APL-2019-00028
New York County Clerk's Index No. 654917/16

Court of Appeals

of the

State of New York

SUTTON 58 ASSOCIATES LLC,

Plaintiff-Appellant,

– against –

PHILIP PILEVSKY, MICHAEL PILEVSKY, SETH PILEVSKY, PRIME ALLIANCE GROUP, LTD. and SUTTON OPPORTUNITY LLC,

Defendants-Respondents.

BRIEF FOR *AMICUS CURIAE* AMERICAN COLLEGE OF MORTGAGE ATTORNEYS IN SUPPORT OF PLAINTIFF-APPELLANT

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Date Completed: November 15, 2019

CORPORATE DISCLOSURE STATEMENT

Pursuant to 22 NYCRR § 500.1(f):

The American College of Mortgage Attorneys ("ACMA") is a Georgia 501(c)(6) non-profit corporation formed in 1974 and comprised of experienced private practice and in-house commercial real estate finance lawyers from the United States, Canada and certain other jurisdictions within North America. ACMA has no parents, subsidiaries or affiliates.

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INTEREST OF AMICUS

The American College of Mortgage Attorneys ("ACMA") is an organization whose members are lawyers servicing and supporting the commercial real estate finance industry. ACMA seeks to enhance the availability of financing for commercial real estate development and foster efficient capital markets in real estate transactions. Among its purposes it to improve and reform real estate lending practices and procedures.

STATEMENT PURSUANT TO 22 NYCRR § 500.23(A)(4)(iii)

No party or its counsel, nor any person or entity other than the Proposed *Amicus* and its counsel, participated in preparing, funding or submitting this brief.

The American College of Mortgage Attorneys ("ACMA") respectfully submits this *amicus curiae* brief in the above-captioned appeal filed by Plaintiff-Appellant Sutton 58 Associates LLC (the "Appellant") seeking the reversal of the January 10, 2019 Decision and Order (the "Decision") of the Appellate Division, First Department (the "Appellate Division"), which reversed the March 8, 2018 Decision and Order of the Supreme Court of New York, New York County and dismissed the underlying action on the ground that it is preempted by the United States Bankruptcy Code under the Supremacy Clause of the United States Constitution.

POINT I

THE DECISION CREATES A JURISDICTIONAL LIMBO IN WHICH CLAIMS BY MORTGAGE LENDERS AGAINST NON-DEBTOR THIRD PARTIES UNRELATED TO PROPERTY OF THE BANKRUPTCY ESTATE CAN NEVER BE ASSERTED

The Appellate Division held that a mortgage lender's claims against non-debtor parties related to their allegedly tortious pre-bankruptcy actions in aiding the borrower/debtor to breach certain covenants in the loan agreement between the lender and the borrower/debtor cannot be adjudicated in the courts of the State of New York because such claims are preempted by title 11 of the United States Code (the "Bankruptcy Code").[1]

[1] Although Appellant asserted that the contract breaches at issue aided the borrower/debtor in the filing and conduct of its chapter 11 bankruptcy case and ultimately made it more difficult and

The Decision is unprecedented because it denies access to the courts of the State of New York to tort claimants who assert no claims against a bankruptcy debtor merely because part of the alleged harm suffered by the injured party resulted from a bankruptcy filing. The Decision holds that the sole venue for adjudication of these claims is in a federal bankruptcy court.

On multiple fronts, the Appellate Division failed to properly consider and interpret established case law governing the limited jurisdiction of bankruptcy courts as tribunals established and functioning under Article I of the United States Constitution. A bankruptcy court cannot adjudicate the Appellant's claims. As a result, the Decision leaves the Appellant in this case, and potentially other mortgage lenders in analogous cases, with no jurisdictional forum in which to assert claims against non-debtor third parties. In light of the clear risk that the Decision may be applied to deny legal recourse to mortgage lenders asserting such claims, reversal of the Decision is essential in order to maintain access to the judicial system for mortgage lenders in commercial real estate transactions in New York.

expensive for the lender to exercise its contractual rights, Appellant did not assert that the filing of the bankruptcy case was wrongful, sought no judicial relief against the borrower/debtor, and asserted no other claims with respect to the borrower/debtor's bankruptcy filing.

