

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW JERSEY

In re: : CHAPTER 11;
: CASE NO.: 03-28572 (MS)
TRUCOLOR, INC., :
: :
Debtor. : Hearing Date:
:

**MEMORANDUM OF LAW IN SUPPORT OF MOTION OF
HACKENSACK INDUSTRIAL ASSOCIATES FOR ORDER GRANTING
RELIEF FROM THE AUTOMATIC STAY, COMPELLING USE
AND OCCUPANCY PAYMENTS FOR NON-RESIDENTIAL PREMISES,
AND FOR ALLOWANCE OF AN ADMINISTRATIVE CLAIM**

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TABLE OF CONTENTS

TABLE OF AUTHORITIES..... 3

PROCEDURAL HISTORY..... 4

STATEMENT OF FACTS..... 4

LEGAL ARGUMENT..... 8

POINT I

**CAUSE EXISTS TO GRANT HICA RELIEF FROM THE
AUTOMATIC STAY BECAUSE THE DEBTOR’S LEASE
WAS TERMINATED PRE-PETITION BY A CONSENSUAL
JUDGMENT OF POSSESSION ENTERED IN THE SUPERIOR
COURT OF NEW JERSEY, AND CONSEQUENTLY THE LEASE
IS NOT ASSUMABLE..... 8**

POINT II

**THE COURT SHOULD COMPEL THE PAYMENT OF
POST-PETITION USE AND OCCUPANCY RENT AND
GRANT AN ALLOWED ADMINISTRATIVE CLAIM BASED
ON THE RENT RESERVED IN THE LEASE UNTIL
THE DEBTOR SURRENDERS POSSESSION OF THE
COMMERCIAL PREMISES 10**

POINT III

**THE COURT SHOULD GRANT HICA AN ALLOWED
ADMINISTRATIVE EXPENSE FOR ITS REASONABLE
ATTORNEY’S FEES INCURRED POST-PETITION TO
ENFORCE ITS RIGHTS AGAINST THE DEBTOR..... 14**

CONCLUSION..... 14

TABLE OF AUTHORITIES

Statutes

<i>11 U.S.C. § 362</i>	8, 10
<i>11 U.S.C. § 362(d)</i>	8, 10
<i>11 U.S.C. § 362(d)(1)</i>	4
<i>11 U.S.C. § 362(g)</i>	8
<i>11 U.S.C. § 365(c)(3)</i> ,.....	8, 9, 10
<i>11 U.S.C. § 365(d)(4)</i>	8, 10
<i>11 U.S.C. § 503(b)(1)(A)</i>	4, 10, 12, 15
<i>11 U.S.C. § 507(a)(1)</i>	4, 10, 12, 15
<i>11 U.S.C. § 1107</i>	4
<i>11 U.S.C. § 1108</i>	4
<i>Section 503(b)(1)(A)</i>	11, 12, 14
<i>Section 507(a)(1)</i>	11, 12, 14

Cases

<i>Cornwall Paper Mills Co., In re</i> , 169 B.R. 844, 851 (Bankr. D.N.J. 1994	11, 12, 13, 14
<i>Geonex Corp., In re</i> , 258 B.R. 336 (Bankr. D.Md. 2001)	14
<i>Gourmet Gallery, Inc., In re</i> , (Bankr. E.D.Pa. 1983).....	10, 11, 12
<i>Grand Union Co., In re</i> , 266 B.R. 621 (Bankr. D.N.J. 2001):.....	12
<i>Great Feeling Spas, Inc., In re</i> , 275 B.R. 476 (Bankr. D.N.J. 2002).....	8, 9
<i>Mohawk Indus. Inc., In re</i> , 54 B.R. 409 (Bankr.D.Mass.1985)	12, 13
<i>Trans World Airlines, Inc., In re</i> , 145 F.3d 124 (3 rd Cir. 1998).....	12, 14
<i>Zagata Fabricators v. Superior Air Prod.</i> , 893 F.2d 624, 627 (3d Cir.1990)	11, 13

PROCEDURAL HISTORY

The Debtor filed this Chapter 11 proceeding on June 3, 2003 (the “Petition Date”). Subsequently, the Debtor has remained in possession of its assets and continued to manage its affairs pursuant to 11 U.S.C. §§ 1107 and 1108 of the Bankruptcy Code.

