



Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Court Says Champerty Can't Curb Debt Buyers' Rights

By **Jacqueline Bell**

Law360, New York (October 16, 2009) -- Reassuring the secondary loan market, the New York Court of Appeals has issued a ruling clarifying the limits of the state's arcane champerty law, ruling that the age-old law with roots in medieval Europe was not designed to curb the ability of buyers of distressed debt to enforce their rights through litigation and collect on a legitimate claim.

In a ruling issued by the New York Court of Appeals Thursday, the state appeals court completed a request from the U.S. Court of Appeals for the Second Circuit, seeking clarity on the proper interpretation of the state's champerty law aimed largely at blocking transfers of litigation rights to parties that had no stake in the original dispute.

The champerty statute has been expanded somewhat beyond those origins, and New York's current law does clearly allow parties to transfer litigation rights in certain circumstances.

Still the exact boundaries of the champerty statute have long been unclear, and the Second Circuit in February asked the New York Court of Appeals to provide some guidance on the matter to help decide a case that has at its core a complex commercial mortgage-backed securities transaction.

The dispute before the Second Circuit was launched by a trust for Merrill Lynch investors that held a securitized pool of mortgage loans. The trust eventually discovered that some of the loans were fraudulent and sued financial services firm UBS AG, which had acquired the company that had originally packaged the loans for securitization.

After prolonged litigation, UBS agreed to settle with the trust, paying millions to put to rest claims over all the loans but one, and agreeing to assign litigation rights over the remaining loan to the trust.

That remaining loan had been originated by a commercial mortgage banking firm called Love Funding Corp., and the trust filed suit against Love Funding, seeking to hold the firm liable for the bad loan. But Love Funding was able to successfully argue before the U.S. District Court for the Southern District of New York that the assignment of UBS' litigation rights to the trust violated New York's champerty law.

The trust appealed that decision to the Second Circuit. Once the New York Court of Appeals agreed to weigh in, debt investors expressed concern that the state appeals court, depending on how it interpreted the statute, had the power to throw a wrench into the massive multibillion-dollar market for secondary loan trading.

In an amicus brief filed with the New York Court of Appeals, the Loan Syndications & Trading Association Inc., a trade group that represents firms involved in the trading of corporate loans, including banks, broker-dealers and insurance companies, argued that an essential part of the value of a loan traded in the secondary market is the power to sue if necessary to protect the investment.

But in its Thursday decision, the court avoided a ruling that would have had any such impact, holding that a corporation or association that received a claim is not violating the state's champerty statute if its purpose is to collect damages for losses on a debt instrument in which it holds a "pre-existing proprietary interest."

Lucinda O. McConathy, a partner at Richards Kibbe & Orbe LLP who co-authored the amicus brief filed on behalf of the Loan Syndications & Trading Association, said she was pleased with the clarity of the New York Court of Appeals decision.

"Any cloud that previously existed over the ability to assign claims along with related debt instruments, and to litigate those claims if necessary to enforce rights under those instruments, has been largely removed," McConathy said.

Owen Pell, partner at White & Case LLP, called the ruling a "huge win" for the financial industry.

"I think the court showed a tremendous sensitivity to the commercial realities that might be involved with respect to issues that were not presented by this case but are presented any time debt is purchased at a discount," Pell said. "If you are a vulture fund, a distressed debt fund, a bank trading desk that trades in distressed debt, this is a good opinion because you shouldn't have to worry about the normal buying and selling of distressed assets."

In addition, the decision by the New York Court of Appeals raised significant barriers to asserting a champerty defense related to those types of transactions, Pell said.

"They made the hurdle sufficiently high and clear that the decision reduced the opportunity for misunderstanding and mischief," Pell said.

Seemingly intent on pulling the state's champerty statute back toward its roots, in its Thursday decision the New York Court of Appeals pointed to the understanding of champerty's definition in the Middle Ages, as well as 19th-century decisions by New York courts that described the purpose of the state's champerty law, and ruling that the prohibition of champerty in New York City has long been chiefly aimed at keeping attorneys from filing lawsuits merely to secure fees, payments and profits.

“Our earliest cases and those of the Court of Chancery clearly demonstrate this narrow scope,” the New York Court of Appeals said in its Thursday ruling.

“New York cases agree that if a party acquires a debt instrument for the purpose of enforcing it, that is not champerty simply because the party intends to do so by litigation,” the court added. “In short, the champerty statute does not apply when the purpose of an assignment is the collection of a legitimate claim.”

In the Love Funding case, the court said, the trust had a “pre-existing proprietary interest” in the loan, so the trust's lawsuit was not a violation of the state's champerty statute.

“The court suggests that champerty is historically a limited and narrow doctrine that's focused on abusive litigation by attorneys not interested so much in underlying rights but ginning up fees and costs in litigation,” McConathy said. “That's a pretty narrow concept of what champerty is.”

Ferdinand J. Gallo, a partner at Katten Muchin Rosenman LLP, said the ruling would help to create significantly more surety on how champerty will be interpreted in New York, the center of the debt-investing universe.

“It's a relief that there's some clarification in the law — to give everyone a little more certainty,” Gallo said.

The decision also brings certainty not only to the world of debt investors, but also to financial services firms that are still working to settle bundles of claims over debt in the wake of the financial crisis, Pell said.

“If you're a bank general counsel, now you know you have a broad discretionary ability to reasonably settle cases, even if it means chopping up claims,” Pell said.

Attorneys for Love Funding and the trust were not immediately available to comment on the ruling Friday.

Love Funding is represented by Bryan Cave LLP.

The trust is represented by Hogan & Hartson LLP.

The case before the New York Court of Appeals is 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., case number 123. Before the U.S. Court of Appeals for the Second Circuit, it is case number 07-1050.