LEASE TERMINATIONS AS FRAUDULENT TRANSFERS: RECONCILING BANKRUPTCY CODE SECTIONS 548 AND 365(C)(3)

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INTRODUCTION

Under section 365(c)(3) of the Bankruptcy Code, the bankruptcy trustee (and its equivalents) may not assume or assign a nonresidential lease that was terminated before the tenant-debtor's bankruptcy.[1] Before bankruptcy, the tenant-debtor may terminate a valuable lease and enrich the landlord as a result. May the bankruptcy trustee claim that the termination is a fraudulent transfer under section 548, *even though* the trustee may not assume or assign the lease?

The Seventh Circuit answered this very question in *In re Great Lakes Quick Lube LP* (*Great Lakes*).[2] There, in a decision delivered by Judge Richard Posner, the Seventh Circuit ruled that a nonresidential lease termination could be a fraudulent transfer from the tenant-debtor to the landlord.[3] In Judge Posner's view, section 365(c)(3) did not apply to the terminations at issue.[4] The creditors' committee sued the landlord under section 548 *not* to assume the leases themselves, but to recover their *value*, an option made available in section 550(a).[5] Recovering the value of the leases from the landlord would not disturb the occupancy of the properties' new tenant.[6] Thus, the distinction between the value of the leases and the leases themselves enabled the creditors' committee to

1 11 U.S.C. § 365(c)(3) (2012).

2 *Great Lakes II*, 816 F.3d 482 (7th Cir. 2016).

3 *Id.* at 486. And in the same breath, that a nonresidential lease termination could be a preferential transfer under section 547. *Id.* This Note does not specifically discuss lease terminations as preferential transfers. But certainly, part of the analysis applies just as well to preferential transfers. *See infra* Section III.A (developing a "control" criterion for use in determining when lease terminations satisfy the Bankruptcy Code's definition of "transfer").

4 *Great Lakes II*, 816 F.3d at 485–86.

5 *Id.* at 486.

6 *Id.* Section 365(c)(3)'s purpose is to promote the occupation of commercial property by protecting the new tenants of such property from having their occupancies disturbed by former tenants' bankruptcy proceedings. *See infra* Section II.C.

pursue its fraudulent transfer claim without defeating section 365(c)(3)'s purpose.[7]

Before discussing the applicability of section 365(c)(3) (or rather, its *inapplicability*), Judge Posner answered the antecedent question of whether the lease terminations were "transfers" under the Bankruptcy Code; and, therefore, for section 548's purposes.[8] He decided they were, relying solely on the text of section 101(54)(D), which defines "transfer."[9] The tenant-debtor and the landlord agreed to terminate their lease agreements, and as a result the tenant-debtor parted with property interests that might have been worth something to the creditors had the terminations not taken place.[10] For this simple reason, the terminations were transfers.[11]

Judge Posner's opinion was, basically, correct. And even though the opinion cites no case law, its arguments are supported by several authorities.[12] But at the same time, *Great Lakes* appears to contradict other cases that say—whether because of section 365(c)(3) or independently of it—that nonresidential lease terminations *do not* satisfy the Bankruptcy Code's definition of "transfer."[13] This Note shows that the case law's apparent inconsistencies are mostly just that—*apparent*, not *actual*. But even the appearance of inconsistency is regrettable because it reflects the failure of courts to develop an adequate theory for applying fraudulent transfer law to lease terminations. As long as this area remains under-theorized, courts may struggle to apply sections 548 and 365(c)(3) consistently. A more comprehensive theory is needed, and this Note intends to provide it.

To that end, I make two main arguments. First, a lease termination is a transfer under the Bankruptcy Code, provided the tenant-debtor had *control* of the lease at the time of its termination.[14] By "control," I mean simply the right of the tenant-debtor to choose between terminating the lease and not terminating it. Take the *Great Lakes* tenant-debtor, for example. It *agreed* to terminate its leases, but had the absolute right *not* to enter that agreement. The tenant-debtor thus exercised the requisite control, making the terminations transfers.

Second, I argue that the scope of section 365(c)(3) is ill-defined for two main reasons.[15] First, courts have, for the most part, dealt clumsily with the interaction of sections 548 and 365(c)(3), applying them where

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7 *Great Lakes II*, 816 F.3d at 486.

8 *Id.* at 485.

9 *Id.*

10 *Id.*

11 *Id.*

12 *See infra* Section II.D.1 (discussing relevant cases).

13 *See infra* Section II.D.2 (discussing relevant cases).

14 *See infra* Section III.A.

15 *See infra* Section III.B.

they should not have and failing to apply them (or even discuss them) where they should have. Judge Posner's *Great Lakes* opinion is a step toward greater sophistication in this area, but it leaves some room for development. Second, the text of section 365(c)(3) is *overinclusive*, meaning it brings into the statute's ambit cases that its background justification does not cover. Specifically, section 365(c)(3), as written, prohibits the trustee from recovering nonresidential leases even where the landlord has not re-leased or sold the property. This prohibition not only fails to serve section 365(c)(3)'s purpose—it threatens to defeat it.

I develop these arguments in four main parts. Part I discusses the operation of fraudulent transfer law in bankruptcy. First, it gives a condensed history of fraudulent transfers. This history is useful because it illustrates some general principles of fraudulent transfer theory. It is relevant also because it discusses the evolution of the fraudulent transfer remedy from a purely in rem theory to one involving an in personam option—which, in a major way, is what *Great Lakes* is all about. Then, Part I discusses the relevant provisions of the Bankruptcy Code. I pay special attention to the definition of transfer, since it is the most basic element of a fraudulent transfer claim, and the element with which this Note is most concerned. Part II discusses section 365(c)(3) and, more generally, the application of fraudulent transfer law to lease terminations. First, I briefly discuss the valuation of leases and section 365(a), which authorizes the trustee to assume unexpired leases of the debtor. Second, I discuss the text and legislative history of section 365(c)(3). Third, I discuss cases in which fraudulent transfer law was applied to lease terminations, and which discuss the scope and effect of section 365(c)(3). Part III develops the arguments already previewed here in this Introduction. And finally, Part IV urges courts and Congress to do their part to reconcile sections 548 and 365(c)(3). I propose simply that courts implement the theory I develop in Part III, and that Congress make a small amendment to section 365(c)(3).

I. FRAUDULENT TRANSFER IN BANKRUPTCY

A. *General Principles*

The point of fraudulent transfer law is to prohibit debtors from selling or giving away their property for the purpose, or with the effect, of defrauding their creditors.[16] Fraudulent transfer law first took written form in the Statute of Elizabeth,[17] which was intended to foil the

16 I GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES 74 (rev. ed. 1940).

17 *Id.* at 79. The Statute of Elizabeth was the first general codification of fraudulent transfer

supposedly common practice of debtors selling their property to favored confederates for a nominal price.[18] Any transfer that violated the statute was declared void against the creditor-claimant, and the creditor-claimant was given a lien on the transferred property.[19]

The Statute of Elizabeth prohibited transfers made maliciously (that is, with the *specific intent*) to defraud creditors, so-called *actual* fraudulent transfers.[20] Since then, the concept of fraudulent transfer has expanded to encompass benevolent transfers too, provided they *effectively* defraud creditors; these are called *constructive* fraudulent transfers.[21] This innovation appears on the face of the Uniform Fraudulent Conveyances Act (UFCA), which prohibits transfers made for less than "fair consideration" by an insolvent debtor, *irrespective of the debtor's intent*.[22] Basically, courts presume that constructive fraudulent transfers are deliberate attempts by debtors to defraud their creditors and avoid them *whether or not* the debtor actually intended to defraud its creditors.[23]

Originally, when a court decided that a transfer was fraudulent, it "avoided" or "set aside" the transfer. Meaning, the court declared the transfer void against the creditor-claimant and gave the creditor-claimant a lien on the property.[24] The creditor-claimant's ability to

law. But the theory of fraudulent transfer is much older: its roots run back to Roman law. *See id.* 82–86.

