ALERTS

Court of Appeals Preserves Lenders' Tort Claims Against Debtors' Insiders

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A lender's state law tort claims against "non-debtor third-parties for tortious interference with a contract" were "not preempted" by "federal bankruptcy law," held the New York Court of Appeals on Nov. 24, 2020. *Sutton 58 Associates LLC v. Pilevsky*, 2020 WL 6875979, *1 (N.Y. Ct. Appeals, Nov. 24, 2020) (4-3). In a split opinion, the Court of Appeals reversed the Appellate Division's dismissal of a lender's complaint against the debtors' non-debtor insiders. The lender will still have to prove its case at trial.

The Asserted Claims

The insiders had allegedly interfered with the borrower debtors' loan agreements with the lender. According to the lender, the defendants wrongfully caused the debtors to breach "covenants in … loan agreements prohibiting …. borrowers from incurring non-permitted indebtedness, owning other assets, and transferring any interest in …. borrowers." *Id.* at *2. The insiders had also caused the borrower debtors to breach provisions requiring the borrowers to remain special purpose bankruptcy remote entities." *Id.* Therefore, asserted the lender, the defendant insiders had delayed the lender's "ability to exercise its contractual remedies" causing the bankruptcy case to be "more protracted" when the borrower debtors had no longer qualified "as single asset real estate entities and [had] taken on another creditor." *Id.* These acts allegedly resulted in "significant loss in value of the [debtor's] development site." *Id.*

Relevance

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No "controlling precedent" existed under New York law, explained the Court of Appeals. *Id.*, at 3. By providing commercial lenders in New York with a state law remedy against a debtor's non-debtor insiders, the court has given them additional leverage in pre-bankruptcy restructuring negotiations. In New York, at least, a debtor's insiders will no longer be able to hide behind the ample protections given to debtors under the Bankruptcy Code ("Code"). Less than a week after the *Sutton* decision, though, a California federal appellate court affirmed the bankruptcy court's disallowance of a lender's abuse of process and tortious interference claims, holding that "the Bankruptcy Code preempted the state law [claims] because they arose from the" debtor's filing of an affiliate's bankruptcy petition. *In re Bral*, 2020 WL 7025096, *1 (9th Cir. BAP Nov. 30, 2020).

Bankruptcy Remote Entities

The borrower debtors in *Sutton* had explicitly agreed in the relevant loan documents to preserve their "bankruptcy remote" status — not incurring indebtedness; not acquiring "unrelated assets"; and not transferring any interest in the debtors or their property. These provisions were intended, explained the court, to minimize the likelihood of the borrowers' seeking bankruptcy relief or, if they did, to expedite the "bankruptcy process." *Id.*, at *1.

Bankruptcy remote special purpose entities ("SPEs") are often created in real estate transactions and structured finance deals to isolate the assets covered by the loan or financing. This structure enables lenders to deal only with the assets securing the loan. More important, the structure minimizes the risk of a bankruptcy filing by the SPE. Because parties cannot contract away the right to seek bankruptcy relief, they typically require, among other things, separate assets, liabilities, books and operations, as was done in *Sutton*.

The Bankruptcy Case

To mitigate its losses, the lender in *Sutton* cooperated during the course of the borrowers' bankruptcy cases and recovered part of its claim. But the lender never waived its contractual rights against the non-debtor insiders.

The Lower Courts

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The trial court denied the defendant insiders' motion for summary judgment dismissing the complaint, reasoning that the lender's suit did "not involve the bankruptcy" and that the insiders had allegedly interfered with "separate contractual agreements." *Id.*, at *3. On appeal, however, the Appellant Division reversed and ordered the complaint dismissed, reasoning that the lender's claims were preempted by federal law because its damages arose "only because of the bankruptcy filings." *Id.*, quoting 168 A.D. 3d 477 (1st Dept. 2019).