First, the Decision contradicts without comment the decision of the United States District Court for the Southern District of New York in *In re Extended Stay, Inc.*, 435 B.R. 139 (S.D.N.Y. 2010), which rejected similar preemption arguments, as noted in Appellant's brief.

Second, and at a more basic level, the Decision fails to consider the established case law related to the limitations on the jurisdiction of an Article I bankruptcy court – an issue that has been weighed extensively by the United States Supreme Court over the last several years.

In *Stern v. Marshall*, 564 U.S. 462 (2011), the Supreme Court held that, even when the Bankruptcy Code provides statutory authority for a bankruptcy court to adjudicate a debtor's compulsory counterclaim to a proof of claim filed by a creditor, the constitutional limits on bankruptcy court jurisdiction bar such adjudications. This is true even though adjudicating a proof of claim is a "core" matter subject to bankruptcy court jurisdiction under 28 U.S.C. § 157. The *Stern* court held that, regardless of the statutory jurisdictional scheme, bankruptcy courts are subject to constitutional restraints that preclude them from performing the duties or assuming the powers of courts established under Article III of the United States Constitution. Thus, even claims or counterclaims that are statutorily "core" under the Judiciary Code cannot be finally adjudicated in a bankruptcy court. *Id.* at 499.

In *Executive Benefits Insurance Agency v. Arkinson*, 573 U.S. 25 (2014), the Supreme Court clarified *Stern*, holding that bankruptcy courts do have the ability to hear and make proposed findings of fact and conclusions of law on so-called "*Stern* claims," but solely for referral to an Article III court for final determination. These are claims that are statutorily core claims under 28 U.S.C. § 157, arising in or under the Bankruptcy Code, and that involve a non-debtor third party not consenting to the jurisdiction of the bankruptcy court to make a final adjudication.

In the following year, the Supreme Court affirmed that where all parties consent to the bankruptcy court making a final adjudication on a "*Stern* claim," the Bankruptcy Code allows for this procedure. *Wellness Int'l Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015).

At a minimum, this trilogy of Supreme Court case law establishes that a state-law-based cause of action asserted *by a debtor* against a non-debtor party, where the non-debtor party has not submitted to the jurisdiction of the bankruptcy court, cannot be finally adjudicated in a bankruptcy court without the consent of the non-debtor party.

The Decision makes an exponential legal leap beyond the *Stern* trilogy without explanation or justification and extends exclusive bankruptcy court jurisdiction to a claim that is strictly *between two non-debtor parties*. Under the guise of constitutional preemption, the Decision assumes that a bankruptcy court can exercise jurisdiction beyond its constitutional limits. Based on that error, the Decision necessarily denies a lender/plaintiff access to the courts of the State of New York to adjudicate state law claims and forces the lender/plaintiff into a forum that cannot constitutionally adjudicate its claims. This is a legal limbo from which there is no escape, rendering such claims impossible to adjudicate. It is the classic example of an alleged wrong without a remedy.

Critically, the claims at issue here are not even "*Stern* claims." These are claims asserted by one non-debtor party against another non-debtor party. State law claims between non-debtors are *per se* non-core under 28 U.S.C. § 157. *In re Scott*, 572 B.R. 492, 521 (Bankr. S.D.N.Y. 2017), *aff'd*, No. 17 Civ. 5881 (AJN), 2018 U.S. Dist. LEXIS 10466 (S.D.N.Y. June 21, 2018).

At best, this leaves the claims addressed by the Decision to be considered as possible "related to" claims under 28 U.S.C. § 157(c)(1), as to which a bankruptcy court may make proposed findings of fact and conclusions of law to be considered subsequently by a district court. But upon consideration, the claims addressed in the Decision cannot even be classified as "related to" claims.

