

## Publication

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### Client Alert: Back From the Dead: Voluntarily Terminating a Distressed Tenant's Lease May Give Rise to an Avoidance Action in Bankruptcy Against the Landlord

A recent decision by the U.S. Court of Appeals for the Seventh Circuit should prompt landlords to give careful consideration before entering into a lease termination agreement with a distressed tenant.

In *In re Great Lakes Quick Lube LP*, 2016 U.S. App. LEXIS 4560 (7th Cir. Mar. 11, 2016), the Seventh Circuit reversed and remanded a bankruptcy court's decision dismissing an adversary proceeding brought by the Official Committee of Unsecured Creditors. In the adversary proceeding, the Committee sought to avoid the pre-petition terminations of two commercial leases. On the somewhat unique facts presented in the case, the debtor and the landlord voluntarily terminated the leases less than two months before the bankruptcy case, even though the debtor's stores at those locations were profitable.

Section 547(b) of the Bankruptcy Code allows the trustee, debtor-in-possession, or a party granted derivative standing (in this case the Committee), to "avoid" certain transfers within the 90 days leading up to bankruptcy. Additionally, section 548(a)(1) of the Bankruptcy Code provides for avoidance of "constructive" and "actual" fraudulent transfers. The Committee advanced both

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preference and fraudulent transfer theories in the adversary proceeding, and it also asserted that the value of the terminated leases belonged to the debtor's bankruptcy estate (with any value to be distributed pro rata amongst the debtor's creditors).

The bankruptcy court, following case law from the 1980s and 1990s, held that the lease terminations did not constitute transfers, and so could not be avoided. The bankruptcy court heard evidence from the debtor's president that the debtor terminated the leases for a variety of reasons, including: (i) a strained relationship with the landlord; (ii) fear of eviction because it had fallen behind on its rent (though not nearly as much as the debtor's president thought at the time); and (iii) hope that the lease terminations would help the debtor avoid bankruptcy and continue operating. Even though the debtor eventually found itself in bankruptcy, the landlord argued that the ongoing maintenance, repairs and other obligations required for the leased properties ultimately would have caused the debtor to lose money. Because the bankruptcy court found that the terminations were not "transfers," it did not decide: (1) whether the debtor received reasonably equivalent value in exchange for the surrender; or (2) whether the landlord received more than it would have received had the leases not been terminated.

On a direct appeal to the Seventh Circuit, the appellate court focused on the very broad definition of "transfer" in the Bankruptcy Code. The Code defines "transfer" as "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." 11 U.S.C. § 101(54)(D). The Seventh Circuit held that this broad definition included the debtor's "transfer" of its leasehold interest in property to the landlord — a creditor. Consequently, the landlord became the sole recipient of assets (the leasehold interests) that otherwise would have been available for monetization and distribution pro rata

to all creditors (e.g., through assumption and assignment of the leases to a new tenant). To that point, the Seventh Circuit specifically noted that, following termination, the landlord leased the properties to a competitor of the debtor. The Committee also offered evidence that the total value of the terminated leases to the debtor was between \$327,000 and \$450,000.

The Seventh Circuit remanded the matter to the bankruptcy court, with directions to determine: (1) the value of the debtor's transfers to the landlord; and (2) whether the landlord had any defenses to avoidance. So, the litigation did not conclude simply as a result of this opinion. But the Seventh Circuit's decision makes clear that such voluntary lease terminations are ripe for avoidance, especially when the leases may have value, such as when the rent under the leases is below market rates.

It is unclear from the opinion whether the Seventh Circuit would view as preferential a pre-petition lease termination pursuant to a landlord's contractual right (e.g., after a default under the lease), rather than voluntary termination by the parties' agreement. But the implication of the opinion is that such a termination also would qualify as a preference and/or a fraudulent transfer. The Bankruptcy Code is clear that a transfer does not require intent or volition, so such an involuntary (on the part of the debtor) termination may give rise to a preference under section 547(b) or a constructive fraudulent transfer under section 548(a)(1)(B). Although the bankruptcy court cited several cases for the proposition that leases validly terminated are not subject to avoidance, the efficacy of these cases — at least in the Seventh Circuit — is now in doubt.

Consequently, before proceeding with termination of a distressed tenant's lease, it would be prudent for the landlord to consult bankruptcy counsel to consider the "value(s)" received by the landlord for the lease



termination. Armed with this information, the landlord will be better equipped to defend against any potential preference or fraudulent transfer claims that may be asserted in the future.