

Bankruptcy Sale of Debtor's Property "Free and Clear" Terminates Lease

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In a case of first impression, *Precision Industries, Inc. v. Qualitech SBQ, LLC*, 327 F.3d 537 (7th Cir. Ind. 2003), *reh'g denied*, 2003 U.S. App. LEXIS 10626 (7th Cir. Ind. May 7, 2003), the U.S. Seventh Circuit Court of Appeals held that under § 363(f) of the Bankruptcy Code, the sale of the lessor-debtor's real property "free and clear" of any "interest" trumps § 365(h) of the Bankruptcy Code ("Code"), which protects the rights of the lessee when the lessor-debtor rejects a lease.

The debtors (collectively, "Qualitech") owned and operated a steel mill in Indiana. The lessees (collectively, "Precision") constructed a supply warehouse on the property, for the sole purpose of providing supply services for Qualitech. In 1998, Precision entered into a ten-year supply agreement with Qualitech. Precision also leased the real property, in 1999, under an unrecorded ten-year lease for a nominal rent of one dollar per year. If an early termination or default occurred under either agreement, Precision had the right to remove all improvements and fixtures. At the end of the lease term, Precision had the right to purchase the property for one dollar provided that the lease was not in default.

Qualitech filed its Chapter 11 bankruptcy petition on March 22, 1999, and on June 30, 1999, sold substantially all of its assets at auction pursuant to a sale order "free and clear of all liens, claims, encumbrances, and interest" under § 363(f) of the Bankruptcy Code. The sale order approved the sale to a group of pre-petition secured lenders for \$180 million. Precision, which had proper notice of the sale, did not object. The purchasers subsequently transferred their interests in the property to a new entity, ("New Qualitech"), which assumed the rights of the purchaser under the sale order and took title to the property. The sale order also provided that the purchaser retained the debtor's right to assume and assign executory contracts pursuant to § 365 of the Code. Negotiations subsequently ensued with respect to assumption of the lease, but were unsuccessful. The result, according to the Seventh Circuit, was that "Precision's lease and supply agreement were *de facto* rejected." *Id.* at 541. By December 3, 1999, Precision had vacated and padlocked the warehouse on the property. Shortly thereafter, New Qualitech, without Precision's knowledge or approval, changed the locks on the building.

Precision then filed suit, claiming that its possessory interest in the leased property, pursuant to § 365(h), survived the bankruptcy sale. The bankruptcy court held that, based on § 365(h) and the fact that Precision's lease was an "interest" under the sale order, New Qualitech had obtained title to the property free and clear of Precision's leasehold interest. The District Court reversed, ruling that the terms of § 365(h) prevailed over those of § 363(f). The District Court reasoned that there was no statutory basis for allowing the debtor-lessor to sell its property and terminate an underlying lease, which

would limit the lessee's post-rejection rights solely to cases where the debtor-lessor retained title and possession of the property.

The Seventh Circuit reversed the holding of the District Court, noting as a threshold issue that Precision never objected to the sale order and that “[s]ale orders are final, appealable orders,” i.e., once the appeal period has expired, *res judicata* precludes a subsequent lawsuit contesting the order. *Id.* at 543. The court then examined the meaning of the word “interest” in § 363(f) (which term is not defined in the Code), and found that based on applicable case law a leasehold estate was clearly an “interest” subject to the provisions of § 363(f). The court also noted that the parties never disputed the fact that the conditions of § 363(f) (which, standing alone, authorized the sale of the bankruptcy estate's property, including any “interest” therein, free and clear of the lessee's possessory interest), had been complied with.

The Seventh Circuit then turned its analysis to § 365(h), and concluded that the terms of this section did not supersede those of § 363(f). The court reasoned that because § 363(f) does not contain any cross-reference subordinating its provisions to the lessee protections of § 365(h), Congress did not intend for § 365(h) to limit § 363(f). (According to the court, “Congress authorized the sale of the estate property free and clear of ‘any interest,’ not ‘any interest *except* a lessee's possessory interest.” *Id.* at 548 (emphasis in text). The court then held that § 365(h) applies only where the trustee (or debtor in possession) actually *rejects* the lease, whereas in the present case a statutory sale of the property (which was leased) had occurred. According to the court, “[t]he two statutory provisions thus apply to distinct sets of circumstances.” *Id.* at 547. Finally, the court ruled that § 363(e) provides a mechanism for lessees to protect their interests, i.e., it directs the bankruptcy court upon the request of any party with an interest in the property to be sold or transferred, to “prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of such interest.” The court reasoned that the lessee therefore was not without an adequate remedy to protect its interests, and that while it was not guaranteed continued possession of the property, it was entitled to adequate protection and could seek to “be compensated for the value of its leasehold interest -- typically from the proceeds of the sale.” *Id.* at 548. The court also found, conversely, where the property is not sold and the lessor-debtor remains in title and possession and rejects the lease, the lessee is entitled to invoke its rights under § 363(f) and remain in possession. Thus, according to the court, both statutory provisions are given effect and are not in conflict. The court also reasoned that its interpretation “is . . . consistent with the process of marshalling the estate's assets for the twin purposes of maximizing creditor recovery and rehabilitating the debtor.” *Id.*

Discussion

- 1) It is interesting that the Seventh Circuit's statement (in connection with its ruling that § 363(f) trumps § 365(h)) that, “Where the property is not sold, and the debtor remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property,” *Id.*, is exactly the

reason that the District Court held that § 363(f) should *not* trump § 365(h) (“There is no statutory basis for allowing the debtor-lessor to terminate the lessee’s possession by selling the property out from under the lessee, and thus limiting a lessee’s post-rejection rights solely to cases where the debtor-lessor remains in possession of the property.” 2001 U.S. Dist. LEXIS 8328, at *14.) There is obviously a major philosophical disagreement between the two courts as to the proper application of the relevant statutory provisions, with both camps claiming that applicable case law (which, as the District Court noted, is divided on the issue) and legislative history support their respective positions.

