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## Feature

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### Lessors Beware

#### Lease Termination Might Give Rise to Fraudulent Transfer or Preference Claims



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The retail sector has been experiencing significant distress lately. A number of retailers are liquidating, and many more are seeking to reduce their brick-and-mortar footprints to avoid bankruptcy. Lessors negotiating lease terminations with tenants in financial distress should be aware of two recent circuit court decisions highlighting a growing risk that a tenant's creditors might seek to claw back the value of the terminated lease if the tenant ends up in bankruptcy.

Bankruptcy courts have struggled with the issue of whether a noncollusive, pre-petition lease termination constitutes a transfer of an interest in property,<sup>1</sup> and even if it is a transfer, whether it can be avoided as a preferential or fraudulent transfer under § 547 or 548 of the Bankruptcy Code.<sup>2</sup> The issue has typically arisen in the context of a trustee seeking to avoid a pre-petition lease termination, and to thereafter assume and assign the revived agreement. In this context, many bankruptcy courts have strained to conclude that a noncollusive transfer may not be avoided, at times heavily relying on policy considerations and the potential negative impact of a contrary holding on the real estate markets.<sup>3</sup> Prior to 2016, the circuit-level authority appeared to support

the conclusions reached by the majority of the lower courts that a noncollusive pre-petition lease termination could not be avoided.<sup>4</sup>

Recent decisions from two different circuits have given rise to lessor concerns about the continued viability of lower court decisions protecting pre-petition lease terminations from avoidance, particularly when the trustee is seeking to recover money damages from the lessor (as opposed to attempting to resurrect, and then assume and assign, a previously terminated lease). Following the Fifth Circuit's decision in *Hometown 2006-1 1925 Valley View LLC v. Prime Income Management LLC*<sup>5</sup> and the Seventh Circuit's decision in *In re Great Lakes Quick Lube LP*,<sup>6</sup> the lessor's analysis of whether (and how) to terminate a lease pre-petition has become considerably more complicated, requiring significant review of the facts and circumstances underlying each lease, as well as consideration of whether and under what conditions the lessee might commence a bankruptcy case.

#### Great Lakes Quick Lube

Great Lakes Quick Lube operated more than 100 automotive service centers throughout the Midwest and leased many of its stores pursuant to net lease arrangements, including five stores leased from TD Investments.<sup>7</sup> Great Lakes' operations took a turn for the worse, and in February 2012 it negotiated a voluntary termination of its five leases with TD Investments.<sup>8</sup> The termination

1 See, e.g., *Pettie v. Ringo (In re White)*, 559 B.R. 787, 798-800 (Bankr. N.D. Ga. 2016) (collecting cases supporting both positions, and holding that voluntary pre-petition lease termination constitutes transfer); *Metro Water & Coffee Servs. Inc. v. Rochester Cnty. Baseball Inc. (In re Metro Water & Coffee Servs. Inc.)*, 157 B.R. 742, 745 (Bankr. W.D.N.Y. 1993) (similar). But see, e.g., *Haines v. Regina C. Dixon Tr. (In re Haines)*, 178 B.R. 471, 474-77 (Bankr. W.D. Mo. 1995) (noncollusive lease termination was not a transfer); *Creditors' Comm. for Jermoo's Inc. v. Jermoo's Inc. (In re Jermoo's Inc.)*, 38 B.R. 197, 203-06 (Bankr. W.D. Wis. 1984) (same).

2 See, e.g., *In re Egyptian Bros. Donut Inc.*, 190 B.R. 26, 28-31 (Bankr. D.N.J. 1995) (holding that §§ 547 and 548 cannot be used to avoid lease termination even if termination was a transfer). But see, e.g., *Fitzgerald v. Cheverie (In re Harvey Co.)*, 68 B.R. 851, 859-60 (Bankr. D. Mass. 1985) (holding that lease termination constituted fraudulent transfer, and appropriate remedy was to reinstate lease for assumption or rejection by trustee).

3 See, e.g., *Haines*, 178 B.R. at 475 ("The avoidance of noncollusive pre-petition lease terminations as fraudulent transfer presents significant policy considerations ... [and could] introduce a significant degree of uncertainty into the termination of leases and the transfer, mortgaging, and insurance of property that has been the subject of a lease termination.") (internal quotation marks and citations omitted).

4 See *Allan v. Archer-Daniels-Midland Co. (In re Commodity Merchs. Inc.)*, 538 F.2d 1260, 1263-64 (7th Cir. 1976) (cancellation of contracts that were not freely assignable was not "transfer").

5 *Hometown 2006-1 1925 Valley View LLC v. Prime Income Asset Mgmt. LLC*, 847 F.3d 302, 305-06 (5th Cir. 2017).

6 *Official Comm. of Unsecured Creditors of Great Lakes Quick Lube LP v. T.D. Invs. I LLP (In re Great Lakes Quick Lube LP)*, 816 F.3d 482, 484-86 (7th Cir. 2016).

7 *Id.* at 484.

