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ACTING FOR A LANDLORD IDENTIFYING SIGNS OF A PENDING TENANT DEFAULT, AND IMPLEMENTING STRATEGIES TO MINIMIZE FINANCIAL LOSS AND/OR ACHIEVE OTHER BUSINESS OBJECTIVES

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Managing the Default Process

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Acting For A Landlord Identifying Signs of a Pending Tenant Default, And Implementing Strategies to Minimize Financial Loss and/or Achieve Other Business Objectives

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Anyone involved in tenancies should develop a strategy for identifying pending tenant defaults, and for implementing strategies in respect of actual tenant defaults so as to be able to act proactively to minimize loss and to achieve business objectives.

The issues to be considered by a landlord, property manager, or their professional advisers vary slightly between commercial, office, and industrial tenancies and this article is written with a commercial shopping centre focus, but much of the content of this article is applicable to any non-residential tenancies.

Issues for Landlords to Consider as Signs of a Pending Tenant Default:

Often landlords are remiss in recognizing signs of a pending tenant default. Those signs include:

1. repeated late payment/underpayment of rent over a period of time;
2. enforcement by other creditors of claims against a tenant's assets;
3. changes in a tenant's senior management;
4. material changes in a tenant's staffing;
5. material changes in levels of a tenant's inventory;
6. material changes in the appearance of a tenant's premises;
7. complaints from tenant's staff, or from its customers, or suppliers;
8. a tenant purporting to temporarily close for renovations, vacations, etc. without advance notice and landlord's permission (if required); and/or

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9. any other factors which evidence a change in the status quo.

Property managers employed by or appointed by landlords, often receive information such as set out above on a day-to-day basis but do not interpret it as signalling a pending tenant default, or if they do, take a laissez-faire approach to a tenant's future viability, as long as rent receivables remain within a landlord's range of tolerance.

A prudent landlord should attempt to ensure that relevant information about a tenancy, such as set out above, is reported to it on monthly or quarterly basis in a standardized form. As such, a landlord should consider all such information on an ongoing basis, share such information on a portfolio wide basis, and assess the risk of a tenancy default; and also consider any landlord opportunities that may arise therefrom.

Timely reporting of relevant tenancy information to decision makers, combined with speedy action is essential to achieving financial recovery, and/or other business objectives.

Leases generally contain standard contractual provisions that create landlord rights upon an "act of default", be it a monetary default or non-monetary default by a tenant. These "acts of default" are generally set out in detail in leases. A tenant's default also creates a common law right of distraint in respect of arrears of rent; and also statutory rights of termination arising out of monetary and non-monetary defaults of a lease (see sections 18 and 19 *Commercial Tenancies Act*, R.S.O. 1990, c.L.7 as amended).

It is important for landlords not to waste opportunities created by a tenant's monetary or non-monetary default of its obligations under a lease, to actively and diligently assess:

1. a landlord's overall business objective for the premises in question;
2. a landlord's overall business objective for the development as a whole; and
3. a realistic analysis of achieving in full (or part) the objectives set out in 1. and/or 2.

This assessment should include a proforma calculation of the likely cost of achieving a landlord's business objectives.

In considering issues related to accomplishing business objectives, a landlord should also consider, apart from those matters which are under a landlord's control or significant influence:

1. local tenancy market conditions;
2. regional tenancy market conditions;
3. foreseeable changes in 1. or 2. (i.e., a new development being built, anchor-type tenant term expirations, changes in borrowing rates, changes in municipal, provincial or federal laws which impact upon a tenant's viability, etc.);
4. recapturing premises to combine and relet with other premises, or to divide to attract different tenancies; and
5. whether other sources of payment of monies due under a lease exist, including lease guarantors, indemnifiers, assignees, subtenants, occupants, etc.

As a general rule of thumb, many "leasing revenue" driven landlords and property managers often underestimate the true "costs" to a landlord of acquiring a replacement tenancy which "costs" often include both "hard" and "soft" costs such as:

1. repair and restoration expenses/tenant improvement allowances/landlord's work;
2. the time and effort which will be required of both a landlord's operations and leasing groups;
3. lost rent during any vacancy period;
4. lease commission expenses thrown away;
5. lease negotiation and preparation expenses thrown away;
6. negative impact on other tenancies of a development, such as decreased traffic (especially true in the context of a "destination" type tenancy); and
7. the time value of money.

