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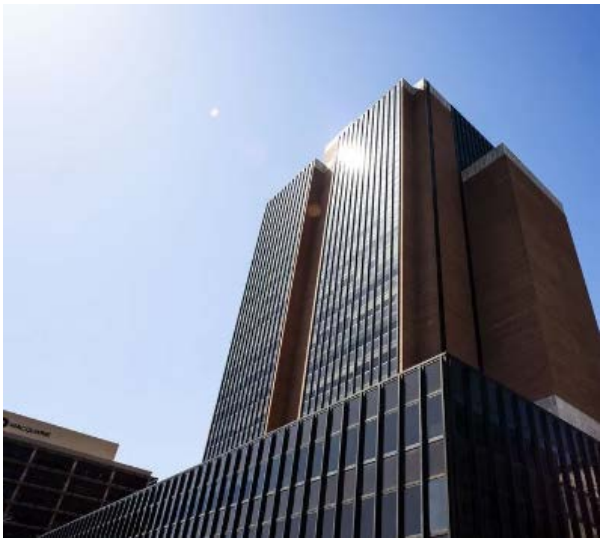
Keeping Your Options Open—Can a Debtor in Bankruptcy Revive an Expired Option?



By Sherry J. Millman and Harold A. Olsen

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In what for the creditor community is likely a welcome but not unexpected ruling, a panel of the U.S. Court of Appeals for the Third Circuit recently held, in *Speedwell Ventures v. Berley Associates (In re Pazzo Pazzo)*, No. 21-2344, (3d Cir. Dec. 15, 2022), that a terminated option to repurchase property could not be resurrected by a claim of the option holder's bankruptcy estate that the termination of the option was a fraudulent transfer. While the decision provides some guidance as to how the prepetition termination or expiration of a purchase option may fare in bankruptcy, the holding is narrow, and leaves open the question of whether the court's reasoning can be applied in other circumstances to shield prepetition transactions from avoidance claims.

The U.S. Bankruptcy Code enables a bankruptcy trustee or Chapter 11 debtor in possession to avoid or "claw back" certain transfers occurring during prescribed periods prior to the bankruptcy filing. The purpose of these provisions is promote fairness and equality of treatment of creditors by permitting the avoidance of certain transfers that result in preferential treatment of a particular creditor, see 11 U.S.C. Section 547, or that constitute constructive or actual fraudulent transfers. See 11 U.S.C. Section 548. The Bankruptcy Code's definition of "transfer" is very broad, including "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property; or an interest in property." Often the issue of whether a transfer has occurred is not in dispute—for example, where a debtor repaid a debt in cash, or conveyed personal property in an attempt to place it beyond the reach of creditors.

The underlying facts in *Pazzo Pazzo* easily supported the conclusion reached by the Third Circuit panel. Pazzo Pazzo (Pazzo) leased its restaurant premises from Speedwell Ventures (Speedwell), and the former owner of the premises, Pazzo's affiliate Berley Associates (Berley), held an option to purchases the premises from Speedwell upon the occurrence of certain events. Speedwell sent a series of notices to declare default, terminate the lease, and trigger Berley's thirty day window to exercise its purchase option. Pazzo and Berley maintained "radio silence" in regard to these notices, took no action to cure defaults or challenge the lease termination, and Berley made no effort to exercise its purchase option. Accordingly, Speedwell sent a further notice indicating the option had lapsed, recorded a discharge of the option in the county records, and sold the underlying property.

More than half a year after these events, Berley and Pazzo filed for bankruptcy under Chapter 11, and listed the terminated lease and option to repurchase the property as assets in their bankruptcy schedules. The debtors argued that the lease had not validly terminated and could be assumed, and sought to avoid the termination of the option as a fraudulent transfer. The Bankruptcy Court concluded that the lease had validly terminated for abandonment and vacation, and that the termination of the option was not a "transfer," because any property interest Berley held was dependent on compliance with the terms of the option contract, which Berley failed to do. The district court agreed, observing that the property at issue was the option, a contingent future intertest in the underlying real property, and that by failing to timely exercise the option, Berley did not "dispose of" or "part with" the option. Rather, it retained the option until it was no longer exercisable, which the district court characterized as the mere failure to pursue a business opportunity. Further, the district court observed that fraudulent transfer law is a narrow exception to the general rule that the bankruptcy estate has no greater interest in property than the debtor prior to bankruptcy, see Mission Product Holdings v. Tempnology, 139 S. Ct. 1652, 1663 (2019), and expanding its reach to permit clawback of interests that had expired on their own terms would be inconsistent with this statutory scheme. The Third Circuit panel affirmed in a nonprecedential opinion.

While *Pazzo Pazzo* speaks specifically to the future contingent nature of the option to repurchase, which option lapsed, there is reason to believe that the "no transfer" analysis could apply more broadly to other pre-petition interests of the debtor which expire on their own terms prior to bankruptcy. Indeed, the Third Circuit panel made the point that it did not "endeavor to 'threaten the rule that the estate can only take what the [debtor's] estate possessed before filing.'" *Pazzo Pazzo* (quoting *Mission Product Holdings,* 139 S. Ct. at 1663). This is consistent with the principle underlying Section 365(c)(3) of the Bankruptcy Code, which prohibits a debtor from assuming or assigning a lease of nonresidential real property that has been terminated in accordance with applicable nonbankruptcy law prior to the tenant's bankruptcy.

It is less clear whether termination of a prepetition interest that is actively effectuated (such as the early surrender of an option or of a lease) rather than passively (through the passage of time or the satisfaction of existing conditions in the applicable documents) would be protected. Given this uncertainty lenders, lessors and other creditors should continue to take precautions to reduce risk when negotiating the termination of an agreement with a counterparty. Creditors should seek to quantify and memorialize the benefit that the debtor is receiving to terminate its position, as ammunition against a challenge that the termination is subject to avoidance as a fraudulent transfer.

Sherry J. Millman*, a partner with Stroock & Stroock & Lavan, has been practicing in the restructuring and bankruptcy field for over thirty years. She has extensive experience representing creditors and other major stakeholders in large complex bankruptcy proceedings and out-of-court restructurings.* **Harold A. Olsen***, a partner with the firm, practices in the area of restructuring and bankruptcy. He regularly represents lenders, commodity trading counterparties and other creditors in Chapter 11 cases.*