

**LEASE ASSIGNMENT AND SUBLEASE AGREEMENTS:
DISTINCTIONS WITH A DIFFERENCE**

**October 24, 2009
9:30 a.m.**

**Presented to the
International Council of Shopping Centers
2009 U.S. Shopping Center Law Conference
JW Marriott Desert Ridge Hotel
Phoenix, Arizona
October 21 – 24, 2009**

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INTRODUCTION

The benefit of real estate leases may be transferred by assignment or subletting, and the advantages and disadvantages must be analyzed. Sometimes they can be the same for both transferor and transferee: for example, if a long-term lease or sublease is taxable for real estate transfer taxes, but an assignment of a long-term lease is not, both parties are drawn to the non-taxable transfer. Sometimes consequences have different effects for a transferor and transferee: for example, when the transferor is trying to be released from further liability under the lease, a goal outside the frame of a sublease structure; or, to mitigate its losses in the event of further default under the lease, a goal, in turn, outside the frame of an assignment structure. As a general rule, transferees prefer assignments, transferors prefer subletting if they are not released in an assignment. Some transferors will go to even further lengths when the tenant is a subsidiary and assignee of the transferor, usually as part of the sale of one of the transferor's business lines, by having the tenant reassign the lease back to transferor to allow the transferor to sublease and thereby retain remedies of damages for rent and eviction for possessions. Arranged below are some of the more troublesome issues and variations on that rule.

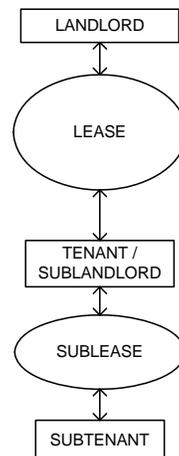
1. FORMAL DIFFERENCES.

1.1. Sublease.

The structure of the sublease resonates with a number of issues found in the ancient rules of tenure. A sublease is created by a grant from the sublandlord to the subtenant of a lesser estate than the estate held by the sublandlord: therefore, it is something less than an assignment. There is no privity between the prime landlord and subtenant, which results in various losses of rights for the subtenant; for example, landlord covenants running with the lease are not enjoyed by the subtenant, like the prime landlord's covenant of quiet enjoyment.

Sublease Without Mortgage

SUBLEASE WITHOUT FEE MORTGAGE: LANDLORD RELATES TO
TENANT/SUBLANDLORD THROUGH LEASE, SUBLANDLORD
RELATES TO SUBTENANT THROUGH SUBLEASE

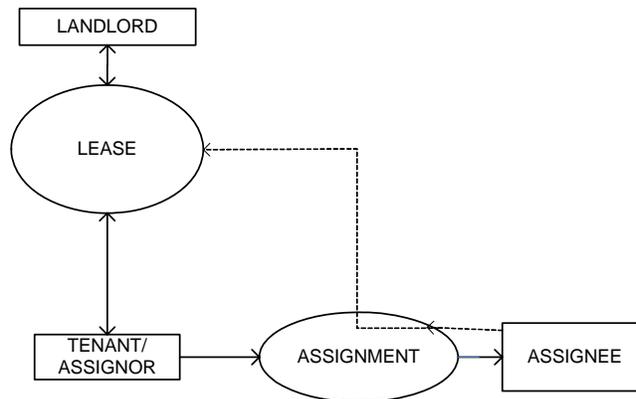


1.2. Assignment.

An assignment of a leasehold, by comparison, is created by the transfer of the tenant's estate (or a pro rated portion of it¹). An important incident of assignment is that the assignor is not automatically released, unless the landlord expressly either releases assignor or limits assignor's liability to its interest in the leasehold.

Assignment without Mortgage

LANDLORD RELATES TO TENANT THROUGH LEASE: BY ASSIGNMENT LANDLORD
RELATES TO ASSIGNEE THROUGH LEASE



The technical result is that there is privity of estate and contract between the landlord and the assignee successor to the tenant,² whereas there is no privity between the landlord and the subtenant. This distinction between the sublease and the assignment of course provides an excuse for tempestuous hairsplitting over characterization. One aberrant outcome of the differences is that while the sublandlord may be able to avoid future liability by simply voluntarily surrendering its paramount leasehold to the landlord thus causing a merger of the estate and most likely the accessory contract liabilities, concerned commentators have been diffident in asserting whether the surrender divests the sublease, substitutes the sublease even though there is a lack of attornment, or merely severs it from liability.³ A surrender by a

¹ See more information on Assignments *pro tanto*, at 51 C.J.S. Landlord and Tenant §§ 37(2) and 44(3), and 49 Am. Jur. 2d Landlord and Tenant §393.

² “An assignment does not relieve the assignor from liability under the contract. Rather, after the assignment, the assignee becomes primarily liable for the obligations under the contract, while the assignor remains secondary liable. The debtor may then sue the assignor, the assignee, or both. See *Herigstad v. Hardrock Oil Co.*, 101 Mont. 22, 52 P.2d 171 (1935); *Southern Surety Co. v. W.E. Callahan Construction Co.*, 283 S.W. 1098 (Tex.Civ.App. 1926); see also *Sobol v. Avila*, 480 P.2d 116 (Colo. App. 1970) (not selected for official publication).” *Roget v. Grand Pontiac, Inc.*, 5 P.3d 341, 345 (Colo. Ct. App. 1999).

³ The consequences are more than anomalous, and reach a level of absurdity. The subtenant has no obligation to pay rent to the sublandlord, because the sublandlord surrendered its rights. The prime landlord has no rights because the doctrine of merger concludes that the prime landlord obliterated any privity of contract or estate when the leasehold was merged into and extinguished by the fee estate. The common law enables the subtenant to retain possession without paying any rent. “A subtenant is not liable to the head landlord under the head lease. He is not liable for rent or for breach of other covenants. There are three general exceptions to this. First, if the prime tenant is insolvent the head landlord may resort to the subrents – and has a preference therein ahead of other creditors of the prime tenant – to the extent necessary to satisfy the prime tenant's liability under the head lease.” . See 1 Milton R. Friedman and Patrick A. Randolph, Jr. FRIEDMAN ON LEASES at 236-237 Section 7:7.1 (5th ed.

subtenant to a prime landlord would be impossible. By comparison, a surrender by an assignor of its interest may divest its contractual liabilities, though the fact that the assignor lacks an estate in realty could prevent the surrender; whereas, a surrender by the assignee would certainly divest an assigned lease.

If the assignor of the lease would not be released by the prime landlord and would remain liable on the lease after assignment, careful drafters try to expressly retain for the assignor the right to re-enter rather than compel a re-assignment. Otherwise, if there is a default by the assignee under the lease and the assignor had no right of re-entry, then the assignor, at least under one case, would be liable to the prime landlord, and yet would be merely a creditor of the assignee, without the express benefit of being able to mitigate those damages through repossessing and reletting the leasehold originally assigned.⁴ Drafters consider an assignor's right of re-entry as equivalent to a landlord right of re-entry: neither of which is a recapture of the term of the remainder of the estate for years.

1.3. Recharacterization.

The characteristic of a sublease is that the sublandlord has a right of repossession and reversion. The use of a reassignment can create an equivalent outcome. Of course, the more the assignment appears to resemble a sublease, or the reverse, they each can be subject to recharacterization for purposes of tax law, lease law, contract law, bankruptcy law, and financial reporting requirements. When the assignor retains a continuing interest in the leasehold estate, even though it does not retain an estate in time, the assignment may be recharacterized as a sublease.⁵ If the re-entry were deemed a re-assignment, there is a higher likelihood the arrangement could be recharacterized as a sublease. To the extent an assignment would require landlord consent, the assignor may also seek the landlord's advance consent to that re-entry without terminating the original assignment. The gravity of this issue is not only the balance between the assignor and assignee as to how remedies must be exercised, but it is also an issue for the landlord as to whether its consent was required. For example, if a sublease term is one day less than the prime lease, but the subtenant has exercised an option to extend beyond that date, there has been litigation as to whether the exercise results in a sublease being

2007, including Release #6). *Id.* at §7:7.3, fn. 590 (5th Ed.). “This preference may be analogized to a vendor's lien.” *Id.* at fn.523. However, language in the prime lease can overcome the presupposition. “California law has long held that a tenant's surrender of his estate to the landlord does not destroy the estate of the underlessee if the tenant has made an underlease. (*Buttner v. Kasser*, (1912) 19 Cal. App. 755, 760 [127 P. 811].)” *Chumash Hill Properties, Inc. v. Peram*, 46 Cal. Rptr. 2d 366, 370 (1995).

