Did The Sky Fall On Leasehold Mortgagees? Ground Lease Financing After *Qualitech*

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The fallout has not been as bad as most people expected.

IN 2003, many leasehold mortgagees and their counsel seemed to fear the sky was falling when the Seventh Circuit issued its decision in *Precision Industries v. Qualitech,* 327 F.3d 537 (7th Cir. 2003).

Now that *Qualitech* has become part of the vocabulary in the leasehold lending community, has this case created the carnage that many commentators feared? How have the courts dealt with the issues that arose in *Qualitech*? Was the case as bad as many commentators said it was?

Shortly after *Qualitech*, an earlier version of this article argued that the case posed no cause for great concern and did not warrant the frenzy that it seemed to prompt. The present article updates the first one.

As before, this article starts by explaining the facts and legal conclusions of the *Qualitech* case. It summarizes how some other commentators reacted with shock to *Qualitech*, and why the author held—and still holds—a different view.

Finally, the current article explores how the courts have handled the issues that arose in *Qualitech*, a history that the author believes confirms his original view: leasehold lenders have nothing to fear from *Qualitech*.

When a lender accepts a ground lease as collateral for a commercial mortgage loan, the lender fears, above all, the risk that somehow the ground lease might terminate

prematurely—and with it, the lender's entire collateral. Any long-term tenant under a ground lease shares similar fears, but lenders worry about them more than tenants do.

Lenders and their lawyers therefore insist that ground leases contain extensive protections so the landlord cannot readily terminate the lease. Through these protections, lenders try to eliminate or control every known risk of premature lease termination. *See, e.g.,* Joshua Stein, *How Much Protection Does A Leasehold Mortgagee Need?,* 19 Prac. Real Est. Law. 7 (Nov. 2003).

Qualitech caused an uproar in the lending community because many feared the decision created a new and previously unknown risk of premature lease termination, by giving bankrupt landlords a new and previously unknown way to terminate a ground lease. The mere possibility of that result allegedly turned some lenders away from leasehold financing transactions, at least for a while.

Commentators' opined rapidly and widely on the implications of *Qualitech*. A few (including the author) thought there was no reason for *Qualitech* to create the frenzy that it did, because the case stood for nothing more than the principle that a tenant must pay attention and object early and often and request protection of its interest in its landlord's bankruptcy. *See, e.g.,* John C. Murray, *Bankruptcy Court Holds Tenant's Rights Must be Protected When Landlord-Debtor Attempts to Sell Property Free and Clear of Lease* (2005), http://www.firstam.com/content.cfm?id=3030; see also John C. Murray, *Precision Industries Part I: Debtor-Lessor's Property May Be Sold "Free and Clear" of Unexpired Lease,* 18 Prob. & Prop. 10, 14-15 (Mar./Apr. 2004).

The majority, however, disagreed. Most commentators argued that *Qualitech* would give any landlord in bankruptcy the right to sell a ground leased location to a third party "free and clear" of the ground lease—without compensating the tenant for the loss of its lease. If this were true, such an outcome would, of course, be a disaster for any leasehold mortgagee.

Here are the facts of *Qualitech* as the court summarized them.

Qualitech leased land to Precision for 10 years, at nominal rent. Precision built a warehouse on the land. Within a year after signing the lease, Qualitech filed for chapter 11 bankruptcy protection.

The Bankruptcy Code says any company in bankruptcy (a "debtor") can, with court approval, raise money by selling its property free and clear of any "interests" of other parties in the same property. Qualitech proposed just such a sale for the site that Qualitech had leased to Precision. Precision did not object in any way to the proposal. Precision said nothing. Precision did nothing. The court then authorized Qualitech to sell the leased site. Treating Precision's leasehold as an "interest" in the asset being sold, the court allowed Qualitech to sell the site free and clear of that leasehold. (The court's willingness to treat the leasehold as an "interest" raised some eyebrows in the bankruptcy community, unjustifiably in the writer's opinion. That issue lies outside the present discussion. The author believes it is intuitively obvious that a leasehold constitutes an "interest" in real property.)

