

Memorandum

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“Contemporary traders in debt instruments have been bedeviled by the centuries-old common law doctrine of champerty.”

Champerty and the Assignability of Legal Claims

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The stage is set for the highest court in New York to issue a definitive opinion concerning New York’s arcane “champerty” law and the circumstances in which a claims purchaser can “stand in the shoes” of its seller and bring a litigation to enforce the claim. The New York Court of Appeals, the state’s highest court, recently agreed to consider several issues framed by a federal appeals court seeking guidance on New York law.¹ Briefing before the New York high court will take place this summer, and oral argument could be scheduled as soon as October.

This memorandum explains why the forthcoming decision by the New York Court of Appeals is important. Participants in the distressed debt market may want to follow developments because there is a potential for the New York court to inadvertently disturb the statutory “safe harbor” for debt trading transactions that was added relatively recently to the New York champerty statute.

CURRENT LAW OF CHAMPERTY

Contemporary traders in debt instruments have been bedeviled by the centuries-old common law doctrine of champerty. As originally interpreted, champerty prohibited *all* transfers of litigation rights. The doctrine of champerty was intended to bar litigation brought by persons not actually parties to the underlying dispute. Modern jurisprudence continued to recognize champerty as a defense to litigation, but modern courts interpreted the law to permit transfers of litigation rights in certain circumstances but not in others. The courts’ decisions have not always been clear and do not necessarily provide guidance in all circumstances.

Accordingly, although legal claims began to be routinely bought and sold in conjunction with transfers of financial instruments, the doctrine of champerty still cast some doubt on the ability of a debt purchaser to enforce its rights by bringing a lawsuit. Particularly for buyers of distressed debt, where it is often apparent at the time of purchase that litigation may be required for any recovery, the ancient specter of champerty - and the potential that a champerty defense could ultimately thwart recovery - continued to loom large.

A version of the champerty doctrine has long been codified in New York as N.Y. Jud. Law § 489(1), which prohibits the “assignment of a bond, promissory note, bill of exchange, book debt, thing in action, or any claim or demand, with the intent and for

¹ The U.S. Court of Appeals for the Second Circuit issued a decision certifying the issues in Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc. Mortgage Pass-Through Certificates, Series 1999-C1, by and through Orix Capital Markets, LLC, as Master Servicer and Special Servicer v. Love Funding Corp., Dkt. No. 07-1050-cv (2d Cir. February 13, 2009). Before the New York Court of Appeals, the case is number 107.

the purpose of bringing an action or proceeding thereon." Previous judicial decisions concerning New York champerty law typically focused on the buyer's intent or purpose in order to determine whether a transfer fell within the statutory prohibition.

In 2004, the New York champerty statute was amended and a new subsection, § 489(2), was added. The change prevents debtors from escaping liability simply because the debt and associated litigation rights have been transferred by the original creditor to a new purchaser, if the purchase price for the debt is greater than \$500,000. The amendment was designed to help the debt trading market, which is primarily governed by New York law. The statutory safe harbor, which became effective August 17, 2004, has not yet been interpreted or applied by the courts.²

IMPORTANCE OF LITIGATION RIGHTS AS AN ASSET

Potential litigation claims related to a debt instrument are an important asset, whether the claims are transferred with the debt instrument in secondary market trading or are transferred, as in the Love Funding case, independently of the debt instrument but to the holder of that instrument. In some circumstances, litigation may become the only means of collecting on the debt or enforcing other rights associated with the instrument, and uncertainty over the ability to sue, when suit is necessary, inhibits trading.

THE LOVE FUNDING CASE

The Love Funding case involved the origination, pooling and securitization of commercial mortgage loans. The plaintiff in the case is a Trust that held a securitized pool of such loans that it received through a chain of transfers. When one of the loans went bad, the Trust (acting through its servicer) sought recovery in a foreclosure action against the borrower and its principals. The Trust also sued a predecessor in the chain of transfers, UBS, seeking to force UBS to repurchase the bad loan (as well as other loans in the pool). In settlement of that litigation, UBS assigned all

its rights and interest in the bad loan to the Trust (and paid the Trust almost \$20 million with respect to the other loans). The settlement was effective September 13, 2004.