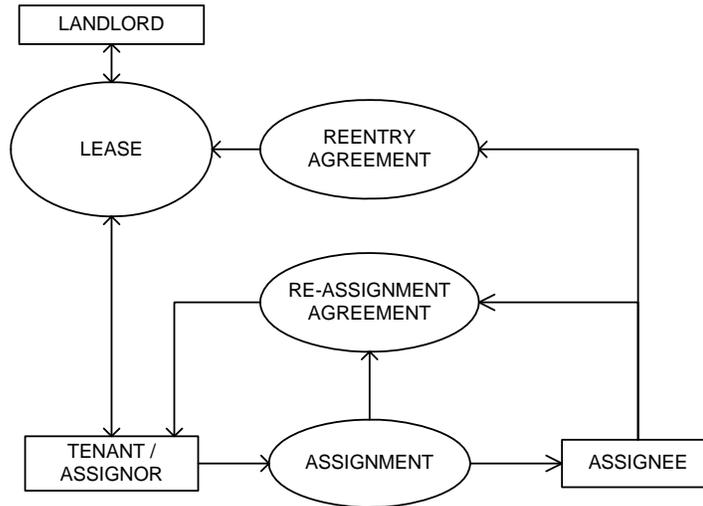
⁴ “When a lease is transferred by assignment, the assignee steps into the lessee's shoes and acquires all the lessee's rights in the lease. Privity of estate ends between the lessor and lessee and is created between the lessor and the assignee. The assignee therefore becomes bound by the covenants running with the land. Privity of contract between the lessor and lessee, however, does not end by the mere assignment of the lease and the lessee is therefore still bound by the lease provisions. Since Italian Fisherman [assignor] transferred to Armand's [assignee] all of its “right, title and interest” in the Rockville property, one may conclude that the assignment was unequivocal and the Italian Fisherman had divested itself of any interest in the property.” *The Italian Fisherman, Inc. v. Middlemas*, 545 A.2d 1, 8-11 (Ct. App. of Md. 1988). There is a common law theory of subrogation that generally applies to protect guarantors, but the court case did not address that as an alternative.

⁵ “A sublease is involved if the tenant has reserved a right to take back the possession of the leased property upon the occurrence of some event, the event usually being the failure of the transferee to meet some rental payment.” RESTATEMENT OF PROPERTY § 15.1 Reporter's Note 8.

recharacterized as an assignment because the exercise of the option caused the entire estate to be held by the subtenant.⁶

Assignment Without Fee Mortgage and with Re-entry Right

TENANT AND ASSIGNEE CAN READJUST ASSIGNEE REMEDIES FOR RE-ENTRY/
REASSIGNMENT RIGHTS



2. TRANSFEROR’S ANALYSIS: TO BE A SUBLANDLORD OR AN ASSIGNOR.

2.1. Sublandlord Duties.

Disregarding the effect of a recognition agreement (discussed below), the analysis of different benefits and the detriments to a sublandlord, when compared to those of an assignor, can be distinguished in different ways. Detriments, as a general matter, revolve around duties and the liability for breach of duties. A sublandlord retains an estate and grants a lesser estate. Consequently, it has independent liabilities for traditional landlord duties; duties and liabilities it cannot avoid merely by referencing the prime lease terms and disclaiming liability for prime landlord duties. For example, one duty is the implied warranty of quiet enjoyment. A second example is that sublandlord is liable for wrongful eviction it may cause. Another duty is that sublandlord generally has to avoid impairment of the subtenant’s leasehold rights. To the extent a subtenant’s rights can be preserved only by entitling it to setoff, to abatement, or to escrow rent due, the sublandlord is in a more perilous position than an assignor because it may entitle subtenant to stop rent while remaining liable to the prime landlord to pay that rent. Though these issues are not dominant, this could sway a sublandlord transferor to prefer to assign rather than sublease to a transferee, notwithstanding the other powerful arguments to the contrary based on rights of damages and eviction.

⁶ *Joseph Brothers Company v. F.W. Woolworth Company*, 641 F.Supp 822 (N.D. Ohio, 1985).

2.2. Sublandlord Administration.

Another characteristic of the sublandlord's duty to the subtenant and the prime landlord is as the intermediary for administrative housekeeping. The sublandlord forwards notices, collects sublease rent, and pays prime lease rent, maintains insurance and is otherwise liable for errors in the performance of its sublandlord duties and prime tenant duties. This administrative responsibility exposes the sublandlord to possible liability claims from subtenant for negligence and business interference in addition to simple breach of contractual duties. These are more reasons for the transferor to prefer the assignment over the sublease. The sublandlord can appoint the subtenant as its agent to perform those duties directly, but the sublandlord would still need to monitor the activity for its own well-being unless it could achieve the unlikely benefit of a release from those duties by prime landlord. Another issue is preservation of sublandlord rights. In the sublandlord efforts to remain aloof from the continuing dynamic of the landlord tenant relationship, a common request of subtenants, which is granted frequently but not uniformly, is that the subtenant be permitted to pursue remedies in the name of the sublandlord. This raises a variety of possible risks that the assignment would handily avoid, such as inappropriate or negligent exercise of the power resulting in unforeseen sublandlord liability.

2.3. Sublandlord Mitigation.

The preeminent benefit to a sublandlord of a sublease, compared to an assignment, is the sublandlord's structural retention of the power to mitigate its own damages, a power inherent in the sublease and non-existent in the assignment. If a subtenant defaults, a sublandlord can exercise traditional landlord remedies and accelerate for rent due, or evict the subtenant, re-enter and relet the subleased premises, or terminate the sublease. A further complement of those protections is that the sublandlord remains involved in the notice procedures and, in the context of actual or constructive notice, is the primary possessor-in-interest for otherwise uninformed third parties. The assignor cannot evict the assignee, nor repossess the leasehold, unless separately agreed to by the prime landlord. However, the sublandlord can evict the subtenant. If the prospective assignor transferor cannot obtain a release or limitation of liability from the prime landlord, this would be an important reason for the transferor to prefer to sublease rather than to assign to a transferee.

2.4. Interference with Assignor Rights to Reentry or Reassignment

The prime landlord would typically have requirements that an assignee have a credit quality at assignment no less than that of the tenant at commencement of the lease and the assignee at the time of the initial assignment. Interference with assignor's right to reassignment or re-entry can arise if the assignee's creditors attach liens to the leasehold; then the assignor's rights may be subject to the reassignor's judgment or creditor liens. By contrast, a sublease would always be subordinate to the sublandlord's estate and therefore liens on the subtenant's interest in the subleasehold would be subordinate as well: the termination of the sublease terminates liens on the sublease. The assignee could also impair the leasehold in ways other than lien encumbrances, so that the assignor's rights would be problematic or of diminished value, such as by permitting third parties' rights of use or occupancy. If the assignee/reassignor is thinly capitalized, it is impractical to expect that the assignor could be able to force the assignee to cover the assignor's losses. The assignor may also face the risk that the reassignment is

frustrated because the prospective assignee/reassignor is unable, rather than unwilling, to make the assignment. For example, the assignee's guarantors may object that the assignor's rights impair their expectations of the performance by their obligor, the initial assignee, and may interfere with the mitigation available by subrogation.⁷ By comparison, the sublandlord in similar situations would not be impeded in terminating the sublease.

2.5. Bankruptcy Rejection of Right to Re-Entry or Reassignment

A more extreme risk to the assignor is if the assignee files for bankruptcy and rejects the contractual obligation to allow re-entry. One countermeasure would be to have the assignee guaranty to assignor the payment of the prime rent, with the guaranty collateralized by a collateral right of re-entry or assignment of the lease. The collateral assignment would need to clear the same hurdles with the prime landlord and assignee's lender, if any, as a pre-approved consent to a conditional reassignment.

2.6. Assignor's Independence from Ownership Risk

A benefit of the assignor over that of a sublandlord is that the assignor lacks incidents of ownership during the period of assignee's tenure. The assignor can sidestep liability that arises during that period. It can also elect to remain outside of the ownership of the leasehold and avoid liabilities that would pre-date but nevertheless survive the reassignment, such as environmental risk.

2.7. Possession as Notice of Rights

Lastly, the assignee has much better circumstances to claim that its possession provides notice for third parties. By comparison, the subtenant's right to that standard by constructive or actual notice is much less clear. Of course, the more the assignment appears to resemble a sublease, or the reverse, it can be subject to recharacterization.

3. TRANSFeree'S ANALYSIS: TO BE A SUBTENANT OR AN ASSIGNEE.

3.1. Divestiture of Subleasehold.

A subtenant has numerous concerns about the risks of a sublease, but a key concern is about the loss of the subleasehold estate for reasons outside of subtenant's control. The principal fear is that the prime landlord is entitled to terminate and divest the prime leasehold and all rights that derive from the leasehold, including the subleasehold estate. The major source of protection against that is the recognition agreement. The subtenant would also seek protections with a non-

⁷ "Although Dow [landlord] may sue either the lessee or assignee of a lease, "as between the assignee and the lessee, the assignee bears the primary liability for rent accruing subsequent to the assignment." After an assignment, the lessee is treated in the fashion of a surety or guarantor of the assignee. In other words, as with a surety or guarantor, the liability of the assignor is secondary vis-à-vis the assignee. * * * Because the lessors of the Rejected leases were entitled to an administrative priority for the postpetition monies due them through the date of rejection, G & W [as guarantor of the lease] may step into their shoes. G & W paid Dow several months' rent which otherwise PS [lessee/assignee] would have had to pay at the time of assumption. Thus, provided G & W protects the estate either by directing Dow to accept the payments under G & W's guarantees or by obtaining an assignment from Dow, it can assert Dow's rights." *In re Wingspread Corp.*, 116 B.R. 915 (SDNY 1990).

disturber. The recognition agreement can be vulnerable to various attacks. For a transferee, it has greater inherent frailties than those that inhere in an assignment.