The buyer, the successful bidder at the bankruptcy sale, said the bankruptcy sale terminated Precision's leasehold. Therefore the buyer locked Precision out of the warehouse on the leased site.

As an aside, the buyer was none other than, in effect, Qualitech's bank group, holder of a huge first mortgage on the property. *Qualitech,* supra, 327 F.3d at 541. One might reasonably assume that the mortgage had priority over Precision's lease and no nondisturbance agreement existed (although the case report says nothing on either point). On those assumptions, the mortgagee could easily have structured its acquisition of the site in a way that preserved the mortgage and therefore the ability to foreclose out Precision in a foreclosure sale—a result not too different from what actually happened.

And if Precision and the bank group had entered into a nondisturbance agreement, it typically would require the mortgagee to honor Precision's lease after "foreclosure." But a typical nondisturbance agreement probably would not have required the mortgagee, or its wholly owned subsidiary, to honor the lease as the successful bidder at a section 363 sale. Tenants negotiating future nondisturbance agreements might want to cover that possibility.

Although Precision had not mortgaged its leasehold, if it had done so, then the section 363 sale would have destroyed the mortgagee's entire collateral—a leasehold lender's worst nightmare come true.

If, in fact, a debtor landlord could, through a court-ordered bankruptcy sale, readily sell its property free of a tenant's lease, *Qualitech* would have introduced a lease destruction technique previously unknown to leasehold mortgagees and their counsel. This is what many commentators feared, arguing that the decision should strike terror into the hearts of leasehold mortgagees everywhere.

Professor Robert M. Zinman argued that *Qualitech* would create problems and risks "severe enough to result in serious problems for the future of leasehold financing and investment unless they are resolved now." *See* Robert M. Zinman, *Precision in Statutory Drafting: The Qualitech Quagmire and the Sad History of Section 365(h) of the Bankruptcy Code,* 38 J. Marshall L. Rev. 97, 101 (2004). He urged Congress to enact legislation to address the problems arising from *Qualitech* in order to preserve real estate leasehold investments and prevent a massive flight from leasehold investment.

One law firm's Web site declared: "Beyond the questions it raises, the court's opinion shows little recognition of its practical effect and commercial consequences. In the Seventh Circuit, tenants can be thrown out of the premises where they may be operating a vital portion of their business, even though they are performing under their leases, because of events in their landlord's bankruptcy." (The comments no longer appear on the firm's Web site, but a copy remains on file with the author.)

In other words, according to these commentators and many others, *Qualitech* represented a serious threat to tenants under ground leases, and hence their leasehold mortgagees. Five years later, has it turned out that such fears were well founded? Does the result in the Qualitech case really require remedial legislation?

No. The *Qualitech* result appears to be unique, and subsequent cases (discussed below) have demonstrated that *Qualitech* has not opened the floodgates to massive floods of lease terminations in landlords' bankruptcy proceedings.

Precision lost its lease primarily because it "sat on its rights." It never bothered to object to Qualitech's section 363 sale of the leased property. The court effectively treated Precision's silence as consent.

If Precision had objected to the sale and tried to block it, the Bankruptcy Code would, without question, have supported Precision. That is because the Bankruptcy Code allows a landlord debtor to sell its property free and clear of a third party's (e.g., Precision's) "interest" in the property only if the particular interest meets one of five tests. The five tests are:

1. State law allows the sale free of the interest;
2. The holder of the interest consents;
3. The interest is a lien securing an amount less than the sale price;
4. The interest is in bona fide dispute; or
5. The holder of the interest could legally be compelled to accept payment and release its lien.

Which of these five tests did Precision's leasehold meet (assuming the court properly treated it as an "interest" in Qualitech's property, an assumption the author is willing to make)? Certainly not "1," "3," "4," or "5." The only remaining possibility is "2"—the notion that Precision somehow con-

sented to Qualitech's sale of the leased property free of Precision's lease.

The Seventh Circuit never actually stated which of the five tests Precision's leasehold met. Instead, the court slid past the issue in a footnote: "[W]e shall assume, as [the new property owner] asserts, that one or more of the statutory criteria were met and that a sale of the property free and clear of Precision's possessory interest as a lessee was permissible." 327 F.3d at 546 n.3. Based on Precision's silence, this inference was perhaps (and perhaps not) reasonable.