- 2) The court in *Precision Industries* held that § 363(f)(5) applies only where the trustee (or debtor in possession) actually rejects the lease, as opposed to the situation where a statutory sale under § 363(f) occurs with respect to leased property. However, its statement that “the two statutory provisions apply to distinct sets of circumstances,” appears to be a distinction without a significant difference because the result is exactly the same in either scenario if, as the Seventh Circuit ruled in this case, § 363(f) trumps § 365(h). This appears to be a somewhat disingenuous attempt by the Seventh Circuit to shoehorn the facts into the statutory interpretation the court desires in this case. The court acknowledges the equivalency of these situations, but insists that (and cites cases to the effect that) § 365(h) applies to a specific event – the rejection of an executory contract by the trustee or debtor in possession – and not to sales of the debtor’s property, which are covered by § 363 (which provision, the court stated, is to be broadly construed and provides that property may be sold free and clear of any interest, whether that interest is a lien or a lease).
- 3) Outside of a bankruptcy case, the seller and purchaser generally are free to keep a potential sale confidential. In a bankruptcy case, the sale must be made public by the filing of a motion in the bankruptcy court requesting the court’s approval of the sale. Notice of the sale must be provided to all creditors, unless the court limits notice to appointed committees, such as the unsecured creditors’ committee and others who have formally requested notice of all matters arising in the case. Section 363(f) provides that the trustee may sell property of the estate “free and clear of any interest in such property of an entity other than the estate” if: applicable nonbankruptcy law permits such a sale; such entity consents; the interest is a lien and the sale price is greater than the aggregate value of all liens against the property; the interest is in bona fide dispute; or such entity could be compelled to accept a money satisfaction of the interest. A sample provision for a sale free and clear of an existing lease, to be inserted in a sale order, would be as follows:

The Debtor is authorized to sell the Debtor's interest in the Property to the Successful Purchaser free and clear of all liens, claims, encumbrances and interests, including, but not limited to, any lease of the Property by _____, pursuant to section 363 of the Bankruptcy Code, with all such valid and enforceable liens, claims, encumbrances and interests to attach to the proceeds of the sale of the Property in the same relative priority as existed with respect to the Property.

- 4) As noted above, assets sold in a bankruptcy case pursuant to a § 363(f) order may be sold free of liens, claims and interests. The liens and claims attach to the proceeds of sale. Unless the party appealing a sale order obtains a stay pending appeal, a good-faith purchaser of assets is protected from reversal on appeal. Under Rule 6004(g) of the Bankruptcy Rules, an order authorizing the use, sale, or lease of property is automatically stayed until the expiration of 10 days after entry of the order, unless the court orders otherwise. The trustee (and the purchaser) should seek to have the sale order contain specific language that, notwithstanding Rule 6004(g), the order is effective immediately (the same is true, under Rule 6006(d), for an order authorizing the trustee to assign an executory contract or unexpired lease). Section 363(m) of the Code provides that the reversal or modification on appeal of a sale authorized by the court does not affect the validity of the sale to an entity that purchased the property in good faith unless such authorization and sale were stayed pending appeal. The sale order therefore also will often contain an express finding of good faith as well as language similar to the following:

Pursuant to 11 U.S.C. § 363(m), absent a stay of this Order pending appeal, the reversal or modification on appeal of this Order, or any provision thereof, shall not affect the validity of any sale transaction approved hereby which is consummated prior to such stay, reversal or modification on appeal.

- 5) As also noted above, one of the subsections of § 363(f) must be complied with in order to sell bankruptcy estate property “free and clear.” In the *Precision Industries* case, the parties may have consented to the sale – a horrible mistake by the lessee’s attorneys, if true. The only other possible applicable subsection would be § 363(f)(5) – on the theory that (depending on what the lease says) the lessee could be forced in a condemnation proceeding to accept a money satisfaction (although it is problematic that this subsection can – or should – be interpreted to apply to a highly hypothetical and improbable situation where there exists an ability to get money for one’s leasehold interest, let alone entitle the debtor or trustee to sell the property free and clear of such interest. Under state law a lessee can’t be forced to surrender the leased premises for a payment of money, absent a provision in the lease permitting such payment).
- 6) Section 363(e) provides that upon request of any entity that has an interest in such property, the court shall prohibit or condition such sale “as is necessary to provide adequate protection of such interest.” When the bankruptcy court has approved the sale of property of the estate by a trustee, § 363(f) provides that the buyer acquires title free and clear of all claims in bankruptcy and the property may not be brought back into the estate in the absence of fraud or collusion in the sale. It is difficult to understand why, in the *Precision Industries* case, Precision did not seek protection under § 363(e) prior to entry of the sale order by the bankruptcy court. The concept of adequate protection is designed to protect property interests, and generally is compensatory. Therefore, the lessee should be able to assert a claim for the value of the leasehold estate and its interest should attach to the proceeds from the sale. (According to the court in *Precision Industries*, “the lessee is to be compensated for

the value of the leasehold – typically from the proceeds of the sale.” *Id.* at 546.) However, generally only creditors with secured claims can “credit bid” or receive the amounts owing on their claims directly from the sales proceeds. If there are other secured claims against the property (e.g., a fee or leasehold mortgage or a judgment lien), what would be the priority of the lessee’s claim against the sale proceeds with respect to such competing interests? Should it make any difference whether or not the lease was recorded, for purposes of determining relative priorities? Should marshalling principles be applied?

Section 363(f) does not require that the lessee receive the benefit of its bargain in “kind” when the property is sold so long as the lessee’s interest is adequately protected “in value.” In contrast, without the protection afforded by § 365(h)(1) (permitting the lessee to remain in possession of the property), if the lease were rejected by the landlord-debtor – as opposed to a sale of the landlord-debtor’s property under § 363(f) – the lessee would lose its leasehold interest in the property and have only a prepetition unsecured claim for damages, upon which it may ultimately recover little or nothing at the conclusion of the bankruptcy proceeding. See Steven R. Haydon and Nancy J. March, *Sale of Estate Property Free and Clear of Real Property Leasehold Interests Pursuant to §363(f): An Unwritten Limitation?*, 19 ABI J. 20 (2000). However, if the lessee has a unique location, or has spent significant funds on tenant improvements, “adequate protection” may be a poor substitute for continued possession of the leased space. (For example, in *In re Port Angeles Waterfront Associates*, 134 Bankr. 377 (9th Cir. BAP 1991), the dissenting opinion noted that the debtor, which had not defaulted under the lease, would lose the \$3.5 million of improvements it had made on the leased property). Lessees’ attorneys will, in any event, be faced with the question, How is the lessee’s possessory interest to be valued for purposes of adequate protection? Is the value determined by the lease rental rate? Is the value determined by reference to the rental rate of other leases in at similar properties in the geographical area? Must mitigation of damages, or special tenant-improvement allowances or rent (or other) concessions, be taken into account? Furthermore, must the lessee’s adequate protection claim for its possessory interest be treated as an administrative expense because it survives rejection (as opposed to being treated as a prepetition unsecured claim)? See Jerald I. Ancel, Marlene Reich, and Jeffrey J. Graham, *Can a § 363 Sale Dispossess a Tenant Notwithstanding § 365(h)?* 22 ABI J. 18 (2003).