3.2. Insulation of Subtenant.

As a general matter, one benefit of a sublease for a subtenant is that it can insulate the subtenant from direct liability for duties that are created under the prime lease except as otherwise expressly provided in the sublease. The liability of the subtenant under the sublease, specifically for rent, may be far less punishing than prime lease rent, though the consequence of default for non-payment of prime lease rent may be more extreme, meaning termination of the sublease without the right to provide substitute cures. In addition, subtenant can negotiate for a number of benefits from the sublandlord that the sublandlord may not have been able to negotiate with the prime landlord, such as set off, limited liability, early termination, and tenant improvement allowances. To the extent subleases are of some smaller portion of the sublandlord premises, subtenants can also negotiate expansion options up to the boundary of the sublandlord's demised premises. Consequently, the subtenant and its guarantors, without privity with the prime landlord, can keep the prime lease requirements at a distance and, if the subtenant is protected by a recognition agreement of its sublease contract terms, virtually irrelevant.

3.3. Mitigation.

From the transferee's point of view, an assignment could be less appealing than a sublease, especially because the subtenant can negotiate to require its sublandlord to mitigate damages. An assignee, by comparison, having no negotiating relationship with the prime landlord, rarely revises the impositions built into the prime lease in an equivalent fashion. The assignee's surrender or abandonment is made directly to the prime landlord.

3.4. Independence of Assignee.

Under an assignment, the transferee would have a direct relationship with the landlord rather than an intermediated relationship as in a sublease. The assignee's right to the leasehold is not at the mercy of the assignor or shaken by its mistakes, as would be the case for a subtenant deriving its continuing right of possession from a sublandlord. For example, after a valid transfer, the dissolution or termination of the assignor cannot affect the assignee's leasehold, whereas as the sublandlord's dissolution or termination could affect the subtenant's estate. The assignee ordinarily has a contractual grant under the lease entitling it to interact with the landlord's mortgage. The sublease has no privity.

4. DRAFTING COMPARISONS AND CONTRASTS.

4.1. Similarities.

In comparing provisions of a sublease to the corresponding provisions of a lease assignment, the first distinction should be between an assignment of the whole lease compared to an assignment *pro tanto*. The assignment *pro tanto* and sublease are much more alike because the assignor retains an interest in the balance of the leasehold space, whereas a sublandlord may retain an interest in the balance of the space but certainly retains an interest in the balance of the term, the reversionary interest. Comparing a sublease and a complete assignment, traditional

provisions can include some of the following. Both approaches would have recitals as to the lease in question: laying the foundation for its parties, the genesis of its formation, and its subsequent history builds a framework around the intended transfer and the real property interest being transferred. The assignor and the sublandlord will both disclaim any responsibility to perform the original landlord's duties, and will insist the subtenant or assignee expressly assume the obligations of tenant under the original lease. One commonly overlooked similarity is the need for the sublandlord and the assignor to control the risk of loss arising from a subtenant or assignee failing to perform tenant obligations: they both should seek to scale back the assignee or subtenant's cure periods. That would allow sublandlord or assignor, as the case may be, to reassert its power to cure a tenant default. They would both look for remedies against the transferee, whether subtenant or assignee, including accelerated damages, right of re-entry, and rights of termination. A more obvious similarity is that both the assignment and sublease generally need a landlord consent where the prime lease has an express provision, but not where it is silent. Both would cover the same areas relating to assignor/sublandlord representation and warranties. As part of that, both the assignment and sublease would typically include the panoply of terms relating to as-is condition; disclaimers by assignor/sublandlord, and releases of claims and waivers of defenses by assignee and subtenant. Another important but frequently overlooked similarity is the transferor's right to reclaim or repossess the occupancy. This drives to the heart of an assignor's risk if the new occupant fails to meet the original landlord's requirement, and consequently leaves the assignor as exposed as a sublandlord. It is actually worse for an assignor because the assignor may have otherwise have foresworn its traditional source of recovery. The assignee and subtenant would both expect to distinguish what materials (whether personalty or alterations) would need to be removed notwithstanding they were not delivered or installed by the subtenant or assignee.

4.2. Dissimilarities.

The sublease would ordinarily elaborate the variety of provisions in the prime lease that are either included or excluded, such as how references for prime landlord are incorporated as to be deemed to mean either sublandlord, both sublandlord and prime landlord (such as for consents), or only prime landlord (such as providing utilities). An assignment rarely addresses those issues because the assignor is cut out of the loop of participation in the landlord-assignee relationship. In that vein, a subtenant will feel compelled to describe its subrogation rights to prime tenant's position in enforcing the prime lease. The assignee already has the power by the nature of the assignment. Similarly, the subtenant would expressly create the right to compel sublandlord to enforce tenant rights, whereas the assignee would not need an express statement because that right is already embedded in the assignment. Issues relating to term, rent options, landlords building services, and premises configuration may be shortened or modified in a sublease, but would generally not be modified in an assignment because the entire lease, with privity of contract and estate, is being assigned. Covenants would be treated dissimilarly because the assignor would believe it is out of the privity of estate and therefore has no further obligation. Many subleases involve smaller portions of larger spaces, so they would emphasize issues relating to sub-demising space, such as splitting life safety and electronic communication systems, subtenant allowances, removal of personalty and alterations upon surrender, and allocation of construction risk. They also dwell on issues relating to destruction and condemnation among other property right issues which an assignor believes it has left far behind. On those lines, the subtenant would need to be sure it could terminate if a large portion of its

space becomes untenable even though it may be a small portion of the larger demised premises. Sublandlords will also typically focus on security deposits and other collateral enhancement which is not part of an assignor's area of future concern.

5. **GROUND LEASES AND LEASEHOLD MORTGAGES.**

5.1. Ground Leases and Mortgages.

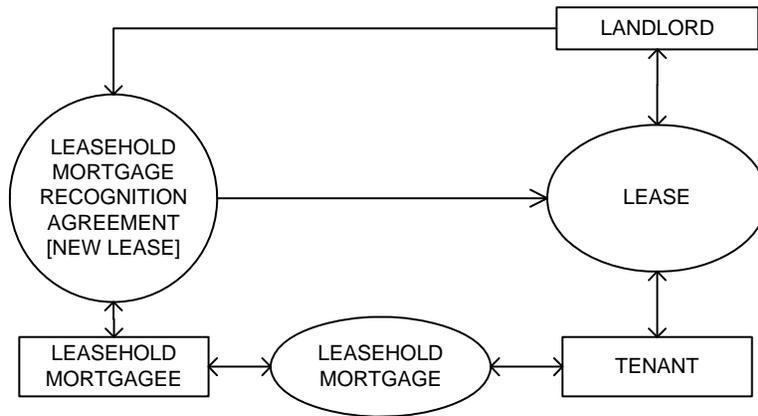
A typical ground lease is designed by the prime landlord and the prime tenant for the prime tenant to have powers and privileges as close to ownership as possible, and to operate with as little interferences from the prime landlord as can be arranged. This is reflected in the fact that the economic design of the ground tenant is either to exclusively occupy the entire site for its own purposes, or to rent to space tenants; but in any event that the ground lease be fully mortgageable.⁸ The issues affecting subtenants and ground leasehold mortgagees, however, are intensified in the circumstance when they intersect. The subtenant seeks a recognition agreement from the leasehold mortgagee to protect the subtenant if the leasehold mortgagee requires a new prime lease with landlord.

5.2. Leasehold Mortgagee Documents.

Broadly put, the leasehold mortgagee needs to know that the leasehold estate will not be terminated when it could be preserved. When the tenant is in default with the landlord, as well as with the leasehold mortgagee, however, the tenant is not a strong candidate to protect the leasehold mortgagee's position. Therefore, the leasehold mortgagee will require (1) direct and explicit covenants from the landlord that the landlord will provide the leasehold mortgagee with contemporaneous copies of notices of default sent to the tenant, (2) the right to undertake a cure for curable defaults within a reasonable period of time, generally more time than is granted the tenant. The leasehold mortgagee would reserve the right to make curative advances if the tenant failed to, and to add the additional advance to the leasehold mortgage principal. The tenant leasehold mortgagee seeks, in addition, a recognition agreement with the prime landlord that runs specifically the leasehold mortgagee and purchasers of the leasehold estate in the event. In some instances where the default does not submit to a cure, such as a tenant misrepresentation of fact or a tenant's rejection of the lease in bankruptcy, the leasehold mortgagee needs assurance that landlord would enter into a new lease on identical business terms with the leasehold mortgagee or its assignee. Similarly, a leasehold mortgagee would look for a subordination, non-disturbance and attornment agreement with the prime landlord's mortgagee.

