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Declaratory Judgments Do Not Always Protect NY Debtors

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Can a debtor obtain declaratory judgment shielding himself from liability to a creditor's officers or associates personally and then use that judgment to preclude subsequent claims by the creditor itself? Not in the Supreme Court of the State of New York, Appellate Division, First Judicial Department, following the recent decision in Avilon Automotive Group v. Leontiev.[1] In Avilon, a unanimous panel reversed the res judicata-based dismissal of fraudulent transfer and other related claims arising from several Russian loan transactions because the claims by the creditors themselves were not the subject of a prior declaratory judgment concerning the debtor's liability to the creditors' representative.

Background

Plaintiffs Avilon Automotive Group and Karen Avagumyan sued the defendant Sergey Leontiev to recover on loans they had made to companies allegedly controlled (and looted) by Leontiev.[2] According to the plaintiffs, Leontiev had promised Avilon's president, Alexander Varshavsky, that he would repay the loans personally after Probusiness Bank — a Russian bank that was allegedly the pillar of Leontiev's financial empire — came under the scrutiny of Russian banking authorities. But after repaying a portion of the loans, Leontiev allegedly used shell companies (defendants Wonderworks and Southpac Trust International) to funnel the remaining assets of the debtor companies to defendant Legion Trust (a Cook Islands entity).

Avilon and Avagumyan sued Leontiev, Leontiev's father, Wonderworks, Southpac, and Legion Trust in the Commercial Division.

Leontiev and Wonderworks moved to dismiss, arguing, among other things, that the claims against them were barred by res judicata (i.e., claim preclusion) of an earlier federal case in which Leontiev had obtained a declaratory judgment that he was not personally liable to Varshavsky.[3] That motion was granted by Commercial Division Justice Barry Ostrager,[4] and Avilon and Avagumyan appealed to the First Department.

Federal Action

Six months before being sued in the Commercial Division, Leontiev had filed a declaratory judgment action in United States District Court for the Southern District of New York seeking a declaration that he did not personally owe a debt to Varshavsky.[5] Although the parties conducted extensive discovery and Varshavsky appeared to argue throughout the case that he had standing to collect on Avilon's loans to Leontiev's companies, Varshavsky ultimately conceded that Leontiev did not owe him any money in his personal capacity.[6] The federal court granted Leontiev's declaratory judgment, and, in the context of an objection to costs, ruled that Leontiev was the prevailing party because the resolution of the case "'stymies any effort by Varshavsky to collect on the loans in his own name, and makes plain that any further debt collection efforts must be in a purely representative capacity.'"[7]

Dismissal in the Commercial Division

In the Commercial Division case, two defendants — Leontiev and Wonderworks — moved to dismiss, asserting that the federal court declaratory judgment precluded Avilon's and Avagumyan's claims. Specifically, they argued that since Avilon and Avagumyan should have intervened in the federal case or assigned their claims to Varshavsky, the ruling in the federal case should have preclusive effect against the plaintiffs in the Commercial Division case.

Justice Ostrager granted the motion to dismiss, describing Avilon's and Avagumyan's failure to intervene in the federal action or assign their claims to Varshavsky as a "blatant misuse of the federal forum."[8] After noting that the same counsel had been involved in both the federal and Commercial Division cases, and thus must have been aware that Varshavsky had suggested that he had authority to act on Avilon's and Avagumyan's behalf during the federal action, the court concluded that the Commercial Division case was merely an attempt to get a "second bite at the apple" that would waste judicial resources.[9]

First Department Revives the Claims

The First Department reversed the dismissal, holding that "plaintiffs herein, as nonparties to the federal litigation, are not precluded from asserting claims that no party in the federal litigation had standing to pursue."[10]

