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Incurable Defaults in Commercial Leases: Can You Un-Ring the Bell?

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Your client-landlord approaches you with a commercial lease and a dilemma: The tenant assigned its lease to a third party without the landlord's knowledge or consent. What are the landlord's rights?

You review the lease—with an emphasis on the "no assignment" provision—and note that like many commercial leases, the lease not only prohibits unauthorized assignments, but even defines "assignment" in various ways, e.g., as (i) the transfer of more than 50 percent of shares of the tenant where the tenant is a corporation,[1] (ii) the transfer of a partnership interest in the tenant where the tenant is a partnership, (iii) the merger or consolidation of the tenant into or with any other entity, (iv) occupancy or possession by someone other than the tenant of record, (v) the sale of all or substantially all of the tenant's assets, or (vi) the garden variety transfer of the lease to a third party pursuant to formal assignment documents.

So you've now determined that the tenant's assignment to a third party is a breach of the lease, permitting the landlord to default the tenant. Your client inquires, "Can we just evict the tenant, who really is no longer in the leased premises, without a long and drawn out court battle? Or can the tenant come back once we default it, in an attempt to cure its default?"

In other words, is the unauthorized assignment by the tenant an "incurable" default of the lease such that the landlord would not be embroiled in a multi-year Yellowstone litigation in Supreme Court, as opposed to a "summary" proceeding in the Civil Court, since the tenant has no substantive defenses to the incurable unauthorized assignment?[2] As explained below, there is no definitive answer in light of a recent Appellate Division, First Department, decision.

This article identifies the various types of commercial lease defaults that courts may find to be "incurable" as a matter of law, followed by a focus on what has been the most controversial of these defaults—the unauthorized assignment of its lease. In the end, we provide a practical tip on terminating commercial leases for unauthorized assignments, where the law and the usual lease default provisions may seem contradictory.

Cases on Incurable Defaults

While it is true that the courts have regularly granted Yellowstone injunctions to tenants who move for such relief before the time to cure the default expires, courts in the First Department have denied Yellowstone relief where the defaults in question were found to be "incurable" as a matter of law. For example: In *Excel Graphics Technologies v. CFG/AGSCB 75 Ninth Avenue*, the court held that Yellowstone injunctions should not issue where a tenant has not disputed that a breach of the lease has, in fact, occurred[3]; in *Definitions Personal Fitness v. 133 E. 58th Street*, the court held that tenant's chronic non-payments are incurable[4]; in *Kim v. Idylwood*, the court held that a tenant's failure to maintain insurance coverage in violation of a lease is an incurable default.[5] Further, in *Paula Sweet NY v. 95 Morton St. Assoc.*,[6] the court held that an illegal sublet was incurable, and in *Zona v. SOHO Centrale*,[7] the court held that assignments in violation of a lease are incurable. Interestingly, the First Department decided *Zona* 11 years after it decided in *Garland v. Titan West*[8] that assignments in violation of a lease could be cured. The First Department has now come full circle back to *Garland*.

While there are no bells that can be un-rung, under New York law are there defaults that cannot be undone? While the First Department in *Excel Graphics*, *Definitions*, *Kim*, and *Zona* appear to answer in the affirmative, there is more to this issue than meets the eye. It now appears that the creative tenant's lawyer will be able to un-ring the incurable bell by positing a host of "what if the

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tenant…" claims in its motion for Yellowstone relief.

'Zona': Assignments

In *Zona*, the First Department summarily denied Yellowstone relief to a tenant accused of assigning its lease without consent from its landlord:

> assignment of the lease without obtaining landlord's prior written consent constitute[s] an incurable default [making] the grant of a Yellowstone injunction…improper.

Notably, in its order to show cause for Yellowstone relief, the tenant repeatedly stated that it was "ready willing, and able" to cure the default if one were found to exist. In affirming the lower court that the unauthorized assignment was incurable, the First Department did not provide the reasoning behind its holding, simply citing to the Second Department case *Pergament Home Centers v. Net Realty Holding Trust* in support.[9]

In any event, the holding of *Zona* seems logical, to wit, once a tenant assigns its lease with no reversionary interest, it no longer has any control of that which it has assigned so as to be able to undo it, as a matter of right, unilaterally. Notwithstanding the tenant's wishful thinking once caught by the landlord, the assignee has no obligation to undo the assignment and it is too late to ask, nunc pro tunc, for the landlord's "reasonable" consent. So you advise your client to terminate the tenancy (without opportunity to cure) for improper and incurable assignment—right? Not so fast. Before going down that road, there are two issues that need to be addressed.

