 265-266.

[12] Supra note 10.

[13] *473807 Ontario Ltd. v TDL Group Ltd.,* (2006), 271 D.L.R. (4th) 636, 47 R.P.R. (4th) 1 (Ont. C.A.), at paras 36-37 [*TDL Group*].

[14] *Ibid*, at para 32.

[15] Some believe the law respecting the rule against third party beneficiaries may someday challenge this part of the decision. N. Vukovich and B Parker ,"*Attornment and Non- Disturbance Agreements* – Six-Minute Commercial Leasing Lawyer, Law Society of Upper Canada,(2013) at page 7.

[16] *TDL Group*, *supra* note 13 at para 54.

[17] *Goodyear, supra* note 5.

[18] *Guscon Enterprises Ltd. v Andsam Masonry Co.*, [1995] O.J. No. 3326 (Gen. Div.) at para 13 [*Guscon*].

[19] *Sadie Moranis Real Estate Ltd. v Hongkong Bank of Canada* (1998), 39 O.R. (3d) 691 (Gen. Div.), aff'd 117 O.A.C. 123 (C.A.); *Guscon* supra note 18

[20] J. W. Lem, "A Case Commentary on Goodyear Canada Inc. v. Burnhamthorpe Square Inc." (1999) 21 R.P.R. (3d) 38, at p. 12.

[21] *Goodyear, supra* note 5 at para 76.

[22] M. Abramowitz, "Insolvent Landlords: Concerns of a Commercial Tenant" The 6-Minute Debtor-Creditor and Insolvency Lawyer, Law Society of Upper Canada (2011), at p. 8.

[23] *Conveyancing and Law of Property Act,* R.S.O. 1990, c. C.34, ss. 53(2).

[24] John D. Falconbridge, Richard H. McLaren, and W B. Rayner, Falconbridge on Mortgages (Agincourt, Ont.: Canada Law Book, 1977), p.465 *[Falconbridge]:* "The lessee is a purchaser of the equity of redemption pro tanto and is entitled to redeem. He is therefore a necessary party to an action for foreclosure or sale ... It is necessary to make the tenant a party no matter how long or short his term may be, if the mortgagee desires to affect him by the proceedings and to compel him to give up possession of the mortgaged lands.."

[25] *Binion v. Evans, [1972] 2 All E.R. 70, [1972] Ch. 359 (Eng. C.A.).* Also, beware of the trap of relying on constructive notice and then compromising it by registering the lease, as was the case in *DeGasperis Muzzo Corp v 951865 Ontario Inc., (*2000), 35 R.P.R. (3d) 243 (Ont. S.C.J. [Commercial List]) aff'd (2001), 42 R.P.R. (3d) 63 (Ont. C.A.).

[26] *Land Titles Act,* R.S.O. 1990, c. L.5, s. 44(1).

[27] *Registry Act,* R.S.O. 1990, c. R.20, s. 70(2).

[28] *Compagnie Trust Royal v Pinkerton Flowers Ltd.,* [2004] R.J.Q. 1148 (Que. C.A.); *Financement agricole Canada v Urscheler,* 2013 QCCA 2086.

[29] *Falconbridge* supra note 35; *Capsule Investments Ltd. v. Heck*, (1993), 12 O.R. (3d) 225, 103 D.L.R. (4th) 556 (Ont. C.A.) at para 16.

[30] *Torelli v. Canadian Imperial Bank of Commerce,* 2005 CanLII 45747 (ON SC) at para 36.

[31] M. Abramowitz, supra note 22.

[32] Supra note 15.

[33] *Mortgages Act*, R.S.O. 1990, c. M.40, s. 6.

[34] Dennis Tobin, W. Colin Empke, and Horatiu Porime, "Rent Abatement in Commercial Leases" The 6-Minute Commercial Leasing Lawyer, Law Society of Upper Canada (2017).

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