⁸ Robert Zinman, "Precision in Statutory Drafting: The Qualitech Quagmire and the Sad History of Section 365 (h) of the Bankruptcy Code, 38, John Marshall Law Review, 97, 114 (Fall 2004), page 9 fn. 24. "Ground leases have been defined as "a lease of the entire property, generally a net lease where the tenant may sublet to people who occupy the premises or to others who sublease to people who occupy the premises. These ground leases were separated from the fee by a 'grant of term' to a subsidiary for priority purpose..." The ground lessees often sublet the entire premises under an 'operating lease' to a person who would lease space to people who actually occupied the premises. Often the grounds lease and the operating lease were separated by one or more layers of 'sandwich leases.'" Id.

Leasehold Mortgage with Recognized Right to Take Over Leasehold
 LEASEHOLD MORTGAGEE READJUSTS RIGHTS BY MORTGAGE
 RECOGNITION AGREEMENT



5.3. Incidental Sublease.

By comparison, aside from the ground lease, the sublease is permitted as a possibility, but rarely a planned economic component. It is not built into the economic stack. In these situations, the subsequent subtenant may reluctantly submit to the risk of divestiture if the prime lease is terminated either by the prime landlord upon prime tenant default or foreclosure of a prime leasehold mortgage. Because, the sublease is not necessarily a planned component, and it is not built into the economic structure, the prime landlord's subsequent consent may appear to be tendered more out of benevolence to the subtenant than out of obligation. The subtenant may accept the risk of divestiture as a component of the occupancy, and factor that risk into its rent negotiations. Generally, the case where the prime tenant is an operating company, deriving revenue from sales or services rather than rent. The ground lease, by contrast, is designed by the prime landlord and the prime tenant to have subleases as an economically essential component. Many subtenants will grudgingly accept the structure as long as it leaves them no worse than a direct lease between subtenant and prime landlord. Therefore, if evil days fall upon the prime tenant, the subtenant would require a direct lease with the ground landlord, as if the prime lease were erased. The express contractual agreement between the prime landlord and subtenant as to recognition, non-disturbance and attornment are preferred safeguards to overcome the ponderous logic required to compel enforcement of the subtenant's occupancy rights based on theories of privity of contract and privity of estate.

6. **RECOGNITION AND NON-DISTURBER.**

The subtenant wants to preserve its rights under the sublease regardless of the defaults or other problems under the prime lease, and it seeks to preserve its rights by use of a no disturbance or recognition agreement, which are usually considered synonymous. The prime landlord would consider the subtenant's request for preservation only if the prime landlord were certain its rights would not be prejudiced or adversely affected or at least it provided a backstop against worse losses. For example, the subtenant would want the prime landlord to confirm in its consent that the sublease meets all prime lease requirements, such as it does not violate or strain

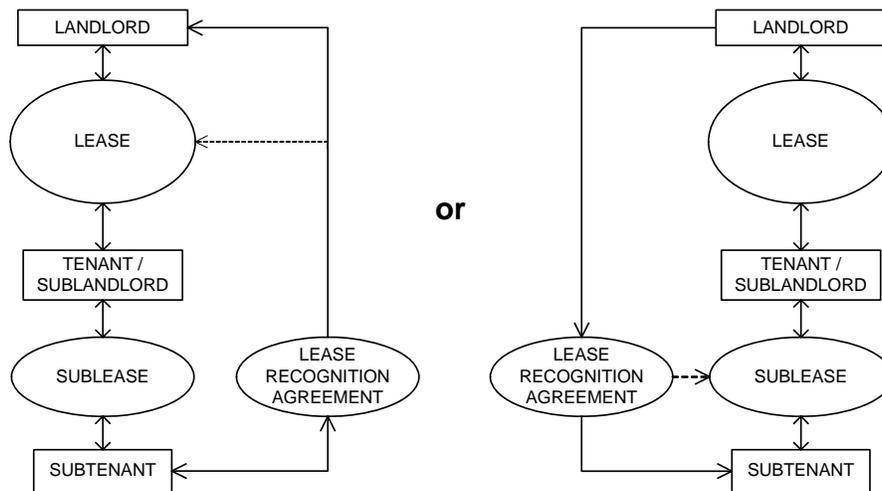
other exclusive or prohibited use clauses, and the prime landlord would be reluctant to confirm more than it knew.

6.1. Lease Survival.

In comparing and contrasting the effects of assignment to those of subleasing, the recognition and non-disturbance agreements play decisive roles. The recognition agreement can follow the route of transporting either the subtenant into the shoes of the prime tenant, or the prime landlord into the shoes of the sublandlord. The assignment follows only one route: the assignee is transported into the shoes of the assignor-tenant. Most importantly, but least appreciated, the recognition agreement falls short of providing a subtenant with the same protections an assignee enjoys, because the commencement of the recognition ordinarily takes effect when the prime lease fails, not at the commencement of the sublease itself. The assignment, by comparison, assigns those rights at that earlier date, at the commencement of assignment.

Sublease Without Mortgage With Recognition Agreement

SUBLEASE WITHOUT FEE MORTGAGE: SUBTENANT RELATES TO LANDLORD WITH RECOGNITION AGREEMENT



6.2. Enforceability.

The subtenant’s recognition agreement, to enter into a lease in the future, would provide subtenant rights in the nature of an *interesse termini*.⁹ If that doctrine applies, the prime landlord

⁹ “In all likelihood this was because at common law a lessee who had not entered into possession was not thought to have an estate in land. Rather, such a lessee was said to have an *‘interesse termini’*, or an interest in a term. Coke. Lit. 46b; 2 Blackstone, Commentaries *144.” *Soffer v. Beech*, 409 A.2d 337, 341 (Pa. 1977). ‘Because no livery of seisin is necessary to a lease for years, such lessee is not said to be seised, or to have true legal seisin of the lands. Nor indeed does the bare lease vest any estate in lessee; but only gives him a right of entry on the tenement, which right is called his interest in the term, or *interesse termini*: but when he has actually so entered, and thereby accepted the grant, the estate is then, and not before, vested in him, and he is possessed, not properly of the

could breach its covenant and merely be liable for damages. The subtenant would have no right to injunction for possession, and the subleasehold mortgagee, if any, would have no collateral. If the sublease could be disregarded, divested, or terminated by payment of damages, the transferee must assess the risk of the loss of the sublease in the event of non-standard unmanageable early termination for causes outside its control. If the recognition covenants are enforceable, then the sublease recognition follows the structure of an assignment.

6.3. Landlord Defenses.

A landlord can defend against the enforcement of the recognition agreement with the traditional defenses of a party to any contract such as coercion, duress, mistake, fraud in the inducement, lack of authority, or lack of consideration. In addition, the recognition agreement may be a mere contractual relationship rather than a real property relationship, and consequently the landlord's liability for breaches may result only in damages, not specific performance. In the assignment, by comparison, because the landlord is not usually a party to the assignment, the landlord has few defenses other than the violation of the conditions contained in the prime lease that is being assigned.

6.4. Differences between Sublease Recognition Agreement and Direct Assignment.

Because the recognition agreement only confirms a late-occurring assignment, it still falls short of providing protections to the subtenant which would be identical to what it would have had if it had a direct relationship with the prime landlord from the outset. One response to overcome this could be to include a non-disturber expressly recognized by the prime landlord, entitling the subtenant to enforce its sublease rights directly against the prime landlord in the event of any defaults under the prime lease or any deterioration in the prime tenant's performance. In tandem with that, the subtenant may also look for a concurrent non-exclusive assignment of the prime tenant's rights and defenses under the prime lease expressly recognized by prime landlord. Rights that benefit the prime tenant, but which the subtenant needs as well, would include both procedural rights and substantive rights. Procedural rights could include rights such as to notice. Substantive rights could include rights to terminate for prime landlord's breach of the covenants such as quiet enjoyment; rights to compensation otherwise payable to the prime tenant, such as condemnation awards or reimbursement for tenant improvements; rights to essential services and amenities, services that sublandlords generally disclaim any liability to provide; and, rights to contest impositions for which the subtenant would otherwise indirectly be responsible. Sublandlord would seek to disclaim liability to provide such services as trash removal, property management benefits and security as well as physical supports such as signage, parking and project amenities, commissary, health club, or nursery and child care. Defense rights that the subtenant may look for include rights to notice, to audit operating expenses, to cure prime landlord defaults, and to participate in responses to governmental actions such as road widening, taxes, and special assessments, and alleged notations of law. Not only would the subtenant seek an assignment of the prime tenant's rights, but depending on the strength of the subtenant's bargaining position, it would want the prime tenant to make the assignment without reservation of rights, whether by waiver or subordination, and to defer its

land, but of the term of years; the possession or seisin of the land remaining still in him who hath the freehold." Blackstone, book II, chap. 9, § 144.

exercise of those rights in deference to the subtenant, such as rights to adjust insurance payments, to prosecute condemnation awards, rights to terminate, and rights to assert continuing possession in the event of prime landlord's bankruptcy and rejection of the prime lease.