A third-party action does not create "related to" jurisdiction when the asset in question is not property of the estate and the dispute has no effect on the estate. *See, e.g., In re Johns-Manville Corp.*, 517 F.3d 52, 65 (2d Cir. 2008), *rev'd on other grounds by Travelers Indem. Co. v. Bailey*, 557 U.S. 137 (2009). The

Second Circuit has held that a bankruptcy court's jurisdiction is limited to third-party non-debtor claims that directly affect the *res* of the bankruptcy estate. *In re Quigley Co.*, 676 F.3d 45, 53 (2d Cir. 2012). The Third Circuit recently held, moreover, that a bankruptcy court cannot cure a jurisdictional defect by transferring a case to a district court under 28 U.S.C. § 610 precisely because there are independent constitutional limitations on the Article I jurisdiction of bankruptcy. *In re IMMC Corp.*, Civ. No. 15-1043 (GMS), 2018 U.S. Dist. LEXIS 203 (D. Del. 2018), *aff'd*, No. 18-1177, 909 F.3d 589 (table), 2018 U.S. App. LEXIS 34030 (3d Cir. Nov. 28, 2019)

The Appellant is a mortgage lender asserting business tort claims against non-debtor parties. No claims were asserted by the Appellant against the debtor/borrower and no damages or other remedies are sought against the debtor/borrower, nor could any result from adjudication of the Appellant's claim against the non-debtor defendant. No property of the bankruptcy estate is involved or affected. Thus, these are not core claims to be treated under the *Stern* trilogy, which results in a finding of no jurisdiction. Neither are they "related to" claims as to which a bankruptcy court might adjudicate non-debtor claims on a preliminary basis before sending them along to a district court. Rather, these are claims by one non-debtor against other non-debtors that do not affect the *res* of any bankruptcy estate.

The Decision bars the Appellant from access to the courts of the State of New York in favor of a forum in which, *constitutionally*, its claims can never be adjudicated. That bar is based solely on the attenuated and unprecedented reasoning that only a bankruptcy court can adjudicate the claims because the damages asserted by the Appellant against third party non-debtor defendants are factually based on the defendants' allegedly tortious behavior in aiding a then-putative debtor to breach its contractual obligations to Appellant, which breaches altered the course and conduct of the debtor's subsequent chapter 11 case. This places Appellant's claims against a non-debtor party in a jurisdictional limbo from which there is no escape. As a result, the claims are essentially dead.

No preemption doctrine allows this result. The preemption governs the forum in which a dispute is to be resolved. It never bars resolution of a claim in *any* forum. But that is precisely, and undeniably, the effect of the Decision – hence why it must be reversed.

POINT II

THE DECISION WILL RESULT IN INCREASED LENDER RISK AND BORROWER COST AND, ACCORDINGLY, NEGATIVELY IMPACT SECURED REAL ESTATE LENDING IN NEW YORK

By denying access to the courts of the State of New York to lenders in real estate finance transactions in order to enforce and protect commonly negotiated contractual rights and relegating mortgage lender claims against non-debtor third parties to a jurisdictional dead end, the Decision denies lenders the benefit of important bargained-for contractual rights at the heart of most commercial real estate financing transactions. Allowing the decision to stand would increase the risk to real estate lenders in New York, which will necessarily increase the cost and availability of secured mortgage credit to owners and developers.

The claims asserted by the Appellant in the trial court are based on the actions of non-debtor/non-borrower third parties that aided the borrower/debtor in breaching its contractual obligations to its mortgage lender. Without regard to the merits of these tortious interference claims, the contractual provisions involved in the case are important and essential to commercial real estate lending.

These provisions include the so-called "SPE" covenant, which is a fundamental and bargained-for element of most commercial real estate finance transactions pursuant to which a borrower contractually agrees that it is a "special purpose entity" that will own nothing other than the property, and that it will conduct no other business other than the operation of the property that is collateral for the mortgage loan. In this structure, the proceeds of the loan are used to acquire, develop or refinance the real estate collateral. The contractual SPE covenant limits the lender's risk because the borrower will not acquire assets in which other entities or lenders have an interest and will not create liabilities or other obligations that might conflict with the rights of the lender as consideration for the making of the loan. It also assures the lender that the borrower will focus its full attention to the maintenance and operation of the lender's collateral. In addition, should the borrower become a chapter 11 debtor, it will be a "single asset real estate debtor" as defined in the Bankruptcy Code, which provides certain additional protections for a secured real estate lender. *See,* 11 U.S.C. § 101(51B); *id.* § 362(d)(3).

These contractual provisions are part of the bargained-for structure of most significant commercial real estate loans[2]. They reduce risk to the lender, which results in lower interest rates for borrowers. Furthermore, these provisions are a necessary component within the context of the commercial real estate lending market in that they directly affect the determination of a loan's relative strength for credit and investment ratings, on which numerous institutional and non-institutional investors rely.