No Federal Preemption

The court rejected the defendant insiders' argument that the lender's claims were preempted by federal bankruptcy law because the defendants had identified no specific Code provisions that had preemptive effect. *Id.*, at *6. In its view, the lender's claims were "peripheral to, and do not impugn, the bankruptcy process." *Id.* Further, resolution of the lender's "claims in state court does not risk interference with the Bankruptcy Court's control over, or disposition of, the bankruptcy estate [because] the present suit does not impair the debtors' estates." *Id.*, at *7. The debtors would be "unaffected by whether plaintiff prevails on its tort claims against defendants, and the state action has no impact on the [debtors'] ability to obtain a 'fresh start.'" *Id.* After trial in the state court, the defendants "may be found to have tortiously interfered with plaintiff's contractual rights prior to the bankruptcy [case] without any inquiry by the state court into whether any provision of the Bankruptcy Code was violated." *Id.*

Federal Decisions

Federal courts faced with claims like those here distinguish "between those claims that are based on conduct that occurs during bankruptcy, and conduct undertaken by a third party before commencement of a bankruptcy [case]." *Id.*, at *8. For example, in *Davis v. Yageo Corp.*, 481 F.3d 661, 678-79 (9th Cir. 2007), the Ninth Circuit held that only "state law causes of action for abuse of process and malicious prosecution involving conduct that occurred during bankruptcy are preempted." The claims in *Davis* were not preempted because they "concern[ed] conduct that occurred prior to bankruptcy" and did "not require the adjudication of rights and duties of creditors and debtors under the Bankruptcy Code." 481 F.3d at 678-679. According to the New York Court of Appeals in

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Sutton, *Davis* "recognized that it is the nature of the legal claim, not the measure of damages, that is relevant to determining whether a state law claim is preempted." 2020 WL 6875979, at *8. In fact, the insider defendants in *Sutton* effectively conceded that no "remedy was available to [the lender] in the bankruptcy [case] to compensate [the lender] for [insider] defendants' alleged wrongdoing." *Id.*

Overstated Threats of Massive Litigation

Finally, the court rejected arguments by defendants and certain "amici" who argued that permitting the lender's tort claims "to proceed will open the floodgates of litigation against attorneys who facilitate bankruptcy filings or provide other legal advice to debtors." *Id.* at *9. Not only are "these concerns … overstated," said the court, but they also can be "addressed through the proper application of [New York] tort law." *Id.* "New York courts have been skeptical of the viability of claims that attorneys, acting as agents of their clients, may be liable for tortious interference based on the provision of legal advice." Moreover, "many potential bankruptcy petitioners are financially bereft and close to breaching contracts with creditors, if not already in breach, due to their inability to satisfy their financial obligations." *Id.* A potential tort plaintiff would thus be unable to show causation.

The Dissent

The dissent strenuously argued that "federal law preempts plaintiff's workaround of the bankruptcy system." *Id.* at *10. In the view of the three dissenting judges, the state law tort claims here were "entirely predicated upon the filing and prosecution of" the bankruptcy petitions. *Id.* at *23, quoting *In re Miles*, 430 F.3d 1083, 1093 (9th Cir. 2005).

Comment

The Nov. 30, 2020 *Bral* decision in California, noted earlier, may have reached a different result in holding the lender's claim to have been preempted by the Code, but its reasoning is consistent with *Sutton*. In *Bral*, the lender had not asserted "prepetition state law [claims] divorced from the Bankruptcy Code." 2020 WL 7025096, at *8. "Rather, its claims arose from" the "bankruptcy filing itself" by the debtor's affiliate. *Id.* The "gravamen" of the lender's claim in *Bral* sought "damages for [papers] filed

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in the bankruptcy court." *Id.* And the lender litigated in the bankruptcy court, not the state court.

Sutton and *Bral* may not be the last word on the preemption issue under federal law. The defendants in *Sutton* may seek review by the U.S. Supreme Court and the lenders in *Bral* may appeal to the Ninth Circuit.

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

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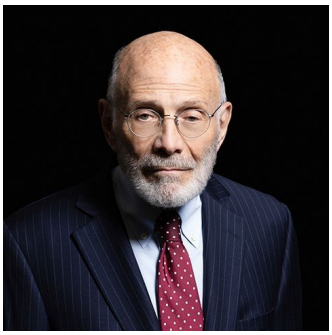

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