If Precision had unambiguously withheld consent to the section 363 sale and argued that Qualitech as debtor had therefore satisfied none of the tests in section 363 to wipe out Precision's "interest," the outcome would almost certainly have changed and Precision might still occupy its warehouse.

As noted above, some writers have called *Qualitech* a disaster for leasehold lenders. This line of reasoning focuses on an issue of statutory interpretation that lies at the heart of the *Qualitech* case.

Qualitech actually considered the interaction of two bankruptcy statutes. The first was section 363(f), which lets a debtor sell property free and clear of certain "interests," as described above. Until *Qualitech*, no one paid great attention to the possibility that a lease might constitute an "interest" that a debtor could terminate through a section 363 sale.

Instead, in thinking about how a landlord might "get out from under" a burdensome lease by filing bankruptcy, everyone focused on Bankruptcy Code section 365(h), which allows a landlord to "reject" a lease. That section goes on to say, however, that a tenant can remain in possession under most of the terms of the "rejected" lease. As a result, unhappy landlords do not regard section 365(h) as a very attractive lease termination technique.

In *Qualitech*, the District Court decided that sections 363(f) and 365(h) conflicted, and resolved the conflict by concluding that a bankrupt landlord could proceed against a tenant only by rejecting the lease under section 365(h) (not very helpful to the landlord). On appeal the Seventh Circuit reversed, concluding that if a bankrupt landlord satisfied any condition to holding a section 363 sale, then the landlord need not worry about section 365(h), and could treat a leasehold as an "interest" capable of being destroyed in a section 363 sale.

The uproar that the Seventh Circuit created hardly seems justified. Precision lost primarily because it "sat on its rights" under section 363(f), not because section 363(f) generally gives landlords a new technique to terminate leases. Precision failed to object to the sale, and therefore, in the words of the Seventh Circuit: "On August 13, 1999, at the conclusion of a noticed hearing, the bankruptcy court entered an order approving the sale (hereinafter, the 'Sale Order'). Precision, which had notice of the hearing, did not object to the Sale Order." *Id.* at 540-41.

Commentators have mostly focused on the statutory interpretation issue and have vehemently criticized the statutory interpretation in *Qualitech*. The dramatics do, however, seem overstated. Subsequent cases support that view.

Even under the most debtor-oriented reading of the *Qualitech* case, a tenant (or presumably the leasehold lender in the tenant's place) should still be able to prevent a bankrupt landlord from selling the leased premises free of the tenant's lease—simply by standing up in court and objecting. Therefore, the leasehold mortgagee's world should not come to an end. The entire problem in *Qualitech* was that Precision failed to exercise its statutory right to protect itself.

A 2005 bankruptcy court case involving a long-term ground lease supports this very limited interpretation of *Qualitech*. In *In re Haskell L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005), Haskell owned an assisted living facility, part of which it rented to New England Baptist Hospital ("NEBH") to operate a short-term stay facility under a 99-year lease. NEBH paid no rent, but did pay certain operating expens-

es and real estate taxes. Haskell, the landlord, filed for chapter 11 bankruptcy protection, and tried to terminate NEBH's lease by selling the property under section 363 free and clear of all liens, claims, and "interests," including the lease. For good measure, Haskell, also filed a motion to reject the lease. Unlike the case in *Qualitech*, however, NEBH, the tenant, actively objected to Haskell's motion to sell under section 363 free and clear of NEBH's leasehold interest.

Haskell argued that it had the right to sell the property free and clear of NEBH's lease because NEBH could be compelled to accept money in satisfaction of its claim under section 363(f)(5). NEBH disagreed, saying its interest could not be reduced to a money claim. Just as the *Qualitech* court had done, the *Haskell* court looked at the relationship between section 363 and section 365, finding that the lessee, NEBH, could "not be compelled to accept money for its rejected lease under §363(f)(5) in view of the provisions of §365(h)," as doing so would eviscerate section 365(h). *Id.* at 9. The *Haskell* court also held that the lessee's interest could not be adequately protected under section 365(h) unless the lessee were permitted to retain possession under the lease. Thus, the court allowed NEBH to stay in place for the remainder of its lease term.