- 7) Interestingly, the preliminary reaction from the major credit-rating agencies (Fitch, Moody’s, and Standard & Poor’s) is that they are not that concerned about the ruling in the *Precision Industries* case, and they do not plan any withdrawals, downgrades, or qualifications of existing credit ratings based on the possible risk of lease avoidance if the property is sold free and clear of all existing property interests in a bankruptcy proceeding pursuant to § 363(f).
- 8) The *Precision Industries* decision is of special concern to leasehold mortgagees, where the fee interest of the ground lessor has not been subordinated to the leasehold mortgage. See *In re Austin Dev. Co.*, *supra*, 19 F.3d at 1081, n. 6 (“legislative history

provides very little guidance for the interpretation of the effect of § 365(d)(4) on mortgagees of a debtor's leasehold"); William E. Winfield, *Rejection of Nonresidential Leases of Real Property in Bankruptcy: What Happens to the Mortgagee's Security Interest?* 17 Pepp. L.Rev. 429 (1990). If the lessee's interest is "wiped out" pursuant to a § 363 bankruptcy sale, or if the lease is rejected or deemed rejected under § 365, the leasehold mortgage could fall also and the leasehold mortgagee would become an unsecured creditor. This seems to be an unfair result, and there does not appear to be any beneficial bankruptcy policy rationale that would justify it. Although it may be true that the policy behind § 365(d)(4) is to provide non-debtor lessors a quick and certain resolution of their disputes with debtor-lessees, this goal would not be achieved by cutting off the rights of parties with secured interests in the leases. As stated by Judge Edith Jones in *In re Austin Dev. Co.*, *supra*, 19 F.3d at 1083, "in eliminating the rights of a mortgagee of the debtor-lessee's interest in a lease, the policies justifying avoidance – to enhance the pot of unencumbered assets available to creditors and to discourage a race to the courthouse before bankruptcy – have not been served. . . . This extraordinary implied power does not reduce claims against the debtor's estate; if anything, it increases the unsecured claims by the amount of the mortgagee's claim in the 'terminated' case"). If, as Judge Jones reasons, the lease is not terminated and the rights of the lessee and leasehold mortgagee are recognized and preserved, the lease will continue and the lessor will have no claim in the bankruptcy proceeding, resulting in a greater overall distribution to creditors.

To protect themselves, leasehold mortgagees commonly insist on a provision in (or amendment to) the underlying ground lease that grants the ground lessee permission to mortgage all or part of its leasehold estate and grant any future leasehold mortgagee numerous rights as a third-party beneficiary of the ground lease. The leasehold mortgage, in turn, will contain "leasehold mortgagee protection provisions" similar to the following: 1) a requirement that the parties to the ground lease obtain the leasehold mortgagee's written consent prior to cancellation, surrender, or modification of the ground lease; 2) the right to cure the lessee's defaults; 3) the right, if termination were to be declared by the landlord, to nullify the termination or indefinitely postpone it by curing all conditions of default; and 4) the right, if termination were to be realized, of the leasehold mortgagee to enter into a new lease with the landlord on the same terms as the terminated lease. As pointed out by the court in *In re Austin Dev. Co.*, *supra*, 19 F.3d at 1081 n.6, "This goal [§ 365(d)(4)] of protecting lessors does not conflict with the protection of leasehold mortgagee's rights, however, because a mortgagee would have to comply with the lease in order to take it over from the debtor. The lessor would have to be satisfied."

As a result of the court's holding in the *Precision Industries* case, attorneys for leasehold mortgagees may seek to build in additional protections (both in the ground lease and the leasehold mortgage) in the form of clauses that could provide, e.g., that: 1) if a bankruptcy proceeding is filed by or against the lessee or the lessor, the leasehold mortgagee will be immediately notified and will receive copies of all notices, pleadings, schedules, etc.; 2) the lessee will be entitled to file all pleadings,

claims, notices, proofs, objections, acceptances, rejections, etc., on behalf of the lessee in any such bankruptcy proceedings, and the lessee will take no action therein against the wishes of the leasehold mortgagee or contest any of the leasehold mortgagee's directions to the lessee or documents or pleadings filed on the tenant's or its own behalf in the bankruptcy proceeding; and/or 3) the leasehold mortgagee is authorized, on behalf of the lessee, to "prove and vote or consent in any proceedings with respect to the lease." For an example of such "leasehold mortgagee protection provisions," see **Exhibit "A"** attached hereto (these specific provisions apply to a securitized loan transaction where loans to several separate single-purpose bankruptcy-remote entities involving separate properties are cross-collateralized and cross-defaulted, some of which properties are to borrowers who are mortgaging their interests as ground lessees).

However, see *In re 203 N. LaSalle Street Partnership*, 246 B.R. 325 (Bankr. N.D. Ill. 2000), which dealt specifically with the rights of parties to an intercreditor agreement. The bankruptcy court rejected the secured lender's requested relief with respect to voting the claim of a subordinate lienholder as provided in both the junior mortgage and an intercreditor agreement executed by the senior and junior lenders. The court found that § 510(a) of the Code, which provides that a subordination agreement is enforceable in bankruptcy to the same extent enforceable under nonbankruptcy law, "does not allow for waiver of voting rights under Section 1126(a)." Section 1126(a) of the Code provides that "[t]he holder of a claim" may vote to accept or reject a plan under Chapter 11. According to the court, since voting is covered explicitly by §1126(a), its provisions trump contrary provisions in private pre-petition agreements - much like the Code does not permit a debtor to contract away its discharge - and "[s]ubordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights." *Id.* at 331. The court further stated that "it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply." *Id.* The court also held that Fed. R. Bank. P. 3018(c) does not allow the secured creditor to vote a subordinated creditor's claim. This rule provides that "the creditor or equity security holder or an authorized agent" must sign an acceptance or rejection of a Chapter 11 plan. The court dismissed the Bank's argument that it was an "agent" of the general partner pursuant to the written agreement, because in voting the claim it would be acting in its own interests and not the general partner's. The court looked to the substance of the relationship, and found that the parties cannot contract in advance for this status consistent with either §1126(a) or Bankruptcy Rule 3018.

Although case law is sparse in this area - probably because most disputes are resolved through voluntary and consensual compromises as to the respective positions and recoveries of the parties in order to prevent costly and time-consuming litigation - other bankruptcy court decisions have generally held that voting rights may be transferred to another creditor as part of a subordination or intercreditor agreement, and that such assignments are valid and enforceable as bargained-for contractual rights. In *In re Curtis Center Ltd. Partnership*, 192 B.R. 648, 659-60 (Bankr. E.D. Pa. 1996), the subordinate lienholder had entered into a subordination agreement with

