

# Nassau Lawyer

DECEMBER 2014 | VOL. 64 | NO. 4 | WWW.NASSAUBAR.ORG

## Tax/Commercial/Bankruptcy Law

### ***Eastman Kodak: Simultaneous Assumption and Assignment of Real Property Leases Under the Bankruptcy Code***

One of the powers afforded to a Chapter 11 debtor under the Bankruptcy Code is the ability to assume or reject its unexpired leases of nonresidential real property. If the debtor opts to assume the lease, the Bankruptcy Code also provides the debtor with the ability to assign the lease to a third party. In most instances, the assumption and assignment of real property leases occur simultaneously.

In a matter of apparent first impression, the U.S. Bankruptcy Court for the Southern District of New York recently held that the assumption and assignment of real property leases do not need to occur at the same time. The decision potentially provides debtors with greater control and flexibility when dealing with their landlords and creates an added layer of uncertainty for landlords dealing with tenants under Chapter 11 protection.<sup>1</sup>



Veronique Urban

#### **The *Eastman Kodak* Facts**

On January 19, 2012, Eastman Kodak Company and certain of its affiliates (collectively, the “Debtors”) filed voluntary petitions under Chapter 11 of the Bankruptcy Code. On July 17, 2012, within the deadline for assuming real property leases imposed by Section 365(d)(4) of the Bankruptcy Code, the Debtors filed a motion to assume certain of their unexpired leases. The motion provided that the leases were being assumed by the Debtors because such leases were critical to the Debtors’ ongoing business operations.

One of the leases that was scheduled

for assumption under the motion was a lease between Eastman Kodak Company and ITT Space Systems, LLC (the “Landlord”) which had been entered into in 2004 (the “Ground Lease”). The Ground Lease included a provision which prohibited its assignment or sublease without the Landlord’s prior written consent. The Landlord did not object to the Debtors’ assumption motion.

On August 15, 2012, the court entered an order authorizing the assumption of the leases, including the Ground Lease. The order contained a paragraph which stated: “Nothing included in or omitted from the Motion or this Order...shall impair, prejudice, waive or otherwise affect the rights of the Debtors and their estates ... to assign any of the Assumed Leases pursuant to, and in accordance with, the requirements of Section 365 of the Bankruptcy Code.”

On December 21, 2012, the Debtors entered into an Asset Purchase Agreement with RED-Rochester, LLC (the “Purchaser”) which was subsequently approved by the Court on January 18, 2013. On June 28, 2013, ten months after the entry of the assumption order and more than five months after the entry of the sale order, the Debtors filed a motion with the court seeking to assign the Ground Lease to the Purchaser. The Landlord objected to the assignment of its lease to the Purchaser.

#### **The Question Before the Court**

The question before the court appeared to be deceptively simple: does the assump-

tion and assignment of an executory contract or unexpired lease under Section 365 of the Bankruptcy Code need to occur at the same time. The Landlord’s position was that a nonconsensual assignment of an unexpired lease cannot occur after assumption, and thus cannot occur outside of the 210-day period set forth in Section 365(d)(4). The Debtors, on the other hand, argued that debtors could utilize the benefits of Section 365(f)(3) to assign contracts free and clear of contractual restrictions on assignment during bankruptcy proceedings but after the date of assumption.

#### **The Governing Law: Bankruptcy Code § 365**

The court’s analysis in the *Kodak* case focused on the wording used in Section 365 of the Bankruptcy Code, whose intersecting provisions govern the assumption, rejection or assumption and assignment of real property leases. Section 365(a) of the Bankruptcy Code provides broad authority for the trustee or Chapter 11 debtor to, subject to the bankruptcy court’s approval, assume or reject any executory contract or unexpired lease of the debtor.

Section 365(d)(4)(A) of the Bankruptcy Code provides that if a debtor does not assume its unexpired nonresidential real property leases by either the date that is 120 days after the date of the order for relief<sup>2</sup> or the date of the entry of an order confirming a plan, whichever is earlier, then such unexpired real property leases will be deemed rejected.

Section 365(d)(4)(B) then provides that the 120-day period may be extended for 90 days on the motion of the trustee, debtor or lessor for cause but that any

subsequent extension will only be granted upon the prior written consent of the lessor. The debtor, assuming it obtains the 90-day extension, therefore has 210 days to assume its unexpired real property leases without requiring consent of the affected landlord.

Section 365(f)(1) provides authority for a debtor or trustee to assign a lease to a third party. To assign the lease, Section 365(f)(2) of the Bankruptcy Code requires that the trustee or debtor assume the lease in accordance with the provisions set forth in Section 365, and also provide the landlord with adequate assurance of the proposed assignee's future performance of the lease.

Lastly, Section 365(f)(3) allows the debtor or trustee to assign the lease notwithstanding any contractual prohibitions on assignment. The policy behind this provision is to maximize the value of the debtor's estate for the benefit of creditors by rendering unenforceable anti-assignment provisions that would impair the debtor's ability to sell the lease.

## The Court's Analysis

With no applicable cases on point on this issue, the court began its analysis by reviewing the plain meaning of the statute.