By Order entered on June 11, 2003, the Court approved the Debtor’s emergent application for DIP financing. A final hearing on the Debtor’s DIP financing is scheduled for July 11, 2003.

Hackensack Industrial Center Associates (“HICA”) brings this motion on short notice seeking relief from the automatic stay pursuant to 11 U.S.C. § 362(d)(1) to recover possession of commercial premises occupied by the Debtor as a holdover tenant, to compel the Debtor to pay post-petition use and occupancy and for allowance of an administrative claim pursuant to 11 U.S.C. §§ 503(b)(1)(A) and 507(a)(1)(hereinafter the “Motion”). In support of its Motion, HICA submits the Certification of its general partner, Harris A. Freeman, and the Certification of its real estate expert, Andrew Moss.

STATEMENT OF FACTS

The Debtor operates a retail and commercial printing, photographic, laboratory and related purpose facility from commercial premises owned by HICA and having a common address of 60-80 Commerce Way, Hackensack, New Jersey. Two (2) separate buildings are located upon the property, one at 60 Commerce Way (hereinafter referred to as “60 Commerce Way”), which consists of a 43,000 square foot industrial warehouse building that is presently vacant, and the second at 80 Commerce Way (hereinafter referred to as “80 Commerce Way”), a 30,000 square foot light industrial building that the Debtor presently occupies as a holdover tenant at sufferance. Certification of Harris

A. Freeman dated July 7, 2003, at ¶¶ 3, 16 (hereinafter referred to as the “Freeman Cert”).

Prior to the Petition Date the Debtor was a tenant of the subject premises pursuant to a lease agreement with HICA dated July 1999 (“Lease”) providing for a base rent of \$16,000.00 per month, plus \$4,461.67 in common area maintenance charges, plus \$2,500.000 per month in amortized construction costs, for a total monthly rent of \$22,961.67 per month. *See* Exhibit A to Freeman Cert.¹ Prior to the Petition Date the Debtor defaulted on its lease obligations with HICA, in that it owed substantial back rents and other additional rent to the HICA. On April 4, 2003, HICA filed an eviction action against the Debtor in the Superior Court of New Jersey, Law Division, Special Civil Part, Landlord/Tenant, Docket No.: 003080-03 (hereinafter the “Eviction Action”). Freeman Cert., at ¶6.

On May 6, 2003, the Debtor, through its current bankruptcy counsel, consented to the entry of a Judgment of Possession thereby terminating the Debtor’s lease and requiring the Debtor to vacate the premises by May 31, 2003. *See* Exhibit B to Freeman Cert. The Debtor has violated the terms of the Judgment of Possession by remaining in possession of the premises over the objection of HICA, and consequently the Debtor is a holdover occupant. The Debtor has a substantial amount of equipment situated at the premises, to which HICA asserts a statutory landlord’s lien against to the extent of the Debtor’s unpaid rental obligations.

As of July 2003 the Debtor owes HICA \$131,648.41 in rent and additional rent, which amounts are split pre and post-petition as follows:

- a) \$85,761.33 in pre-petition rent through June 2, 3003;

¹ The construction costs were incurred by HICA at the inception of the lease, when HICA agreed to refit the premises to meet the specific needs of the Debtor’s intended use.

- b) \$21,604.17 in post-petition rent due for the month of June 2003 pro rated from June 3rd to June 30th; and
- c) \$24,272.91 in post-petition rent due for the month of July 2003.

These amounts are exclusive of attorney's fees, as permitted under Article 34² of the terminated lease. Pursuant to Article 2 of the terminated lease, the monthly rental increases to \$17,125.00 starting on July 1, 2003.

The Debtor has obtained temporary approval of DIP financing as authorized by this Court's Order entered on June 11, 2003, however the Debtor has neither surrendered possession of the premises nor paid any rent to HICA for the months of June and July 2003. HICA is presently marketing the premises for sale through the efforts of James E. Hanson, Inc., a commercial real estate brokerage company. HICA has received numerous inquiries from prospective purchasers, however any interested party has backed away upon learning that there is a Chapter 11 tenant in occupancy. In fact, HICA received a recent purchase offer conditioned on delivery of the property "vacant" at the closing. Freeman Cert., at ¶11.

