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Third Circuit: Pre-Bankruptcy Commercial Lease Termination Not Fraudulent Transfer

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Is an insolvent debtor's pre-bankruptcy termination of a commercial lease a fraudulent transfer? The Third Circuit said no when it held that a lessor's pre-bankruptcy termination of the debtors' lease and purchase option "was not a transfer under Bankruptcy Code §548(a)(1)(B)." *In re Pazzo Pazzo Inc.*, 2022 WL 17690158 (3d Cir. Dec. 15, 2022). But the Seventh Circuit held that a chapter 11 debtor's pre-bankruptcy "surrender of [two] … leases to [its landlord] could be regarded as a preferential [or fraudulent] transfer." *In re Great Lakes Quick Lube L.P.,* 816 F.3d 482 (7th Cir. 2016). Reversing the bankruptcy court's holding that "the terminations were [not] transfers, … preferential or fraudulent," the Seventh Circuit stressed that the debtor's termination of its "interest in property — … the leaseholds — which it parted with by transferring that interest to [the landlord]," fell within the broad definition of "transfer" in the Bankruptcy Code (Code). *Id*. at 485. A close reading of both *Pazzo* and *Great Lakes*, however, shows that the circuits are not split, and that the reasoning of both courts can be reconciled on their facts.

Pazzo

The debtors in *Pazzo* had intended to abandon their property, receiving the lessor's ample notice of termination of a lease and repurchase option. Their "radio silence" after receiving warning notices from the lessor, based on their non-payment of taxes and utility bills, their lapsed liquor and food licenses, their non-existent employment force and multiple maintenance issues, "provided ample grounds for the finding that the debtors had intended to vacate the premises." On these facts, the bankruptcy court properly held the lease to have been abandoned. Indeed, the debtors knew that the lessor considered the lease and option to be terminated, but they never responded. They made no claim of an interest in the lease or the option until after filing a bankruptcy petition several months later. Although the purchase option was a "future contingent interest protected under the Bankruptcy Code," the debtors' "failure to convert this contingent interest into actual ownership did not amount to" disposing or parting with their property "interest." *Id*. at *4. Thus, the debtors "did not transfer their option rights," but only "failed to pursue a business opportunity" by allowing that property interest to lapse. They no longer had a property interest before they even commenced their bankruptcy case. Termination of the option was therefore not a "transfer" under Code §548(a)(1)(B).

Great Lakes

The facts in *Great Lakes* were different. The debtor there operated a number of retail stores and had "negotiated the termination of the leases [on two stores] 52 days before bankruptcy." At the time, the debtor was in serious financial trouble and had agreed with the landlord "to terminate the two leases… even though the leased stores were profitable." 816 F.3d at 485.

The creditors' committee in the *Great Lakes* Chapter 11 case later sued the landlord, alleging that the

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"termination was either a preferential or fraudulent transfer of the leases … and that whichever it was the value of the lease belongs to the bankrupt estate and should therefore be available to … creditors." According to the Seventh Circuit, the "transfer alleged is the surrender by [the debtor] of the two leases [it] had previously obtained from the landlord]." The parties disputed whether the debtor had received reasonably equivalent value, but the bankruptcy court avoided the issue by ruling that the "terminations had not been transfers."

The Seventh Circuit reversed the bankruptcy court, stressing "that the leases would have had … significant value to creditors of the bankrupt estate." Thus, the debtor's "surrender of the leases … could be regarded as a [preferential or fraudulent] transfer." *Id*. It rejected the landlord's argument that the debtor had "abandoned" the leases, as had been done in *Pazzo*. According to the court, Code §101(54)(D) "defines 'transfer' broadly" so as 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*." (emphasis in original). Because the leaseholds were "an interest in property," and because the debtor had transferred that interest to the landlord, it would have been available to the debtor's "other creditors had the transfers not taken place." *Id*. Accordingly, the creditors' committee was justified in asserting preference and fraudulent transfer claims against the landlord.

Broad Definition of 'Transfer'

Courts have wrestled with the definition of "transfer" in the bankruptcy context. *See*, *e.g.*, *In re Cristwell*, 102 F.3d 14111415 (5th Cir. 1997) ("[T]he definition of 'transfer' under the Bankruptcy Code is comprehensive and includes every conceivable mode of alienating property, whether directly or indirectly, voluntarily or involuntarily."); S. Rep. No. 989, 95th Cong., 2d Sess. 27 (1978) ("the definition of transfer is as broad as possible."); *but see*, *In re Wey*, 854 F.2d 196 (7th Cir. 1988) (forfeiture of down payment pursuant to contract does not qualify as a "transfer").

Interest of Debtor In Property

Whether a debtor has transferred its property, as required by Code §§547(b) and 548(a) has generated litigation because the Code does not define "an interest of the debtor in property." *See*, *e.g.*, *Begier v. IRS*, 496 U.S. 53, 58 (1990) ("property that would have been part of the estate had it not been transferred before" bankruptcy); *Butner v. U.S.*, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights and the assets of a [debtor's] estate to state law."); *In re Computrex*, 403 F.3d 807 (6th Cir. 2005) (funds transferred from manufacturer to debtor for sole purpose of allowing debtor to pay manufacturer's carriers held not property of debtor's estate although commingled by debtor with funds belonging to other clients).

The Uniform Voidable Transactions Act

Section 8(e)(1) of the Uniform Voidable Transactions Act (UVTA) (https://bit.ly/42VHaP1), formerly known as the Uniform Fraudulent Transfer Act, provides as follows ("A transfer is not voidable under Section 4(a)(2) or Section 5 if the transfer results from … termination of a lease upon default by the debtor when the termination is pursuant to the lease and applicable law…." According to the official comments, "subsection (e) rejects the rule adopted in" *Darby v. Atkinson* (*In re Farris*), 415 F. Supp. 33, 39-41 (W.D. Okla. 1976) (termination of lease on default in accordance with its terms and applicable law may constitute a fraudulent transfer). *See*, *In re Jermoo's Inc.*, 38 B.R. 197, 205 (Bank. W.D. Wisc. 1984) (rejecting Farris as "anomalous"; no fraudulent transfer when contract "right … terminated according to the terms of the agreement ….").

Conclusion

Pazzo and *Great Lakes* are reconcilable. In *Pazzo*, the debtors allowed their interest in their lease and purchase option to expire by its terms prior to bankruptcy. On the date of bankruptcy they had no property interests and had not transferred anything. In contrast, the debtor in *Great Lakes* did have a valid property interest in its leases and did transfer the leases by surrendering them to the landlord for less than reasonably equivalent value. Significantly, the UVTA §8(a)(1) recognizes this distinction, confirming the correctness of the Third Circuit's *Pazzo* decision. The lease and purchase options there had terminated "upon default… pursuant to the lease and applicable law."