18 *Id.* at 83–86. The Statute of Elizabeth was also a way for the English Crown to raise revenue from penal forfeitures and persecute Catholics for attending Mass. *See id.* at 91–92.

19 *Id.* at 95–96 ("[T]he judgment creditor could take advantage of the Statute [of Elizabeth] by ignoring the fraudulent transfer and levying execution on the property involved.").

20 *Id.*

21 *See* UNIFORM FRAUDULENT CONVEYANCES ACT, Prefatory Note (UNIF. LAW COMM'N 2017) ("There are many conveyances which wrong creditors where an intent to defraud on the part of the debtor does not in fact exist. . . . Certain conveyances which the courts have in practice condemned . . . are declared fraudulent irrespective of intent.").

22 *Id.* § 4 ("Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors *without regard to his actual intent* if the conveyance is made or the obligation is incurred without a fair consideration." (emphasis added)). "Fair consideration" means roughly the same as "reasonably equivalent value," the standard used in the Bankruptcy Code. *See* 11 U.S.C. § 548(a)(1)(B) (2012); *infra* Section I.B.1. On the differences between them, see Michael L. Cook & Richard E. Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87, 92–93 (1988).

23 *See* Morris v. Flenner, 25 F.2d 211, 213 (E.D. Ill. 1928) ("[A] conveyance of property may be deemed fraudulent as against creditors upon two distinct grounds: First, where the conveyance is entered into with the fraudulent intent to hinder and delay creditors; second, where, from the terms of the agreement for the conveyance or the nature of the transaction, the conveyance is declared fraudulent as to a conclusive presumption of law, without regard to the real motives or purposes of the debtor. In the first class of cases the fraudulent intent is always a question of fact to be established by extrinsic proof. In the latter the conveyance is denounced as fraudulent as a legal inference, though the parties may not have been moved by any real design to hinder, delay, or defraud the creditor.").

24 *See* GLENN, *supra* note 16, at 95–96. Not that it has much, or any, bearing on this Note, "avoidance" and "set aside" are metaphorical terms whose imprecision causes a great deal of confusion. *See generally* David Gray Carlson, *The Logical Structure of Fraudulent Transfers and*

recover the value of the property depended upon the independent theory of conversion, a tort that yields a money judgment.[25] This pure in rem theory appears on the face of the UFCA, which makes no mention of money judgments but instead speaks only of the creditor's right to have the transfer "set aside" and to levy upon the property.[26] Then, in 1978, the Bankruptcy Code introduced, in section 550(a), the option of money judgments instead of in rem recoveries.[27] For the first time in the history of fraudulent transfer law, the creditor-claimant was invited to substitute a money judgment for an in rem recovery. Still, the in rem idea appears to predominate since, according to section 550(a), the money judgment option is available only if the court permits it.[28]

Whether the creditor-claimant gets a lien on the property or wins a money judgment, it applies the eventual cash to satisfy a claim against the debtor.[29] Importantly, the creditor-claimant does not sue the debtor. The reason is simple: *the debtor no longer has title to the property*. As a result of the alleged fraudulent transfer, the transferee owns the property.[30] From this, two important points follow. First, the fraudulent transfer is voidable by creditors, but is otherwise valid.[31] And second, for that reason, the defendant in a fraudulent transfer action is always the recipient of the fraudulent transfer, or else a transferee of that recipient.[32]

Equitable Subordination, 45 WM. & MARY L. REV. 157 (2003). They imply that the fraudulent transfer remedy rescinds the transfer from the debtor to the transferee. But this is not a realistic description. More truly, the transferee holds the property in trust for the benefit of the debtor's creditors. *See id.* at 165–83.

25 "Conversion is an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel." RESTATEMENT (SECOND) OF TORTS § 222A(1) (AM. LAW INST. 1965).

26 UNIFORM FRAUDULENT CONVEYANCE ACT § 9(1) (UNIF. LAW COMM'N 2017) ("Where a conveyance or obligation is fraudulent as to a creditor, such creditor . . . may . . . (a) Have the conveyance set aside . . . to the extent necessary to satisfy his claim, or (b) Disregard the conveyance and attach or levy execution upon the property conveyed.").

27 11 U.S.C. § 550(a) ("[T]o the extent that a transfer is avoided . . . the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, *the value of such property* . . . ." (emphasis added)).

28 *Id.* ("[T]o the extent that a transfer is avoided . . . the trustee may recover, for the benefit of the estate, the property transferred, *or, if the court so orders*, the value of such property . . . ." (emphasis added)).

29 *See* GLENN, *supra* note 16, at 413 ("The primary right of the [creditor-claimant] is to apply the property which has been fraudulently conveyed, to the realization of his debt . . . .").

30 *See id.* at 225 ("[A] fraudulent conveyance is actually a conveyance, with all the natural consequences. A wicked debtor, therefore, cannot later call upon his grantee for a reconveyance, unless he has reserved such a right by the terms of the deed or through a secret trust. . . . [A]n out and out transfer cannot be uprooted by either party. . . . Neither party, to repeat, can deny that title passed although the deed was fraudulent.").

31 *See id.* at 237 ("[A] fraudulent conveyance is a real transaction and is voidable by creditors only.").

32 *See id.* at 77 (explaining that fraudulent transfer law "allows recapture of the property

B. *The Bankruptcy Code's Fraudulent Transfer Law*

Section 548(a) sets forth the prima facie cases for actual and constructive fraudulent transfers. The most basic element of both is a transfer of the debtor's property. Section 550(b) contains an affirmative defense available to the fraudulent transfer recipient. And finally, section 550(a) lists the recovery options available to a successful fraudulent transfer claimant.

1. Section 548(a) and the Requisite Transfer of Property

The preamble to section 548(a) states that, to be avoidable, a fraudulent transfer must have taken place within two years of the debtor's petition in bankruptcy.[33] Section 548(a)(1)(A) gives the trustee the ability to avoid actual fraudulent transfers.[34] And section 548(a)(1)(B), the ability to avoid constructive fraudulent transfers, which it defines as transfers made for less than "reasonably equivalent value" by an insolvent debtor; or by a debtor who was rendered insolvent by the transfer; or which left the debtor with an amount of property insufficient to carry on its business.[35]

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from *the fraudulent grantee or from a subgrantee* who took gratuitously and with notice" (emphasis added)); *id.* at 241 ("[I]t is hardly necessary to repeat that you cannot set aside a fraudulent conveyance unless you go after the fraudulent grantee.").

33 11 U.S.C. § 548(a)(1).

34 *Id.* § 548(a)(1) ("The trustee may avoid any transfer . . . if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted . . . ."). Proving actual fraud is difficult because a specific intent to defraud "is rarely admitted by a debtor." *In re* Kelsey, 270 B.R. 776, 782 (B.A.P. 10th Cir. 2001). To ease this difficulty, courts have identified certain factors which, where found, raise a presumption of actual intent; these factors are called "badges of fraud." *See In re* Saba Enters., Inc. 421 B.R. 626, 643 (Bankr. S.D.N.Y. 2009) (identifying some badges of fraud, including "the family, friendship or close associate relationship between the parties; . . . the retention of possession, benefit or use of the property in question; . . . and . . . the secrecy, haste, or unusualness of the transaction").