HICA refuses to enter into any new lease agreement with the Debtor, and yet the Debtor continues to occupy the premises "rent free" to the detriment and prejudice of HICA. In the interim and until such time as the Debtor vacates the premises, whether voluntarily or involuntarily, HICA is entitled to reasonable fair market use and occupancy rent from the Debtor so that HICA does not suffer any further financial hardship. Especially considering that HICA must continue servicing its maintenance

² Article 34 of the terminated lease reads in pertinent part, as follows:

- 34.1 Tenant shall reimburse Landlord for the actual, reasonable attorneys' fees incurred by Landlord...for any action to enforce Tenant's obligation pursuant to this lease, including, but not limited to, collection of Fixed Rent and/or Additional Rent or any other monetary obligations, dispossess actions and distraint.
- 34.2 If any litigation ensues between the Landlord and Tenant the prevailing party as determined by a judgment shall be entitled to be reimbursed by the non-prevailing party for all reasonable legal fees, expenses and costs of suit incurred in connection with said litigation.

obligations, property taxes, and insurance for the subject premises. HICA respectfully submits that the contractual monthly rent of \$22,961.67 represents the fair market rental value of the subject premises for the month of June 2003, and that \$24,272.91 is the fair market rental value for July 2003 and thereafter. *See* Certification of HICA's real estate expert, Andrew Moss submitted herewith.

In addition, the Debtor has failed to produce proof of general liability insurance coverage and property damage. Article 6.2 of the parties' terminated lease requires the Debtor to maintain a \$3,000,000.00 single limit comprehensive general liability insurance policy against claims for bodily injury, death or property damage occurring on or about the Property or any adjoining sidewalk, curb or vault. Post-petition demand was made upon the Debtor, through its counsel, to produce proof of insurance and premium payments, however the Debtor has not complied.

There are also environmental concerns that may be triggered under environmental laws when the Debtor ceases operating at the premises. As previously noted, the Debtor operates a photo-finishing lab, a process that HICA believes involves the use of chemicals that may fall within the definition of hazardous materials/waste. Freeman Cert., at ¶18. As an operator of the premises, the Debtor is responsible by statute and under the terms of its terminated lease agreement with HICA for any environmental clean-up costs and inspections that may be required upon it vacating the premises. Likewise, HICA is a potentially responsible party for any environmental clean-up costs required by the activities of the Debtor at the premises. In the absence of an escrow, HICA is concerned whether the Debtor will have sufficient funds on hand to cover any potential cleanup costs required by any state, local or federal agency upon the Debtor relocating to another space.

LEGAL ARGUMENT

POINT I

CAUSE EXISTS TO GRANT HICA RELIEF FROM THE AUTOMATIC STAY BECAUSE THE DEBTOR'S LEASE WAS TERMINATED PRE-PETITION BY A CONSENSUAL JUDGMENT OF POSSESSION ENTERED IN THE SUPERIOR COURT OF NEW JERSEY, AND CONSEQUENTLY THE LEASE IS NOT ASSUMABLE

Motions for relief from the automatic stay are governed by *11 U.S.C. § 362*.

Pursuant to subsection (d) of the statute, a party may seek relief from the stay:

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization;

11 U.S.C. § 362(d). The party opposing relief from the automatic stay bears the burden of proof on all issues except the issue of a debtor's equity in property. *11 U.S.C. § 362(g)*.

Under § 365(d)(4) of the Bankruptcy Code, a trustee or debtor-in-possession may extend the time to assume or reject a lease of nonresidential real property upon a showing of good cause. *See 11 U.S.C. § 365(d)(4)*. Pursuant to *11 U.S.C. § 365(c)(3)*, a nonresidential lease may **not** be assumed, however, if such lease "has been terminated under applicable nonbankruptcy law prior to the order for relief." *11 U.S.C. § 365(c)(3)*.

