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Is Pre-Petition Termination of an Executory Contract a Fraudulent Transfer in the Seventh Circuit? Maybe . . . Maybe Not!

By Peter C. Blain*

A case decided by the U.S. Court of Appeals for the Seventh Circuit has caused insolvency attorneys in the Seventh Circuit to carefully review the advice they give on the question of whether a pre-petition termination of an agreement can be subsequently challenged as a fraudulent transfer. The author of this article reviews prior decisions on the issue and explains the Seventh Circuit's opinion.

When advising a counterparty to an executory contract with a financially distressed entity or individual, attorneys frequently advise their clients to consider terminating the agreement before the debtor seeks protection under the U.S. Bankruptcy Code.[1] This prevents the agreement from becoming property of the estate under Code Section 541 and being subject to the rules regarding assumption or rejection of executory contracts under Code Section 365. However, pre-petition termination raises the following question: Can the pre-petition termination of an agreement be subsequently challenged as a fraudulent transfer under Code Section 548?[2]

A case decided last year by the U.S. Court of Appeals for the Seventh Circuit has caused insolvency attorneys in the Seventh Circuit to carefully review the advice they give. In *Great Lakes Quick Lube LP v. T.D. Investments I, LLP.*,[3] the court concluded that, in the right circumstances, the answer to the above question might be "yes." At first blush, the decision appears to be inconsistent with prior Seventh Circuit precedent. However, a close reading of the facts of *Great Lakes* appears to reconcile the case with the court's prior decisions on the subject.

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1 11 U.S.C. § 101-1532 (the "Code").

2 Fraudulent transfer liability may also arise under applicable law pursuant to Code Section 544.

3 *Great Lakes Quick Lube LP v. T.D. Invs. I, LLP. (In re Great Lakes Quick Lube, LP),* 816 F.3d 482 (7th Cir. 2016).

THE PRIOR DECISIONS

In re Commodity Merchants, Inc.

The Seventh Circuit first addressed the issue of whether a pre-petition contract termination constitutes a fraudulent transfer in *Allan v. Archer-Daniels Midland Co.,*[4] a case decided under the prior Bankruptcy Act. After the debtor, Commodities Merchants, Inc. ("CMI") experienced severe financial difficulties, the counterparty, Archer-Daniels Midland Co. ("ADM"), sent a notice of termination of certain commodities contracts relying on the provisions in the contracts permitting termination in the event that CMI's financial position became unsatisfactory. Ten days later, CMI was adjudicated bankrupt.

In the bankruptcy case, CMI's trustee asserted that termination of the contracts constituted a transfer that was avoidable as a fraudulent transfer and/or an avoidable preference under the Act. Ruling in favor of ADM, the bankruptcy court and the district court found that no transfer occurred.

Affirming the lower courts, the Seventh Circuit found that the "essence of a transfer is the relinquishment of a valuable property right."[5] The court acknowledged the Bankruptcy Act's broad definition of transfer.[6] However, it noted that because the contracts were terminated pre-bankruptcy, ADM did not reacquire any rights from CMI. The court also found that a provision in the contract restricting the transfer of the contracts without ADM's consent precluded the terminated contracts from having market value.

In *dicta,* the court implied that if the contracts had been freely transferable, the trustee's argument that pre-bankruptcy termination deprived CMI of a property right to resell the contract may have had merit.[7] However, the limitations on alienability precluded the contracts from having any market value and reinforced the court's conclusion that no transfer occurred.[8]

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[4] *Allan v. Archer-Daniels Midland Co. (In re Commodity Merchs., Inc.),* 538 F.2d 1260 (7th Cir. 1976).

[5] *Id.* at 1263.

[6] *Id.*

[7] *Id.*

[8] *Id.* at 1264. In a Western District of Wisconsin case decided under the Code, *Creditors' Committee for Jermoo's Inc. v. Jermoo's Inc. (In re Jermoo's Inc.),* 38 B.R. 197 (Bankr. W.D. Wis. 1984), relying on *Commodity Merchants*, Judge Robert Martin found that a pre-petition termination of a franchise agreement which could not be transferred without Amoco's consent (which could not be unreasonably withheld) did not constitute a transferable property right, and therefore the termination was not subject to avoidance as a fraudulent transfer.