language remarkably similar to that contained in the intercreditor agreement executed by the first and second lienholders in *203 North LaSalle* (i.e., providing that the first lienholder was authorized, on behalf of the junior lienholder, to file all claims and proofs for the full outstanding amount of the junior debt and to “prove and vote or consent in any proceedings with respect to [the junior] debt”). The court ruled that the junior lender could not vote on the debtor’s plan because of the “plain and unambiguous” language in the subordination agreement, the clear language of Section 510(a) of the Bankruptcy Code as to the validity and enforceability of intercreditor agreements, and the inapplicability and irrelevance of the junior lienholder’s implied argument that it could ignore the plain language of the subordination agreement because it was to be paid, as part of the debtor’s plan, from some “source other than the debtor.” Based on that portion of the court’s ruling that prohibited the Bank from voting the subordinated creditor’s claim because no agency relationship existed (or would be deemed to exist) between the parties, some commentators have suggested that creditors who wish to exercise such rights insert a provision in the intercreditor or subordination agreement expressly appointing the senior creditor as the agent of the subordinate creditor for purposes of voting the subordinate claim, in addition to an assignment of the right to vote the claim. See Bruce H. White and William L. Medford, *Subordination Agreements and Voting Rights: Will Your Inter-Creditor Agreement Be Enforced?*, 20 ABI J. 32 (2001). This strategy is problematic, as a court may construe it as a transparent and impermissible attempt to avoid the court’s ruling in *203 N. LaSalle*. As noted above, the court in *203 N. LaSalle* held that the parties cannot contract in advance for agency status consistent with either §1126(a) or Bankruptcy Rule 3018, because in voting the claim the senior creditor would be acting in its own interests and not those of the subordinated creditor.

- 9) The insertion of additional “leasehold mortgagee protection” provisions in the leasehold mortgage (or ground lease) is not a cure-all for the leasehold mortgagee. This is because such provisions are not self-actuating, i.e., they will not automatically assure the leasehold mortgagee of standing in a bankruptcy proceeding by or against the lessor or lessee, and will do little to protect the leasehold mortgagee if the lessee does not honor its affirmative obligations as set forth in such provisions. To further motivate the lessee to comply with such affirmative obligations, it may be prudent (where possible) to seek a “springing guaranty” from a creditworthy third party not affiliated with or related to the lessee. Under the springing guaranty, the lessee’s obligations under the lease (or some agreed-upon portion thereof) are guaranteed but the guaranty only becomes effective upon the occurrence of certain future events, such as: the filing of a bankruptcy petition by or against the lessee or the lessor; the assertion of claims or relief against the leasehold mortgagee, including the institution of litigation by the lessee seeking injunctive relief, or otherwise seeking to prevent the leasehold mortgagee from exercising its rights and remedies as provided in the leasehold mortgage or the ground lease; the contesting of actions taken by the leasehold mortgagee on its own or the lessee’s behalf in the lessee’s or the lessor’s bankruptcy proceeding; or the violation of certain “bad acts” covenants in the ground lease or the leasehold mortgage. For an example of such a springing guaranty, see **Exhibit “B”** attached hereto

Section 524(e) of the Bankruptcy Code provides that a bankruptcy discharge does not discharge the obligation of any non-debtor party. Courts have generally construed this statutory provision as prohibiting bankruptcy plans from modifying or releasing the obligations and liabilities of guarantors under third-party guaranties and prohibiting bankruptcy courts from preventing the enforcement of such guaranties. *See, e.g., Star Phoenix Mining Co. v. West One Bank*, 147 F.3d 1145, 1147 (9th Cir. 1998) (“under § 524(e), a bankruptcy court does not have the power to discharge the liabilities of a bankrupt’s guarantor”); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 601 (10th Cir. 1991) (finding that “[n]either the confirmation of a plan nor the creditor’s recovery (or partial satisfaction) thereunder bars litigation against third parties for the remainder of the discharged debt”); *In re Sandy Ridge Devel. Corp.*, 881 F.2d 1346, 1351 (5th Cir. 1989) (confirmation of plan would not release non-debtor guarantors); *Mellon Bank v. M.K. Siegel*, 96 B.R. 505, 506 (Bankr. E.D. Pa. 1989) (holding that the bankruptcy court lacked the power to discharge the obligations of non-debtor guarantors of the debtors’ obligations to creditors); *Union Carbide Corp. v. Newboles*, 686 F.2d 593, 594-95 (7th Cir. 1982) (holding that the bankruptcy court’s discharge of the liability of a guarantor did not preclude a collateral action by the creditor to enforce the guaranty); *Peterson v. Peterson*, 118 B.R. 801, 803 (Bankr. D. New Mexico 1990) (affirming that the discharge of the debt did not affect the liability of any other entity for such debt); *Underhill v. Royal*, 769 F.2d 1426, 1431-32 (9th Cir. 1985) (holding that a bankruptcy court’s discharge of the liability of co-debtors or guarantors is without effect and does not bar collateral actions against such co-debtors or guarantors by creditors of the debtor); *R.I.D.C. Indus. Devel. Fund v. Snyder*, 539 F.2d 487, 490 (5th Cir. 1976), *cert. denied*, 429 U.S. 1095 (1977) (holding that a bankruptcy court has no power to affect the obligations of guarantors).

- 10) In an earlier Seventh Circuit decision, *Gouveia v. Tazbir*, 327 F.3d 537 (7th Cir. 2003), the court held that the bankruptcy trustee was not entitled to sell the debtor’s land free of a restrictive, reciprocal covenant recorded on all the lots of a residential subdivision, which the court held was a property interest and not an executory contract that could be rejected by the trustee. The court was asked to rule whether § 363(f)(5), which permits the sale of real property free of any interest when “such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest,” applied to the subdivision landowners. The court ruled that the Chapter 7 trustee could not sell the debtor’s property free and clear of the covenant (which had been found to be enforceable by the Indiana Court of Appeals) under § 363(f)(5) because the covenant did not “compel” the landowners to accept monetary satisfaction of their interest; the covenant instead provided that enforcement “shall be by proceedings at law or in equity against any person or persons violating or attempting to violate any covenant either to restrain violation or recover damage.” In this case, the objecting neighbors had requested equitable relief and had not sought damages. According to the court, “Since the . . . landowners cannot be forced to accept money damages in lieu of equitable relief, we conclude that § 363(f)(5) is inapplicable to the case at bar.” *Id.* at 299. Although this case did not involve a lease

or the interplay between § 363(f) and § 365, it did specifically address the threshold issue of the invocation of § 363(f) in the first instance because of the applicability of one of the five alternative conditions stated therein authorizing the sale free and clear of all other property interests. Based on this holding and the Seventh Circuit's subsequent holding in the *Precision Industries* case, it may be prudent for lawyers for lessees (and their lenders) to add specific language in commercial leases providing that if any action is commenced that could result in the dispossession of the lessee from the premises for any reason whatsoever during the term of the lease (including, without limitation, as the result of a proposed sale of the property pursuant to § 363 of the Code in connection with a bankruptcy proceeding filed by or against the lessor-debtor) the lessee would be expressly entitled to any available equitable remedies or, in the alternative, to seek monetary damages at its sole election. The lessee would, of course, then assert its right to equitable relief (or be required to do so by a leasehold mortgagee) (or be required to do so by a leasehold mortgagee) in the event of a subsequent lessor bankruptcy as a bar to assertion of the applicability of § 363(f)(5).