In the instant case, relief from the automatic stay is necessary and appropriate because the Debtor's pre-petition Lease was terminated the consensual Judgment of Possession entered in the Superior Court of New Jersey. In *In re Great Feeling Spas, Inc.*, 275 B.R. 476 (Bankr. D.N.J. 2002)(Hon. Raymond T. Lyons), the Court held that a commercial debtor's lease was terminated under New Jersey state law upon the entry of a

judgment of possession in a pre-petition eviction suit brought in the Superior Court of New Jersey, and thus the lease was not assumable under 11 U.S.C. § 365(c)(3). The Court rejected the debtor's argument that issuance of a warrant of removal, and not the judgment of possession, should be the controlling factor in determining whether a commercial lease has been terminated:

[I]t is a judgment of possession ... which will terminate a tenancy. An action for possession will be dismissed if the tenant pays the amount of rent owed before a judgment is entered. *Stanger v. Ridgeway*, 171 N.J.Super. 466, 473, 410 A.2d 59 (App.Div.1979); see also *Vineland Shopping Ctr., Inc., v. De Marco*, 35 N.J. 459, 173 A.2d 270 (1961). Thus, the effect of a tenant's payment of rent before a judgment is entered ... is to dismiss the complaint and continue the tenancy at issue...Based upon the foregoing, it is clear to this court that, under prevailing New Jersey law, a lease is terminated upon entry of a judgment for possession.

Great Feeling Spas, 275 B.R. at 481.

Since the Debtor no longer has any leasehold interest in the subject premises by virtue of the pre-petition Judgment of Possession, the Court should grant relief from the stay to permit HICA to continue with the eviction process through the Superior Court of New Jersey and with its efforts to market, sell and deliver the property in "vacant broom clean condition" to any new purchaser. In the absence of this relief, HICA will sustain irreparable harm and prejudice, as the Debtor's motive is to delay eviction by continuing its occupancy as a holdover tenant without paying rent to HICA. In the meantime, HICA must continue paying its debt service, real estate taxes and insurance for the property, thereby further eroding its position as this case continues in Chapter 11.

POINT II

THE COURT SHOULD COMPEL THE PAYMENT OF POST-PETITION USE AND OCCUPANCY RENT AND GRANT AN ALLOWED ADMINISTRATIVE CLAIM BASED ON THE RENT RESERVED IN THE LEASE UNTIL THE DEBTOR SURRENDERS POSSESSION OF THE COMMERCIAL PREMISES

As a pre-condition to the Debtor's continued occupancy as a holdover tenant and until such time as the Debtor surrenders possession of the premises, whether voluntarily or involuntarily, and to protect HICA's interests from further eroding, the Court should compel the Debtor to immediately pay post-petition use and occupancy based on the rent reserved in the Lease. As of the Petition Date the rent reserved in the Lease was \$22,961.67. The base rent increased to \$17,125.00 commencing July 1, 2003 thereby bringing the total rent reserved under the Lease to \$24,272.91.

Concurrently, HICA respectfully requests that the Court grant HICA an allowed administrative expense claim under §§ 503(b)(1)(A) and 507(a)(1) to the extent of the Debtor's monthly lease obligations, including rent pro-rated for the month of June 2003, and thereafter continuing at the lease rental of \$24,272.91 per month.

Bankruptcy Code § 503(b)(1)(A) defines an administrative expense as including, "the actual necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case ..." 11 *U.S.C.* § 503(b)(1)(A). Administrative expenses are categorized as a first priority claim in a bankruptcy case under 11 *U.S.C.* § 507(a)(1). As Bankruptcy Judge Winfield explained in *In re Grand Union Co.*, 266 B.R. 621 (Bankr. D.N.J. 2001):

The purpose of granting administration expenses a priority for payment is to encourage creditors to cooperate with a debtor's reorganization efforts so that the debtor can effectively reorganize and continue its business, thereby maximizing the value of the estate for the benefit of all creditors ... Additionally, by granting administrative expense priority under section 503(b)(1)(A) to those expenses actual and necessary to preserve the debtor's estate unjust enrichment of the debtor's estate is prevented.

However, "[b]ecause the presumption in bankruptcy is that the debtor's limited resources will be equally distributed among his creditors, statutory priorities are narrowly construed." ... As such, courts have established demanding criteria for determining whether a claim should be afforded an administrative priority.

Grand Union Co., 261 B.R. at 625 (internal citations omitted).