35 11 U.S.C. § 548(a)(1)(B). The Bankruptcy Code does not define "reasonably equivalent value," leaving its definition to courts. *See In re* R.M.L., Inc. 92 F.3d 139, 148 (3d Cir. 1996). Some courts use the bright-line standard set forth in *Durrett v. Washington National Insurance Co.*, 621 F.2d 201 (5th Cir. 1980), according to which seventy percent or more of a property's fair market value satisfies reasonable equivalence. Other courts reject the *Durrett* standard as too rigid, choosing instead to determine reasonable equivalence on a case-by-case basis. *See, e.g.*, *In re* Bundles, 856 F.2d 815, 824 (7th Cir. 1988) ("Reasonable equivalence should depend on all the facts of each case. . . . The implementation of this approach requires case-by-case adjudication."); *see also* Vic Sung Lam, *Avoidability of Foreclosure Sales Under Section 548(a)(2) of the Bankruptcy Code: Revisiting the Transfer Issue and Standardizing Reasonable Equivalency*, 68 WASH. L. REV. 673, 685 (1993) ("Not only is a rigid 70-percent rule unable to effectively achieve the statutory purpose of protecting debtors' equity, it also fails to comport with the statutory language of section 548(a)(2). Congress has chosen the words 'reasonably

The trustee may sue the initial recipient of the fraudulent transfer or any subsequent transferee of the initial recipient.[36]

Whether actual or constructive, a fraudulent transfer presupposes a *transfer of property*.[37] It follows that, when analyzing a section 548 claim, the court must begin by figuring out whether the debtor actually transferred property prior to declaring bankruptcy.[38] So, the court must know exactly what "transfer" and "property" mean for section 548's purposes. Figuring out what transfer means is easy because the Bankruptcy Code defines it,[39] and it is well-established that the Bankruptcy Code's definition controls in any action brought under section 548.[40] This definition appears in section 101(54)(D) and is *extremely* broad.[41] It states that a transfer is "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."[42] Courts, quite understandably, have read this language as covering virtually every instance of parting with property.[43]

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equivalent value' to express its intended standard rather than fixing a numerical formula.").

36 *See* 11 U.S.C. § 550(a) ("[T]o the extent that a transfer is avoided under section . . . 548 . . . the trustee may recover . . . from—(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee.").

37 *In re* Brajkovic, 151 B.R. 402, 405 (Bankr. W.D. Tex. 1993) ("In order for there to be an avoidable fraudulent conveyance . . . we must be able to identify a *transfer* of *an interest of the debtor in property*."); *see also* GLENN, *supra* note 16, at 76 ("That there must be a transfer, or some other change in title, is clear on its face. If the debtor has not succeeded in effecting any change in title under applicable rules of law, then he still has the asset, and this book may be laid aside.").

38 *In re* McFarland, 619 F. App'x 962, 967 (11th Cir. 2015) (stating that whether a transfer occurred is the "threshold issue" in fraudulent transfer analysis); *In re* Indri, 126 B.R. 443, 445 (Bankr. D.N.J. 1991) ("It is axiomatic that in order for a transaction to be subject to scrutiny under [section 548] . . . there must have been a 'transfer' within the meaning of the statute.").

39 Figuring out what amounts to a "transfer," on the other hand, can be difficult. Hence, in part, this Note.

40 *See In re Brajkovic*, 151 B.R. at 405 ("The first concept, that of a 'transfer,' is controlled by federal law, as this term (as it is used in section 548) is defined by the Bankruptcy Code itself.").

41 *See In re* Besing, 981 F.2d 1488, 1492 (5th Cir. 1993) ("Congress intended for the Code's definition of 'transfer' to be as broad as possible." (citing S. REP. No. 95–989, at 27 (1978))); *In re Brajkovic*, 151 B.R. at 405 (discussing the extensive breadth of "transfer").

42 11 U.S.C. § 101(54)(D) (2012).

43 *See* Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. J. 55, 71–73 (1991). Williams, collecting cases, found that "transfer" includes:

> [A] gift, a nonjudicial foreclosure sale, a filing of a lis pendens for alimony, an execution on a judgment lien, a renewal of a loan and payments thereunder, a pledge of securities and subsequent involuntary sale, a *termination of a lease*, a settlement agreement, a consignment of goods, a bonus, a planting of crops, a bank's forebearance in collection of indebtedness in exchange for a security interest in livestock, a garnishment of the debtor's bank account, an attachment of a judgment lien, a leveraged buyout, an upstream, downstream, or cross-stream guaranty, a ratification of security interests, a draw on a credit line, a collusive judgment, an encumbrance, a release by a beneficiary of an interest in a trust estate, a change in a beneficiary of a life insurance policy, a divorce or separation agreement, a rescission

In contrast to transfer, the Bankruptcy Code does not explicitly define property. But a fairly well-established meaning has emerged all the same. Left to define it themselves, courts usually decide that something is property or an interest therein if it would have been included in the debtor's bankruptcy estate and made available for the benefit of unsecured creditors had the debtor not transferred it.[44] Section 541(a)(1) states that the bankruptcy estate consists of "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case."[45] In line with Supreme Court dictum, courts interpret the phrase "legal or equitable interests" broadly.[46] It includes all of the debtor's rights and interests in real property, including rights and interests existing under leases.[47]

If the meaning of property remains unclear, these hypothetical facts should clarify it. Suppose the debtor, *D*, owns a piece of land outright. When *D* declares bankruptcy, the land becomes part of the bankruptcy estate. Since the bankruptcy estate includes the land, the trustee of the bankruptcy estate may sell it to raise cash for the unsecured creditors. So, the land is property. And if *D* does not own the land outright but instead has a leasehold interest in it, then that interest becomes part of the bankruptcy estate and the trustee may assume and assign it to raise cash for the unsecured creditors—subject, of course, to the provisions of section 365.[48] Thus, the leasehold interest is property too.

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of a profitable contract, a payment of a dividend, and a payment of usurious interest.

Id. (emphasis added) (footnotes omitted). The Uniform Fraudulent Transfer Act specifically states that lease terminations are *not* fraudulent transfers when they occur as a result of default by the debtor. UNIFORM FRAUDULENT TRANSFER ACT § 8(e)(1) (UNIF. LAW COMM'N 2017); *see also* Frank R. Kennedy, *Involuntary Fraudulent Transfers*, 9 CARDOZO L. REV. 531, 567 (1987).

44 Begier v. IRS, 496 U.S. 53, 58 (1990). ("The Bankruptcy Code does not define 'property of the debtor.' Because the purpose of the avoidance provision is to preserve the property includable in the bankruptcy estate—the property available for distribution to creditors—'property of the debtor' subject to the [avoidance] provision is best understood as that property that would have been part of the estate had it not been transferred before the commencement of the bankruptcy proceedings.").

45 11 U.S.C. § 541(a)(1).

46 *See* United States v. Whiting Pools, Inc., 462 U.S. 198, 204–05 (1983) ("Both the congressional goal of encouraging reorganizations and Congress' choice of methods to protect secured creditors suggest that Congress intended a broad range of property to be included in the estate.").

47 1 COLLIER ON BANKRUPTCY, ¶ 541.04 (Richard Levin & Henry J. Sommer eds., 16th ed. 2017) ("The provision of section 541(a)(1) that the debtor's estate shall include 'all legal or equitable interests of the debtor in property as of the commencement of the case' is extremely broad and includes all rights and interests of the debtor in real property. . . .the debtor's rights under contracts and leases are property of the estate.").

48 *See* 11 U.S.C. § 365; *infra* Section II.A–B.

2. Section 550(b): Affirmative Defense to Fraudulent Transfer

A prima facie case does not lead to automatic success for the trustee; the transferee-defendant can escape liability by proving an affirmative defense.[49] Relevant to this Note is the defense in section 550(b), which protects from liability any *subsequent* transferee of the *initial* transferee, so long as the subsequent transferee proves that it took the property for value and in good faith.[50] The Bankruptcy Code does not define "good faith," leaving the definition to courts.[51] Ordinarily, courts apply an objective standard, asking whether the transferee knew or reasonably should have known that the transfer was fraudulent.[52] So, if the initial recipient of a fraudulent transfer sells the property to another party, and this subsequent transferee takes the property without knowledge or notice that the initial transfer was fraudulent, then the subsequent transferee's interest in the property is superior to the trustee's.[53]

These hypothetical facts should illustrate how the section 550(b) defense works. Suppose that *D* fraudulently transfers a piano to *X*. Thereafter, *X* sells the piano to *Y*, who takes the piano not knowing that *D* fraudulently transferred it to *X*. The trustee of *D*'s bankruptcy estate cannot recover the piano from *Y* because section 550(b) prevents it. Under section 550(b), *Y*'s interest in the piano is superior to the trustee's.