8 *Id.*

agreement covered all five stores, including two profitable stores.<sup>9</sup> According to Great Lakes, the termination followed months of a strained relationship and increasingly aggressive demands by TD Investments.<sup>10</sup> Great Lakes asserted that even though the two stores in question were operating profitably, the deferred maintenance costs and other expenses that it would incur pursuant to the lease agreements would greatly reduce or eliminate the profitability of these stores.<sup>11</sup> Great Lakes claimed that terminating all of the leases was in its best interest because the termination agreement eliminated its payment and performance obligations with respect to the unprofitable sites and included a complete release of all claims by TD Investments.<sup>12</sup>

The unsecured creditors' committee brought a fraudulent transfer and preferential transfer action against TD Investments, seeking to recover the value of the two profitable leases.<sup>13</sup> The bankruptcy court dismissed the complaint, holding that the relinquishment of a leasehold interest did not constitute a "transfer" that could be avoided pursuant to the Bankruptcy Code.<sup>14</sup> However, the Seventh Circuit reversed, noting that "transfer" is broadly defined in § 101(54)(D) of the Bankruptcy Code to include "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."<sup>15</sup> The Seventh Circuit held that "Great Lakes had an interest in the property — namely the leaseholds — which it parted with by transferring that interest to T.D. That was a transfer to one creditor of what might have been an asset to Great Lakes' other creditors had the transfer not taken place; and if so, it was a preferential transfer and therefore avoidable."<sup>16</sup>

In its short three-page decision, the Seventh Circuit did not cite any case law standing for the proposition that termination of a lease constitutes a "transfer" under § 101(54)(D), instead relying solely on the statute's language. The Seventh Circuit also did not mention — let alone distinguish or reject — its two earlier decisions, *Commodity Merchants* and *Wey*,<sup>17</sup> which several lower courts relied on to hold that a noncollusive termination of an agreement does not constitute a transfer of an interest in the property.<sup>18</sup> The Seventh Circuit remanded the case for a determination of the value, if any, of the transfers to TD Investments, and also whether TD Investments had any defenses to the claims.<sup>19</sup>

## Prime Income

In *Prime Income*, the Fifth Circuit addressed whether a voluntary pre-petition termination of asset-management agreements constituted a fraudulent transfer under the Texas Uniform Fraudulent Transfer Act (TUFTA). The agreements at issue were assignable only by mutual consent and were terminable at will, but they required 60-day written notice

prior to termination to avoid a termination penalty.<sup>20</sup> The lower court held that the contracts were not "assets" covered by TUFTA, thus no transfers occurred when the agreements were terminated.<sup>21</sup>

**Lessors should document — and be prepared to demonstrate — that any action taken by the lessor was within its rights under the lease and permitted by applicable state law, and that reasonably equivalent value was exchanged.**

In reversing the lower court, the Fifth Circuit ostensibly agreed with the two Seventh Circuit decisions relied upon by the lower court, *Commodity Merchants* and *Wey*, without mentioning the more recent Seventh Circuit *Great Lakes Quick Lube* decision. The Fifth Circuit approvingly cited *Commodity Merchants* for the proposition that "[t]he essence of a transfer is the relinquishment of a valuable property right," noting that because at the time of termination the debtor in *Commodity Merchants* had no right to the commodities that were the subject of the contract, cancellation of that contract did not constitute a transfer.<sup>22</sup> The Fifth Circuit also approvingly cited *Wey*, a case involving forfeiture of a real estate down payment where the down payment was delivered outside of the preference period, but the sale contract was terminated for breach within the preference period.<sup>23</sup>

However, the Fifth Circuit then held that "[t]he rub is that the contracts here were not freely terminable."<sup>24</sup> Unlike the agreements in *Commodity Merchants* and *Wey*, which were "freely terminable" upon default, the *Prime Income* agreements provided for termination only upon 60 days written notice. In light of this distinction, the Fifth Circuit held that a "[w]aiver of the sixty-day notice period effected a transfer of the right to continue performance under the Agreements and receive the payments due thereunder, payments [that] had ascertainable value and were sufficiently vested to constitute 'assets' under TUFTA's broad definition of 'anything that may be the subject of ownership.'"<sup>25</sup> The Fifth Circuit also disagreed with the defendants' argument that "the presence of a nonassignment clause renders the contracts valueless:"

That the contracts themselves are not assignable does not render the stream of income and the opportunity to perform services within the sixty-day notice period valueless. While the presence of the non-assignment clause dampens the market value of the [contracts], the right to perform and collect revenue during the sixty-day notice period still had value and was an asset under TUFTA.<sup>26</sup>

9 *Id.* at 484-85.

10 *Id.*

11 *Id.* at 485.

12 *Id.* at 484-85.

13 *Id.*

14 *Id.* at 484.

15 *Id.* at 485.

16 *Id.*

17 *Commodity Merchs.*, 538 F.2d 1260, and *Sullivan v. Willock (In re Wey)*, 854 F.2d 196, 199-200 (7th Cir. 1988).