"In general, a debtor's post-petition rental expense will constitute actual and reasonable expenses of the estate as required by section 503(b)(1)(A) so as to be accorded administrative expense priority pursuant to section 507(a)(1)." *In re Cornwall Paper Mills Co.*, 169 B.R. 844, 851 (Bankr. D.N.J. 1994). In *Zagata Fabricators v. Superior Air Prod.*, 893 F.2d 624, 627 (3d Cir.1990), the Third Circuit noted:

There is no question, of course that the payment of rent for the use and occupancy of real estate ordinarily counts as an "actual, necessary" cost to which a landlord, as a creditor, is entitled. (Citations omitted). In order to survive, a financial entity almost always needs a physical space to occupy. When a debtor owns no suitable real estate of its own, its only choice is to become a tenant, and to assume the obligations of paying periodic rent to a landlord. In such circumstances, therefore, rent is clearly an "actual, necessary" cost of preserving the estate, since the debtor's survival depends on its ability to pay the landlord for the right to possess the space necessary to conduct its business. Because bankruptcy proceedings are considered to be equitable, however, the landlord's right to collect monetary relief is somewhat curtailed; a debtor is generally required to pay only a reasonable value for the use and occupancy of the landlord's property, which may or may not equal the amount agreed upon in the terms of the lease.

Zagata, 893 F.2d at 627 (internal citations omitted).

In determining the reasonable value of post-petition use and occupancy of leased premises for administrative expense purposes, the rental value fixed in the lease will control unless there is convincing evidence that such rental rate is unreasonable. *Cornwall Paper Mills, supra*. In *Cornwall Paper Mills*, the Honorable Novalyn L. Winfield relied upon the Third Circuit's opinion in *Zagata, supra*, in concluding "that the

objective approach to determine a debtor's reasonable use and occupancy of a landlord's premises is consistent with the express language of Code sections 503 and 507, and properly balances the interests of the debtor's estate and those of the landlord.” *Cornwall Paper Mills*, 169 B.R. at 851. As Bankruptcy Judge Winfield further explained:

Under the objective approach, "the lessor is entitled to collect the fair rental value of the leased premises so long as the debtor is occupying the leased property and using it to help preserve the estate" regardless of whether the property is being put to the same use as it was pre-petition. *Id.* In re F.A. Potts & Co., Inc., 137 B.R. 13, 17 (E.D.Pa.1992). "[T]he court 'should not consider that the [debtor] has used only for storage purposes property that had been occupied by a going business.' " *Id.* (quoting *Diversified Services, Inc. v. Harralson*, 369 F.2d 93, 95 (5th Cir.1966)). Similarly, the court in *Mohawk* stated that "where the debtor continues to possess the premises, its liability for the lease payment rate is not affected by its purported use of the property for storage." *Mohawk*, 54 B.R. at 412; In re Grimm & Rothwell, Inc., 108 B.R. 186, 190 (Bankr.S.D.Ohio 1989) (it is inconsequential to the determination of the rental value that property previously used for business was used for storage).

169 B.R. at 861. *See also In re Trans World Airlines, Inc.*, 145 F.3d 124 (3rd Cir. 1998)(Rent provided for in lease is not necessarily treated as an administrative expense, since administrative expenses are allowable only for “the actual, necessary costs and expenses of preserving the estate.” 11 U.S.C. § 503(b)(1)(A). Thus, it is well settled that the debtor is responsible only for the fair market value of the property at the time of its use).

In *Cornwall Paper Mills*, Judge Winfield discussed the opinion of the *In re Mohawk Indus. Inc.*, 54 B.R. 409 (Bankr.D.Mass.1985), where the court refused to differentiate the fair rental value for the time when the property was used for manufacturing versus when it was used for storage.

The court found that the use of the property for storage directly benefited the debtor. *Id.* at 413. Thus, the court refused to differentiate between the manufacturing and

storage periods and held that absent convincing evidence that the rent reserved in the lease was unreasonable, the lease terms controlled for both periods. *Id.* The court then calculated the fair rental value by multiplying the amount of rent reserved in the lease by the amount of square feet occupied by the debtor, not the amount of space actually leased by the debtor. *Id.*; Grimm, 108 B.R. at 190 (the court made an allowance for administrative rent only for the actual amount of space used).