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49 As with any affirmative defense, the defendant-transferee bears the burden of pleading and proving each element of the following defense. *See In re* Bayou Grp., L.L.C., 362 B.R. 624, 631 (Bankr. S.D.N.Y. 2007).

50 11 U.S.C. § 550(b) ("The trustee may not recover under section (a)(2) of this section from—(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or (2) *any immediate or mediate good faith transferee of such transferee*." (emphasis added)).

51 *In re* M&L Bus. Mach. Co., 84 F.3d 1330, 1335 (10th Cir. 1996) ("[T]he Bankruptcy Code does not define 'good faith.' Likewise, the legislative history related to section 548(c) never defines, and scarcely addresses, good faith." (internal quotation marks omitted) (citation omitted)).

52 *See id.* at 1338 ("[W]e conclude that . . . good faith under § 548(c) should be measured objectively and that if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent." (internal quotation marks omitted) (citation omitted)). *But see In re* Taneja, 743 F.3d 423, 431–34 (4th Cir. 2014) (introducing a degree of subjectivity into the analysis of good faith under section 548(c)).

53 *See, e.g.*, *In re* Queen City Grain, Inc., 51 B.R. 722, 727–29 (Bankr. S.D. Ohio 1985) (granting subsequent transferee's motion for summary judgment and dismissing fraudulent transfer claim because subsequent transferee proved the elements of the section 550(b) defense).

3. Section 550(a): To Recover the Property or Its Value

A prima facie case, combined with the defendant-transferee's failure to prove an affirmative defense, spells success for the trustee. In that event, the court must determine what the trustee is entitled to recover. Section 550(a) gives two options. It states that the trustee may recover "the property transferred, or, if the court so orders, the value of such property . . . ."[54] But it does not make clear when one or the other is available: when the property may be recovered instead of its value and vice-versa. On this, courts have reached different conclusions. Some have said that the decision is entirely up to courts.[55] Others have said—in part, at least, because of the predominance of the in rem option apparent in the text—that the property itself must be returned to the estate *unless* it would produce an inequitable result.[56]

Under either view, it seems that the trustee may recover the value of the property where the defendant-transferee has spoiled the property or made it unrecoverable by an act of conversion.[57] Conversion is an intentional tort whose essence is the wrongful deprivation of property.[58] These hypothetical facts illustrate how the defendant-transferee's conversion leads to a money judgment. Suppose that *D* fraudulently transfers a piano to *X*. Next, *X* sells the piano to *Y*, who neither knows nor has reason to know that *D* fraudulently transferred the piano to *X*. Under section 550(b), *D*'s trustee cannot sue *Y* to recover the piano itself. But the initial transfer from *D* to *X* was fraudulent; so, had *X* not sold the piano to *Y*, the trustee could have avoided the initial transfer and gotten a lien on the piano. By selling the piano to *Y*, *X* converted the piano. For this reason, the trustee should be able to recover the value of the piano from *X*.

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54 11 U.S.C. § 550(a).

55 *See, e.g.*, *In re* First Software Corp., 107 B.R. 417, 423 (Bankr. D. Mass. 1989) ("The Bankruptcy Code does not provide guidelines to aid a court in deciding when to order recovery of the value of property rather than the property itself. . . . *It is simply within the court's discretion to determine whether a return of the value of property or return of the actual property is the appropriate remedy*." (emphasis added) (internal citation omitted)).

56 *See In re* Classic Drywall, Inc., 127 B.R. 874, 876–77 (Bankr. D. Kan. 1991) ("Some courts have said [section 550(a)] gives a preference to the return of the property unless it would be inequitable to do so. . . . This approach finds some support in the language of § 550(a) and the history behind it. Section 60(b) of the Bankruptcy Act allowed the recovery of value only when the property had been converted. While this limitation is gone, § 550(a) lists first the recovery of property and then permits the recovery of value only upon the order of the court." (internal citation omitted)).

57 *See, e.g.*, *id.* at 877 ("Where the property is unrecoverable or its value diminished by conversion or depreciation, courts will permit the recovery of value.").

58 *See* Colavito v. N.Y. Organ Donor Network, Inc., 860 N.E.2d 713, 717 (N.Y. 2006) ("A conversion takes place when someone, intentionally and without authority, assumes or exercises control over personal property belonging to someone else, interfering with that person's right of possession . . . .").

Ordinarily, the subject matter of conversion is limited to wrongful deprivations of *tangible personal* property.[59] But the logic of conversion applies just as well to the deprivation of real property and interests therein—when it comes to fraudulent transfers, at least. Suppose *D* fraudulently transfers a piece of land to *X*. *X* then sells the land to *Y*, who neither knows nor should know that *D* fraudulently transferred the land to *X*. Again, under section 550(b), *Y*'s interest in the land is superior to the trustee's, so the trustee cannot sue *Y* to recover it. But the trustee should be able to recover the value of the land from *X* because *X* "converted" the land. This logic also applies to the debtor's unexpired leases, leaving aside any restrictions on the trustee's ability to assume them.

II. LEASE TERMINATIONS AS FRAUDULENT TRANSFERS AND THE SCOPE OF SECTION 365(C)(3)

A. *Section 365(a) and Lease Valuations*

The bankruptcy estate includes the debtor's rights and interests in real property, including rights and interests existing under leases.[60] Section 365(a) authorizes the trustee to assume and assign (or reject) unexpired leases of the debtor.[61] But an unexpired lease may be assumed only after certain defaults have been cured and future performance assured.[62]

The trustee will only assume an unexpired lease if, after curing its defaults, it is valuable enough to benefit the unsecured creditors. Otherwise, the trustee will reject it. Consider a ten-year lease with monthly rent payments. Its value is calculated in this way[63]:

$$L = \sum_{t=1}^{120} \frac{B - C}{(1+\frac{r}{12})^t}$$

If the calculated value is less than or equal to zero, then the cost of

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59 *See In re* Stillwater Asset Backed Offshore Fund Ltd., 559 B.R. 563, 620 (Bankr. S.D.N.Y. 2016) ("'[C]onversion' is a tort theory that applies only to personal property, not real property."); ARB Upstate Commc'ns L.L.C. v. R.J. Reuter, L.L.C., 940 N.Y.S.2d 679, 684 (N.Y. App. Div. 2012) ("[T]he subject matter of a conversion action must constitute identifiable tangible personal property; real property and interests in business opportunities will not suffice . . . ." (alteration in original) (citations omitted) (internal quotation marks omitted) (citations omitted)).

60 *See supra* Section I.B.1.

61 *See* 11 U.S.C. § 365(a) (2012).

62 *See id.*

63 *L* represents the value of the lease; 120, the number of periods (12 months per year for 10 years); *B*, the benefit of the lease to the trustee; *C*, the cost; and *r*, the annual rate of return.

assuming the lease is greater than the amount of cash it will raise for the unsecured creditors; so, the trustee will not assume the lease. But if the value exceeds zero, the trustee will assume the lease because its benefit to unsecured creditors will be greater than its cost.

B. *The Value of a Terminated Lease to the Landlord*

When a lease is terminated, the landlord receives a possessory interest in the property for the duration of the lease. The value of this possessory interest is reduced by the present value of the rent that the landlord will not receive as a result of the lease termination. Consider again a ten-year lease with monthly rent payments. The tenant terminates the lease five years in, leaving sixty remaining rent periods. The landlord is able to re-lease the property for $12,000 a month, $2000 more than the former tenant was paying. The tenant basically receives $600,000 in return for a $720,000 property interest; and the landlord receives a windfall of $120,000.

If the tenant later enters bankruptcy, the bankruptcy trustee may want to recover the lease to assign it to a third party, for $12,000 a month, to raise cash for the tenant-debtor's unsecured creditors. To that end, the trustee may be able to avoid the termination as a constructive fraudulent transfer, depending on whether the $600,000 in excused rent obligations amounts to a reasonably equivalent value for the $720,000 possessory interest.

