

## Seventh Circuit Holds Pre-Bankruptcy Termination of Lease May Be Avoidable Transfer

Landlords dealing with troubled tenants often enter into termination agreements that dictate terms for the consensual terminations of unexpired leases. Among other benefits, such termination agreements provide certainty and allow landlords to move on from unprofitable tenant relationships. Additionally, by entering into termination agreements, troubled tenants can be prevented from later assuming or assigning such terminated leases to an undesirable third-party if the tenant later files for bankruptcy. Generally, under section 365(c)(3) of the Bankruptcy Code, a debtor is prohibited from assuming or assigning a lease of nonresidential real property that has been terminated in accordance with applicable non-bankruptcy law prior to the bankruptcy being filed by the tenant.

We are alerting you to the recent decision of *In re Great Lakes Quick Lube LP*,<sup>1</sup> in which the Seventh Circuit held that the termination of a debtor's leasehold interest pre-bankruptcy via a termination agreement is subject to being set aside as either a preferential and/or fraudulent transfer under the Bankruptcy Code. In so holding, the *Great Lakes* decision has departed from prior case law, which held that pre-petition terminations of leases cannot be attacked as avoidable transfers because such a holding would conflict with the treatment of terminated leases under the aforesaid section 365(c)(3) of the Bankruptcy Code.<sup>2</sup> As a result, the *Great Lakes* decision could upset traditional commercial expectations and landlord/tenant contractual relationships.

### Factual Background and the Bankruptcy Court's Decision

In *Great Lakes*, the debtor operated a series of oil change and automotive servicing stores. Fifty-two days before filing for bankruptcy the debtor entered into a voluntary termination agreement with one of its landlords and relinquished its leasehold interest in five leases. Two of the stores operated by the debtor on premises covered by the subject leases were profitable for the debtor and three of the stores were unprofitable for the debtor. In exchange for surrendering the leases, the landlord released the debtor from all past and future rent obligations, deferred maintenance and real estate taxes.

After filing for bankruptcy, a Committee of Unsecured Creditors (the Committee) appointed in the bankruptcy case initiated an adversary action against the landlord to avoid the termination of the two profitable leases as a preferential transfer and/or a "constructively" fraudulent transfer under sections 547 and/or 548 of the Bankruptcy Code and sought to recover from the landlord the value of the leases for the two profitable store locations. In general terms, as applied in this case, a "preferential transfer" under section 547 of the Bankruptcy Code is the transfer of a debtor's interest in property to a favored creditor (here the landlord), on account of a debt owed, which is made while the debtor is insolvent, within 90 days prior to bankruptcy and resulted in the subject creditor receiving more than it would have otherwise received in bankruptcy.<sup>3</sup> Similarly, a "constructively" fraudulent transfer under section 548 of the Bankruptcy Code includes transfers made by an insolvent (or nearly insolvent) debtor to anyone within two years before the debtor's bankruptcy that gave the debtor less than reasonably equivalent value in exchange.<sup>4</sup> In this case, the Committee claimed that the leases for the profitable store locations were worth a combined \$777,000 to the debtor and that the transfer of such leases to the landlord enabled the landlord to receive more than it would have otherwise received in bankruptcy and/or the debtor received less than the reasonably equivalent value in exchange for agreeing to the termination of such leases.

The bankruptcy court disagreed with the Committee and sided with the landlord. After a two-day trial, the bankruptcy court entered an order dismissing the adversary action against the landlord, stating that the pre-petition termination of a lease under applicable non-bankruptcy law (i.e., state



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law) is not an avoidable “transfer” as used in sections 547 and/or 548 of the Bankruptcy Code. As the bankruptcy court stated, “the specific statutory provision regarding validly terminated nonresidential leases in § 365(c)(3) must control over the more general statutes allowing the avoidance of preferences and fraudulent transfers.”<sup>5</sup>

## Seventh Circuit Reverses Bankruptcy Court and Finds Pre-Bankruptcy Termination of Leasehold Interest May Be Avoidable Transfer

On direct appeal, the Court of Appeals for the Seventh Circuit reversed the bankruptcy court and held that the termination of a lease pre-petition can be avoided as a preferential and/or fraudulent transfer. As an initial matter, the Seventh Circuit explained that the definition of “transfer” under the Bankruptcy Code is broad, including any transfer of a debtor’s interests in property. Furthermore, in this case, the debtor “had an interest in property – namely the leaseholds – which it parted with by transferring that interest to [the landlord]” through the termination agreement.<sup>6</sup> Accordingly, the termination of the subject leases can be attacked as an avoidable transfer if the debtor received less than reasonably equivalent value for the terminated leases or if the landlord received more as a result of the termination than it would have otherwise received in bankruptcy if the termination agreement had not been executed.