Conversely, many landlords and property managers also underestimate the true impact on the financial value of a development caused by a troubled tenancy, to which experts such as lenders

and/or purchasers are not prepared to attribute any value. Troubled tenancies limit the options available to a landlord to deal with a development.

Landlord opportunities upon a tenant's monetary and/or non-monetary default of the terms of a lease may include:

A. Lease Termination:

1. Terminating the lease (after compliance with contractual or statutory notice periods) to achieve a replacement tenancy with:

- i) a better rental covenant that has a CAP value to lenders or purchasers;
- ii) a higher basic rent;
- iii) a better track record as an operator; and
- iv) an enhanced tenant profile to create an increase in customer traffic at a development.

This approach may also avoid a risk of a trustee in bankruptcy exercising its statutory right to delay the provision of a disclaimer of lease for a period of 90 days, without payment of any rent to a landlord.

2. It should be noted that judicial relief from forfeiture is generally readily available to a tenant upon application to a court, and a tenant bringing a lease into good standing. The risk of a tenant's application for relief from forfeiture and its chances of success should be considered by a landlord in determining any "fall back" strategy if the termination is challenged.

B. Lease Continuation:

To the extent provided for in a lease, a landlord may, in the event of a tenant's default:

1. void exclusive use options;
2. void options to extend;
3. accelerate three months rent;
4. claim payment of conditionally forgiven free rent;

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5. claim repayment of conditionally granted tenant improvement allowances;
6. register a security interest; and
7. exercise any other contractual right provided for in a lease.

A landlord may also distrain against a tenant's goods and chattels at the premises for any sums due by the lease (subject to crown priorities); and/or enter into some form of a tenant assistance agreement with an enhancement of a landlord's contractual rights in exchange for assistance.

Either lease termination or continuation may give rise to a situation in which a landlord voluntarily resiles from strictly enforcing its legal rights under a lease or at law in exchange for written, binding amendments to a lease including:

1. provision of an enhanced security deposit or deposit of prepaid rent;
2. provision of a guarantee and/or indemnity;
3. provision of a security interest;
4. granting a landlord only right of termination if a replacement tenant is located;
5. access to confidential tenant financial information; and
6. any other rights of benefit to a landlord.

Generally, a prudent landlord should conduct the following searches as part of its due diligence in considering an overall strategy for dealing with an apparently pending tenancy default:

1. a Bar-ex search (to determine province-wide writs of execution);
2. a PPSA search (to determine the nature and class of secured creditors);
3. an intellectual property search (to determine registration of trademarks, patents, etc.);
4. if a privately-held corporation, corporate profile report to determine the identity of the officers and directors and then to conduct on each such person:
 - i) a bankruptcy search;
 - ii) a Bar-ex search;

- iii) a PPSA search; and
- iv) a subsearch to determine ownership and, if applicable, equity in any real property owned by them (and thus their financial ability to support the tenant).

Tenant Restructuring

Signs of a pending tenant default, or actual defaults are often precursors to a tenant restructuring.

“Restructuring” when referred to in this article includes bankruptcies, proposals pursuant to the *Bankruptcy and Insolvency Act* (“*BLA*”), proposals pursuant to the *Companies Creditors Arrangement Act* (“*CCAA*”), private receiverships, and court appointed receiverships.

Restructuring is often the mid-term to long term fate of troubled tenancies.

A landlord should, after considering the foregoing signs of pending tenant default, determine whether it is best served by seeking to terminate a tenancy in the face of warning signs of pending material default, which is expected to or could lead to tenant restructuring.

The answer to such an enquiry generally is dependent on what the landlord’s sees as its ability to relet the premises (and at what cost), and what basic rent can be achieved through a replacement tenancy (i.e. increase or decrease to basic rent).

On occasions landlords will want to actively act to expedite a tenant restructuring if they are confident the tenant will need to continue to occupy space as generally a court will order payment of contract rent on a go forward basis.

A landlord may consider, having regard to the perceived impact upon it (after a cost-benefit analysis), contacting the tenant’s senior management in writing requesting to be provided written notice in advance of the issuance of any restructuring order providing the tenant protection from its creditors. This would be done with a view permitting to the landlord (to the extent possible), to have some impact upon the terms of any such order affecting the rights of landlords including:

1. the timing of the payment of occupation rent;

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2. creating a judicial obligation upon tenant, to abide by all non-monetary tenancy terms contained in a lease such as:
 - i) honouring the contractual use restrictions;
 - ii) honouring prohibitions upon parting with possession of a portion of any premises;
 - iii) honouring restrictions on new signage;
 - iv) preventing the transfer to the premises of other store inventories for discount sales such as “bankruptcy sales”;
 - v) preventing the liquidation of non-tenant inventory at the tenant’s premises; and/or
 - vi) any other conduct prohibited by a lease.