C. *Section 365(c)(3)*

Section 365(c)(3) restricts the trustee's ability to assume and assign the debtor's unexpired leases. It states that the trustee "may not assume or assign any executory contract or 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."[64] So, where the debtor's lease has ended for some valid reason other than the completion of its term, the trustee may not assume or assign the lease to raise cash for the unsecured creditors.[65] It follows that the trustee may not use section 548 to avoid such terminations—at least not if it wants to recover (assume) the lease itself.

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64 11 U.S.C. § 365(c)(3).

65 Even before the enactment of section 365(c)(3), it was established that the initiation of bankruptcy does not resurrect leases validly terminated prior to the bankruptcy. *See In re* Triangle Labs., Inc., 663 F.2d 463, 467–68 (3d Cir. 1981) ("[A] lease validly terminated prior to the institution of bankruptcy proceedings is not resurrected by the filing of the petition in bankruptcy, and cannot therefore be included among the debtor's assets.").

Section 365(c)(3) was added to the Bankruptcy Code in 1984.[66] The statute's legislative history shows that Congress added it specifically to help the occupants of shopping center retail space. Congress recognized that the interests of different businesses within the same shopping center are, to a great extent, connected; that the prolonged vacancy of one retail space negatively affects surrounding businesses; and that bankruptcy cases and the lawsuits arising from them can prolong the vacancies of shopping center space.[67] The problem, in a nutshell, was that shopping center occupants' bankruptcies were hurting their neighbors' businesses.

Section 365(c)(3) ameliorates the problem by making it easier for landlords to re-lease property previously occupied by tenants currently going through bankruptcy.[68] And this, for its part, reduces the amount of time that retail space stays vacant. In the absence of section 365(c)(3), the trustee could sue under section 548 and, potentially, assume and assign an unexpired lease even if the landlord has already re-leased or sold the property. Obviously, that would disturb the new tenant's occupancy and probably hurt the performance of its business. The risk of this happening would repel potential tenants, thus prolonging the property's vacancy. Section 365(c)(3) ostensibly eliminates this risk by preventing the trustee from assuming nonresidential leases terminated prior to bankruptcy.[69]

The legislative history suggests that Congress added section 365(c)(3) specifically to protect shopping center occupants. But the text

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66 *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98–353, 98 Stat. 333 (codified as amended in scattered sections of 11 U.S.C. and 28 U.S.C.).

67 *See* 130 CONG. REC. H7489 (daily ed. June 29, 1984) (statement of Sen. Rodino, Jr.) ("Approximately half of all U.S. retail trade is conducted in shopping centers. Retail merchants in shopping centers depend upon the operation of a carefully chosen mix of stores, all contributing to the success of the entire shopping center. If shopping center tenants[,] especially major tenants, are not operating their stores, are not paying charges necessary for the upkeep of the shopping center[,] or are using their space in ways not provided for in the lease and which disrupt the tenant mix, the financial health of all the other merchants and of the shopping center itself can be threatened. This bill will reduce the likelihood that provisions of the Bankruptcy Code will themselves add to the economic distress of retail merchants in shopping centers."); Robinson v. Chi. Hous. Auth., 54 F.3d 316, 319 (7th Cir. 1995) ("Section 365(c) was added to the Code by the Bankruptcy Amendments and Federal Judgeship Act of 1984 in response to concerns of shopping center owners and tenants. Congress recognized that the long delays attendant to resolution of bankruptcy disputes and the prolonged inaction under an automatic bankruptcy stay are particularly harmful to shopping centers. . . . Congress was concerned because the fortunes of separate retail businesses in the same shopping center are inextricably linked; if one retail space in the center remains vacant for a long period of time the business of the other tenants suffers accordingly." (internal citation omitted)).

68 *See Great Lakes II*, 816 F.3d 482, 485 (7th Cir. 2016) ("Section 365(c) is aimed at facilitating the re-leasing of commercial property during bankruptcy proceedings by forbidding the trustee to interfere with the occupancy of the new tenants." (citing *Robinson*, 54 F.3d at 319)).

69 *See id.*

of section 365(c)(3) does not distinguish between types of nonresidential real property. And vacant commercial property negatively affects surrounding properties—and, in itself, represents foregone economic activity—*whether or not* it lies in a shopping center.[70] Thus, section 365(c)(3) applies with equal force and with good reason to every kind of nonresidential property.[71]

D. *Case Law on Lease Terminations as Fraudulent Transfers, Including the Scope of Section 365(c)(3)*

The relevant case law is split into two groups.[72] One supports the position that nonresidential lease terminations can be fraudulent transfers. The other supports the opposite position: that nonresidential lease terminations *cannot* be fraudulent transfers.

1. Nonresidential Lease Terminations Can Be Fraudulent Transfers

We look first at the cases that say a nonresidential lease termination *can* be a fraudulent transfer. *In re Queen City Grain, Inc.* (*Queen City*) is one of them.[73] There, the tenant-debtor and the landlord were related corporations.[74] Soon after they entered their lease agreement, both corporations found themselves in financial trouble.[75] They held a meeting and decided that the landlord would sell all of its properties, including the property it was leasing to the tenant-debtor.[76] The landlord found a buyer and agreed to sell its properties.[77] While the landlord and the buyer were negotiating the sale, the buyer requested that the tenant-debtor's lease be terminated, and the landlord told the

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70 *See* STEPHEN S. FULLER, NAIOP RESEARCH FOUND., ECONOMIC IMPACTS OF COMMERCIAL REAL ESTATE (2017), https://www.naiop.org/en/Research/Our-Research/Reports/Economic-Impacts-of-Commercial-Real-Estate-2017; NAT'L VACANT PROPERTIES CAMPAIGN, VACANT PROPERTIES: THE TRUE COSTS TO COMMUNITIES (Aug. 2005), https://www.smartgrowthamerica.org/app/legacy/documents/true-costs.pdf (listing negative externalities of vacant property).

71 See, for example, the cases discussed in Section II.D, *infra*, which involve various types of nonresidential real property.

72 By no means is this an exhaustive collection of the relevant cases. That would require more space than this Note has been allotted; and, in any case, is not necessary to develop my arguments.

73 51 B.R. 722 (Bankr. S.D. Ohio 1985).

74 *See id.* at 723–24.

75 *See id.* at 724.

76 *See id.*

77 *Id.*

buyer that it could see to the lease's termination.[78] The tenant-debtor and landlord subsequently discussed the lease's termination, after which the landlord sent the tenant-debtor a letter stating that the lease was terminated for rent default.[79] The letter requested the tenant-debtor's consent to the termination, and the tenant-debtor gave it.[80]

After the tenant-debtor declared bankruptcy, the trustee sued the buyer under section 548 to recover the lease, arguing that the lease termination was a constructive fraudulent transfer.[81] The court found that the termination was a transfer under the Bankruptcy Code simply because it was a "parting with . . . an interest in property."[82] But the court ultimately ruled for the buyer because the buyer successfully proved the good-faith defense under section 550(b).[83] The court never discussed section 365(c)(3).[84]

In *In re Edward Harvey Co.* (*Harvey*),[85] too, a nonresidential lease termination was a fraudulent transfer. But in contrast to *Queen City*, *Harvey* discussed section 365(c)(3) and its apparent tension with section 548.[86] In *Harvey*, the tenant-debtor and the landlord entered an agreement to terminate their lease agreement before the completion of the lease's term.[87] After the tenant-debtor declared bankruptcy, the trustee sued the landlord under section 548 to recover the lease, arguing that the lease termination was a constructive fraudulent transfer.[88] The factual record contained no evidence that the landlord re-leased or sold the property.[89]

The court ruled for the trustee for these reasons. First, the lease termination satisfied the Bankruptcy Code's definition of transfer.[90] And second, section 365(c)(3) did not apply to the facts of the case because the lease termination violated section 548 and, therefore, could

78 *Id.* at 725.

