New York Court of Appeals Holds No Bankruptcy Preemption of Lender Tort Claims Against Related Third Parties

By Dominic J. De Simone, Dean C. Waldt, and Paul E. Harner*

New York's highest court, the New York Court of Appeals, has held that claims against non-debtor related parties, based on their actions to aid or induce Chapter 11 debtors to breach contractual loan covenants, were not subject to preemption under federal bankruptcy law. The authors of this article discuss the decision, which will certainly be a point of reference in future litigation arising from single asset real estate cases.

The State of New York Court of Appeals (the highest appellate court in New York) has held that claims against non-debtor related parties, based on their actions to aid or induce Chapter 11 debtors to breach contractual loan covenants, were not subject to preemption under federal bankruptcy law.

The 2-1 decision by the New York high court is a case of first impression and will certainly be a point of reference in future litigation arising from single asset real estate cases. The case has direct relevance for real estate lenders bringing actions against non-debtor parties after a bankruptcy filing by the borrower, such as non-recourse carve-out guarantors or debtor-related parties who may have aided the borrower/debtor in breaching its loan covenants to the lender.

BACKGROUND

The case of *Sutton 58 Associates v. Philip Pilevsky, et al.,* involved a lender's development loan to a single asset real estate borrower and a mezzanine loan to its parent entity. Both the borrower and parent defaulted and filed Chapter 11 bankruptcy cases, which were jointly administered. The lender filed but then withdrew a motion in the bankruptcy court to dismiss the cases as bad faith filings. Prior to the bankruptcy filings, individuals and entities related to the debtors engaged in various loan and property transfer transactions with the debtors. These transactions resulted in debtors breaching loan covenants. These breaches created a factual scenario that disqualified the borrower from being a "single asset real estate" ("SARE") debtor in its Chapter 11 case.

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The bankruptcy cases were ultimately resolved through an auction sale under a confirmed Chapter 11 sale plan, through which the lender acquired its collateral by credit bid. However, the lender asserted that the cases were longer and more expensive than they would have been if the borrower had been required to file as a SARE debtor. During the pendency of the Chapter 11 cases, the lender filed an action in New York state court against the related persons and entities that had engaged in pre-petition transactions with the debtors, alleging that their actions constituted tortious interference with contract. The lender sought damages against these defendants based on the additional costs of the protracted Chapter 11 cases and the decline in collateral value that occurred during the delay.

Defendant non-debtor related parties moved to dismiss the state court lawsuit, alleging that any claims against them were preempted by federal bankruptcy law. The defendants asserted both "field preemption" and "conflict preemption" theories in support of dismissal. Field preemption involves the intent of Congress to comprehensively override state claims in a particular area of law. Conflict preemption involves situations in which state law stands as an obstacle to the accomplishment of the intent of Congress under federal law. As a policy matter, the defendants argued that allowing tort claims against non-debtor parties who aided the debtor would chill the freedom of debtors to seek bankruptcy relief.

The trial court rejected these preemption arguments and denied the defendants' motion to dismiss. The New York Appellate Division reversed, holding that the lenders' business tort claims against non-debtor related parties were preempted by federal bankruptcy law. That ruling effectively created a Catch-22 situation. The bankruptcy court had no jurisdiction to adjudicate state law tort claims between non-debtor parties. Nevertheless, the appellate division ruled that the claims were preempted and could not be brought in state court. This left the lender with claims to assert against non-debtor parties and no forum in which to assert them. The lender appealed.

THE COURT OF APPEALS' DECISION

The Court of Appeals reversed the decision of the appellate division and held that preemption did not apply. The court made short work of the defendants' field preemption arguments, holding that there is no basis to assert a congressional intent to interfere with the authority of state court[s] to provide tort remedies for claims between non-debtor parties. As to conflict preemption, the court recognized the distinction between cases in which the filing of a bankruptcy case itself was asserted to be a tortious act and cases in which independent claims are asserted against non-debtor parties which do not

question the propriety of the bankruptcy filing. Preemption applies in the first instance, but does not apply in the second.

In this case, the court recognized that the lender asserted "a claim for tortious interference with contract and the remedy for that tort would not affect the debtor's estate." While tort claims seeking damages calculated by the impact of a bankruptcy filing may create some "tension" between state and federal law, the court held that the mere existence of 'tension" does not provide a basis for preemption.

CONCLUSION

The *Sutton 58* decision presents a thorough and detailed analysis of the preemption issue as it relates to lender claims against non-debtor parties, including guarantors and those who facilitate covenant breaches by a putative debtor/borrower. It preserves the rights of lenders to pursue such third-party claims in state court forums and negates the Catch-22 situation created by the New York intermediate appeals court decision. As a case of first impression, *Sutton 58* will provide guidance to courts addressing these issues in the future.