7. CONSENTS.

7.1. Prime Landlord Conditions.

A prime landlord may refuse to non-disturb the subtenant but instead call upon the subtenant to assume an assignment of the prime tenant's interest in the prime lease, or more properly enter into the equivalent as a new lease, as the condition for recognizing the subtenant's possessory right after a prime tenant default. Then the prime landlord is assured of getting its stipulated rent, as well as its bargained for covenants. Its major risks are setting standards to qualify the subtenant as a direct tenant, and to manage the exposure caused by existing lease violations. The prime landlord may also need approval of its lenders, rating agencies and similar parties to which it is subject. The prime landlord and its mortgagee frequently condition their acceptance of assumption or privity with a subtenant on various requirements. The subtenant may be required to possess credit qualifications at least as good as the prime tenant (measured at the date of lease commencement and at the date of assignment) or landlord's then current leasing requirements for new tenants, such as good business reputation, experience in the business it proposes to conduct, numerosity of locations, appropriate guaranties, and similar use of premises. Conditions also apply to the prime tenant: that it shall not have caused any default or any material adverse effect to the detriment of landlord or its mortgagee, that it has made a timely request for consent, or that it is not soliciting the same potential occupants the prime landlord is soliciting for its other available space. Sometimes the prime landlord will reserve rights of recapture, as mentioned above. The prime landlord and its mortgagee would look to the recognition agreement as a means of scrubbing off any special concessions that the prime landlord afforded the prime tenant or the prime tenant conceded to the subtenant. Just as in the case of the successor landlord's view of the SNDA, the prime successor landlord does not expect to be liable for personal covenants or for covenants that impose extra expense such as expansion options, or perpetuation of loss-leader amenities. In addition, the prime landlord would want the subtenant to (1) commit to pay rent commensurate with the base and additional rent requirements of the prime lease, or provide an adequately subsidizing enhancement to protect the prime landlord from shortfall; and (2) be subject to relocation if the subtenant occupied less than all of the prime leased space so that the most attractive qualities of the remainder of the prime leased space that enhance its value are preserved, such as configuration, visibility, and contiguity.

7.2. Landlord's Mortgagee Conditions.

To address the risks of unintended loss of rent revenue, the prime landlord's mortgagee would impose restrictions on the prime landlord consents to transfers. Whether the sublease or the assignment were the chosen vehicle, the mortgagee would look for (1) right to approve any prime landlord (a) consent to assignment, (b) consent to sublease or (c) new recognition agreement; (2) collateral assignment of prime landlord's rights in the recognition agreement; (3) pre-approval of any modification that would impair or prejudice the prime landlord mortgagee's rights, (4) prohibition against assignment or sub-subleasing of the subleasehold without mortgagee consent, and, (5) as with the SNDA model, extinguishment of the subtenant's right to

recognition if subtenant is in default under either (a) its sublease beyond cure periods, (b) the recognition agreement beyond cure periods, or (c) under either the sublease or the recognition agreement where the default is incurable.

7.3. Prime Tenant Condition.

In any event, a tenant would seek an exemption to the prime landlord's right of consent, such as for transfers by (1) operation of law through merger or consolidation, (2) affiliates, (3) of all or substantially all assets, stock or control, directly or indirectly, to a third party, and (4) securities offerings. Sometimes tenants avoid the explicit restriction by engaging in transfers that are not expressly addressed such as stock sales, when only asset sales are prohibited.

7.4. Subtenant Conditions.

Subtenants would seek similar freedom on transferability as tenants on restrictions. But additional issues arise when the sublease and prime lease do not have the same effect, such as when the sublease space is less than the prime lease space, or the rents are not matched.

7.4.1. Relocation.

From the subtenant's point of view, similar issues for relocation that apply under a prime lease would apply to the unintermediated sublease: the landlord, or successor landlord, would need to be responsible for providing

- 7.4.1.1 an equivalent location as to aesthetics, sight lines, height, proximity, and prestige;
- 7.4.1.2 subtenant's relocation costs including fit-out for equivalent tenant improvements, interior demising walls, sufficient HVAC, segregable security, independent entry and delivery sites, submetered utilities or equable allocations, use of restrooms, signage, parking and similar amenities;
- 7.4.1.3 subtenant's incidental costs such as substitute letterhead and calling cards, providing formal notice to all customers, vendors, consultants, regulators and the like; and
- 7.4.1.4 refiling organizational documents with regulators, service companies, lenders and other creditors.

7.4.2. Excess Space.

If the subtenant assumes the prime lease with its excess space, then either the subtenant as substitute prime tenant subleases the excess space, or the prime landlord effects a recapture of the excess space. The subtenant would want the prime landlord to agree in advance to release the subtenant from direct or secondary liability related to that excess space upon subtenant achieving agreed upon conditions. Looking for early withdrawal, the subtenant would generally seek more liberal rights of assignment if it were required to take over more space than it had originally

subleased. The prime tenant, if not released, would, just as an assignor would, at least want acknowledgment that its liability is secondary and in the nature of a guaranty for collection not payment.

8. MORTGAGES IN SUBLEASE AND ASSIGNMENT TRANSACTIONS.

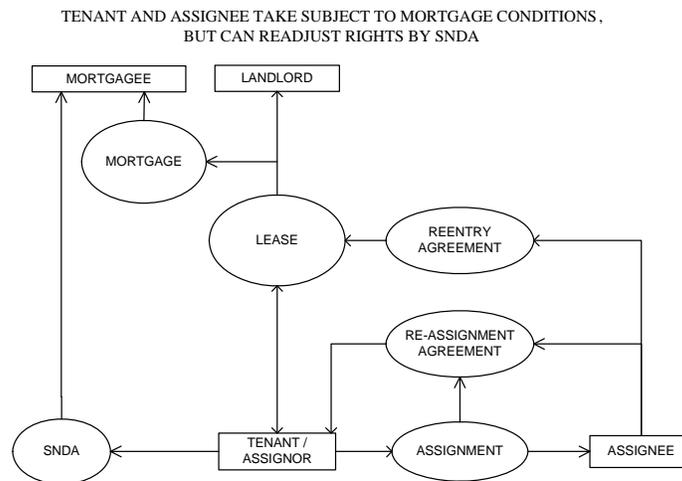
The presence of mortgages is a complicating element for the transferee in analyzing the differences between a sublease and an assigned lease, or which of them to select if it has a choice. The two primary causes for differences are based on whether the recognition agreement for the sublease would be deemed a future assignment or a novation, and whether the leasehold or fee mortgages occur earlier or later in priority than the sublease or assignment.

8.1. Landlord Mortgage.

8.1.1. Senior to Prime Lease as Assigned

A prime landlord's mortgage that is prior to a prime lease would be prior to the prime lease even if it is assigned. Consequently, the prime tenant, or its assignee would be motivated to obtain a non-disturbance agreement from the mortgagee to maintain the superiority of the lease provisions over conflicting mortgage provisions, and to preserve the lease from divestiture upon foreclosure of the mortgage. Similarly, the subtenant would also be motivated to obtain a non-disturbance agreement to anticipate the need to sustain its prevailing rights and preserve it from divestiture if the subtenant takes over the position of the prime tenant.

Assignment of Lease with Fee Mortgage Prior to Lease

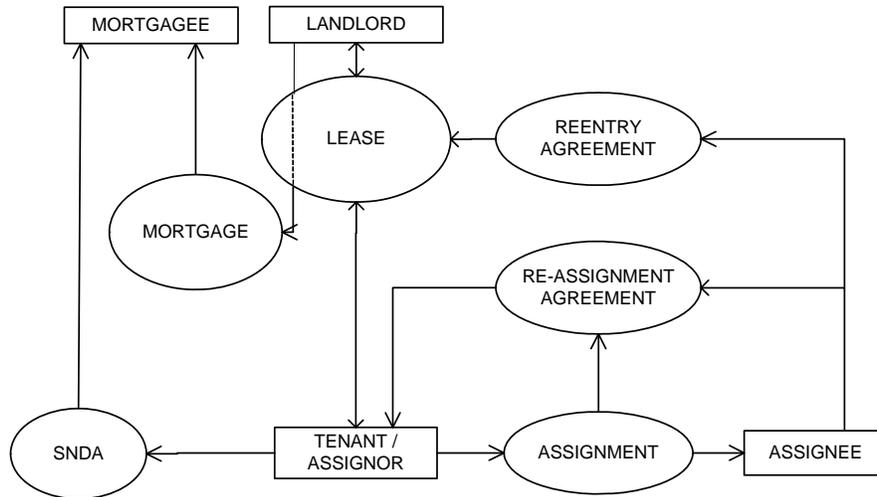


8.1.2. Subordinate to Prime Lease as Assigned

A mortgage on the prime landlord's interest that is subordinate to a prime lease would be subordinate to the prime lease as assigned. Consequently, the mortgagee, rather than the tenant, would be motivated to obtain a direct assignment of rents from the landlord and an attornment agreement from the tenant or its assignee, whichever is the current holder of the lease.

