

Client Alert

Financial Restructuring Practice Group

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Seventh Circuit Holds That Termination of a Commercial Lease Prior to Tenant's Bankruptcy May be an "Avoidable Transfer"

On March 11, 2016, the US Court of Appeals for the Seventh Circuit (the "Court") ruled that a termination of lease that occurred prior to the tenant's bankruptcy may be an "avoidable transfer" under title 11 of the United States Code (the "Bankruptcy Code"), thereby allowing the bankruptcy estate to recover the value of the lease from the landlord.¹

Background and Applicable Statutes

Prior to filing bankruptcy, Great Lakes Quick Lube LP (the "Debtor") leased more than 100 oil-change stores. Two of those leases were with T.D. Investments I, LLP (the "Landlord"). Fifty-two days before it filed bankruptcy, the Debtor agreed with the Landlord to terminate the two leases early, even though the leased stores were profitable.

After the Debtor filed bankruptcy, a committee was appointed to represent the unsecured creditors of the Debtor (the "Committee"). The Committee sought to recover the value of the terminated leases, asserting that the termination was avoidable under the Bankruptcy Code as either a preferential or a "constructive" fraudulent transfer and that the value of the leases should be available to the Debtor's creditors.

Section 547(b) of the Bankruptcy Code forbids "preferential transfers" by debtors. Generally speaking, a "preferential transfer" is a transfer made by an insolvent debtor within ninety days before filing bankruptcy to a creditor (in this case the Landlord) for a debt that gave the creditor more than if it had waited for the debtor's assets to be distributed in the bankruptcy proceeding.² Similarly, section 548(a)(1)(B) of the Bankruptcy Code prohibits "constructive" fraudulent transfers, which include transfers made by an insolvent (or nearly insolvent) debtor to anyone within two years before the bankruptcy that gave the debtor less than what it transferred. A trustee (or in this case an unsecured creditors committee) may seek to avoid these types of transfer and, thereby, recover property of the bankruptcy estate.

The Court's Reversal of the Bankruptcy Court's Decision

The Bankruptcy Court ruled in favor of the Landlord, concluding that the termination of leases was not an avoidable transfer because the termination

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was not a “transfer” as defined by law.³ Instead the Bankruptcy Code deals separately with the effect of terminated leases in Section 365(c) 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 non-bankruptcy law prior to the order for relief.”⁴

On direct appeal, the Court disagreed with the legal conclusion that a termination of lease is not a transfer, explaining that the Bankruptcy Code, in section 101(54)(D), defines “transfer” broadly, to include the parting with an interest in property.⁵ Here, the Debtor had an interest in property—the leaseholds—which it parted with by transferring the interest to the Landlord.⁶ Thus, if the Debtor received less than equivalent value for the surrendered leases or if the Landlord received more as a result of the surrender than it would have received had the leases been part of the bankruptcy estate, than the transfer was fraudulent or preferential. However, those value questions required factual findings by the Bankruptcy Court.

Accordingly, the Court reversed and remanded the case to the Bankruptcy Court for it to determine the value of the transfer and, thus, determine whether the transfer could be avoided as preferential or fraudulent.⁷

Conclusions

The Court’s decision in *Quick Lube* is a departure from prior cases that have held that the termination of a lease does not constitute a transfer subject to avoidance in bankruptcy. In determining whether to terminate a lease with a distressed tenant, Landlords should consider the impact of *Quick Lube* and the possibility that they will have exposure for the value of lease in a subsequent bankruptcy of the tenant.

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¹ *Official Committee of Unsecured Creditors of Great Lakes Quick Lube LP v. T.D. Investments I, LLP (In re Great Lakes Quick Lube LP)*, Case No. 15-2093 (7th Cir. Mar. 11, 2016).

² 11 U.S.C. §547(b).

³ *Quick Lube*, Case No. 15-2093 at 2.

⁴ 11 U.S.C. §365(c)(3).

⁵ *Quick Lube*, Case No. 15-2093 at 5. In doing so, the Court rejected the Landlord’s argument that section 365(c)(3) applied. *Id.* at 5-6. The Court held that the section did not apply because the Committee was not seeking to assume or assign the leases, but rather was seeking to avoid the transfer and recover value for the bankruptcy estate. *Id.* at 6-7.

⁶ *Id.* at 5. The Court drew the important distinction between the value of the leases (value to which the creditors may be entitled) and the leases themselves (which could not lawfully be transferred to them), explaining that the Committee could not seek to evict the current tenants but could recover from the Landlord the value of the terminated leases.

⁷ *Id.* at 7.