In re Wey

In *Sullivan v. Willock (In re Wey)*,[9] the Seventh Circuit revisited the issue of whether a pre-petition contract termination constituted a fraudulent transfer. The debtor contacted to purchase the Limetree Beach Hotel in the U.S. Virgin Islands for $5.2 million. Wey paid $520,000 as a 10 percent down payment, with the $4.6 million balance due on September 30, 1984. The contract provided that if Wey defaulted, the down payment would be forfeited. Wey defaulted, forfeited the deposit and, one month later on October 29, 1984, became the subject of an involuntary bankruptcy proceeding. Wey's bankruptcy trustee brought an adversary proceeding against the seller of the hotel, asserting that the forfeiture of the down payment was a fraudulent transfer or an avoidable preference.

The bankruptcy court ruled that no rights were transferred when Wey defaulted on the contract. On appeal, the district court found that there was a transfer, but that there was no antecedent debt. This precluded avoidance as a preference. The district court also found that Wey received reasonably equivalent value for the down payment, which prevented the transfer of the down payment to the seller from being avoided as a fraudulent transfer.

The Seventh Circuit began its analysis by referencing the definition of "transfer" in Code Section 101 as including "every mode, direct or indirect, absolute or contingent, voluntary or involuntary, of disposing of or parting with property or with an interest in property. . . ."[10] The court went on to discuss the bankruptcy court's reliance upon *Commodity Merchants* in holding that, upon payment of the down payment, Wey did not possess any rights which he could transfer.[11]

The trustee argued that, unlike *Commodity Merchants,* Wey was not the counterparty to a terminated commodities contract, but instead was a vendee of an equitable interest in real estate. The court found that when Wey breached the contract to buy the hotel, pursuant to the terms of the contract, he lost that equity interest and his down payment.[12]

The court found that the bankruptcy court correctly held that the seller did not receive any right that he did not already have when the contract was signed. The only transfer in connection with the transaction was Wey's initial tendering of the down payment to the seller. The court held that "what actually occurred

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[9] *Sullivan v. Willock (In re Wey)*, 854 F.2d 196 (7th Cir. 1988).

[10] *Id.* at 199 (citations omitted).

[11] *Id.*

[12] *Id.*

when Wey defaulted was an extinguishment of his equity interest in the hotel, not a transfer."[13]

THE *GREAT LAKES QUICK LUBE LP* DECISION

Great Lakes owned a series of stores in the Midwest that provided oil change and other automotive maintenance services. Prior to its Chapter 11, Great Lakes acquired more than 100 stores, usually buying a store, selling it to investors and then leasing it back. Great Lakes came under increasing financial distress and, with bankruptcy looming, 52 days before its voluntary filing, Great Lakes negotiated the termination of two leases of two profitable stores[14] with its landlord, T.D. Investments I, LLP ("T.D").

The reasons given for the termination were varied, but included a strained relationship between Great Lakes and the head of T.D. While the leases were apparently not in default, T.D. argued that even though the two stores were profitable, ongoing maintenance, repairs and other obligations would have caused the stores to operate at a loss had Great Lakes retained them.

In the bankruptcy, the unsecured creditors' committee filed an adversary proceeding seeking to avoid the lease terminations as fraudulent transfers and/or avoidable preferences. T.D. argued that the leases were abandoned rather than transferred, and that the terminations did not constitute transfers, let alone preferential or fraudulent transfers. The bankruptcy court agreed that no transfers had occurred, relying in particular upon Code Section 365(c)(3), which precludes the assumption or assignment of leases which are terminated pre-bankruptcy pursuant to applicable non-bankruptcy law.

Upon the request of the committee, the bankruptcy court asked the Seventh Circuit to accept a direct appeal.

Seventh Circuit Judge Richard Posner authored a three page opinion which cited only one case regarding the purpose of Code Section 363(c). As it did in the *Commodity Merchants* and *Wey* decisions, the court cited Code Section 101's broad definition of a "transfer" which includes the voluntary or involuntary parting with an "interest in property."[15] However, without referencing either *Commodity Merchants* or *Wey,* Judge Posner reached a different conclusion, finding that Great Lakes had an interest in the leaseholds which it transferred

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[13] *Id.*

[14] The committee asserted that the two stores were worth $327,000 and $450,000, respectively. *Great Lakes,* 816 F.3d at 485.