Cornwall Paper Mills, 169 B.R. at 651 (citing *Mohawk*, *supra.*)

HICA anticipates that the Debtor may argue that it should not be responsible to pay the contractual rent during the post-petition occupancy. It should be emphasized that the Debtor, and not HICA, bears the burden of proof to sustain an objection that the contractual rental of the parties' lease agreement is unreasonable as an administrative expense. *See In re Gourmet Gallery, Inc.* (Bankr. E.D.Pa. 1983). In point of fact, during the post-petition period the Debtor's equipment has remained dispersed throughout the premises as it always has, and there has been no reduction in the Debtor's use of the premises. Freeman Cert., at ¶16. HICA has submitted the Certification of Andrew Moss, its real estate expert, as evidence that the rent reserved in the lease represents the fair market rental value for the subject premises. Mr. Moss concludes that the subject premises have a fair market rental value of \$7.25/sf. Under the terminated Lease, the cost of the Debtor's space was \$6.40/sf for the month of June 2003, and \$6.85/sf for the month of July 2003 and thereafter. These amounts are below the fair market value as opined by Mr. Moss. However, should the Debtor dispute the fair market value asserted by HICA, then HICA respectfully requests that the Debtor be required to deposit with HICA's attorneys an escrow of \$23,147.91 representing pro rated rent for the month of June 2003, and \$24,272.91 per month thereafter until such time as this issue

is resolved by an evidentiary hearing.³ In the absence of this relief HICA will suffer irreparable harm and prejudice.

POINT III

THE COURT SHOULD GRANT HICA AN ALLOWED ADMINISTRATIVE EXPENSE FOR ITS REASONABLE ATTORNEY'S FEES INCURRED POST-PETITION TO ENFORCE ITS RIGHTS AGAINST THE DEBTOR

Pursuant to Article 34.1 of the terminated lease, HICA moves for allowance of an administrative claim for its reasonable attorney's fees incurred post-petition to enforce its rights against the Debtor as holdover tenant. *See e.g., In re Geonex Corp.*, 258 B.R. 336 (Bankr. D.Md. 2001)(Court held that landlord is entitled to counsel fees as an administrative priority expense if authorized by the terms of the lease). If this aspect of the Motion is granted, HICA will submit the Affidavits of its co-counsel as evidence of the fees that it has incurred post-petition.

CONCLUSION

For the reasons and authorities cited, the Court should grant HICA relief from the automatic stay pursuant to subsection (d)(1) of Section 362 of the Bankruptcy Code to permit HICA to continue with its eviction of the Debtor through the Superior Court of New Jersey. The Debtor's lease was terminated pre-petition by entry of the Judgment of Possession, thereby rendering the lease non-assumable under federal bankruptcy law. Notwithstanding, the Debtor continues to occupy the premises and is not paying rent to HICA. In the absence of stay relief, HICA will suffer irreparable harm and prejudice.

³ In fact, Article 25.1 of the Lease entitles HICA to charge the Debtor rent equal to 1 ½ times the amount of the rent reserved in the Lease, a provision that was negotiated by the Debtor at the outset of the Lease and which represents less than the double rent permitted to be charged to a holdover tenant under New Jersey law.

In addition, the Court should compel the Debtor to pay HICA reasonable use and occupancy at the contractual rental rates set forth in the terminated lease until such time as the Debtor surrenders possession of the premises, either voluntarily or involuntarily. If the Debtor disputes the fair market rent value, then the Court should require the Debtor to escrow the rent reserved in the Lease as adequate assurance for future performance; an escrow would certainly be appropriate in that instance considering the Debtor bears the burden of proof on this issue and, in the absence of such relief, HICA would sustain irreparable harm and prejudice.

Concurrently, HICA requests that it be granted an administrative priority expense claim under Sections 503(b)(1)(A) and 507(a)(1) of the Bankruptcy Code for reasonable use and occupancy awarded by the Court, as well as for its reasonable attorneys' fees incurred post-petition in enforcing its leasehold rights against the Debtor.

Respectfully submitted

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By: /s/Glenn R. Reiser
Glenn R. Reiser

Dated: July 8, 2003