79 *Id.*

80 *Id.*

81 *Id.*

82 *Id.* at 726 ("There is just no getting away from the fact that upon the termination of [the] lease, there was a 'parting with . . . an interest in property', for after the termination of the lease [the tenant-debtor] no longer had an interest in the [property].").

83 *Id.* at 728–29.

84 The court may have decided not to discuss section 365(c)(3) because section 550(b) was dispositive of the case. *See infra* Section III.B.1. Alternatively, the case was decided very shortly after section 365(c)(3) was enacted, which may explain the omission.

85 68 B.R. 851 (Bankr. D. Mass. 1987).

86 *See id.* at 853 ("[This case] raises a number of novel issues as to the relationship between sections 548 and 365 of the Bankruptcy Code.").

87 *Id.*

88 *Id.*

89 Robert E. Goodman, Jr., *Avoidance of Lease Terminations as Fraudulent Transfers*, 43 BUS. LAW. 807, 808 (1988).

90 *In re Harvey*, 68 B.R. at 858.

not have been executed in compliance with state law.[91]

This second reason implies that section 365(c)(3) does not apply where section 548 has been violated. But this definitely proves too much. If section 365(c)(3) *never* applies where section 548 has been violated, then section 365(c)(3) is basically a dead letter. This becomes clear when we consider that, practically speaking, the only time section 365(c)(3) need apply is when the lease termination is otherwise potentially avoidable. Suppose the tenant-debtor terminates a lease whose cost in rent exceeds its value to the tenant-debtor. Since the lease is a "loser," its termination cannot be a fraudulent transfer. And precisely because it is a loser, the trustee will not attempt to assume it. But if the lease is a "winner," then, according to *Harvey*, the trustee may be able to use section 548 to avoid the termination and assume the lease, rendering section 365(c)(3) ineffective in the very situation it is meant to have effect.

2. Nonresidential Lease Terminations Cannot Be Fraudulent Transfers

Other cases seem to stand for the proposition that a nonresidential lease termination *cannot* be a fraudulent transfer. We look first at *Haines v. Regina C. Dixon Trust* (*Haines*).[92] There, the tenant-debtor defaulted on its lease.[93] In response, the landlord obtained a state court judgment terminating the lease.[94] As debtor-in-possession, the tenant-debtor sued the landlord, under section 548, to recover the lease.[95] The court ruled for the landlord, reasoning that section 365(c)(3) prohibited the debtor-in-possession from assuming the lease.[96] The court explicitly refused to follow *Harvey*: Since section 365(c)(3) is more specific than section 548, it reflects Congress's intent that section 365(c)(3) control in cases where the two statutes conflict. Following *Harvey* would have rendered section 365(c)(3) meaningless and, in this way, frustrated Congress's intent.[97]

The court stated that section 365(c)(3) was dispositive, but proceeded still to say that the lease termination was not a transfer for section 548's purposes.[98] It distinguished the termination before it from the ones in *Harvey* and *Queen City*. In *Harvey*, the tenant-debtor and

91 *Id.* at 856–58.
92 178 B.R. 471 (Bankr. W.D. Mo. 1995).
93 *Id.* at 473.
94 *Id.*
95 *Id.*
96 *Id.* at 474–75.
97 *Id.*
98 *Id.* at 476–77.

the landlord *agreed* to terminate the lease. By contrast, in *Haines*, the termination occurred because the tenant-debtor defaulted.[99] Once the state court handed down its judgment terminating the lease, the tenant-debtor's leasehold interest ceased to exist.[100] Quite simply, the tenant-debtor had no interest in property to transfer.[101] And in *Queen City*, even though the termination occurred by reason of default, the close relation between the tenant-debtor and landlord suggested an element of collusion not present in *Haines*.[102]

Next, *In re Egyptian Brothers Donut, Inc.* (*Egyptian Bros.*) is another case in which section 365(c)(3) prohibited the debtor-in-possession from using section 548 to recover a terminated nonresidential lease.[103] As in *Haines*, the tenant-debtor defaulted on its lease and the landlord obtained a state court judgment terminating it.[104] The court claimed to rely on *Haines*,[105] but its reasoning differed in a meaningful way. Remember that in *Haines*, the court concluded that the lease termination was not a transfer, and that even if it was, section 365(c)(3) prohibited the debtor-in-possession from using section 548 to assume the lease. The *Haines* decision implied, pretty clearly, that a termination *can* be a transfer despite the application of section 365(c)(3). By contrast, in *Egyptian Bros.*, the lease termination was not a transfer *precisely because* section 365(c)(3) applied.[106] The court acknowledged that a literal reading of the definition of transfer includes lease terminations but chose not to read the definition too literally because doing so would have brought sections 548 and 365(c)(3) into conflict.[107] I argue in Part III of this Note that the termination truly was not a transfer. But the court's argument was, frankly, wrong. Instead of saving sections 548 and 365(c)(3) from conflict, it created conflict between them.[108]

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99 *Id.*

100 *Id.*

101 *Id.*

102 *Id.* at 476.

103 190 B.R. 26 (Bankr. D.N.J. 1995).

104 *Id.* at 27–28.

105 *Id.* at 30 ("The court is persuaded by the analysis of the statutory framework stated by . . . *Haines*.").

106 *Id.*

107 *Id.* ("[T]hough the court agrees with the Debtors view that a literal definition of the term transfer encompasses termination of the franchise agreements and the leases, its application in Code §§ 547 or 548 so as to avoid the terminations is not consistent with the statutory framework." (citation omitted)).

108 *See infra* Section III.A.

3. *Great Lakes*

In *Great Lakes*, the tenant-debtor agreed with its landlord to terminate several leases early.[109] After the tenant-debtor declared bankruptcy, a committee made up of its creditors sued the landlord, under section 548, alleging that two of the terminations were constructive fraudulent transfers.[110] The landlord had since re-leased the properties to a new tenant.[111] The creditors' committee did not want to assume the leases; instead, it wanted to recover the value of the leases.[112] At trial, the bankruptcy court ruled for the landlord.[113] Relying mainly on *Egyptian Bros.*, the court held that section 365(c)(3) applied and, for that reason, the terminations were not fraudulent transfers under section 548.[114]

On appeal, the Seventh Circuit reversed.[115] First, Judge Posner discussed the Bankruptcy Code's definition of transfer. Relying solely on the text of section 101(54)(D), he concluded that transfer necessarily covered the lease terminations before him.[116] He rejected the landlord's argument that the terminations amounted to abandonments of the property and, therefore, were not transfers, on the ground that even abandonments of property satisfy the definition of transfer.[117]

After determining that the terminations were transfers, Judge Posner addressed the apparent conflict between sections 548 and

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109 *In re* Great Lakes Quick Lube Ltd. P'ship (*Great Lakes I*), 528 B.R. 893, 894 (Bankr. E.D. Wis. 2015), *rev'd sub nom. Great Lakes II*, 816 F.3d 482 (7th Cir. 2016).

110 *Great Lakes I*, 528 B.R. at 894.

111 *Great Lakes II*, 816 F.3d at 486.

112 *Great Lakes I*, 528 B.R. at 896.

113 *Id.* at 900–01.

114 *Id.* at 898 ("The court in *Egyptian Bros.* held that while the literal definition of 'transfer' encompasses termination of a franchise agreement or lease, authorizing the avoidance of the termination as a preference or fraudulent transfer is inconsistent with the statutory framework, i.e., the operation of § 365(c)(3), when the contract or lease was validly terminated pre-petition. . . . This Court agrees. Although arguably not as clear for an executory contract or residential lease that has terminated pre-petition, if a nonresidential lease has been terminated under state law prior to the petition, the termination is not an avoidable transfer under § 547 or § 548 of the Bankruptcy Code. The specific statutory provision regarding validly terminated nonresidential leases in § 365(c)(3) must control over the more general statutes allowing the avoidance of preferences and fraudulent transfers." (internal citations omitted)).