To the extent that leasehold mortgagees still fear their investments after *Qualitech*, *Haskell* ought to dissipate any such fears. The latter case confirms the author's view that a lessee can protect itself under section 363 merely by voicing its objection to the proposed sale of the leased premises.

Two years later, another bankruptcy court decided *In re Samaritan Alliance, LLC*, 58 Collier Bankr. Cas. 2d (MB) 1635 (Bankr. E.D. Ky. Nov. 21, 2007), a case that should further reassure leasehold mortgagees. Here the court again recognized the importance of allowing a lessee to object to a section 363 motion to sell free and clear, and decided to preserve the leasehold of a lessee that made such an objection.

In *Samaritan Alliance*, the debtor-sublandlord, Samaritan, leased a hospital from Ventas. Samaritan then entered into various sublease agreements with a subtenant, Cardinal Hill. Soon after, Samaritan filed for chapter 11 bankruptcy protection.

The landlord and the debtor entered into various transactions that included a termination of the lease from Ventas to Samaritan and apparently culminated in Samaritan's purported section 363 transfer of a new leasehold interest in the hospital "free and clear" to a new purchaser. Samaritan never bothered to tell Cardinal Hill about the resulting termination of its sublease. Cardinal Hill objected. The court, explicitly following *Haskell*, held that the purchaser did not buy Samaritan's leasehold free and clear of Cardinal's subtenancy because, as the *Haskell* court had ruled, section 365(h) preserved Cardinal Hill's possessory interests, and nothing in section 363 allowed the termination of those interests. Thus, the court allowed Cardinal Hill to remain in its subleased space for the rest of the sublease term.

A third decision demonstrated that the courts know how to apply section 363 without destroying the legitimate expectations of ground lessees and their lenders. In *S. Motor Co. v. Carter-Pritchett-Hodges, Inc.* (*In re MMH Auto. Group, LLC*), 385 B.R. 347 (Bankr. S.D. Fla. 2008), RGA leased space for a billboard to CPH for 99 years in exchange for a single up-front payment of $15,000.

RGA then sold the property to MMH, subject to the billboard lease. MMH filed for chapter 7 bankruptcy protection, but did not include the billboard lease on its schedule of executory contracts. Therefore, the trustee did not file a motion to assume or reject it. The property was sold in a court-approved sale under section 363 to the purchaser free and clear of all claims, liens, and encumbrances. When the purchaser learned that the billboard lease existed, it sought to have the sale order enforced and to obtain a declaration that CPH had no interest in the property.

The court first found that CPH had not received the notice to which it was statutorily entitled. If CPH had received such notice and objected, the court said, both sections 363(f) and 365(h) would have applied. As a result, the trustee could not have sold the property free and clear of the billboard lease unless one of the section 363(f) conditions were met. Because the billboard lease expressly provided for a valuation and liquidated buy-out of CPH's leasehold interest, the court found that CPH could be compelled to accept a money satisfaction of its interest as contemplated under section 363(f)(5).

Thus, this was a case where section 363 would have allowed the debtor-landlord to have sold the property free and clear of the leasehold—as an "interest" whose holder could have been forced to accept a monetary payment in substitution for its interest. But, because CPH's interest would have been protected by receiving payment of the valuation amount contemplated by the lease itself, the court confirmed the sale and ordered that CPH receive the liquidated value of its interest from the sale proceeds.

The *MMH Automotive* decision again shows that the fears that *Qualitech* might destroy lenders' investments through section 363 sales are unfounded. Not only will a court respect a tenant's interests upon actual objection, but it will assume that if a tenant were given appropriate notice of an attempt to sell free and clear of any interests, the tenant would file an objection to such a sale and request protection of its leasehold interest. And the case also demonstrates that the use of section 363 may be a perfectly appropriate mechanism to terminate a lease when the lease by its terms allows termination upon payment of a liquidated amount—precisely a category of "interest" that section 363 allows to be terminated. The termination of the billboard lease through a section 363 sale in *MMH Automotive* hardly seems shocking.