- 11) A cautionary tale for leasehold mortgages that purchase the lessee-debtor's leasehold estate in a bankruptcy proceeding is provided in *Cherry v. First State Bank*, 112 S.W. 3d 129, 2003 Tenn. App. LEXIS 119 (Tenn. App. 2003). In this case, the lessees filed for bankruptcy, and the bankruptcy court held an auction in which the leasehold mortgagee (who also held a collateral "Assignment of Lease" executed by the lessees-debtors as additional security for the loan, which was consented to by the lessor and recorded with the register of deed's office) was the successful bidder. The leasehold mortgagee made the rent payments under the lease for a period of time, then suddenly stopped paying rent. The lessors filed a complaint in State court for the rent that was in arrears at the time. The leasehold mortgagee argued that under the Assignment of Lease it would not be liable for any rent or other obligations of the debtors-lessees under the lease "so long as the Bank shall not have exercised its option (of taking over the leased premises pursuant to written notice)," and that it had not assumed possession of the premises nor provided the lessee-debtor of its intention to do so, thereby never legally obligating itself to make the rent payments. The leasehold mortgagee further argued that it bid at the auction sale only to "protect its interests." The court summarily rejected these arguments, stating that "[n]otwithstanding the terms of the . . . Assignment of Lease, it is clear that [the lessees-debtors'] entire interest in the leased premises was sold to [the leasehold mortgagee] at the bankruptcy auction." *Id.*, 2003 Tenn. App. LEXIS at *14. The court noted that the leasehold mortgagee purchased the entire leasehold interest; i.e., the lessee-debtor had no reversionary interest, and that the bankruptcy court order authorizing the sale "both provided that it was to be a sale resulting in an assignment of [the lessees-debtors'] leasehold interest to the purchaser and gave notice of this fact to potential purchasers, including [the leasehold mortgagee]." *Id.* at *16. The court reasoned that the leasehold mortgagee's duty to pay rent arose as a result of its purchase of the leasehold interest pursuant to the bankruptcy court's order, not under the collateral Assignment of Lease.

- 12) There is disagreement among the bankruptcy courts as to whether a debtor-lessor's rejection (actual or deemed) of a lease terminates all of the tenant's rights under a lease. Under § 365(h) of the Code, a lessor who files for reorganization has the right to reject any lease, subject to bankruptcy court approval. The lessee then has the right, under § 365(h)(1)(A), either to (1) treat the lease as terminated and vacate the space, or (2) remain in possession for the balance of the lease term and any renewal or extension. Before the enactment of the 1994 Bankruptcy Reform ("Reform Act"), there was uncertainty concerning the nature and extent of the lessee's right to remain in possession. Bankruptcy court decisions were divided as to whether restrictive lease covenants binding on the lessor (for example, an exclusive business use granted to the lessee) would continue if the lessor rejected the lease. Section 365(h) was amended by the Reform Act to eliminate these uncertainties. Section 365(h)(1)(A)(ii) now provides that the lessee may retain those rights in the lease that are in or appurtenant to the real property, "including rights such as those relating to the amount and timing of the payment of rent and any right of use, possession, quiet enjoyment, subletting, assignment or hypothecation," to the extent that such rights are enforceable under applicable nonbankruptcy law.

Accordingly, it is now clear that a lessee under a rejected lease may "retain its rights" under the lease, which should apply, e.g., to a lessee's option right to the extent it is enforceable under applicable state law (assuming that an option to purchase contained in a lease is a right "in or appurtenant to the real property"). Such rights should survive rejection of the lease by the lessor-debtor or the bankruptcy trustee. Although an option right is not explicitly listed among the surviving lessee rights stated in § 365(h)(1)(A)(ii), the language in this section is clear that it is only listing those specific rights as examples and not as an exclusive list of such rights.

However, in *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999), the court ruled that a right of first refusal to purchase real property granted to a nondebtor party by the debtor-owner was not terminated by the debtor's rejection of the contract, and was enforceable by specific performance if and when the debtor subsequently decided to sell the property. The court found that, based on the holding of the Ninth Circuit Court of Appeals in *Unsecured Creditors' Committee of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp.*, (*In re Robert L. Helms Constr. & Dev. Co.*), 139 F.3d 702 (9th Cir. 1998), an option agreement (or at least one that was not in the process of being exercised at the time of the bankruptcy filing) is not an executory contract that can be rejected by the debtor. The court in *Bergt* noted that "[t]he trend of the law is . . . that rights created by state law in a specific asset (for example, the right of a nondebtor optionee to purchase land) are not avoidable by rejection under 11 U.S.C. § 365(a) alone." *In re Bergt*, 241 B.R. at 21. The court also stated that "bankruptcy law recognizes third parties' equitable interests in property, including interests the essence of which is the right to obtain the specific property" and "rejection protects the estate from the financial obligation of affirmatively performing the debtor's obligations—but, this does not mean that the nondebtor's property rights in estate property should be cut off, and if necessary, enforcement of thus [*sic*] rights may be by specific performance." *Id.* at 23. The court further stated that "nondebtors' rights are protected in other situations—e.g., secured creditors' rights trump the equality of distribution policy." *Id.* at 24.

The court distinguished other cases holding that rejection is the equivalent of termination, because these cases involved debtor-lessees and not debtor-lessors who had granted rights to a nondebtor in the debtor-lessor's property. However, the court acknowledged that "a few cases . . . hold that a rejection of an executory contract or lease terminates it, and any rights a nondebtor may have had under state law in the property involved," including the avoidance of an option or contract to sell (at least in those situations where no security interest existed in the option agreement or other executory contract). For example, in *In re Gillis*, 92 B.R. 461 (Bankr. D. Haw. 1988), the debtor-lessee failed to assume the commercial lease within the statutorily mandated sixty-day period, and the lease was deemed rejected. The debtor-lessee had made a pre-petition assignment of its interest in the lease, as evidenced by a recorded Assignment of Lessee's Interest in Lease and Consent (which document was consented to by the lessor), to a bank lender in return for a \$125,000 loan from the bank. The court – completely disregarding the bank's rights in the collateral – held that the deemed rejection terminated the lease, and that the rejection related back to the commencement of the bankruptcy proceeding. Therefore, the court ruled, there was nothing for the bank's assignment to attach to and the bank's security interest was "completely extinguished" because the bank "cannot hold a security interest in property in which the debtor has no interest." *Id.* at 465.