115 *Great Lakes II*, 816 F.3d at 486. On remand, the bankruptcy court ruled for the creditors' committee after finding that the terminations were made for less than reasonably equivalent value. *In re* Great Lakes Quick Lube Ltd. P'ship (*Great Lakes III*), No. 12–24163–svk, at *5 (Bankr. E.D. Wis. May 23, 2017) ("TD received a constructively fraudulent transfer . . . . Judgment on the Committee's § 548 claim will be entered accordingly.").

116 *Great Lakes II*, 816 F.3d at 485.

117 *Id.* Judge Posner's point is supported by *In re General Search.com*, where debt forgiveness constituted a transfer because the debtor parted with an interest in property that it was otherwise entitled to receive and which it could have used to satisfy its creditors' claims. 322 B.R. 836, 842–43 (Bankr. N.D. Ill. 2005).

365(c)(3). Emphasizing section 365(c)(3)'s purpose, he concluded that it prohibits the trustee (in this case, the creditors' committee) from selling a lease to someone who as lessee would be able to occupy the property.[118] Since the landlord had re-leased the properties to a new tenant, the creditors' committee could not assume and sell the leases.[119] But the creditors' committee did not want to assume the leases. Instead, it wanted to take advantage of section 550(a)'s money judgment option to recover the value of the leases.[120] Since recovering the value would not result in the new tenant's eviction, section 365(c)(3) did not apply.[121]

Judge Posner's opinion was short and to the point. Its brevity downplays the highly innovative nature of its reasoning. In ruling that the creditors' committee could sue under section 548 to recover the value of the leases from the landlord, Judge Posner implied a free disconnection between in rem and in personam recoveries. That is, where section 365(c)(3) makes the lease itself unrecoverable, the trustee may sue the defendant-transferee (the landlord, at least) for the lease's value.

III. RETHINKING LEASE TERMINATIONS AS FRAUDULENT TRANSFERS, INCLUDING THE SCOPE OF SECTION 365(C)(3)

Though it may appear inconsistent, the relevant case law can, for the most part, be reconciled. This Part does just that. First, I introduce a control standard to distinguish lease terminations that are transfers from those that are not. And second, I redefine the scope of section 365(c)(3) by exploring factual situations in which it appears to conflict with section 548 but really does not (or at least does not *have to*). This analysis makes use of Judge Posner's free disconnection between in rem and in personam recovery options. The payoff should be a clear and prompt basis for the adoption of Part IV's proposals.

118 *Great Lakes II*, 816 F.3d 485–86.
119 *Id.*
120 *Id.*
121 *Id.* at 486.

A. *Using "Control" to Determine Which Lease Terminations Are "Transfers"*[122]

Read literally, section 101(54)(D)'s definition of transfer strongly seems to include lease terminations. *Queen City*, *Harvey*, and *Great Lakes* all thought so. But a lease termination can also be viewed, quite reasonably, as the happening of a condition subsequent that divests the tenant-debtor of its interest in the property. Under this view, lease terminations are not transfers at all, because the divestment leaves the tenant-debtor without any interest in property to transfer. This, basically, was the view of the court in *Haines*.

These views can be reconciled using a "control" standard. Very simply, where the tenant-debtor had control of the property, the lease termination amounts to a transfer. But where the tenant-debtor did not have control of the property, the termination amounts to the occurrence of a condition subsequent, not a transfer.

This control standard can be drawn from *Drye v. United States*.[123] As the Supreme Court held in *Drye*, a taxpayer who disclaimed an inheritance did not, by doing so, prevent federal tax liens from attaching to the inheritance.[124] The Supreme Court emphasized the taxpayer's practical control over the disposition of the decedent's estate: since the taxpayer had the unqualified right to choose between receiving the inheritance and disclaiming it, the inheritance was property within the meaning of the relevant statute and, therefore, subject to federal tax liens.[125]

The utility of the control standard, as applied to lease terminations, becomes clear when applied retrospectively to the cases already discussed. In *Harvey* and in *Great Lakes*, the tenant-debtor had the unqualified right to choose between terminating its lease and not terminating it. These tenant-debtors had *control* over the fate of their leases. So, by choosing to terminate the leases, the tenant-debtors made a transfer of their interest in the property.

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122 As discussed earlier, see *supra* note 3, this section applies also to preferential transfers (11 U.S.C. § 547 (2012)), whose basic element, like fraudulent transfers, is a transfer of the debtor's property or an interest therein. *See* Barnhill v. Johnson, 503 U.S. 393, 396–97 (1992).

123 528 U.S. 49 (1999).

124 *Id.* at 61.

125 *Id.* ("[I]n determining whether a federal taxpayer's state-law rights constitute 'property' or 'rights to property,' '[t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property.'" (quoting Morgan v. Comm'r of Internal Revenue, 309 U.S. 78, 83 (1940))); *see also* U.S. Small Bus. Admin. v. Bensal, 853 F.3d 992, 998–1000 (9th Cir. 2017) (applying the analytical framework of *Drye* to find that the disclaimer of an inheritance was a transfer of property under the Federal Debt Collection Procedures Act because the taxpayer exercised the requisite control).

By contrast, the tenant-debtor in *Haines* defaulted, and this was the basis for the state court's judgment terminating the lease. The tenant-debtor *did not* have the absolute right to choose between terminating the lease and not terminating it. The tenant-debtor *lacked control* of the lease because the state court had already decided the lease's fate. For this reason, the termination was not a transfer, but the happening of a condition subsequent that divested the tenant-debtor of its property interest. The tenant-debtor in *Egyptian Bros.* similarly lacked control, and the court *should have* found that the termination at issue was not a transfer for this reason. But instead, the court said the termination was not a transfer simply because section 365(c)(3) applied. This created a needless conflict between section 365(c)(3) on the one hand, and sections 101(54)(D) and 548 on the other.

In *Queen City*, the tenant-debtor *appeared* to lack control because the lease termination occurred, formally, by reason of the tenant-debtor's default. But, as noted in *Haines*, the facts surrounding the tenant-debtor's default strongly suggested collusion between the tenant-debtor and the landlord.[126] If the parties actually colluded to terminate the lease, then the tenant-debtor did, in fact, have control of the lease, and the termination was a transfer. And even if there was no collusion, the tenant-debtor may have had control of the lease. Remember that the tenant-debtor consented to the lease's termination.[127] Instead, it could have contested the landlord's letter of termination in court. So, by consenting to the lease's termination before the lease was terminated by court judgment, the tenant-debtor arguably exercised the requisite control, making the termination a transfer.[128]

Using this control standard may create an incentive for collusion between related tenant-debtors and landlords. They may (as they might have in *Queen City*) try to conceal the tenant-debtor's control of the lease in order to avoid a court-finding that the lease termination was a transfer. Combatting collusion of this sort is the province of actual fraudulent transfer. Trustees can prove such collusion using the badges of fraud, as they would any alleged actual fraudulent transfer.[129] So any potential incentive for collusion is not reason enough to forego using

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126 In *In re Queen City Grain Inc.*, the tenant-debtor and landlord were related corporations whose stakeholders arranged to terminate the tenant-debtor's lease in furtherance of selling the property. 51 B.R. 722, 724 (Bankr. S.D. Ohio 1985); *see supra* Sections II.D.1–2.

127 *See In re Queen City*, 51 B.R. at 725; *supra* Section II.D.1.

128 I do not claim to define the exact parameters of control. The determination may well be, to an extent, case-dependent.

129 *In re* MarketXT Holdings Corp., 376 B.R. 390, 402–12 (Bankr. S.D.N.Y. 2007) (finding that the trustee made a prima facie case for actual fraudulent transfer, under section 548, by providing evidence of several "badges of fraud," including "[a] close relationship between the parties to the alleged fraudulent transaction" and "[c]oncealment of facts and false pretenses by the transferor").

the control standard.

B. *Reconciling Sections 548 and 365(c)(3)*

These hypothetical cases assume that the tenant-debtor exercised the requisite control, leaving no doubt that the terminations are transfers for section 548's purposes.