First, in light of recent First Department case law, is *Zona* still controlling, or is *Zona*, as the First Department indicated, limited to the situations where the tenant failed to present the buzz words "ready, willing and able to cure"? And second, assuming that the lease, like most leases, requires the landlord to serve a notice to cure prior to termination, should the landlord serve such a notice (in compliance with the lease, thereby, proclaiming the incurable to be curable), or can the landlord bypass the notice-to-cure step (believing that under no circumstances will the tenant be able to cure the illegal assignment)? Both of these issues are discussed below.

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'Artcorp' and Curing

In holding contrary to *Garland* that an unauthorized assignment is incurable, *Zona* ignited a bit of controversy. This controversy was re-ignited on Jan. 26, 2015, when the First Department held in *Artcorp v. Citirich Realty*[10] that unauthorized assignments can be cured:

> Contrary to defendant landlord's contention, plaintiff tenant clearly asserted its willingness to cure the allegedly improper assignment of its shares, and had the ability to do so either by transferring its shares back to the deceased owner's estate or by seeking consent from the landlord. Further, consent may be obtained after the assignment and even in the absence of a lease provision authorizing this post-assignment cure. [internal citations omitted]

Wow! What happened to the basic contract construction tenet that courts may not modify or re-write a lease to achieve a result not provided for—or contrary to—the lease? Inasmuch as an assignment involves an assignor conveying all interest in the lease to the assignee (and assuming no reversionary interest as in a sale/leaseback situation), that assignor has no right to unilaterally take back what it unconditionally assigned so as to undo the assignment, or to speculate that the landlord will bless, nunc pro tunc, an illegal assignment.[11]

Artcorp then concludes by attempting to distinguish *Zona* in one sentence:

> *Zona*…is distinguishable because the tenant there failed to assert that it had the ability to cure its default.

Thus, *Artcorp* held that unauthorized assignments can be cured where, either: (i) the assignee transfers its shares back to the tenant of record even if not provided for in the assignment, or (ii) the tenant seeks the landlord's consent retroactively. However, by this logic, any lease default can be cured nunc pro tunc and there is no longer such a thing as an "incurable default." In other words, *Artcorp* gives every defaulting tenant who is willing, the opportunity to find its way out of a default as long as the tenant is creative enough to dream up a solution that would undo that default, even if the undoing requires the actions of an unwilling assignee or a less-than-friendly landlord. For example, the default of failure to maintain insurance coverage might be cured if the tenant belatedly covenants to its landlord to indemnify and hold harmless the landlord against the unknown universe of claims that could have arisen during the period that it was not covered by offering to post a huge bond to cover that possible event (but see *Kim*, supra).

Likewise, chronic non-payments could be cured by the tenant simply paying what is outstanding under the lease and speculating that the landlord may agree to forgive all previous chronically late payments (but see *Definitions*, supra). Similarly, unauthorized assignments could be cured by the assignor later asking the landlord for its "reasonable" consent to assign nunc pro tunc, (although *Zona* expressly states that an "assignment of the lease without obtaining landlord's prior written consent constitutes an incurable default") or by the assignor convincing the assignee (i.e., paying him off) to undo the assignment by transferring back what was illegally transferred in the first place.

Indeed, whether the fact of the default is disputed or undisputed, there is no default that cannot be undone since, technically, any mistake can somehow, someway, be fixed by thinking of scenarios that will accomplish that goal, no matter how desperate or far-fetched, (but see *Excel Graphics*). However, the glaring problem in every such scenario, which the Artcorp court overlooks, is that the defaulting tenant has no unilateral rights. It is required to act in tandem, either with its transferee or the landlord, in order to make its cure a reality. And do we really believe that will happen?

Moreover, *Artcorp* attempted to distinguish *Zona* by reasoning that, in *Zona*, the tenant's failure to "assert that it had the ability to cure" was the reason that the court concluded as it did. This distinction, however, is questionable for three reasons. First, as noted above, the tenant in *Zona*, in fact, did assert that it was "ready, willing, and able" to cure in the event that the court found it in default of the lease. Second, *Zona's* holding simply was not based on whether or not the tenant "asserted" an ability to cure. See *Zona*, supra ("This conclusion [i.e., that unauthorized assignments are not curable] is *particularly warranted* since tenant has failed to assert that it has the ability to cure.") (emphasis added).