In *Syufy Enters. V. City of Oakland*, 104 Cal. App. 4th 869, 881-82 (2002), the court stated that:

The parties have directed us to no cases from the Ninth Circuit considering the effect of a deemed rejection of a master lease on attached subleases. In *re Elm Inn, Inc.*, *supra*, 942 F.2d at page 633 and *Sea Harvest Corp. v. Riviera land Co.*, 868 F.2d 1077, 1080-81 (9th Cir. 1989), both reach the unremarkable conclusion that a deemed rejection terminates the *debtor-lessee's* right to possession, but neither of these cases addressed subleases or other third-party interests [emphasis in text]. Though arguably at odds with some 'termination' language in these Ninth Circuit Court of Appeals cases, lower federal courts in California and Alaska have begun to adopt the 'emerging rule' (see *Vallely Investments v. BancAmerica Commercial Corp.*, 88 Cal. App. 4th 816, 829 (2001)) that a debtor's deemed rejection of a lease constitutes a breach and not a complete termination. *In re Bergt*, (241 B.R. 17, 25 (Bankr. D. Alaska 1999); *In re Locke*, 180 B.R. 245, 261 (Bankr. C.D. Cal. 1995); *In re Picnic N Chicken, Inc.*, 58 B.R. 523, 525 (Bankr. S.D. Cal. 1986).

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The current trend in Ninth Circuit bankruptcy cases is apparently to treat a debtor's rejection of a lease as a breach, rather than a termination. (See *Vallely Investments v. BancAmerica Commercial Corp.*, 88 Cal. App. 4th at 829-30. Under this 'emerging view' (*id.* at 829), the Master Lease was not terminated as a matter of law for *all* purposes as a result of OAH's deemed rejection. Thus, the continuing viability of Syufy's sublease is a question of California law. (*In re Stalter & Company, Ltd.*, *supra*, 99 B.R. at p. 330; *In re Dial-A-Tire, Inc.*, 78 B.R. 13, 16 (Bankr. W.D.N.Y. 1987). This result is consistent with another relevant bankruptcy provision, which provides that when a lease

is rejected by a debtor-*lessor*, 'the lessee may retain its rights under such lease . . . to the extent that such rights are enforceable under applicable nonbankruptcy law.' (11 U.S.C. § 365 (h)(1)(A)(ii)); see also *In re Dial-A-Tire, Inc.*, *supra*, at p. 16 [noting the "anomalous result" produced by sections 365(d)(4) and 365(h)(1) that a debtor-sublessor must surrender the premises but its sublessee does not necessarily have to]).

In *Valley Investments, L.P. v. Bankamerica Commercial Corp.*, *supra*, 88 Cal. App. 4th at 829, the court stated that, "the emerging rule is 'the effect of rejection of an executory contract or unexpired lease is limited to a breach or abandonment by the debtor or trustee rather than a complete termination of the lease. *Rejection should not operate to damage the rights of third parties with rights to the leasehold estate.*'" (quoting LAWRENCE P. KING ET AL EDs., COLLIER ON BANKRUPTCY (15th ed.) ¶ 365.90[2], at 365-36 and 365-37) (emphasis added) (footnotes omitted). See also *In re Tri-Glied, Ltd.*, 179 B.R. 1014, 1017 (Bankr. E.D.N.Y. 1995) (deemed rejection of lease under § 365(d)(4) constituted mere breach of lease and not termination); *Bronner v. Chenoweth-Massie (In re Nat'l Financial Realty Trust)*, 226 B.R. 586, 590 (Bankr. W.D. Ky. 1998) (ruling that subject option agreement, which was assigned post-petition by debtor to third party, was not an executory contract requiring assumption by debtor-optionee and was valid and enforceable because debtor did not have any remaining obligations). *But see Kaonohi Ohana, Ltd. v. Sutherland (In re Kaonoi Ohana, Ltd.)*, 873 F.2d 1302, 1306 n.5 (9th Cir. 1989) ("specific performance of a rejected executory contract cannot be required"); *In re Kellstrom Industries, Inc.*, 286 B.R. 833, 8 (Bankr. D. Del. 2002) (holding that right of first refusal is an executory contract under § 365 of Bankruptcy Code).

- 13) Special rules apply to leases of nonresidential real estate under which the tenant is the debtor. Under § 365(d)(4), such leases are "deemed rejected" and the trustee is required to "immediately surrender such . . . property to the lessor" unless the lease has been assumed or rejected within 60 days after the filing of the bankruptcy petition (as such period may be extended by the court). With respect to nonresidential real estate, bankruptcy cases are sharply divided with respect to whether such rejection results in termination of the lease, with the majority of courts ruling that the express requirement for surrender of the premises when the trustee does not assume or reject an unexpired lease of non-residential real estate with the statutory period necessarily implies a termination of the leasehold estate. See, e.g., *In re Henderson*, 245 B.R. 449 (Bankr. S.D.N.Y. 2000); *Harvest Corp. v. Riviera Land Co.*, 868 F.2d 1077 (9th Cir. 1989); *In re Locke*, 180 B.R. 245 (Bankr. C.D. Cal. 1995); *In re 6177 Realty Assoc.*, 42 B.R. 1017 (Bankr. S.D. Fla. 1992); *In re Hawaii Dimensions*, 39 B.R. 606 (Bankr. D. Haw. 1984), *aff'd* 47 B.R. 425 (D. Haw. 1985). See also *Eastover Bank for Savings v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1080 (5th Cir. 1994) (noting that the effect of rejection of an unexpired lease has generated "starkly conflicting opinions among the bankruptcy courts"); *Federal Realty Investment Trust v. Park (In re Park)*, 275 B.R. 253, 257 (Bankr. E.D. Va. 2002) (listing cases supporting majority position, as well as cases that have disagreed with majority position).

However, there is significant case law to the contrary, especially in those instances where the rights of third-party secured creditors would be negatively affected. *See In re Austin Dev. Co.*, supra, 19 F.3d at 1083 (holding that, with respect to a non-residential lease, it would be inequitable and “capricious” to construe § 365(d)(4) in such a way that it resulted in a forfeiture of an interest in property by a secured creditor through the automatic operation of law and without any procedural protection, because § 365(d)(4) was enacted only to address problems that arise between lessors and lessees); *In re Park*, supra, 275 B.R. at 258 (“the court is of the opinion that the minority line of cases, as exemplified by *Austin Development Co.*, is nevertheless the better reasoned and more persuasive); *CASC Corp. v. Milner (In re Locke)*, 180 B.R. 245, 257, 263 (Bankr. C.D. Cal. 1995) (ruling that rejection of lease under § 365 did not result in termination or extinguishment of covenants, rights, or remedies created by lease, and therefore interest of judgment creditor in lease was not terminated or extinguished, and stating that “[n]owhere in the legislative history of § 365(d)(4) is there is there support for the . . . conclusion that Congress also intended to cut off the rights of secured creditor’s interest in leases rejected under § 365”); *Block Properties Co., Inc. v. American Nat’l Ins. Co.*, 998 S.W.2d 168, 16 (Mo. Ct. of Appeals 1999) (holding that under Code, rejection of master lease by lessee was mere breach of contract and not an outright termination, and therefore sublessee’s rights remained and landlord could not evict sublessee because lessee’s right of possession under lease remained intact; the court stated that “[b]ecause the appellant has failed to demonstrate that the rejection of the master lease was a substantial breach or that it was damage thereby, it has failed to establish that the rejection of the master lease . . . terminated the [sublessee’s] right to remain in possession of the property”). *See also* Lawrence P. King, 3 Collier on Bankruptcy, P 365.09 at 365–74 (15th ed. rev. 2000) (“The effect of rejection . . . is limited to breach or abandonment by the debtor or trustee rather than a complete termination of the lease”).