1. New Tenant Who Takes in Good Faith

To facilitate re-leasing, section 365(c)(3) protects the new tenants of commercial property from having their occupancies disturbed by former tenants' bankruptcy cases. For this reason, it might seem necessary to apply section 365(c)(3) whenever the landlord re-leases the property to a new tenant. But if the new tenant leases the property in good faith, section 365(c)(3)'s purpose can be fulfilled without having to apply the statute.

Consider these facts. The tenant-debtor and the landlord agree to terminate the tenant-debtor's lease. The landlord then re-leases the property to a new tenant, who takes for value and in good faith. The trustee is able to prove a prima facie case of constructive fraudulent transfer. But the new tenant can prove the section 550(b) defense, making its interest in the leased property superior to the trustee's. And so, the trustee cannot recover the lease itself from the new tenant—not because of section 365(c)(3), but because section 550(b) protects the new tenant's interest.

But the initial transfer from the tenant-debtor to the landlord is no less fraudulent because of the subsequent transfer from the landlord to the new tenant. The trustee simply cannot recover the *lease itself*. The lease's unrecoverability resulted from the landlord re-leasing the property. In essence, the landlord *converted* the lease. Since the lease was made unrecoverable by the landlord's conversion of it, the trustee can, under section 550(a), secure a money judgment for the value of the lease.

Queen City illustrates these points. There, the trustee could not recover the lease itself because the landlord's transferee proved the section 550(b) defense. The court did not discuss section 365(c)(3) because it did not have to. Had the trustee and the landlord not settled their dispute out of court,[130] the trustee could have sued the landlord to recover the value of the lease because the landlord made the lease

130 *See In re Queen City*, 51 B.R. at 725.

unrecoverable by selling it to an innocent transferee. The landlord could have been held liable for converting the lease—or, more accurately, for conduct tantamount to converting the lease.

2. New Tenant Who Takes in Bad Faith

If the new tenant cannot prove the good-faith defense under section 550(b), then the trustee *would* have a winning case against the new tenant but for the application of section 365(c)(3), which operates to prevent the trustee from avoiding the termination and recovering the lease itself. Here, sections 548 and 365(c)(3) inescapably conflict. And since section 365(c)(3) is more specific than section 548, section 365(c)(3) should govern.[131]

But just because the in rem option fails does not mean the in personam option must fail, too. Not under *Great Lakes*, at least. There, the failure of the in rem option *opened up* the option, under section 550(a), of securing a money judgment against the landlord. By making the in personam option available to the creditors' committee, Judge Posner used section 550(a) to give effect both to section 548 and section 365(c)(3). This is not only a reasonable reading of section 550(a). It is the *correct* reading, because it enables courts to satisfy the well-established principle that they shall, where possible, give effect to every part of a statutory scheme.[132]

3. No New Tenant

As written, section 365(c)(3) fails to distinguish between leases relating to property that has been re-leased or sold, and leases relating to property that *has not* been re-leased or sold. It therefore prevents the trustee from assuming and assigning a lease even if the landlord has not

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131 *See* RadLax Gateway Hotel, L.L.C. v. Amalgamated Bank, 566 U.S. 639, 645 (2012) ("The general/specific canon is perhaps most frequently applied to statutes in which a general permission or prohibition is contradicted by a specific prohibition or permission. To eliminate the contradiction, the specific provision is construed as an exception to the general one."); HCSC-Laundry v. United States, 450 U.S. 1, 6 (1981) (stating that the specific governs the general "particularly when the two are interrelated and closely positioned, both in fact being parts of [the same statutory scheme]").

132 *See In re* Asher, 488 B.R. 58, 69 (Bankr. E.D.N.Y. 2013) (stating that courts may not read provisions of the Bankruptcy Code "without reference to the Code's other provisions," because the "whole act rule of statutory construction demands that a court read a section of a larger statute not in isolation from the context of the whole Act but look to provisions of the whole law" (citation omitted) (internal quotation marks omitted)); *see also* United States v. Pacheco, 225 F.3d 148, 154 (2d Cir. 2000) ("[W]e must interpret a specific provision in a way that renders it consistent with the tenor and structure of the whole act or statutory scheme of which it is a part." (citation omitted) (internal quotation marks omitted)).

re-leased or sold the property. This prohibition is not needed to fulfill section 365(c)(3)'s purpose. In some cases, it may even *defeat* that purpose.

Suppose the trustee wants to assume the lease because the trustee has determined it will help raise cash for the unsecured creditors. Here, the trustee's assuming the lease will not disrupt the occupancy of the property's new tenant *because there is no new tenant*. In fact, preventing the trustee from recovering the lease may prolong the property's vacancy. Presumably, the trustee plans to put the property to profitable use. Otherwise, the trustee would not try to recover the lease because the game would not be worth the candle.[133] So, by preventing the trustee from recovering idle property, section 365(c)(3), as written, stands to defeat its own purpose. The trustee should be able to sue the landlord under section 548 to assume the lease.

This situation basically mirrors *Harvey*—assuming, of course, that the property in *Harvey* really had not been re-leased or sold at the time of litigation.[134] In deciding that the lease termination violated section 548, *Harvey* reached the right outcome because it properly applied section 548 without defeating the purpose of section 365(c)(3). But it reached the decision for the wrong reason. Remember that, in *Harvey*, section 365(c)(3) did not apply *simply because* the termination violated section 548. But as previously stated, this proves too much. If section 365(c)(3) never applies to terminations that violate section 548, then section 365(c)(3) is a mostly ineffective statute. Instead, *Harvey should have* decided that section 365(c)(3) did not apply because there was no new tenant. That way, it would have reached the right decision without creating needless conflict between sections 548 and 365(c)(3).

IV. RECONCILING SECTIONS 548 AND 365(C)(3): A JOB FOR COURTS AND CONGRESS

Part III develops a comprehensive (*more* comprehensive, at least) theory for reconciling sections 548 and 365(c)(3). Putting the theory into practice is a job for courts and Congress.

In cases commenced before the landlord has re-leased or sold the property, the plain language of section 365(c)(3) prohibits the trustee from avoiding the termination to assume the lease. Here, section 365(c)(3) is *overinclusive*. Its text exceeds the scope of its purpose, thus

133 *See supra* Section II.A (explaining that the trustee will not assume a lease unless it is valuable enough to benefit the unsecured creditors).

134 *See* Goodman, *supra* note 89, at 808 (noting that *Harvey*'s factual record contained no evidence that the landlord had re-leased or sold the property at the time of the adversary proceeding); *supra* Section II.D.1 (same).

bringing into the statute's ambit cases that its background justification does not cover.[135] As a result, the text threatens to impede the proper application of section 548 and to defeat section 365(c)(3)'s very purpose.

Congress should amend section 365(c)(3) so that it does not cover lease terminations where the landlord has not re-leased or sold the property. The section currently reads:

> The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if— (3) such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief.[136]

Instead, the section should read: "... (3) such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief, *and has been re-leased, sold, or otherwise transferred by the landlord to a subsequent transferee*." This amendment will ensure that overinclusive statutory text no longer impedes the proper application of section 548, without defeating section 365(c)(3)'s underlying purpose.

CONCLUSION

Sections 548 and 365(c)(3) both serve important goals. It is worthwhile to make sure the application of one does not interfere with the other. I believe this Note offers a theory that enables the harmonious application of sections 548 and 365(c)(3). It is up to courts and Congress to put the theory into practice; or, if they choose not to, then at least take this Note as a challenge to reconcile sections 548 and 365(c)(3) in their own way.

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135 FREDERICK SCHAUER, THINKING LIKE A LAWYER: A NEW INTRODUCTION TO LEGAL REASONING 26–27 (2009) ("The [overinclusive] rule includes or encompasses instances that the background justification behind the rule would not cover . . . . In such cases the reach of a rule is broader than the reach of its background justification, and so we say that the rule is overinclusive.").

136 11 U.S.C. § 365(c)(3) (2012).