

Real Estate, Restructuring and Bankruptcy

Landlords Beware: Termination of a Distressed Tenant's Lease May Be Voidable In Bankruptcy

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On March 11, 2016, the Seventh Circuit ruled that a distressed company's termination of a lease pursuant to an agreement with its landlord and the relinquishment of its leasehold interest to its landlord constituted "transfers" that may be avoidable as fraudulent transfers and preferences under the Bankruptcy Code. The decision, *Official Comm. Of Unsecured Creditors v. T.D. Invs. I, LLP (In re Great Lakes Quick Lube LP*, 816 F.3d 482 (7th Cir. 2016)), serves as a cautionary tale for landlords dealing with distressed tenants.

Background

Great Lakes Quick Lube owned and operated more than 100 automotive oil change and service center stores throughout the Midwest. Great Lakes leased many of its stores pursuant to net lease arrangements, including five stores Great Lakes leased from T.D. Investments. Great Lakes operations took a turn for the worse and, in February 2012, a mere 52 days before it declared bankruptcy, Great Lakes negotiated the termination of its leases with T.D. The termination agreement related to all five stores, including two profitable stores. The termination of the leases for profitable stores was the subject of the Seventh Circuit's decision.

According to Great Lakes, the termination followed months of a strained relationship and increasingly aggressive demands by T.D. Moreover, Great Lakes believed that, even though the two stores in question were operating profitably, deferred maintenance costs and other expenses it would incur pursuant to the lease agreements could greatly reduce or eliminate profits from these stores. As a result, Great Lakes determined that terminating all of the leases was in its best interest because the termination agreement would eliminate its payment and performance obligations with respect to the sites and would include a complete release of all claims by T.D. Similarly, T.D. maintained that the lease termination agreement enabled Great Lakes to "rid itself of locations that were burdensome to its operations with the hopes that such action would allow it to avoid bankruptcy and continue operating." *Id.* at *2.

No matter the motivation, once in bankruptcy, the committee appointed to represent the unsecured creditors and pursue potential recoveries brought fraudulent transfer and preferential transfer actions against T.D. with respect to the two profitable leases. The Bankruptcy Court dismissed the committee's case, holding that the relinquishment of a leasehold interest did not constitute a "transfer" that could be avoided pursuant to the Bankruptcy Code. The Seventh Circuit, however, reversed this ruling and noted that "transfer" is defined by the Bankruptcy Code broadly 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." 11 U.S.C. § 101(54)(D). Thus, 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." *Id.* at *3.

It is important to note, however, that the Seventh Circuit opinion addressed only whether or not the relinquishment of the lease constituted a “transfer.” Because the bankruptcy judge had ruled that the

relinquishment of the leasehold interests did not constitute “transfers” under the Bankruptcy Code, the bankruptcy court did not reach the key issue of whether reasonably equivalent value was exchanged. It also did not reach any of the potential defenses available to T.D., including whether it received the transfers in good faith (i.e. without inquiry notice of Great Lakes’ financial distress) and if the transfers were characterized as preferences, whether T.D. received the transfers in the ordinary course of business. Now that the Seventh Circuit has reversed, it will be up to the bankruptcy court on remand to rule on these issues.

Key Take-A-Ways

The ascendance of Amazon and other “disruptive” retailers to the top of the retail sector food chain has thrown many traditional bricks-and-mortar retailers into a state of financial distress. Recent bankruptcies in the retail space include Radio Shack, Sports Authority, Aeropostale, PacSun, Quicksilver, Wet Seal, Delia’s and Vestis Retail Group (which manages Eastern Mountain Sports, Bob’s Stores and Sport Chalet). And in nearly all retail bankruptcies, there is no reorganization, only liquidation.

Because of this dislocation in the retail sector, there are increasing vacancies in malls, and many malls are closing altogether. In addition, when one tenant files for bankruptcy and goes dark, co-tenancy clauses can wreak havoc on both the landlord and other retailers on the property. Landlords should proceed with caution when dealing with distressed tenants and be sure to document (and be prepared to demonstrate) that any action taken by the landlord was within the landlord’s rights under the lease and permitted by applicable state law, and that reasonably equivalent value was exchanged. For example, lease termination agreements should clearly delineate the nature of the defaults under the lease and the value of the current and future rent obligations that are being forgiven (including the projected costs of maintenance, repairs, insurance and taxes) in connection with the lease termination, and should include a mutual release of all current and future payment and performance obligations. In addition, if a landlord believes a lease it is terminating could be considered to be below market, including a valuation of the lease in the file to demonstrate that the value of the lease is reasonably equivalent to what was exchanged may assist in persuading a bankruptcy trustee not to pursue the transfer as a fraudulent transfer.

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