Thus, the "conclusion" that the assignment was not curable came *before* the court considered whether or not the tenant "asserted" an ability to cure. Third, irrespective of whether or not the tenant "asserts" it (and putting aside the fact that, as explained above, it is impossible for an assignor to unilaterally undo an unauthorized assignment), the Zona court could have just as easily applied Artcorp's two-pronged "what if the tenant…" solution to the facts before it. After all, all unauthorized assignments can be undone by: (i) transferring the lease back to the tenant of record (who would be required to return any payment received for the assignment), or (ii) retroactively seeking the consent of the landlord (who would most likely not give it).

In essence, *Artcorp* totally does away with the concept of an "incurable default." Everything is now curable if you can come up with a sufficient "what if the tenant…."

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Notice to Cure

Assuming that *Zona* can still be relied on—i.e., that unauthorized assignments are incurable per se—landlords are nevertheless caught between a rock and a hard place. On the one hand, where a tenant defaults under its lease (unauthorized assignments included), most leases will require a landlord to serve its tenant with a notice to cure as a predicate to terminating the tenancy by way of a notice of termination.

On the other hand, however, *Zona* holds that unauthorized assignments are defaults that, as a matter of law, cannot be cured. If you serve a notice to cure, then you may be estopped from later arguing that the unauthorized assignment is incurable since, after all, your notice to cure is proof that even you believe unauthorized assignments to be curable. If you go straight to a notice of termination, then you run the risk of a court dismissing your case for failure to comply with an express condition precedent under the lease (to wit, service of a notice to cure). A horns of a dilemma situation to which the authors welcome the readers' thoughts.

Conclusion: a Practical Tip

This apparent Artcorp/Zona split leaves litigants in a lurch, and all the authors can do is recommend anticipating the tenant's "what if the tenant…" claims and try to head them off. For example, in the context of unauthorized assignments, affirmatively assert in the predicate notices that the assignor-tenant assigned its lease and retained no reversionary interest, and the assignee invested great sums of money in the assignment and would not agree to undo the assignment, and further, that your client, the landlord, will in no way, shape, or form approve the unauthorized assignment nunc pro tunc. In any event, the goal should be to somehow put the tenant on the defensive at the outset, so that it must bear the burden of proving otherwise, i.e., that it has a practical plan for undoing the default.

Nevertheless, until the Court of Appeals steps in to resolve the apparent split, landlords will continue relying on cases such as *Zona*, *Excel Graphics*, *Definitions*, and *Kim*, and tenants will continue trying to un-ring the bell.

1. But See *East Best Food v. NY 46th,* 56 A.D.32 302 (1st Dept. 2008) (finding that no assignment occurred where two of the three shareholders transferred their shares, which in the aggregate totaled more than 50 percent, because the transfers were not undertaken to circumvent the lease's "no assignment" provision).

2. *First National Stores v. Yellowstone Shopping Center*, 21 N.Y.2d 630 (1968). Simply stated, a Yellowstone injunction is equitable relief whereby a commercial tenant—after being served with a notice of default, a notice to cure, or a threat of termination of the lease by its landlord—is able to preserve the status quo of its tenancy until the parties' rights can be fully adjudicated.

3. 1 A.D.3d 65, 71 (1st Dept. 2003).

4. 107 A.D.3d 617 (1st Dept. 2013).

5. 66 A.D.3d 528 (1st Dept. 2009); see also *C.C.B. Prep Testing of New York v. 73 M&C Realty*, 41 H.C.R. 367C (Sup. Ct. Queens Co. 2013).

6. N.Y.L.J., May 19, 1999, p. 27, col. 2, 27 H.C.R. 291A (Sup. Ct. N.Y. Co.).

7. 270 A.D.2d 12 (1st Dept. 2000). See also *C.C.B. Prep Testing of New York*, supra).

8. 147 A.D.2d 304 (1st Dept. 1989).

9. 171 A.D.2d 736 (2d Dept. 1991) Significantly, the subject lease in *Pergament* gave the landlord the express right to terminate the tenancy in the event of an unauthorized assignment, thereby allowing the landlord to skip the "notice to cure" step. Therefore, by immediately terminating the tenancy, the landlord was merely exercising an explicit right conferred to it under that lease. The court gave no indication that the lease at issue in *Zona* conferred the same express right on that landlord.

10. 2015 N.Y. Slip Op. 00650 (1st Dept.)

11. Ironically, the Artcorp court distinguished *Zona* based on the fact that the tenant in *Zona*, unlike the tenant in *Artcorp*, did not assert its ability to cure (notwithstanding the Zona tenant's statements that it was "ready, willing, and able" to cure). Yet, nowhere in the Artcorp tenant's sworn statements was there an allegation that it would transfer the "shares back to the deceased owner's estate" as the court stated. The court seems to have developed the "what if the tenant…" solution sua sponte.