- 14) Section 363(f)(1) of the Code provides that, “notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease” if the trustee assumes the lease and provides adequate assurance of future performance. In *In re E-Z Serve Convenience Stores, Inc.*, 289 B.R. 45, 51-52 (Bankr. M.D. N. Carolina 2003), the bankruptcy court held that, based on the facts and circumstances of the case, the landlord’s right of first refusal to purchase the buildings and permanent improvements constructed on the leased land by the debtor-tenant was enforceable and would not be excised by the court. The bankruptcy trustee sought to obtain the court’s approval of the assumption, assignment and sale of the debtor-lessee’s interest under the lease to a third party free and clear of the right of first refusal, arguing that it was unenforceable under § 365(f) as an impermissible restraint on assignability of the lease. The court noted that, “courts have applied 365(f) to ‘lease provisions that are so restrictive that they constitute de facto anti-assignment provisions” (citation omitted). The court also acknowledged that “[w]hile a trustee is required to assume a contract as a whole, the court may strike provisions that are contrary to the provisions of the Bankruptcy Code

such as those that place restrictions on assignment.” *Id.* at 49. However, the court ruled in favor of the lessor based on the undisputed facts that the landlord had submitted the highest bid for the property, the clause was specifically and heavily negotiated by the parties as consideration for below-market rent, the landlord planned to develop the adjacent land, and the clause was necessary to protect the landlord from violating a non-compete clause in another lease to another party on nearby property. The court stated that “[n]umerous courts have recognized a right of first refusal with no analysis of the application of § 365(f)” (citations omitted) . . . A review of these cases reveals that the concern of these courts when presented with a contractual right of first refusal is not whether to enforce such right, but how to incorporate a right of first refusal into the bidding and sale procedures of the bankruptcy auction in a fair and equitable manner that still allows for maximization of the value of the estate.” *Id.* at 52-53. The court also noted that the majority of courts hold that a right of first refusal is an executory contract, but stated that “[w]hether the right of first refusal is part of a larger executory contract or lease, or stands alone, should not alter the treatment of that right. The Trustee has chosen to assume the lease, which includes [the landlord’s] right of first refusal.” *Id.* at 53 n.11.

15) A debtor in a Chapter 11 bankruptcy ordinarily must obtain confirmation of a reorganization plan before selling all or substantially all of its assets. See generally §§ 1121-29 of the Code. However, under § 363(b)(1), a debtor in possession, “after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate.” Further, under § 363(f), a § 363 sale can be made “free and clear of any interest” in the property of an entity other than the estate if:

- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
- (2) such entity consents;
- (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
- (4) such interest is in bona fide dispute; or
- (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

With respect to (3) above, the Code does not contain a definition of “value.” The bankruptcy courts disagree as to the definition of value, i.e., whether the term refers to the “face amount” of the lien or to the “economic value” of the lien. (The face amount of the lien refers to the actual amount of the claim secured by the lien, while the economic value of the lien is determined by the fair market value of the property.) In a recent decision by the Federal District Court for New Jersey, *Crimi Mae Services Ltd. Partnership v. WDH Howell, LLC (In re WDH Howell, LLC)*, 2003 U.S. Dist. LEXIS 14804 (D. N.J., Aug. 27, 2003), the court sets forth the decisions that support these contradictory views. The court in *WDH Howell*, after acknowledging the ambiguous results produced by the case law on this issue and reviewing the rationale of the courts with respect to these respective approaches, stated that, “We decline to rely on either reasoning and conduct our own analysis employing accepted principles of statutory

construction [i.e., that the role of courts in interpreting a statute is to give effect to Congress's intent]." *Id.* at * 13.

The court held that the correct approach was to utilize the face amount of the lien as the relevant test. According to the court, value in the § 363(f) context could not mean economic value because "the sale price for overencumbered property can never be greater than the aggregate economic value of the liens on the property (quoting *In re Canonigo*, 276 B.R. 257, 262-63 (Bankr. N.D. Cal. 2002)". *Id.* at *15. The court reasoned that because liens can never be more than their face value, the sale price could be greater than the aggregate economic value of the liens on the property only if the sale price also exceeded the face value of the liens. Finding that the property in this case was "overencumbered" (i.e., that the aggregate economic value of the property at the time of the sale to the proposed purchaser was the purchase price of \$8.3 million offered by the purchaser pursuant to a valid auction of the property and that the aggregate economic value of all the liens on the property would be the same amount and therefore not less than the sale price, while the face value of the objecting creditor's mortgage lien was \$11.8 million and thus greater than the sale price), the court ruled that "the sale free and clear of all liens, claims, and encumbrances was inappropriate under both the economic value and face value approaches. In light of this inevitable outcome, we conclude that Congress must have meant face value when it stated 'value' in § 363(f)(3)." *Id.* at *18. The court, referencing the "plain language" of § 363(f)(3) and the legislative history of § 363 (f)(3), further stated that, "[Since] Congress consistently refers to the value of a secured party's interest when it intends to denote economic value, our interpretation is consistent with the legislative history of § 363(f)(3)" (citation omitted). *Id.* at *18 n.11. Finally, the court noted in a footnote that even if it had ruled against the debtor based on its interpretation of § 363(f)(3), it would have remanded the case to the bankruptcy court because "the bankruptcy court ruled that the sale was appropriate without consulting any evidence or conducting an evidentiary hearing." *Id.* at *20 n. 12.

EXHIBIT "A"

Leasehold Mortgagee Protection Provisions

Section ____ Bankruptcy.

(i) If any Ground Lessor shall reject any Ground Lease under or pursuant to Section 365 of Title 11 of the Bankruptcy Code, the Borrowers shall not elect to treat the Ground Lease as terminated but shall elect to remain in possession of the applicable Ground Leased Property and the leasehold estate under such Ground Lease. The lien of the Mortgage covering such Property does and shall encumber and attach to all of the applicable Borrower's rights and remedies at any time arising under or pursuant to Section 365 of the Bankruptcy Code, including without limitation, all of such Borrower's rights to remain in possession of such Property and the leasehold estate.