In so ruling, the First Department rejected both of the defendants' arguments for claim preclusion. First, the defendants had argued that Avilon's and Avagumyan's interests were represented in the federal action because Varshavsky was Avilon's president and Avagumyan's designated negotiator. The First Department acknowledged that claim preclusion may be enforced against parties that are "'in privity with'" a party bound by the earlier action.[11] But preclusion through privity must be carefully applied by courts to ensure that "'the severe consequences of preclusion flowing from a finding of privity strike a fair result under the circumstances.'"[12] In this case, nothing about Varshavsky's relationship with Avilon or Avagumyan gave Varshavsky standing to assert claims on their behalf.[13] Since the claims could not have been raised by Varshavsky in the federal litigation, the First Department concluded that it would not be a "fair result" to preclude them in the later case.[14] This was particularly true because Avilon and Avagumyan's rights derived from their own status as parties to the loan agreements, and not from Varshavsky's (nonexistent) rights.[15] Thus, the defendants' first preclusion argument was rejected.

As a second argument, the defendants contended that Avilon and Avagumyan should have intervened in

the federal litigation or assigned their claims to Varshavsky. The First Department rejected this argument for two reasons. First, it was not clear that intervention would have been possible, because it may have defeated diversity jurisdiction, and assignment of the claims would have arguably violated 28 U.S.C. § 1369, which bars assignments used "improperly or collusively" to invoke the jurisdiction of a federal court.[16]

More importantly, the First Department held that Avilon and Avagumyan should not be required to intervene in the federal case to avoid preclusion, even if it were procedurally feasible. The panel noted that parties are generally not bound by judgments against others in matters to which they are not joined, and that neither of the twin aims of claim preclusion — ensuring finality of judgments and avoiding inconsistent adjudications — was implicated in this case. The court also observed that in the federal litigation, there was "no adjudication of anything but that Leontiev owes no debt or obligation to Alexander Varshavsky in the latter's personal capacity," and emphasized that "there has been no final adjudication concerning defendants' alleged liability for the loans at issue."[17] Concluding that the dismissal of Avilon and Avagumyan's claims had improperly denied them a chance to pursue their claims, the First Department reversed the Commercial Division's preclusion-based dismissal, and remanded for consideration of the other grounds of dismissal and proposed amendment to the complaint.

Conclusion

As the First Department noted, dismissal of Avilon and Avagumyan's claims would imply that "a debtor may, by suing a creditor's principal or associate, require the creditor to participate in the action or have its claims precluded."[18] More broadly, the Commercial Division's dismissal of the claim endorsed an expansive view of res judicata that applied the preclusive effects of a prior judgment not only to the claims that were brought or that could have been brought directly by the actual parties to the original suit, but also to claims that could arguably have been raised through intervention or assignment by a nonparty. In reversing this outcome, the First Department emphasized that res judicata does not operate to bar claims that the parties to the prior case did not have standing to bring. It thus rejected applying res judicata in a way that, in practice, would create broad mandatory joinder requirements. Instead, the court reiterated that claim preclusion should be narrowly applied to only those situations which would require re-examining claims that were already resolved, or that a party had standing to bring, in a prior matter.

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[1] Avilon Auto. Grp. v. Leontiev ("Avilon II"), No. 656007/16, 2019 BL 1016 (N.Y. App. Div. 1st Dep't Jan. 3, 2019).

[2] Id. at *1.

[3] Id.

[4] Avilon Auto. Grp. v. Leontiev ("Avilon I"), No. 65007/16, 2017 BL 364147 (N.Y. Sup. Ct. Oct. 5, 2017).

[5] Avilon II, 2019 BL 1016, at *2.

[6] Id. at *3.

[7] Id. at *4 (quoting Leontiev v. Varshavsky, No. 16-cv-3595, 2017 U.S. Dist. LEXIS 67146, at *3 (S.D.N.Y. May 1, 2017)).

[8] Avilon I, 2017 BL 364147, at *4.

[9] Avilon II, 2019 BL 1016, at *6.

[10] Id. at *5.

[11] Id. at *5 (quoting People v. Applied Card Sys., Inc., 11 N.Y.3d 105, 122, 984 N.E.2d 1, 863 N.Y.S.2d 615 (2008)).

[12] Id. at *5 (quoting Applied Card Sys., 11 N.Y.3d at 123).

[13] Id. at *5.

[14] Id.

[15] Id. at *6.

[16] Id. at *7.

[17] Id.

[18] Id. at *5.