18 See, e.g., *Jermoo's*, 38 B.R. at 205; *In re Great Lakes Quick Lube LP*, 528 B.R. 893, 897 (Bankr. E.D. Wis. 2015).

19 *Great Lakes Quick Lube*, 816 F.3d at 486.

20 *Prime Income Asset Mgmt. LLC*, 847 F.3d at 305-06.

21 *Id.* at 306.

22 *Id.* at 307-08 (citing *Commodity Merchs.*, 538 F.2d at 1262-64).

23 *Id.* at 308 (agreeing that "[w]hen a termination is pursuant to the terms of the contract, there is no transfer") (quoting *Wey*, 854 F.2d at 197-98 (forfeiture of down payment and extinguishment of equitable interest in real estate was not a transfer)).

24 *Id.*

25 *Id.* (quoting Tex. Bus. & Comm. Code Ann. § 24.002(10)).

26 *Id.* at 309.

In some respects, the logic of *Prime Income*, *Great Lakes Quick Lube* and the earlier Seventh Circuit decisions simply cannot be reconciled. However, there are common threads. The courts' analyses often hinge on whether the contract was assignable and terminable at will.<sup>27</sup> A contract that is terminable at will and unassignable likely has no fair market value. Accordingly, while several of the circuit and lower courts have framed the question as one of whether a "transfer" of an interest in property occurred when the contract was terminated, a more precise framework might be whether the contract had any value at the time of termination.<sup>28</sup> If the contract is terminable at will and is unassignable, it likely has no intrinsic market value. Indeed, had the asset management agreements been assignable or of a specified duration, the *Prime Income* court very well could have found potential damages exceeding the 60-day revenue stream guaranteed under the contract.<sup>29</sup>

## The Lessor's Dilemma

The *Prime Income* and *Great Lakes Quick Lube* decisions are problematic from the lessor's point of view, particularly in the current distressed retail environment. Retailers throughout the U.S. are reducing their brick-and-mortar footprints by way of store closures and the negotiated termination of leases. A lessor negotiating with a distressed retailer faces a real catch-22: If the lease is terminated pre-petition, the lessor may take possession and re-let the property, and will typically receive a termination payment, but the lessor faces the risk of an avoidance action seeking to recover the value of the terminated lease after the retailer files for bankruptcy, potentially years later. Once viewed to be relatively low risk, these types of claims might become increasingly common as estate fiduciaries in retail bankruptcy cases investigate and pursue avoidance actions to enhance meager creditor recoveries.

On the other hand, if the lessor waits until a bankruptcy proceeding is commenced, the risk of an avoidance action is eliminated, but the lessor might become embroiled in a messy bankruptcy case. Instead of a terminated lease, the lessor may end up with its lease assigned to an undesirable tenant, may be delayed in taking the property back, or may be left with only pennies on the dollar in rejection damages.

In weighing its termination risks, a lessor should consider the anticipated use of the property post-termination. If the lessor has a new tenant waiting in the wings who is willing to make considerably higher monthly lease payments on otherwise-comparable terms, it will be much easier for an estate fiduciary to estimate the terminated lease's market value and later bring an avoidance action to recover what will be argued to be a lessor windfall. This does not necessarily mean that the lessor should not terminate the lease; rather, the lessor simply needs to take into account the increased risk of a subsequent avoidance action in which some or all of what will be alleged to be a windfall might be lost. However, if no comparable replacement lease terms

exist post-termination (e.g., the property will be redeveloped for other uses or a new lease will include additional properties), the estate fiduciary will need to look to other extrinsic evidence of value, making it considerably more difficult to investigate and bring a fraudulent transfer cause of action against the lessor. Depending on the circuit, the lessor must also consider such factors as whether the lease is freely assignable or terminable at will.

Lessors should document — and be prepared to demonstrate — that any action taken by the lessor was within its rights under the lease and permitted by applicable state law, and that reasonably equivalent value was exchanged. Lease-termination agreements should clearly state any existing defaults and the value of the current and future rent obligations that are being forgiven (including the projected costs of maintenance, repairs, insurance and taxes), and should include a mutual release of all obligations. If feasible, the lessor should obtain a contemporaneous valuation of the lease and maintain that documentation in its file. If there is a third-party guarantor on the lease, the lessor should also consider requiring that any guarantor provide an indemnification against future avoidance actions. No matter what termination decision the lessor makes, the *Prime Income* and *Great Lakes Quick Lube* decisions highlight risks for terminating lessors that should be taken into account whenever advising a lessor that is contemplating a pre-petition lease termination. **abi**

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<sup>27</sup> See, e.g., *id.* at 308; *Commodity Merchs.*, 538 F.2d at 1263.

<sup>28</sup> Several lower courts have used this approach, including *White*, 559 B.R. at 203-06.

<sup>29</sup> See *Prime Income*, 847 F.3d at 306 ("While the presence of the nonassignment clause dampens the market value of the [contracts], the right to perform and collect revenue during the sixty-day notice period still had value.")