Assignment of Lease with Fee Mortgage Subject to Lease

TENANT AND ASSIGNEE NOT SUBJECT TO MORTGAGE CONDITIONS,
BUT CAN READJUST RIGHTS OF SNDA

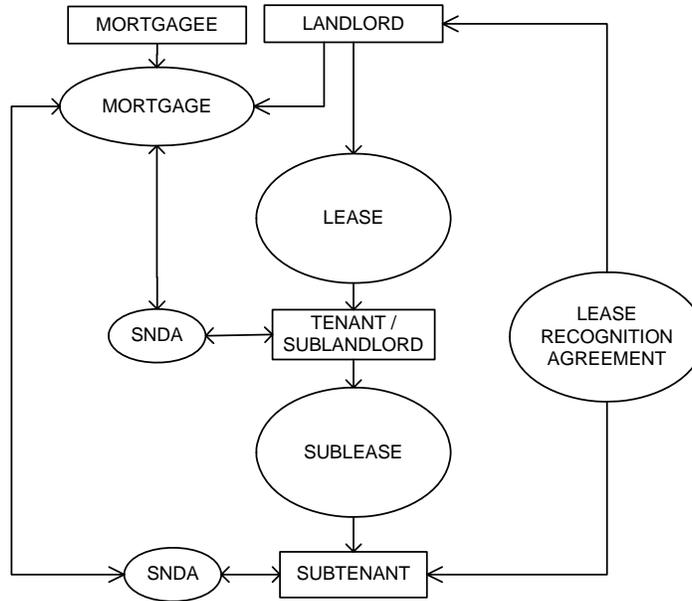


8.1.3. Senior to Prime Lease as Subleased

If a landlord mortgage is senior to a prime lease, it will also be senior to a sublease. Then the prime tenant and subtenant are subject to the mortgagee's rights and each would seek a non-disturber; the prime tenant to avoid divestiture if the mortgage is foreclosed and the subtenant to avoid divestiture if the prime lease is terminated and the landlord enters into a direct lease with the subtenant. The subtenant would also seek confirmation that its rights under the recognition agreement would not be disturbed upon a foreclosure of the senior mortgage.

Sublease with Fee Mortgage Senior to Prime Lease

LANDLORD SUBJECT TO MORTGAGE, RELATES TO TENANT THROUGH LEASE; SENIOR TENANT RELATES TO MORTGAGEE THROUGH SNDA; SUBTENANT TO MORTGAGEE THROUGH SUBTENANT SNDA

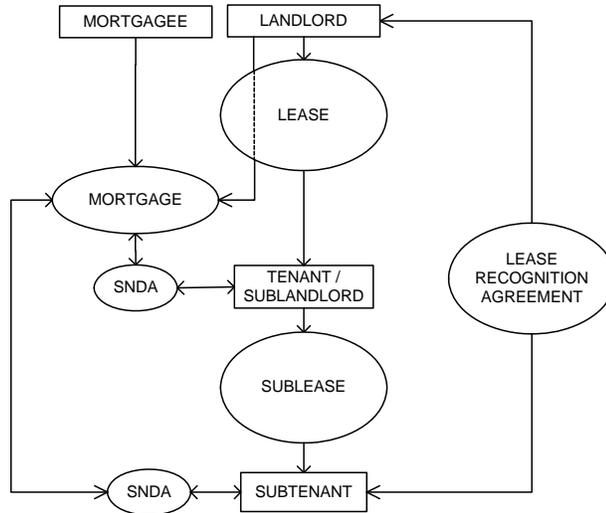


8.1.4. Subordinate to Prime Lease as Subleased

If a landlord mortgage is subordinate to a prime lease, it will also be subordinate to a sublease whether the sublease is earlier or later in time than the landlord mortgage, because the rights on which the sublease depends are already senior to the mortgage. The mortgagee takes subject to all grants by the prime tenant, such as subleases, easements, and leasehold mortgages. However, regardless of the lease being prior, it is likely that under the terms of an SNDA, the mortgagee would impose restrictions on future assignments or subletting of the lease. Consequently, the landlord's mortgagee would look for a subordination agreement by tenant to reaffirm tenant's obligation to pay mortgagee upon a foreclosure, and to otherwise reorganize mortgagee's rights to approve amendments or postpone remedies by tenant for landlord defaults.

Sublease with Fee Mortgage Subordinate to Prime Lease

LANDLORD SUBJECT TO MORTGAGE, RELATES TO TENANT THROUGH LEASE;
 SUBORDINATE TENANT RELATES TO MORTGAGEE THROUGH SNDA;
 SUBTENANT TO MORTGAGEE THROUGH SUBTENANT SNDA



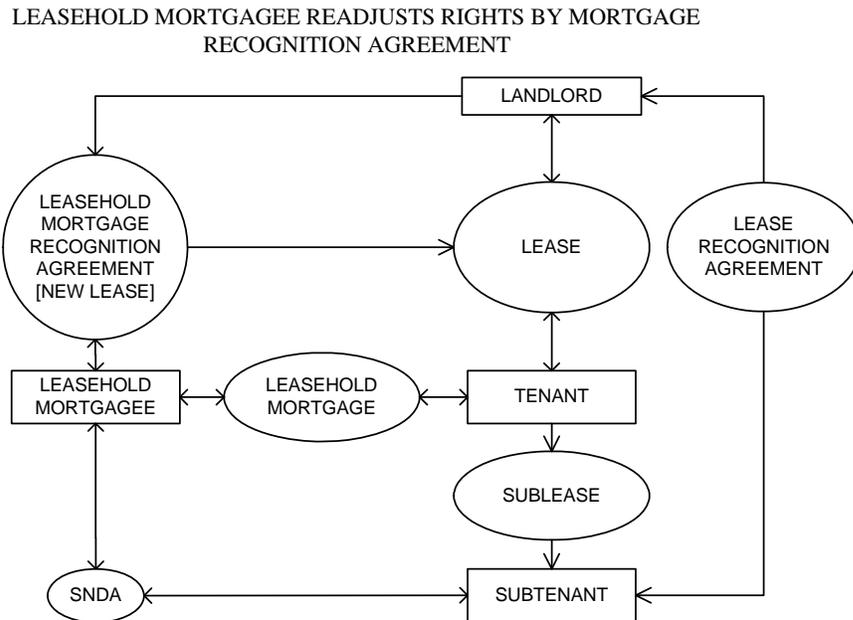
If the prime tenant rights were deemed assigned to the subtenant, or the sublandlord rights were deemed assigned to the prime landlord, following the same logic, the later occurring fee mortgage is subject to that.

8.1.5. But if the relationship between the prime landlord and subtenant were a novation, such as when a leasehold mortgagee enters into a new direct lease with the prime landlord, or the assigned lease were a novation because the assignor were expressly released, then the break in the relationship-back could make the novated lease subordinate to what otherwise would have been the later-in-priority landlord mortgage.

8.2. Leasehold Mortgage.

A mortgage by the prime tenant on its leasehold would follow similar logic as the preceding analysis of the landlord's mortgage, as to interests among mortgagees, landlords, and tenants, even though they are leasehold mortgagees, sublandlords and subtenants. The change is that the overlay of the prime lease and the landlord's mortgage adds more risk of termination, more stress, by those outside forces. In the case of a prime lease default by the prime tenant, a prime landlord right of termination would divest the leasehold mortgage unless the leasehold mortgagee had an agreement allowing it to be substituted upon its cure or overcoming the prime tenant default. In that case the sublease may remain in place, if the leasehold mortgagee were an assignee of the prime tenant's leasehold. But if the prime lease were instead replaced with a new prime lease, the sublease may be divested which is a significant risk increased in the case of the prime tenant bankruptcy. For that risk, the subtenant would seek a recognition agreement directly with the leasehold mortgagee, and re-affirmation by the landlord that the grant to enter into a direct relationship with subtenant is senior to the leasehold mortgagee's right to divest the sublease.

