BURR ALERT

Termination of a Commercial Lease May be an "Avoidable Transfer" in Bankruptcy, holds Seventh Circuit

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In March 2016, the U.S. Court of Appeals for the Seventh Circuit ruled that a landlord may be liable to a debtor's bankruptcy estate for the value of a lease the debtor terminated early, holding the termination may be an "avoidable transfer" under the Bankruptcy Code.[1] The opinion in *Official Comm. of Unsecured Creditors v. T.D. Invs. I, LLP (In re Great Lakes Quick Lube LP)*[2] reversed the Bankruptcy Court's ruling, and in doing so perhaps expanded the definition of a "transfer" under the Bankruptcy Code.

Background

The debtor in the case, Great Lakes Quick Lube LP (the "*Debtor*"), operated more than 100 oil-change stores before it filed bankruptcy. The Debtor leased its locations and, two months before it filed bankruptcy, decided to terminate two of its leases with T.D. Investments I, LLP (the "*Landlord*"), even though the two stores were profitable.

The committee of unsecured creditors appointed in the Debtor's chapter 11 bankruptcy case challenged the two lease terminations as preferential or fraudulent transfers under the Bankruptcy Code. Under § 547(b) of the Bankruptcy Code, a preferential transfer is a transfer made by an insolvent debtor to a creditor within 90 days before bankruptcy that gives the creditor more than if it had waited for the bankrupt's assets to be distributed in the bankruptcy proceeding. A constructive fraudulent transfer under § 548(a)(1)(B) of the Bankruptcy Code is a transfer made by an insolvent debtor to anyone (creditor or non-creditor) within two years before the bankruptcy for which the debtor received less than reasonably equivalent value. Under either theory, the Bankruptcy Code provides for recovery from the transferee in an amount equal to the value of the transfer received.

The Seventh Circuit's Opinion

The Bankruptcy Court in *Great Lakes Quick Lube* ruled in favor of the Landlord, concluding that the lease terminations were not "transfers" as defined by the Bankruptcy Code. The Bankruptcy Court also agreed with the logic of prior bankruptcy courts that had addressed this issue and concluded that holding a lease termination to fall within the definition of an avoidable transfer would be inconsistent with the specific provisions of § 365(c)(3) dealing with nonresidential leases terminated prepetition.[3]

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[1] References to the Bankruptcy Code are to title 11 of the United States Code.

[2] Case. No. 15-2093, 2016 WL 930298 (7th Cir. Mar. 11, 2016) (Posner, J.)

[3] Section 365(c)(3) states, in relevant part: "the trustee may not assume or assign any…unexpired lease of the debtor…if…such lease is of nonresidential real property and has been terminated under applicable non-bankruptcy law prior to the order for relief."

On direct appeal, the Seventh Circuit reversed, holding the lease terminations do fall within the broad definition of "transfers" set forth in § 105(54)(D) of the Bankruptcy Code. That section defines transfers as including "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property; or (ii) an interest in property." The Court found the Debtor had a valuable interest in property (e.g., the leaseholds) that it parted with by transferring them back to the landlord.

The Seventh Circuit also dismissed the Bankruptcy Court's concern for harmony between § 365(c)(3), on the one hand, and §§ 547 and 548, on the other. The Court pointed out that § 365(c)(3) is "aimed at facilitating the re-leasing of commercial property during bankruptcy proceedings by forbidding the trustee to interfere with the occupancy of the new tenants." Therefore, allowing the creditors' committee to recover the value of the terminated leases, not the leases themselves, is not inconsistent with the purpose of § 365(c)(3).

Accordingly, the Seventh Circuit held the Landlord could be held liable to the bankruptcy estate for the value of the terminated leases if either (i) the Landlord received more as a result of the surrender than it would have received had the leases been part of the bankruptcy estate (i.e., the terminations were preferential transfers), or (ii) the Debtor received less than equivalent value for the terminated leases (i.e., the terminations were fraudulent transfers). The Court reversed and remanded the case to the Bankruptcy Court to determine the value of the transfers and, thus, whether the transfers could be avoided as preferential or fraudulent.

Takeaways

The Seventh Circuit's decision expands the already vast universe of potentially avoidable transfers by including a debtor's termination of a valuable lease. Notably, this decision follows on the heels of the Seventh Circuit's February 2016 decision holding the issuance of a tax deed to a tax certificate holder under Illinois law could be avoided as a constructively fraudulent transfer, and that the taxbuyer is therefore liable for the value of the property transferred.[4]

Whether the Seventh Circuit's liberal view of avoidable transfers is an outlier or a trailblazer remains to be seen. But for now, unsecured creditors should consider attempting to use the *Great Lakes Quick Lube* decision to their advantage, even outside the Seventh Circuit, by bringing preference or fraudulent transfer actions to challenge the termination of valuable leases or other executory contracts. On the other hand, landlords and others dealing with a potentially insolvent party should attempt to analyze the risk of a future clawback action in bankruptcy before consummating any transaction that could fall within the ever-expanding definition of "avoidable transfer."

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[4] *Smith v. SIPI, LLC, et al. (In re Smith)*, 811 F.3d 228 (7th Cir. 2016).