(ii) Each Borrower acknowledges and agrees that in any case commenced by or against such Borrower under the Bankruptcy Code, Lender by reason of the liens and rights granted under the Mortgage encumbering any Ground Lease to which such Borrower is a party and the Loan Documents shall have a substantial and material interest in the treatment and preservation of such Borrower's rights and obligations under such Ground Lease, and that such Borrower shall, in any such bankruptcy case, provide to Lender immediate and continuous adequate protection of such interests to the extent it may do so under applicable law. Each Borrower and Lender agree that such adequate protection shall include but shall not necessarily be limited to the following to the extent permissible under applicable law:

(a) Lender shall be deemed a party to the Ground Lease (but shall not have any obligations thereunder) for purposes of Section 365 of the Bankruptcy Code, and shall have standing to appear and act as a party in interest in relation to any matter arising out of or related to the Ground Lease or the Property.

(b) Such Borrower shall serve Lender with copies of all notices, pleadings and other documents received by such Borrower relating to or affecting the Ground Lease or the applicable Property. Any notice, pleading or document served by such Borrower on any other party in the bankruptcy case shall be contemporaneously served by such Borrower on Lender, and any notice, pleading or document served upon or received by such Borrower from any other party in the bankruptcy case shall be served by such Borrower on Lender promptly upon receipt by such Borrower.

(c) Upon written request of Lender, such Borrower shall assume the Ground Lease, and shall take such steps as are necessary to preserve such Borrower's right to assume the Ground Lease, including without limitation obtaining extensions of time to assume or reject the Ground Lease under Subsection 365(d) of the Bankruptcy Code to the extent it is applicable.

(d) If any Borrower or the applicable Ground Lessor seeks to reject any Ground Lease or have the Ground Lease deemed rejected, then prior to the hearing on such rejection Lender shall be given no less than twenty (20) days' notice and opportunity to elect in lieu of rejection to have the Ground Lease assumed and assigned to a nominee of Lender. If Lender shall so elect to assume and assign the Ground Lease, then the applicable Borrower shall continue any request to reject the Ground Lease until after the motion to assume and assign has been heard. If Lender shall not elect to assume and assign the Ground Lease, then Lender may obtain in connection with the rejection of the Ground Lease a determination that the applicable Ground Lessor, at Lender's option, shall (1) agree to terminate the Ground Lease and enter into a new lease with Lender on the same terms and conditions as the Ground Lease, for the remaining term of the Ground Lease, or (2) treat the Ground Lease as breached and provide Lender with the rights to cure defaults under the Ground Lease and to assume the rights and benefits of the Ground Lease.

The applicable Borrower shall join with and support any request by Lender to grant and approve the foregoing as necessary for adequate protection of Lender's interests. Notwithstanding the foregoing, Lender may seek additional terms and conditions, including such economic and monetary protections as it reasonably deems appropriate to adequately protect its interests, and any request for such additional terms or conditions shall not delay or limit Lender's right to receive the specific elements of adequate protection set forth herein.

Each Borrower hereby appoints Lender as its attorney in fact to act on behalf of Lender in connection with all matters relating to or arising out of the assumption or rejection of any Ground Lease to which it is a party, in which the other party to the lease is a debtor in a case under the Bankruptcy Code. This grant of power of attorney is present, unconditional, irrevocable, durable and coupled with an interest.

EXHIBIT “B”

Springing Guaranty Provision – Mortgage or Loan Agreement

Section _____. **Partial Recourse.** Notwithstanding Section ____, each Borrower and Guarantor (but no other Person) shall be personally liable in the amount of any liability, loss, damage, cost or expense (including, without limitation, attorneys’ fees and expenses) resulting from any and all of the following: (i) fraud; (ii) material and intentional misrepresentation by any Borrower Party in this Loan Agreement or any other Loan Document or otherwise in connection with obtaining the Loan; (iii) insurance proceeds, condemnation awards, or other sums or payments attributable to the Property that any Borrower has received and which are not applied in accordance with the provisions of the Loan Documents; (iv) all rents, profits, issues, products and income of any Property received or collected by or on behalf of any Borrower or any Borrower Party and not deposited into the Rent Account or the Central Account in accordance with Article ____ and the Cash Management Agreement or otherwise received after the occurrence and during the continuance of an Event of Default (other than by Lender or Servicer) and not applied in accordance with the Loan Documents; (v) failure to turn over to Lender upon demand, after the occurrence and during the continuance of an Event of Default, or misappropriation of any tenant security deposits or rents collected in advance (other than by Lender or Servicer); (vi) failure by any Borrower or any indemnitor or guarantor to comply with the covenants, obligations, liabilities, warranties and representations contained in the Environmental Indemnity or Sections ____, ____ or ____ hereof, (vii) the commission of waste in connection with any Property; (viii) all liabilities and expenses under the indemnification provisions of Section ____; (ix) any actual, attempted or purported modification, amendment, termination or surrender of any Ground Lease (except pursuant to rejection of any Ground Lease by the Ground Lessor in a case under the Bankruptcy Code in which such Ground Lessor is a debtor) without the prior written consent of Lender; and (x) failure of Borrower to pay Impositions or other Liens on any Property in accordance with the provisions hereof to the extent that Net Operating Income from the Properties is sufficient to pay for such Impositions and Liens; and provided that neither any Borrower nor Guarantor shall be liable under this clause (x) if and to the extent Lender is then holding sufficient funds in escrow for payment of Impositions and fails to so apply such funds when required hereunder.

Section _____. **Springing Full Recourse.** Notwithstanding Section ____ above, each Borrower and Guarantor (but no other Person) shall be fully and personally liable for payment and performance of the entire Principal Balance of the Loan, accrued and unpaid interest thereon and all other Obligations under the Loan Documents, if any of the following shall occur (i) a Transfer of all or any portion of any Property or any interest therein or any direct or indirect ownership interest in any Borrower in violation of Section ____; (ii) a material default with respect to the single-purpose entity provisions under Article ____; (iii) if a bankruptcy proceeding shall be commenced by or against any Borrower or any Property becomes subject to any bankruptcy or insolvency

proceeding as described in Subsections 8.1(0), 8.1(11), or 8.1(I); provided, however, that the Borrowers and Guarantor shall not be personally liable by reason of an involuntary bankruptcy unless such involuntary bankruptcy is solicited, procured or supported by any Borrower, Guarantor, or any Related Person of any of them.

Section _____. **Miscellaneous**. No provision of this Article shall (i) affect the enforcement of the Environmental Indemnity, the Guaranty or any guaranty or similar agreement executed in connection with the Loan, (ii) release or reduce the debt evidenced by the Note, (iii) impair the lien of any Mortgage or any other security document, (iv) impair the rights of Lender to enforce any provisions of the Loan Documents, or (v) limit Lender's ability to obtain a deficiency judgment or judgment on the Note or otherwise against any Borrower Party to the extent necessary to obtain any amount for which such Borrower Party may be personally liable in accordance with this Article or any other Loan Document.