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Don't Lend No Hand to Raise No Flag Atop No Ship of Fools: Breach of SPE Provisions by Non-Borrower Exposes Non-Borrower to Potential Tort Liability

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A recent decision of New York's highest court potentially strengthens the ability of lenders to bring suits against third parties for participation in a borrower's breach of single purpose entity/bankruptcy remote loan document covenants.

The case, Sutton 58 Associates LLC, Appellant v. Philip Pilevsky, *et al.*, Respondents, involved a development project in Manhattan's Sutton Place neighborhood. The lender made mortgage and mezzanine loans in the aggregate amount of $147,250,000 to the owner of the project and its sole member. The loans were not repaid upon maturity, and the lender sought to foreclose under its mezzanine loan. Prior to the scheduled UCC foreclosure sale, the mezzanine borrower filed a voluntary Chapter 11 bankruptcy case, which was followed by the voluntary Chapter 11 filing of the mortgage borrower. In a separate state court action, the plaintiff lender alleged that prior to the bankruptcy filings, defendant Philip Pilevsky caused an affiliated entity to lend the mezzanine borrower $50,000 to retain a law firm to file a bankruptcy petition, resulting in a breach of the loan document special purpose entity requirements. The plaintiff further alleged that defendants Michael Pilevsky and Seth Pilevsky caused an affiliated entity to transfer three apartments to the mortgage borrower, in violation of the loan document single purpose entity requirements and in order to prevent the mortgage borrower from being a Single Asset Real Estate Business for purposes of the Bankruptcy Code, which would deprive the lender of procedural advantages in the bankruptcy case. The lender further alleged that a Pilevsky entity acquired a 49% interest in the parent of the mezzanine borrower, which also violated the loan documents. Based on the above, the lender sued the Pilevsky defendants in state court for tortious interference with contractual relationships. At the trial court level, the defendants moved for summary judgment on the basis that the lender's claims were preempted by federal bankruptcy law. The trial court denied the motion. The defendants appealed, and the initial appellate court reversed and granted the defendants' motion. The lender then appealed to the Court of Appeals. The Court of Appeals, by a narrow 4-3 majority, held that the lender's tortious interference claims were not preempted, and that these claims could proceed in New York State court.

The majority wrote that federal bankruptcy law does not suggest an intent of Congress to interfere with a state court's authority to provide tort remedies for claims brought by a person that is not a debtor in the bankruptcy proceeding against persons that are also non-debtors in the proceeding for interference with contractual relations that exist independently of the bankruptcy proceeding. The majority noted that the claims against the defendants are based on conduct that occurred prior to the institution of the bankruptcy proceedings, do not raise any question as to the propriety of the bankruptcy proceedings, and do not risk interference with the Bankruptcy Court's control over the debtor's estate.

The dissent, on the other hand, contended that because the plaintiff's claims arise from and seek damages caused by the bankruptcy filings, the plaintiff lender had "recast as state law causes of action what are in fact complaints of bad-faith filings and misuse of the bankruptcy system." In addition, the dissent expressed concern that the majority's decision will affect debtor access to bankruptcy remedies (particularly debtors of limited means) because the prospect of state court litigation may discourage lawyers and secondary lenders from assisting debtors. Accordingly, the dissent concluded that the claims were preempted by federal bankruptcy law and could not be brought in a state court action.

The case did not involve claims under a recourse carve-out guaranty or any other loan documents. The opinion addressed claims by the lender against third parties that, based on the facts recited in the court's decision, appear to have become involved with the project in the context of a distress scenario. The court held that under the

circumstances of this case, the Bankruptcy Code did not provide these third parties protection against claims by the lender alleging that they tortiously interfered with the contractual relationship between the borrowers and the lender. Thus, it can be viewed as strengthening the potential remedies that a lender can assert against third parties that introduce themselves into a distress situation and aid the borrower in frustrating lender protections contained in the loan documents. While nothing in the opinions indicate that the Pilevsky defendants had any previous involvement with the borrowers, there is no reason to assume that the court would have ruled any differently if affiliates of the borrowers had engaged in similar actions, which could potentially expose them to liability even though those affiliates themselves might not have been parties to a recourse carve-out guaranty or any other loan documents. It is important to note, however, that the Court of Appeals did not address the sufficiency of the lender's allegations to support a cause of action based on tortious interference, and did not address the prospects of the lender actually prevailing on such claims. It simply held that under the circumstances, the federal Bankruptcy Code did not preclude the lender from bringing such claims in state court, independent of the bankruptcy proceedings.

The facts in this case seem suspicious at best. It was an apparent attempt by a "friend" of the borrower to provide funds to finance the borrower's fight with its lender and through transactions which were impermissible under the loan documents to prevent a lender from availing itself of the protections of a Single Asset Real Estate Business under the Bankruptcy Code. The transactions orchestrated by the third party were clearly prohibited by the loan documents and arguably were not entered into for an independent business purpose based on standard economic objectives. The transactions seem more likely to have been driven by the impact they would have on the borrower's distressed situation and its "fight" with its lender. It is unclear whether this third party was looking to capitalize on a distressed situation and end up a majority owner of the asset down the line – however, others should be cautioned by the ramifications of this decision. This decision is a welcome result which may deter other third parties from allegedly aiding and abetting borrowers in violating bargained-for restrictions in their loan documents.