Among the rights held by UBS - and assigned to the Trust - was the right to be held harmless, including the right to recoup costs and attorneys fees, from litigation arising from a breach of contract by Love Funding, an entity engaged in the business of bringing prospective loans to lenders. Love Funding had brought the bad loan to UBS (through a predecessor lender merged into UBS). The Trust sued Love Funding, and, standing in the shoes of UBS, asked to be held harmless from the consequences of Love Funding's breach. The Trust sought to collect the interest that had been accruing on the loan for years, along with attorneys' fees and costs that had accrued in the various litigations related to Love Funding's breach.

The federal district court applied the prohibition contained in the first subsection of the New York champerty statute, and, after a bench trial, found that Love Funding had established a valid champerty defense to the action. That court found that the Trust's "primary purpose" in accepting the assignment of the bad loan from UBS was to buy a lawsuit against Love Funding, which the court viewed to be prohibited by the statute. The court did not mention the safe harbor in its opinion. Trust v. Love Funding, 499 F. Supp. 314, 322 (S.D.N.Y. 2007).

The Trust then appealed the district court's decision to the U.S. Court of Appeals for the Second Circuit.

ISSUES CERTIFIED BY THE SECOND CIRCUIT IN LOVE FUNDING

On appeal, the Second Circuit concluded that it could not determine whether the lower court had properly applied the New York champerty statute because, the Second Circuit said, New York judicial decisions concerning the statute have "not always been clear or consistent." The Second Circuit described in detail why

² In addition, the 2004 amendment added a third subsection, § 489(3), which provides that the rights of an indenture trustee are not affected by the safe harbor provision.

it considered prior judicial decisions ambiguous and sought a definitive opinion from New York's highest court regarding the proper interpretation of the champerty statute. The Second Circuit explained that it was taking the unusual step of seeking guidance from the New York high court because of the multi-billion dollar size of the market for commercial mortgage-backed securities and "the importance of New York law to the State's preeminent role in world financial affairs."

The Second Circuit also highlighted a unique aspect of the Love Funding case - the assignment was separate from the transfer of the debt instrument to which it related. The Second Circuit said it was unaware of any New York judicial decision addressing facts like those in Love Funding: "where a party that holds a proprietary interest in a debt instrument accepts an assignment of rights that allows it to sue a party that had purportedly misrepresented to the assignor that the instrument was not in default."

The Second Circuit, like the federal district court, made no mention of the New York champerty safe harbor. It is unclear from the published opinions why this provision - which may have been applicable - was not discussed.

The Second Circuit certified three questions:

- Whether the champerty defense bars a claim if the assignee obtained the litigation right with the "primary" intent of suing, or whether the defendant must show that the assignee's "sole" purpose for the assignment was to bring litigation;
- Whether a party may "buy a lawsuit" in order to collect damages on a debt instrument in which it holds a pre-existing proprietary interest; and
- Whether the holder of a defaulted debt obligation may pursue a lawsuit on an assigned claim in order to collect more damages through litigation than it demanded in settlement from the assignor, and in particular whether the assignee may exercise the assignor's indemnification rights for reasonable costs and attorneys' fees.

The Second Circuit noted that the New York court is not bound to address the particular questions presented. It is not clear whether the New York court will address each of the questions - in accepting certification, the New York court said only that it would consider them. After the New York court issues its opinion regarding the champerty statute and addresses the issues as it sees fit, the Second Circuit will then apply the law, as articulated by the New York high court, to the particulars of the Love Funding case.

IMPORTANCE OF THE PENDING DECISION

New York's highest court has been asked to clarify the law of champerty in New York. A definitive opinion could facilitate the buying and selling of debt instruments and claims and increase liquidity in the markets. The New York court's attention has been directed only to the prohibition against champerty, however, and not the possible applicability of the safe harbor. This leaves open the potential for the court inadvertently to issue an opinion that confuses the law or even conflicts with the proper application of the safe harbor in appropriate circumstances.

Interested persons who could be affected by the decision may be permitted by the New York high court to present their views in a friend-of-the-court or amicus curiae brief. Such amicus participation would be a way of calling to the attention of the New York Court of Appeals the vitally important safe harbor from champerty for large debt trading transactions and assisting the Court of Appeals in its analysis.



QUESTIONS

If you have questions about this case or the evolution of the law of champerty and the efficient transfer of legal claims related to underlying debt instruments in general,³ please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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³ RK&O has represented debt market participants in litigation asserting assigned legal claims and continues to follow developments in the law of champerty for clients. We often advise market participants in structuring their trades regarding issues of assignability. We understand the importance litigation claims can play in asset recovery and valuation. We do not represent the plaintiff Trust in the Love Funding case.