[15] *Id.* at 485.

to T.D., depriving Great Lakes' other creditors of realizing on the value of the leases.[16]

The court reconciled the definition of a transfer under Code Section 101 with the provisions of Code Section 365(c)(3), observing that the committee was seeking to avoid the transfers, rather than attempting to assume or assign the leases in violation of Code Section 365(c)(3) (or to evict the new tenant).[17]

By avoiding the transfer, the committee was merely looking to recover the value of the leaseholds from T.D. under Code Section 550. Making the distinction between the value of the leases to which creditors may be entitled, as opposed to the leases themselves, which cannot be lawfully transferred to the creditors, said the court, avoided a needless conflict between the two Bankruptcy Code sections.[18] The Seventh Circuit reversed the bankruptcy court, ruling that a transfer had occurred and remanded the case, ordering the bankruptcy court to determine the value of the leases and whether T.D. had any defenses to avoidance.[19]

RECONCILING THE DECISIONS

In each of *Commodity Merchants, Wey,* and *Great Lakes*, the Seventh Circuit acknowledged that the definitions of transfer under the prior Bankruptcy Act and the Code were very broad, extending to and including the parting with property or an interest in property on a voluntary or involuntary basis. However, in *Commodity Merchants* and *Wey,* the court found that no transfer had occurred, while in *Great Lakes* it determined that there was a potentially avoidable transfer. How can these different results be reconciled?

Both *Commodity Merchants* and *Great Lakes* dealt with executory contracts which were terminated pre-petition. *Wey* addressed a contract which was terminated pre-petition by a debtor breach. One difference appears to be that in *Great Lakes,* the debtor and T.D. mutually agreed to terminate the contracts. By contrast, in *Commodity Merchants*, ADM unilaterally terminated the contract because of the debtor's deteriorating financial condition.

In *Wey*, the debtor's breach caused the agreement to purchase the hotel to automatically terminate, resulting in the automatic loss of the down payment.

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[16] *Id.*

[17] Subsequent to the termination of the leases, T.D. leased them to an unrelated third party. *Id.* at 486.

[18] *Id.*

[19] *Id.*

However, the very broad definition of "transfer" in Code Section 101 clearly includes the voluntary and involuntary parting with an interest in property, which would seem to extend to the extinguishment of a debtor's rights, whether the extinguishment occurs by mutual agreement, by one party pursuant to the terms of the contract, or by breach.

The most significant difference among the cases appears to be based upon two factors: The transferability of the contract at the time of termination, and the resulting value arising from the right of the debtor to alienate it. In *Commodity Merchants,* the court found that because the contracts were not assignable without ADM's consent, they had no market value. It was based upon this fact that the court held that no transfer occurred.[20] In *Wey,* the court held Mr. Wey's default resulted in the extinguishment of an equity interest, and that as of the time of the breach, the debtor possessed no rights it could transfer. Therefore, no transfer of anything of value occurred.

In *Great Lakes,* the two leases in question were apparently not in default and were profitable. The termination of the leases was negotiated between the debtor and T.D., and did not arise because of action taken by T.D. after default. While the court does not specifically discuss alienability of the leases, if on the petition date the leases were not in default, or if they were in default but T.D. had not taken action to terminate them, the leases would have been assumable and assignable post-bankruptcy under Code Section 365, making them a valuable asset for the estate's creditors.

It is somewhat surprising that Judge Posner did not specifically discuss *Commodity Merchants* and *Wey* in his *Great Lakes* opinion, given that the prior decisions appear to be directly on point. One has to read the three decisions carefully to tease out a way to read them consistently.

However, the current state of play appears to be that a non-debtor's pre-petition termination of a contract which is in default, or the automatic pre-petition termination of a contract because of the debtor's breach, and will not constitute a transfer which can be avoided, at least where the contract by its terms restricts debtor's ability to assign its rights thereunder.

On the other hand, the mutual agreement to terminate pre-petition a contract that has value and that is not in default (or if in default, is not terminated as of the petition date), and which therefore could be assumed and assigned to realize value for the estate's creditors, is subject to avoidance as a

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[20] The bankruptcy court in *Jermoo's* also found that the severe restriction on alienability caused the contract to lack the requisite element of transferability required by *Commodity Merchants. In re Jermoo's,* 36 B.R. at 206.

fraudulent transfer or an avoidable preference. At least in the Seventh Circuit that seems to be the case.