The Seventh Circuit also clarified that section 365(c)(3) of the Bankruptcy Code is not in conflict with the potential avoidance of a pre-bankruptcy termination of a lease. By seeking to avoid the termination of the leases, the Committee is not seeking to assume or assign the underlying leases but rather the return of “the value of the leases that [the debtor] transferred to [the landlord].”<sup>7</sup>

This distinction between the value of the leases (the value to which the creditors may be entitled) and the leases themselves (which cannot lawfully be transferred to them) enables the purpose of section 365(c)(3) to be fulfilled without making inroads into [the definition of transfer under the Bankruptcy Code].<sup>8</sup>

Accordingly, the Seventh Circuit reversed the judgment of the bankruptcy court and remanded with instructions for the bankruptcy court to determine the value of the terminated leases and/or whether the landlord had any defenses to the preference and fraudulent conveyance claims.

## Takeaways

The *Great Lakes* decision should serve as a cautionary tale for landlords entering into termination agreements and/or otherwise terminating leases with financially troubled tenants. Although not a settled issue of law in all circuits, the *Great Lakes* decision provides ammunition for future attacks on pre-petition terminations of a tenant’s leasehold interest as either a preferential and/or fraudulent transfer.

To reduce exposure to such avoidance actions, landlords should be diligent in documenting the value (or lack thereof) of such leases to tenants, including an analysis of any potential liability for non-payment of rent and/or other defaults and/or other current or future obligations (including obligations for lease rejection damages under Section 502(b)(6) of the Bankruptcy Code) of the tenant under the subject lease. A potential defense against such avoidance actions can be the value provided by the landlord to the tenant in exchange for entering into a termination agreement. As such, landlords entering into termination agreements should consider **specifically identifying** in the termination agreement any value being exchanged for the termination (i.e., the value of released claims against the tenant for unpaid rent, return of any deposits and/or release of letters of credit, the release of defaults and/or other obligations of the tenant under the subject lease). If possible, landlords should try to extract consent to such values being exchanged and/or lease burdens as part of the termination agreement with the tenant. Although not necessarily dispositive, the more documentation of the burden of the subject leases to the troubled tenant and/or the value transferred to the tenant as part of the agreement, the more likely a landlord may be to convince potential plaintiffs and/or the bankruptcy courts that such transactions are not avoidable as fraudulent or preferential transfers.

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**To discuss any questions you may have regarding the opinions discussed in this Alert, or how they may apply to your particular circumstances, please contact a member of Cozen O'Connor's Bankruptcy, Insolvency & Restructuring Practice Group.**

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<sup>1</sup> *Official Comm. of Unsecured Creditors of Great Lakes Quick Lube LP v. T.D. Invests. I, LLP (In re Great Lakes Quick Lube LP)*, --- F.3d ---, 2016 WL 930298 (7th Cir. Mar. 11, 2016).

<sup>2</sup> See *In re 421 Willow Corp.*, 2003 WL 22318022, at \*6 (Bankr. E.D. Pa. Oct. 9, 2003) ("a prepetition termination of a nonresidential lease cannot be avoided by the more general provisions of Section 547 and 548"); see also *In re Egyptian Bros. Donut, Inc.*, 190 B.R. 26, 29 (Bankr. D.N.J. 1995) (declining to find that terminated agreement could be avoided "since such a consequence ... violates the express language of Code § 365(c)(3)").

<sup>3</sup> 11 U.S.C. § 547(b).

<sup>4</sup> 11 U.S.C. § 548(a)(1).

<sup>5</sup> See *Official Comm. of Unsecured Creditors of Great Lakes Quick Lube LP v. T.D. Invests. I, LLP (In re Great Lakes Quick Lube LP)*, 528 B.R. 893, 898 (Bankr. E.D. Wis. 2015).

<sup>6</sup> *Great Lakes*, 2016 WL 930298 at \*3.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*