Does A Creative Bankruptcy Scheme Imperil Commercial Real Estate Lending?

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A real estate developer faced foreclosure and the loss of a large and very visible condominium project in Manhattan. A prominent New York City real estate investor, Philip Pilevsky, with help from his family members tried to rescue the developer by implementing a fairly obvious and perfectly legal technique to delay the foreclosure by almost a year.

Bankruptcy law created the opportunity they seized. Under bankruptcy law, if a borrower is not a "single asset real estate" company and it files bankruptcy, then the bankruptcy filing can delay a lender's foreclosure for months or years. But a "single asset real estate" borrower will find the bankruptcy process almost useless. So the developer's loan documents, like nearly all other commercial mortgage loan documents, required the borrower to remain a "single asset real estate" company.

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That was a problem because it meant the developer couldn't really use bankruptcy as a weapon against the lender. To solve the developer's problem, the Pilevsky team helpfully transferred three apartments and some cash to the borrower in exchange for a share of the deal. That way, when the borrower filed bankruptcy to stop foreclosure, it owned four assets – the original collateral plus three apartments – instead of just a single piece of real estate. With Pilevsky's help, the borrower was instantly not a "single asset real estate" company. So the bankruptcy took much longer to resolve, delaying the foreclosure by almost a year.

The borrower's mere filing of a voluntary bankruptcy flagrantly violated the loan documents. It made the developer's principal, as a guarantor, liable for the full amount of the loan. A court enforced that guaranty, awarding the lender a large judgment against the guarantor. The lender achieved exactly the outcome it had negotiated for in its loan documents.

The outraged lender then decided to go above and beyond its loan documents. In a separate action, the lender sued Pilevsky for helping the desperate developer torment the lender and stave off foreclosure for almost a year. The lender claimed Pilevsky hurt the lender by turning the borrower into something it wasn't supposed to be, and then helping the malevolently transformed borrower file a voluntary bankruptcy. The lender said Pilevsky's scheme was so evil — "tortious interference" with the loan — that the schemers should compensate the lender for all the delays and losses their scheme had caused.

The lender persuaded the trial court that if Pilevsky and the developer could get away with their scheme with impunity, then this would likely, in the court's words, "upend the way contracts are written here in New York City and upend the whole development industry." So the court allowed the litigation to proceed (hearing transcript, March 8, 2018, New York State Supreme Court case no. 654917/2016). Pilevsky appealed. The appellate court ordered the litigation dismissed (https://tinyurl.com/y4lr942m). The lender appealed to the state Court of Appeals, where the dispute now sits, as of mid-November 2019 (APL-2019-0028).

If the courts deny the lender the relief it seeks, will that derail commercial real estate lending? No. When Pilevsky and developer figured out their creative scheme to drag out the bankruptcy, did they do something so wrongful and outrageous that the lender ought to have a claim against Pilevsky for helping out the developer? No.

Pilevsky's laughably simple scheme broke no law. It just violated the loan documents. That gave the lender a good strong claim against the guarantor — exactly what the lender had negotiated for in its loan documents. Although the lender pursued that claim, it probably turned out to be less valuable than the lender had expected or hoped. And the guarantor's potential exposure to that claim didn't stop the developer from proceeding with the scheme that Pilevsky had cooked up. Maybe the lender should have demanded a stronger guarantor or not made the loan.

Pilevsky and his team did nothing more than bring some minimal creativity, shameless audacity, and bankruptcy expertise into the picture. Whether the Pilevskys advised, helped, motivated, or pushed the developer to implement a perfectly legal scheme to drag out the bankruptcy, it was still the developer's decision, acting from its own free will. And it gave the lender exactly the rights and remedies that the lender had demanded in its loan documents.

The developer could just as easily have come up with Pilevsky's scheme based on a conversation with a second-year law student who took a bankruptcy course, another parent at parent-teacher night, an evil fortune teller, or any commercial real estate lawyer minimally familiar with bankruptcy. Very likely, the borrower and its counsel could even have hatched Pilevsky's scheme all by themselves. It required nothing more than reading and applying one simple definition in the bankruptcy code.

Bankruptcy is legally available to all Americans, including failing real estate developers. The bankruptcy law – its definition of "single asset real estate" – and Congress, not Pilevsky, are what enabled Pilevsky and the developer to use three apartments to delay the lender's foreclosure by a year. If the lender doesn't like the way Congress wrote the bankruptcy code, maybe the lender should sue Congress.

Contrary to some dire expressions of great alarm in the real estate press, if the courts decide the lender has no claim against Pilevsky, that in no way jeopardizes ordinary single-purpose entity covenants, nonrecourse carveout guaranties, or the structure and viability of commercial real estate financing.

Lenders and their counsel should still watch this litigation. It offers both a source of amusement and a reminder of what lenders should consider when they choose their borrowers and guarantors. Some other issues raised in the case could, if adversely decided, in fact impair and increase the cost of ordinary nonrecourse financing. But they aren't anywhere near as interesting or fun to read about as Pilevsky's great scheme.

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