

# Alert

## Seventh Circuit Holds Lease Termination to Be Voidable Transfer

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A Chapter 11 debtor's pre-bankruptcy "surrender of [two] ... leases to [its landlord] could be regarded as a preferential transfer," held the U.S. Court of Appeals for the Seventh Circuit on March 11, 2016. *In re Great Lakes Quick Lube LP*, 2016 WL 930298, at \*2 (7th Cir. March 11, 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 — mainly 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 \*3.

### Relevance

Courts have long wrestled with the definition of "transfer" in the bankruptcy context. *See, e.g., In re Criswell*, 102 F.3d 1411, 1415 (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").

Whether a debtor has transferred its property also 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 in 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).

### Facts

The debtor 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." 2016 WL 930298, at \*1.

The creditor's committee in the Chapter 11 case later sued the landlord, alleging that the "termination was either a preferential or fraudulent transfer of the leases ... and that whichever it was the value of the leases 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.” *Id.*

### **Transfer of Debtor’s Property**

The Seventh Circuit, in reversing the bankruptcy court, stressed “that the leases would have had ... significant value to creditors of the bankrupt estate.” *Id.* at \*2. 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 the court reasoned, Code Section 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, that asset would have been available to the debtor’s “other creditors had the transfer had not taken place.” *Id.* at \*3. Accordingly, the creditors’ committee was justified in asserting preference and fraudulent transfer claims against the landlord.

### **Creditors Only Sought Value of Transferred Property**

The court also rejected the landlord’s reliance on Code Section 365(c)(3), which provides that the “trustee ... may not assume or assign any ... unexpired lease of the debtor ... if ... such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief.” In the court’s view, this section “is aimed at facilitating the re-leasing of commercial property during bankruptcy ... by forbidding the trustee to interfere with the occupancy of the new tenants.” Here, however, the creditors’ committee did not “want the leases; their action for the avoidance of the [preferential and fraudulent] transfers of the leases and recovery of the leases’ value ... did not require” the assumption or assigning of the leases, making Section 365 (c)(3) “inapplicable” to this case. Because the creditors were seeking “the *value* of the leases that [the debtor] transferred to the [landlord],” they were “not trying to evict anyone” (emphasis in original). *Id.* The court thus remanded the dispute to the bankruptcy court “to determine the value of [the debtor’s] transfer to [the landlord] and whether [the landlord] has any defenses to the creditors’ claims.” *Id.* at \*4.

Authored by [Michael L. Cook](#).

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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