In another bankruptcy case, the court interpreted section 363(f) to extinguish any interests the tenant held, including the tenant's rights under section 365(h). The case includes no factual history that would shed light on the context or the court's conclusion. The case does seem to suggest that—as in *Qualitech*—the tenant never objected or sought to have her interests protected. Still, the commentators who feared terrible consequences from *Qualitech* might point to this particular case as an example. *See In re Sophie H. Ng,* 2007 Bankr. LEXIS 4212 (Bankr. N.D. Cal. Dec. 13, 2007).

The push for legislation to clarify the distinction between sections 363 and 365, urged by many commentators and supported by the American Bar Association, has thus proven unnecessary, and has indeed gone nowhere. *See* Christopher C. Genovese, *Precision Industries v. Qualitech Steel: Easing the Tension Between Sections 363 and 365 of the Bankruptcy Code?,* 39 Real Prop. Prob. & Tr.. J. 627, 649 (2004) ("This clear division among authorities [regarding the proper application of sections 363 and 365] demonstrates the need for Congress to intervene and provide guidance about what it desires as a result"); Zinman, supra; Letter from ABA to Congress, supra. The fact that Congress has tabled the proposed legislation leaves leasehold mortgagees with the cases discussed in this article. Those cases demonstrate that when a tenant does object to a section 363 sale, the courts seem eminently capable of applying section 363 in a sensible way, without destroying the legitimate expectations of tenants and their leasehold mortgagees. Again, all a tenant must do to protect its interests is object. It is now evident that the holding in *Qualitech* was nothing more than a direct result of the tenant's failure to object. It turns out that, after all, the sky did not fall on leasehold mortgagees.

Even though these cases suggest the fears about *Qualitech* were overstated, a leasehold mortgagee should think about section 363 in its loan documents. What lessons can tomorrow's leasehold mortgagees learn from the *Qualitech* case?

Most leasehold mortgage documents already require that the tenant/borrower preserve its leasehold. That obligation should include an obligation for the tenant/borrower to object vociferously (not in those words exactly) if the landlord wants to destroy the lease through a section 363 sale.

Typical leasehold mortgage documents also usually let a leasehold mortgagee take any steps necessary to protect its collateral. This should include the right to try to stop the landlord from terminating the lease through a section 363 sale. The leasehold lender may want a nonexclusive agency appointment toward that end.

For new transactions, *Qualitech* may lead leasehold lenders and their counsel to add some new language to their loan documents to say the borrower/tenant really shouldn't let the landlord destroy the lease through a section 363 sale, and the lender can stand up and object to such a sale. A leasehold lender may also want to see corresponding language in the ground lease itself. Others have suggested adding language to confirm that the tenant cannot be compelled to accept a monetary payment in place of its leasehold. Any such statement would amount to a pre-emptive defense against another possible theory (suggested and rejected in the *Haskell* case) by which a landlord might try to use section 363(f) to terminate leases. But this particular acknowledgment seems fairly self-evident—no more necessary or appropriate than adding a statement that the lease is not a giraffe or a chimpanzee.

Any new lease verbiage of any of the types just suggested should be perfectly noncontroversial and routine. It should solve whatever problems *Qualitech* caused, if existing language and existing law did not already.

Looking forward, for both new and old transactions, ground tenants and leasehold lenders should pay attention to their ground leases. This represents no great new insight. If a tenant or leasehold lender receives notice of the landlord's bankruptcy and the landlord's desire to sell the leased property under section 363, the tenant and leasehold lender should do something about it and object if necessary. (One would think that the lender should have a constitutional right to notice of any proposed sale.) If Precision had done exactly that, *Qualitech* would never have taught leasehold mortgagees about new bankruptcy risks over which to lose sleep.

Ultimately, *Qualitech* stands for just three principles, none justifying the hysteria the case generated:

- Anyone who holds an interest in real estate must monitor its position and act proactively to protect that position when necessary;
- Not only do bad facts produce bad law, but bad law based on bad facts produces ever-longer documents; and
- Surprises never end in the world of ground leases.

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