First, the court looked at the language of Section 365(f)(2), which the Landlord argued required the simultaneous assumption and assignment of the lease because that section uses the present tense of the verb "to assume" (assignment is authorized if the trustee "assumes such contract or lease"). The court, however, found that the plain meaning of the statute does not support any requirement for simultaneous assumption and assignment. Rather, the court found that "there is no authority that use of the present tense in this instance requires simultaneous assumption and assignment. The words of the statute, reasonably interpreted, do not require it."<sup>3</sup> Instead, the only requirement imposed by Section 365(f)(2) is that the assumption must occur before the assignment. The court then looked at the other provisions of Section 365 and reiterated its belief that "assumption and assignment are independent concepts."<sup>4</sup>

The court also reviewed Section 365(d)(4), which provides a deadline on the assumption of a lease but is silent on any deadline with respect to the assignment of such lease. It noted that Congress enacted Section 365(d)(4) in order to "limit the discretion of judges to extend time to assume or reject certain commercial contracts and to provide landlords with greater certainty as to such tenancies."<sup>5</sup> Interpreting Section 365(d)(4) to permit the assignment of a lease outside

of the 210-day deadline for assumption, in the court's opinion, "reasonably balances the goal of providing protection to landlords and the goal of maximizing the value of a debtor's estate."<sup>6</sup>

The Landlord also argued that allowing debtors to assume a lease and then subsequently assign the lease outside of the 210-day period was unfair to landlords. The court did not find this argument persuasive, stating that even if such a ruling were unfair, "the disruption of non-debtors' expectations of profitable business arrangements is common in bankruptcy proceedings."

The court also noted that the Landlord would suffer no harm from the assignment since the Ground Lease would continue post-assignment on its present terms and since the Purchaser could provide adequate assurance of its future performance as required under Section 365(f)(2)(B) of the Bankruptcy Code. In addition, the assignment of the Ground Lease should not have come as a surprise to the Landlord since the assumption order clearly included a provision which reserved the Debtors' rights to subsequently assign the assumed leases in accordance with Section 365.

Lastly, the Landlord argued that the Ground Lease was assumed *cum onere* (Latin phrase meaning that the lease was assumed subject to all of its burdens). The Landlord pointed out that the Ground Lease contained an anti-assignment provision and that the Debtors could therefore not assign the Ground Lease without the Landlord's prior written consent.

The court, however, found that a debtor that is still in bankruptcy continues to enjoy the benefits provided to it under the Bankruptcy Code, including Section 365(f)(3), even if the lease has already been assumed. Such provision allows the debtor or trustee to assign a contract notwithstanding an anti-assignment clause in the contract.

The court therefore entered an order granting the assignment of the Ground Lease to the Purchaser over the Landlord's objection.

## The Potential Implications of Kodak

It has been over a year since the court in *Kodak* entered its decision, but to date there have been no cases, whether positive or critical, that have made reference to the *Kodak* decision. It therefore remains to be seen whether the assignment of a lease after the assumption of such lease free and clear of contractual anti-assignment provisions will be supported by other bankruptcy courts.

As an initial matter, the decision appears to provide debtors with more flexibility with respect to the treatment of their executory contracts and unexpired

leases in bankruptcy. Debtors, especially large retail debtors who may be parties to hundreds of real property leases, may see the outcome of the *Kodak* case as one that is decidedly in their favor. While such debtors will still face the pressure of determining which leases they must assume or reject by the deadline imposed by Section 365(d)(4), it may not be necessary for them to also immediately decide whether those assumed leases should be assigned. This breathing room will allow debtors to take a more critical look at the leases they have assumed to determine the best strategy for maximizing their estates.

On the other hand, landlords may resent the uncertainty created by the *Kodak* decision in that their leases may be assumed and then assigned at any later point in a debtor's bankruptcy case. This may cause landlords who are involved in those bankruptcy cases that linger for years in bankruptcy to feel like they are caught in an endless game of limbo. Such landlords may take comfort in knowing that, on assumption, the landlord obtains a cure of defaults and reinstatement of the lease; any subsequent defaults or rejection by the debtor will provide the landlord with an administrative expense claim for some of its damages. In addition, any subsequent assignment of the lease would still require that the proposed assignee provide adequate assurance of its future performance.

Lastly, it is possible that the result in *Kodak* may have been avoided if the Landlord had objected to the provision of the assumption order that specifically reserved the Debtors' rights to assign the Ground Lease.

**Veronique Urban is an associate in the Bankruptcy & Creditors' Rights practice group of Farrell Fritz, P.C. in Uniondale, New York.**

1. *In re Eastman Kodak Company*, 495 B.R. 618 (Bankr. S.D.N.Y. 2013) ("*Kodak*").
2. The date of the "order for relief" is different in a voluntary bankruptcy case from an involuntary bankruptcy case. In a voluntary bankruptcy case, such date is the date that the debtor filed its bankruptcy case. In an involuntary bankruptcy case, such date is the date that the court determines that the debtor is generally not paying its debts as such debts become due. See 11 U.S.C. § 303(h).
3. *Kodak*, 495 B.R. at 622.
4. *Id.*
5. *Id.*
6. *Kodak*, 495 B.R. at 623.
7. *Kodak*, 495 B.R. at 624 (internal citations and quotations omitted).

