When a Lease Is Being Assigned, LANDLORDS MUST ACT

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As any commercial landlord who has been through a tenant's bankruptcy is aware, the tenant must accomplish three things to assume and assign a real property lease under Bankruptcy Code Section 365:

1. Cure all monetary and nonmonetary defaults capable of being cured.
2. Provide adequate assurance of future performance.
3. Assume and assign the lease in its entirety (and not just its benefits).

Creative debtors and asset purchasers, through sale and confirmation orders, aim to poke holes in these core concepts by disregarding non-monetary defaults, providing minimal adequate assurance information, and using backdoors in asset purchase agreements to limit liability of a new tenant under an assigned lease. When dealing with nontraditional assignment issues, as opposed to ordinary monetary cures and adequate assurance issues, landlords must actively protect their rights to eliminate surprises following the assignment of their leases.

Protection Starts With the Bid Procedures Motion

In most Chapter 11 cases, the sale process commences when the debtor files a motion to establish bidding procedures. This motion will govern the auction, sale, and assumption/assignment of contracts and leases. These bidding procedures often propose accelerated timelines for providing information and limit the time to object, including the asserted amount of the cure (which is the amount that must be paid to assume and assign the lease).

If landlords do not timely object to the proposed bidding procedures, bankruptcy courts nearly always adopt those offered by a debtor, which may not allow the landlord sufficient time to review and respond to a cure statement. Relevant information regarding a debtor's assertion of required amounts to cure existing defaults should be provided at least seven to 10 days before the deadline to object. Taking proactive steps at this stage can save landlords substantial time and money at the subsequent sale hearing.

Carefully Review the Cure Statement

As a condition to the assumption and assignment of a lease, the Bankruptcy Code requires a debtor to promptly cure or provide adequate assurance of a prompt cure for existing monetary and nonmonetary defaults. Establishment of the necessary cure is generally effectuated through a cure statement provided under the bidding procedures by which a debtor asserts the amount required to cure existing lease defaults and, if a landlord fails to timely object to an incorrect amount, the debtor's number will typically be deemed correct.

Debtors, when preparing cure statements, focus exclusively on unpaid monetary obligations while ignoring non-monetary lease obligations. For example, most commercial leases have attorneys fee provisions. Depending on the wording in a lease, a debtor may be required to pay the landlord's professional fees and other expenses to assume and assign a lease. Broad provisions that include payment of reasonable professional fees and expenses incurred in connection with enforcement of rights and remedies are far more likely to be enforced in bankruptcy than an

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ordinary "prevailing party" attorney fee provision. Why? It is not always clear who prevails in a bankruptcy case, so a prevailing party clause may be insufficient to protect a landlord's right to attorneys fees. Under a broadly drafted professional fee provision, the debtor must pay the landlord's attorneys fees in connection with the assignment and assumption of a lease. Regardless of the type of attorneys fee provision, cure statements never include landlord's attorneys fees, making it incumbent on landlords to protect their rights.

Additionally, most commercial leases include an obligation to maintain and repair the property. If the debtor neglected to maintain the property during its occupancy, the landlord, as a condition of assumption and assignment, may compel performance of any necessary repairs, even if the landlord did not provide a previous notice of default. The landlord, therefore, may want to exercise any inspection rights provided by the lease after learning that the tenant is having financial difficulties to assess whether any repairs are necessary. Failure to protect nonmonetary rights may have dire economic consequences. A landlord must carefully review their lease when analyzing and timely responding to a debtor's cure statement to protect their rights in bankruptcy and receive the benefit of the bargain in the lease.

The Donut Hole

Most assignment orders contain strong free-and-clear transfer language combined with release, injunctive, prohibition of successor liability, and/or discharge provisions that could preclude the later assertion of liabilities against the new tenant. While the reasons for such attempted limitations of liability are clear—because a new tenant does not want to be burdened by an old tenant's mistakes—such provisions are contrary to Bankruptcy Code requirements that the lease be assumed and assigned in its entirety, with adequate assurance of future performance.

Most leases also contain provisions to keep the property maintained. Importantly, these provisions are ongoing and not temporal. For example, what if, pre-assignment, a broken window requires repair? A new tenant may argue, relying on the assignment order, that it has no obligation to repair it because they took the property free and clear of pre-assignment conditions and liabilities. The landlord, of course, argues that someone is required to repair the window, whether that is the debtor as part of its cure obligations or the assignee as an element of future performance.

This situation is referred to as the "donut hole" because it could be unclear who is responsible for the repair. To close this hole—and to ensure that the property is properly maintained under the lease—landlords should assert such repair obligations as a default that the debtor must cure while insisting on a provision in an assignment order that clarifies that any new tenant is required to comply with the lease, regardless of any other liability-limiting provisions in the asset purchase agreement or assignment order.

Watch Out for the Insurance Trap

Many assignment orders do not contain an insurance carveout that protects landlords if a pre-assignment liability claim is not asserted until after assignment. Such a carveout permits a landlord to assert a claim against a debtor's insurance policy if the landlord is named as a defendant post-assignment for a pre-assignment event or occurrence. The most common example is a slip-and-fall case based on a pre-assignment event at the leased premises, where the statute of limitations has not expired at the time of the assignment but the third-party claim is asserted later. The landlord has indemnification rights under the lease, including the right to assert claims under a debtor's property and general liability coverage.

Upon learning of a tenant bankruptcy, landlords should assess whether that tenant's insurance coverage is claims-made or occurrence-based. Because the debtor's claims-made coverage would otherwise terminate following the assignment, the landlord would lose the benefit of bargained-for insurance coverage, even when the landlord was named as an additional insured. To provide for adequate assurance of future performance of the lease's indemnification obligations, the landlord should insist that the debtor or its assignee purchase "tail" coverage, which protects against pre-assignment third-party claims that might not be asserted until after the assignment.

Occurrence-based coverage provides greater protection to landlords because it is available based on the date of the occurrence, not when the claim is ultimately asserted. Issues with occurrence coverage are possible even when a landlord is named as an additional insured, because overly broad release language in an asset purchase agreement or assignment

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order may insulate or release the debtor-tenant (and, thus, its insurer) from liability for such pre-assignment claims, while simultaneously providing that the assignee does not assume pre-assignment liabilities.

To avoid such an outcome, landlords can protect themselves by negotiating language that addresses this issue in the assignment order. Without clear order language, landlords may not be able to access a debtor's insurance policy and may incur unintended liabilities.

Landlords can protect themselves by negotiating language that addresses this liability issue in the assignment order. Without clear order language, landlords may not be able to access a debtor's insurance policy and may incur unintended liabilities.

Landlords should also be wary of sizable deductible and self-insured retentions under debtor-tenant's insurance policies. While a landlord bargained for "first dollars" protection (that is, no liability through "hold harmless" lease language), a debtor may liquidate after the lease assignment so funds would not be available to satisfy any deductible amount. In that case, the landlord should consider requiring that deductible or self-insured retention amounts be escrowed to be available to satisfy future claims when they arise, or that the assignee be required to assume the deductible or self-insured retention liability to provide future performance of the indemnification obligations of the lease.

Vigilance Pays Off

The Bankruptcy Code is not a friend to landlords if they do not use the tools available to them. To obtain the benefits that the Bankruptcy Code provides landlords and to reduce the likelihood of disputes with future tenants, landlords must actively participate throughout the bankruptcy process, especially in connection with the proposed assumption and assignment of leases. Leases do not simply ride through the bankruptcy assignment process—valuable rights and obligations may be lost if landlords fail to act timely. Landlords may not get all the potential protections in every case, but they can materially improve their position through diligence and timely action.