Practically speaking, landlords with multiple tenancies, or individual landlords banding together in groups, often seek to influence, with some degree of success, the timing and the form of *CCAA* orders providing tenants with protection from creditors.

Issues for a Landlord to Consider after a Tenant Seeks Protection from its Creditors:

Once a tenant seeks protection from creditors, preliminary landlord issues include:

A. *CCAA* Proceedings or *BIA* Proposal

- (i) determining if arrears of rent exist which predate the initial *CCAA* order;
- (ii) if so, classifying a landlord’s claims for pre-*CCAA* order arrears of rent as being secured or unsecured claims;
- (iii) reviewing the initial order for any judicial restriction of contractual rights;
- (iv) monitoring post initial *CCAA* order compliance with the monetary and non-monetary provisions of any applicable lease; and
- (v) considering a landlord’s rights and obligations if a request to assign a lease is made.

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B. Bankruptcy

- (vi) determining if pre-bankruptcy arrears of rent exist;
- (vii) if so, classifying a landlord's claims for arrears of rent as being secured, preferred, or unsecured claims or a combination of some of them;
- (viii) determining if the Trustee in Bankruptcy intends to occupy the premises, and if so, monitor the Trustee's compliance with the monetary and non-monetary terms of the lease; and
- (ix) considering a landlord's rights and obligations if a request to assign a lease is made.

C. Receivership

- (x) determining if the receivership is private or judicial, in which case the receiving order should be reviewed for any judicial restriction of a landlord's contractual rights; and
- (xi) determine a receiver's intentions in respect of the continuation of a tenant's business.

While generally a tenant seeking protection from its creditors often creates a financial loss for a landlord (in terms of both income stream and the total value of a development), it also provides the potential for a landlord to utilize its rights under a lease in a creative and proactive manner which can minimize or even avoid a loss.

Once a tenant restructures, a landlord should:

1. determine which tenancies in its portfolio of properties are affected by the tenant's actions and assemble all related tenancy documentation and review all such documentation to determine with specificity a landlord's contractual rights under each relevant lease (see comments on pages 4. and 5. above);
2. for each development, prepare a list of exclusive uses granted to other tenants, which may be relevant to responding to any request for assignment;
3. consider market conditions to attempt to determine whether basic rent payable by the affected tenant is above or below market conditions, which will assist a landlord to consider the viability of its options;
4. consider other realistic tenancy opportunities, and the realistic costs of obtaining same, should the premises become available;

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5. determine arrears of rent if any, and prepare a summary of any monies payable by the lease that may be demanded from any assignee;
6. communicate with the Monitor/Trustee to determine its intentions for the tenant which could include: sale of the Tenant's business (or part thereof) as a going concern; sale of real property leases; continuation of the business after the completion of a proposal; winding up, etc.; and
7. focus on attempting to strengthen its position in respect of a future tenant failure.

Monitors/Trustees often seek to minimize through negotiation, the impact on any proposed assignee of a lease, of any contractual terms set forth in a lease that require (by reason of a tenant's default), changes in basic rent, repayment of conditionally forgiven sums, or the voiding of conditional rights such as exclusive use provisions or options to extend. Public policy type arguments are commonly advanced that seek to extend to a proposed assignee, any judicial restrictions on exercising contractual rights that are contained in orders that bind the landlord and defaulting tenant. Generally these issues are rarely, if ever, litigated as the parties prefer the certainty of outcome which comes with a negotiated settlement.

The foregoing article is a brief overview of issues that prudent landlords, managers and their professional advisers would be well advised to consider in the context of a pending or actual tenant default or restructuring. This article is not intended in any way, to be an exhaustive summary of all potential landlord issues, or an analysis of the significant differences to a landlord between proposals made by a tenant under the *CCAA* and the *BLA*, and a bankruptcy; and the respective rights and obligations of defaulting tenants and their Monitors/Trustees and landlords.

The writer is available to provide preliminary complimentary advice, and a "sounding board" for strategies in the context of a tenant default or restructuring.

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