Leasehold Mortgage with Recognized Right to Take Over Leasehold



If the prime tenant is in default under the sublease then the leasehold mortgagee would foreclose and take over the leasehold estate. Either the sublease is senior and not divested or the subtenant would seek an SNDA with the leasehold mortgagee to be contractually protected; just the same as a fee mortgagee were foreclosing where a tenant has a leasehold. A much more remote outcome would be the prime landlord's effort to divest the prime lease for default without the leasehold mortgagee taking recovery action. One could imagine a leasehold mortgagee delaying its recovery if there were embedded diligence issues, such as liabilities for environmental or physical conditions, or there were complex structuring issues, such as battles among loan participants in the leasehold mortgage loan, or a collapse in the credit market stultifying lenders generally in what would otherwise be predictable foreclosures. The reluctance to exercise remedies would further weaken Leasehold Mortgage rights compared to subtenant's rights under its recognition agreement. An assignment to the subtenant of the sublandlord's interest as prime tenant then may result in the leasehold mortgage being preserved because the assignee take subject to the liens against the assigned asset. On the other hand, if the sublandlord's interest were assigned to the prime landlord, the sublandlord's mortgagee would try to use the same argument but it would be weaker: that the sublandlord's rights under the sublease and its liens against the prime leasehold were together deemed assigned to the prime landlord. Sublandlord's mortgagee would assert it should be treated as it would be in any assignment and the assignee takes subject. The prime landlord would counter that the prime leasehold estate by assignment to the prime landlord merged into the prime landlord's estate and no further leasehold interest survived.¹⁰ To avoid that conflict, the prime landlord would need to

¹⁰ "Where a leasehold estate for years merges in a greater estate * * * the relationship of landlord and tenant which had been created by the estate is extinguished." Annotation (1943), 142 A.L.R. 93, 124. See, e.g., *In re Chambers Development Securities Litigation*, 912 F. Supp. 822, 843 fn. 15 (W.D.Pa. 1995) ("[I]n Pennsylvania, whose laws govern the lease, the general rule is that purchase of the fee simple by the tenant results in the merger of the leasehold with the fee. *Waldron v. Wahl*, 286 Pa. 237, 133 A. 252 (1926) (general rule is that where a person holds a term for years and subsequently acquires the fee, 'the former is lost and merged in the latter'); see also

expressly confirm that the implementation of any recognition would be free and clear of mortgages and other encumbrances against the assigned lease where prime landlord assumes the position of the sublandlord. In this negotiation among the prime landlord, subtenant, and leasehold mortgagee, relative priority of the subtenant and leasehold mortgagee estates would have a strong effect. In any case, the subtenant's mortgagees would need waivers and access agreements from the prime landlord unless they had been granted and were assigned as incidents to the rights under the prime lease, and the prime landlord assumed and took subject to those grants.

8.3. Subleasehold Mortgage.

A mortgage on the subtenant's leasehold is a more difficult analysis and a more remote occurrence; and, the analysis shadows the leasehold analysis, except it includes the possibilities of a fee mortgage and a leasehold mortgage so there are three levels of concern. If the prime lease predates prime landlord's mortgage, as mentioned above, the sublease and recognition agreement could be senior to the prime landlord's mortgage, and survive its foreclosure. If the prime lease is after the prime landlord's mortgage, then all derivative rights of tenants and subtenants are at risk of foreclosure without a direct non-disturber and, in the case of the subtenant, recognition agreement. If the prime leasehold mortgage predates the sublease, by the same logic, the sublease and its subleasehold mortgagee, as derivative rights, are at risk of the prime leasehold mortgage foreclosure, unless the prime lease expressly provides otherwise: the subleasehold mortgagee would seek a direct agreement that it would have the right to notice and cure for prime tenant/sublandlord's prime lease and sublease defaults, and in any event upon the bankruptcy of the prime tenant/sublandlord, notification and rights to elect possession if the prime tenant/sublandlord rejects the sublease. Similarly, the sublease mortgagee would negotiate for the right to require a new sublease in the case of a subtenant bankruptcy. If the prime leasehold mortgage arises after the sublease, then the rights of the subleasehold mortgage surviving a foreclosure are much like the rights of a prime leasehold mortgage surviving a prime landlord's mortgage foreclosure: the prime leasehold mortgagee takes subject to the subleasehold mortgage. If the prime lease is terminated, then the issue for the subleasehold mortgagee is whether the new relationship between the subtenant and the prime landlord is by way of a new lease, in which case the subleasehold mortgagee could be divested and would need a new mortgage, or by way of an assignment. If the prime tenant is deemed to have assigned its interest to the subtenant, there may be theories that the estates merge and the subleasehold mortgage may be deemed extinguished. Similarly, if the sublandlord is deemed to have forfeited its interest to the prime landlord so that it is considered merged back into the reversionary interest, the sublease and the sublease mortgage could be extinguished; but if instead it is deemed an assignment to the prime landlord, then the estate of the subtenant should remain unaffected, and consequently the subleasehold mortgage would be equally unaffected.

RONALD L. FRIEDMAN, PENNSYLVANIA LANDLORD-TENANT LAW AND PRACTICE, § 3.5(a) (3rd Ed. 2001): 'The sale of the leased premises by the landlord should have no legal effect upon the continuation of the lease agreement, unless the leased premises was sold to the tenant, in which case the lease terminates by operation of law.' *See also Kershaw v. Supplee*, 1 Rawle 131, 132 (1829) ("[B]y the purchase of the fee simple of three fifths, the term for years for those three fifths is extinguished; for nothing is better settled that that where a term for years, or life, exists in a person in his own right, and he subsequently acquires the fee in his own right, the former is lost and merged in the latter. Where the term and the fee unite in the same person, but in different rights it is otherwise. . .").

9. BANKRUPTCY.

The different effects of bankruptcy on the prime landlord, prime tenant, subtenant and leasehold mortgagee shape how the parties design their preferred outcomes.¹¹

9.1. Prime Landlord Bankruptcy.

9.1.1. Assume or Reject.

If the prime landlord files bankruptcy, it can assume or reject an unexpired lease.¹² If it assumes, there is no change to the prime tenant or subtenant. If the prime landlord rejects, the prime tenant can treat the rejection as a landlord breach of the lease and either terminate the prime lease and seek damages as an unsecured creditor,¹³ or retain occupancy, perform its lease obligations and set off for its curative advances to cover other breaches of the lease by the prime landlord.¹⁴ The subtenant would want to control, or at least participate in, the prime tenant's decision. In the event of the prime landlord's bankruptcy, if the prime tenant acquiesces to the rejection of its lease, the prime landlord in bankruptcy may be able to both (1) reject the recognition agreement as an executory contract, and (2) refute the theory that the Bankruptcy Code¹⁵ entitles the subtenant to right of possession as if it were the landlord's tenant. The debtor prime landlord's argument is that it, as debtor, is not the landlord under the sublease nor is the subtenant the tenant under the prime lease. The subtenant has no privity of estate to allow the claim for continued possession. To protect against this, the subtenant, if it had the bargaining position, would take an assignment from the prime tenant of the right to exercise the prime

¹¹ See generally, Geoffrey Hargreaves-Heald, Esquire, "Bankruptcy In The Context Of The Sublease: The 48th Street Steakhouse Zinger And Other Woes," American Bar Association 14th Annual Real Property Symposia New York, NY April 3-4, 2003. Also see Sankaran, Vivek, Rejection Versus Termination: a Sublessee's Rights in a lease Rejected in Bankruptcy Proceeding under 11 U.S.C. 369(d)(4), Michigan L. Rev. (2001).

¹² 11 U.S.C. § 365(a) "Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."

¹³ 11 U.S.C. § 365(h).

¹⁴ Id.

¹⁵ (A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and —
(i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or
(ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.
(B) If the lessee retains its rights under subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.
(C) The rejection of a lease of real property in a shopping center with respect to which the lessee elects to retain its rights under subparagraph (A)(ii) does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance.
(D) In this paragraph, "lessee" includes any successor, assign, or mortgagee permitted under the terms of such lease.
11 U.S.C.A. § 365(h) (1) (A)-(D)(West 2004)

tenant's right to retain possession.¹⁶ This could be structured as the adoption of a recognition agreement where the subtenant takes its future interest by assignment and assumption of the prime tenant's leasehold, rather than current substitution or current assignment of the subtenant's interest. By comparison, the assignee has privity of estate. The assignee cannot be dispossessed by a prime landlord in bankruptcy, because if the debtor landlord under the lease rejects the lease, the tenant-assignee then has a right to elect a continuing right of possession,¹⁷ a right which does not automatically inure to a subtenant. If the transferee tries to bridge over the risk by making a current assignment in the recognition agreement with the right of possession postponed until the termination of the prime lease, it may still hold merely an *interesse termini*. The sublease with a recognition agreement, therefore, remains at greater risk of surviving sublandlord's bankruptcy than an assignment of the leasehold.

9.1.2. Notice and Control.

In the case of a prime landlord bankruptcy, the estates of both the subtenant and a leasehold mortgagee are dependent upon the prime tenant's leasehold. The dependent parties aspire to the state of an assignee, as if holding all of the prime tenant's rights. Specifically, to suppress their risks from the event of a prime landlord bankruptcy, the leasehold mortgagee and subtenant may negotiate in the leasehold mortgage and the sublease, respectively, for the prime tenant to provide them notice of the prime landlord's bankruptcy. Depending on their bargaining strength, they may also negotiate to control the prime tenant's rights, in response to the landlord in bankruptcy's rejection of the lease, to terminate the lease or possess the leasehold under the Bankruptcy Code.¹⁸ In that case, they may press the prime tenant to formally act as their agent in the exercise of its economic rights and disposition rights in the event of the prime landlord's bankruptcy, to enable the dependent party to have standing to elect not to terminate in the case of taking over the lease, or at a minimum to extend the deadline for electing termination. The dependent parties may also press for an express grant of rights, or collateral pledge of the prime tenant's rights, so as to exercise those rights directly: (1) the rights to file claims and pleadings on the tenant's behalf, and (2) to control tenant objections to any sale by the landlord which could result in a divestiture of the leasehold.¹⁹

9.1.3. Duty to Subtenant

One issue is whether the prime tenant has an implicit obligation to the subtenant to elect possession, in order to honor its implied or expressed covenant of quiet possession for the

¹⁶ Id.