Over the last two decades, many, if not most, significant real estate lending has involved the pooling of multiple real estate loans in a so-called commercial mortgage backed securities trust ("CMBS Trust"). CMBS Trusts often contain billions of dollars-worth of commercial real estate loans. Participation certificates

[2] The Court may wish to consult an article entitled *Bankruptcy Remote Entities in Commercial Real Estate Transactions*, published in 2015 as part of the Practical Law series by Thompson Reuters, which provides an overview of the importance of special purpose entities in commercial real estate transactions. *See,* https://www.rlf.com/files/11679_Bankruptcy Remote Entities in Commercial Real Estate Transactions (8-606....pdf.

in the trusts are sold in a manner similar to bonds or other securities, with a return based on the performance of the loan portfolio. Rating agencies rate the quality of the loan pool in a CMBS Trust based on various factors, including the inclusion and enforceability of SPE covenants contained in the loan documents for the loans in a given pool. Without a satisfactory rating, participations in the CMBS Trusts could not be marketed and sold in the financial market[3].

Provisions such as the SPE provisions involved here are an important and necessary, as well as expected, part of the rating and underwriting process and therefore directly affect the credit quality and resulting rating of a given loan pool. New York law is commonly selected as the governing law for real estate financing transactions involving properties located both inside and outside of New York and hundreds of millions, and perhaps billions, of dollars in pooled and non-pooled commercial real estate loans. As a result, if real estate lenders do not have ready access to the courts of the State of New York, or other state courts are forced to forgo the jurisdiction to enforce these provisions under New York law, then commercial real estate lending not only in New York but nationally would become

[3] The Court may wish to consult the published Standard & Poor's U.S. Legal and Structured Finance Criteria applicable to commercial real estate loans rated for inclusion in commercial mortgage backed securities pools, which provide a significant portion of commercial real estate financing in the United States. Section 4 of these materials is devoted to the importance of the special purpose entity structure in commercial real estate financing transactions. *See,* http://1stsss.com/referencematerials/SP_CMBS_Legal_and_Structured_Finance_Criteria.pdf at 89-98.

uncertain and potentially riskier and, therefore, less available and more expensive to real estate purchasers, developers and investors.

The Decision also poses increased risk to real estate lenders through the potential analogous application of the Decision to other common actions by lenders against non-debtor third parties based upon a bankruptcy filing by a borrower. The quintessential example is the enforcement of a conditional guaranty of a commercial real estate loan by a non-debtor third party, often a principal or control party of the borrower. Nearly all significant commercial real estate loans are non-recourse in nature, since the single purpose entity borrower owns nothing but the collateral Lenders are willing to assume the risk of the performance and rely on the value of their collateral provided lender's rights against the borrower and the collateral are not otherwise adversely affected by certain actions by the borrower, its principals, controlling party or other related parties, as provided in the relevant loan documents.

The typical control-party guarantee is limited in nature and liability is contingent upon certain conditions precedent, which usually are specific prohibited acts, one of which is usually taking action to cause the voluntary filing of a bankruptcy case by the borrower. Since the guarantor usually controls the decision to file a voluntary bankruptcy for the borrower entity, this provision creates a disincentive to filing consistent with the balancing of risk agreed upon by the parties at the time the loan was originated.

Courts have routinely and uniformly enforced such guaranty provisions, which are a standard part of most commercial real estate loan transactions. Should the Decision not be reversed, one can anticipate that a guarantor in a New York commercial real estate lending transaction, whose liability is triggered by a bankruptcy filing by the borrower it controls, will argue that, based on the Decision, the enforcement action on the guaranty must be relegated to the same legal limbo created for the business tort claims addressed in the Decision.

Such a result would render the guaranty an unenforceable obligation notwithstanding the fact that non-debtor parties otherwise agreed to the terms of the guaranty as part of the consideration to the lender for making of a loan. The potential loss of this important credit enhancement mechanism increases risk to lenders, increases costs to borrowers and creates a severe negative impact on secured real estate lending in New York and nationally. This creates a result wholly at odds with the fundamental market expectations of borrowers and lenders alike throughout the commercial real estate finance industry.

CONCLUSION

For all of these reasons, ACMA respectfully submits that the Decision should be reversed.

DATED: November 15, 2019
New York, NY

Respectfully Submitted,

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