¹⁷ Id. at § 365 (h)(1)(A)(ii).

¹⁸ 11 U.S.C. § 364(h).

¹⁹ The fashionable case of the day for discussion is *Qualitech*, in which the 7th circuit confirmed that a sale of the debtor's assets "free and clear of any interest in such property of an entity other than the estate" [11 U.S.C. Section 363(f)] plainly included the tenant's leasehold estate, defined as "a right that is not [simply] connected to or arising from the property, ... but a (limited) right to the property itself." 327 F.3rd at 545. Because (1) Section 363(f) does not expressly protect leaseholds, (2) leaseholds are protected under 365(h) only in the case of rejection, and (3) 363 (f) has very narrow stringent compliance requirements that would ordinarily protect a tenant, (which the tenant in the *Qualitech* case did not avail itself of in a timely fashion), the court held the property was sold free of the leasehold. For an elaboration of issues related to *Qualitech* see John C. Murray, "Precision Industries Parts I and II," *Probate & Property Journal* 10 (March /April 2004); Joshua Stein, "Is the Sky Falling on leasehold Mortgagees? Ground lease Financing After *Qualitech*," 20 *The Practical Real Estate Lawyer* 6 (July 2004); Zinman, *Precision*.

subtenant. Usually there is a provision exculpating the prime tenant for liability from termination of the prime lease, unless due to a default by the prime tenant. Careful drafters try to address the obligation or the exculpation in the sublease.

9.1.4. Set-Off

If the prime landlord fails to provide services or perform personal covenants, and the prime tenant also fails to perform, the subtenant should contractually preserve a right of set off, to match what the prime tenant is entitled to under the Bankruptcy Code. This preservative would still be a disadvantage to the subtenant to the extent the sublease rent were less than prime lease rent, or the sublease space were materially smaller than the prime lease space.

9.2. Prime Tenant Bankruptcy

9.2.1. Assumption

Instead of rejecting the prime lease the prime tenant in bankruptcy has the power to assume the prime lease.²⁰ Then the prime tenant, as sublandlord, can either reject or assume the sublease.²¹ If the prime tenant as sublandlord rejects the sublease, and the subtenant elects to retain possession, then the prime tenant as sublandlord may not be able to nor want to pay rent under the prime lease, especially if the subtenant exercises set off rights for curative advances. If the sublandlord assumes the prime lease and rejects the sublease, the rejection of the sublease prevents the subtenant from enforcing personal covenants against the sublandlord. One key covenant is the one that empowers the subtenant to enforce the prime lease, whether by the assignment of subtenant's rights or by a grant of a power of attorney to perform in sublandlord's name. If the prime landlord fails to adequately perform, the subtenant may have no independent right to compel performance by the prime landlord. Even if the prime landlord and subtenant had a separate recognition agreement permitting direct assignment, the prime landlord may have defenses besides the lack of consideration, mutuality and privity, protecting the prime landlord from having to assume sublandlord's rights and responsibilities. If the cause of subtenant's exercise of the recognition agreement is due to the prime landlord's performance deficiencies under the prime lease, there would be little reason for the prime landlord to be a co-operative party under the recognition agreement. By comparison, if the subtenant were an assignee, the assignee would have privity with and direct rights against a derelict prime landlord.

9.2.2. Rejection

If the prime tenant is in bankruptcy, it has the power to reject the prime lease.²² Rejection may cause a termination of the sublease,²³ though termination is not uniformly conceded to be the outcome. The Bankruptcy Code provides that if the tenant does not assume or reject the lease within 120 days, and if such period is not extended, the lease is deemed

²⁰ 11 U.S.C. 365(a).

²¹ Id.

²² 11 U.S.C. § 365(a).

²³ "Rejection of a non-residential lease results in termination of the lease. Once the underlying lease is terminated, leasehold mortgagees or sublessees retain no interest that can be pursued in bankruptcy court or state court." *6177 Realty Assoc. Inc.*, 142 B.R. 1017, 1019 (Bankr. S.D. Fla 1992)

rejected.²⁴ By following the modern theme that rejection is a breach but not an automatic termination, one reported case concluded that the rejection of the prime lease did not automatically divest the sublease. The court concluded that the prime landlord suffered no damages upon the debtor prime tenant's breach by rejection because under facts of that case the subtenant paid the full prime lease rent and the prime landlord was deemed to have been made whole.²⁵ The language of the prime lease and the sublease, and the conduct of the parties,²⁶ can affect the determination. Prior to such termination, the prime landlord retains the right of reversion and the subtenant retain rights of possession under local law.²⁷

9.2.3. Recognition.

To cushion the risk of a prime tenant bankruptcy, the dependent parties would negotiate for a recognition agreement with the prime landlord and its mortgagee that the dependent party could become or be named as assignee or successor tenant. Under the recognition agreement, if the prime tenant in bankruptcy rejected the prime lease, the prime landlord and its mortgagee, as the case may be, would enter into a new lease to replace the rejected prime lease. The prime landlord may condition its offer of a new lease on the dependent party paying all arrearages and performing all obligations of the debtor tenant that might otherwise be in breach. The dependent parties would negotiate for the new lease to date back to the commencement of the terminated lease, essentially as a concurrent lease, but with their liabilities to accrue from the date of termination of the prime lease: the commencement of their tenure. The dependent parties would want to receive all rights the debtor tenant had as to personal or real contract rights: condemnation, insurance, subleases, licenses, covenants running with the land, exclusives,

²⁴ 11 U.S.C. § 365(d)(4)(A).

*** "Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of—

- (i) the date that is 120 days after the date of the order for relief; or
- (ii) the date of the entry of an order confirming a plan.

(B)(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance."

²⁵ ". . . we must look to the terms of the master lease and sublease to determine whether either contains a clause which provides for the termination of the lease upon a breach, general or specific.***There is no provision in either the master lease or the sublease which would have operated to terminate the master lease or give the appellant the right to retake possession of the property under the circumstances presented here.***Generally, to recover for breach of a contract, the party seeking to recover must show that the alleged breach was substantial.***Because the appellant has failed to demonstrate that the rejection of the master lease was a substantial breach or that it was damaged thereby, it has failed to establish that the rejection of that master lease by Food Barn [prime tenant] terminated the respondents' right to remain in possession of the property." *Block Props. Co, Inc. v. American National Ins. Co.*, 998 S.W.2d 168, 176 (Mo.Ct. Appls. 1999). But see *6177 Realty Assoc., Inc.*

²⁶ "Here, since Peram [prime landlord] made no allegations that Chumash [subtenant] was not fulfilling its obligations as a sublessee, under the lease Peram was not entitled to evict or eject Chumash from the subleased premises, either because of Newton's [prime tenant] surrender of his lease in bankruptcy or his nonpayment of rent." *Chumash Hill Properties, Inc. v. Peram*, 46 Cal. Rptr. 2d 366, 369 (1995)

²⁷ See *Chaltos Sys., Inc. v. Kaplan*, 147 B.R. 96 (D. Del. 1992), aff'd, 998 F.2d 1005 (3d Cir. 1993); *In re Dial-A-Tire, Inc.*, 78 B.R. 13 (Bankr. W.D.N.Y. 1987); and *In re Storage Technology Corp.*, 53 Bankr. 471 (Bankr. D. Co. 1985).

options, and indemnities. The dependent party would seek a lease covenant to permit setoff, conditioned on having first notified prime landlord's mortgagee before a right to setoff were exercised. The dependent parties would want to accept the title in the condition held at the commencement of the prime lease, with such additional exceptions as the dependent party may have approved in advance. Entering into a new lease, however, may invite intervening encumbrances to prime the new lease, notwithstanding the prime landlord's covenants to the contrary.

9.3. Subtenant Bankruptcy

If the subtenant is in bankruptcy, it can assume or reject the sublease. What is interesting is that at least one reported case²⁸ concluded that the automatic stay in a subtenant bankruptcy prevented the prime landlord from terminating the prime lease because it would cause the subtenant to be dispossessed notwithstanding the absence of any formalized relationship of privity.

CONCLUSION

Though the lease assignment and sublease seem to be equivalent in allowing a third party these and occupancy of currently demised premises, there are significant differences in formation, operation, liabilities, and bankruptcy. The effect of accessory agreements, such as recognition agreements, non-disturbance agreements, subordination agreements and attornment agreements, can readjust by contract the rights and responsibilities set by case law and real estate law. When the latent characteristics of the various strategies are understood, and whether the direct goal can have unwanted and intended consequences, then the client can be more successfully advised.

²⁸ "...the landlord's actions [terminating the prime lease] were intended to obtain for it by indirection that which it recognized it could not obtain directly -- recapture of the premises in which 48th Street [the subtenant in bankruptcy] had an interest. But that effort cannot be allowed to succeed, for section 362(a)(3) stays not only acts to obtain "property of the estate" but acts to obtain "property from the estate" and the attempt to wrest possession of property away from a debtor without the imprimatur of bankruptcy court is therefore proscribed." *48th Street Steakhouse, Inc. v. Rockefeller Center, Inc. et. al*, 61 B.R. 182, 189 (1986).