

Torts

Champerty

Second Circuit Affirms Assignee's Ability to Enforce Rights Under Acquired Debt in Decision Favorable to Secondary Loan Markets

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In a case followed closely by banks and other financial institutions, *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc. v. Love Funding Corp.*,¹ the Second Circuit recently entered judgment in favor of the plaintiff, a trust, that sued the originator of a loan to enforce the trust's rights under the loan. The decision's significance lies in the fact that the trust acquired its rights from the lender that originally held such rights, which the trial court determined was a violation of New York's "champerty" law.² Last year, in a nod to the potentially severe consequences for the financial markets, the Second Circuit took the unusual step of asking the New York Court of Appeals to interpret the statute. The New York Court issued its ruling in October 2009, providing a narrow interpretation of the law that allowed the secondary loan markets to breathe an uneasy sigh of relief. In the wake of the New York Court's interpretation, the Second Circuit now has entered judgment in the trust's favor in a carefully-worded ruling that should end the controversy. If the trial court's ruling had stood, it could have had severe repercussions for the distressed and secondary loan markets, where buyers want certainty that they can monetize their acquired debt through litigation, if necessary.

The champerty defense traces its origins to feudal times, and was originally intended to prohibit the transfer of litigation rights to parties not involved in the dispute who might be looking to generate and then recover attorneys' fees and other litigation costs. However, the law has expanded over the years and the New York statute's language on its face appears to prohibit any assignment of a debt for the purpose of suing on it. In 2004, the New York champerty statute was amended to add a safe harbor for debt buyers asserting claims related to acquired debt, but the cases interpreting the champerty defense have been inconsistent and have created substantial confusion. The *Love Funding* decisions have resolved this confusion by clarifying the limited scope of the New York champerty statute.

Background Facts

The *Love Funding* case stems from a sophisticated commercial mortgage-backed securitization transaction. In April 1999, Love Funding entered into a conduit-lending arrangement under which UBS Real Estate Securities, Inc. ("UBS") agreed to purchase commercial real estate loans originated by Love Funding. The arrangement was memorialized by a mortgage loan purchase agreement (the "Love MLPA"), which contained a representation by Love Funding that none of the loans purchased by UBS were in default at the time they were sold. Upon a breach of such representation, Love Funding was obligated to repurchase the loans and indemnify UBS against liabilities or expenses, including attorneys' fees, resulting from the breach.

On November 1, 1999, as part of a securitization program, UBS sold a package of loans that included a Love Funding loan to Merrill Lynch Mortgage Investors, Inc. ("Merrill") pursuant to a separate mortgage loan purchase agreement (the "UBS MLPA"). In the UBS MLPA, UBS represented that the loans were not in default. Merrill bundled the loans and assigned them, along with all rights under the UBS MLPA, to a trust.

The underlying borrower defaulted on the Love Funding loan. In 2002, following the trust's acceleration of the Love Funding loan and the conclusion of enforcement proceedings against the borrower, the trust sued UBS alleging that the loan was already in default when it was assigned to the trust and, therefore, UBS had breached its representation in the UBS MLPA. In 2004, UBS and the trust settled. As part of the settlement, UBS assigned its rights under the Love MLPA to the trust. These rights included repurchase and indemnification claims against Love Funding on account of any breaches of its representations.

After taking assignment of the claim, the trust sued Love Funding in the Southern District of New York to recover the repurchase price under the Love MLPA. Love Funding argued that the trust violated the New York champerty statute by taking assignment of the claim for the purpose of bringing the lawsuit.

The trial court agreed with Love Funding that the champerty statute prohibited the trust from prosecuting the claims it took by assignment. On appeal, the Second Circuit declared that the New York state court decisions interpreting the champerty statute were inconsistent and requested clarification from the New York Court of Appeals. On October 15, 2009, the Court of Appeals entered its opinion holding that the champerty statute bars only lawsuits initiated for the purpose of recovering from the defendant the costs of the lawsuit itself.³ Notably, the Court of Appeals stated that the champerty statute does not bar the enforcement of a legitimate claim: "[I]f 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."⁴ Thus, according to the Court of Appeals, acquiring via assignment a debt instrument or claim related thereto, even for the purpose of commencing litigation to collect on the instrument, does not constitute champerty.

Second Circuit Decision

Applying the New York Court's interpretation, the Second Circuit concluded that Love Funding's champerty defense failed as a matter of law and entered judgment in favor of the trust. In reaching its decision, the Second Circuit found that the trust did not acquire the claim to generate and recover the fees and expenses of the litigation, but rather to enforce its rights under the claim. The Second Circuit also upheld the indemnification portion of claim, which sought payment of the costs that UBS previously had incurred in pursuing repayment of the loan. Thus, even though the trust was seeking to recover amounts in excess of its own losses (*i.e.*, the losses of UBS), the Second Circuit nevertheless held that the trust's actions to recover "previously incurred" fees and costs did not constitute champerty. According to the Second Circuit, because the record did not demonstrate any intent on the part of the trust to generate new litigation fees and costs, Love Funding's champerty defense was fatally flawed.

The *Love Funding* decisions have clarified New York law, overturning those cases which concluded that an assignee's claims could be defeated by the champerty statute if the assignee's "sole" or "primary" purpose in taking the assignment was to pursue litigation. It appears that, as long as an assignment of the debt or claim is consummated for the purpose of enforcement (in contrast to an assignment designed to generate fees and costs in litigation), it does not violate New York law. Notably, the Second Circuit relied on the trust's pre-existing interest in the loan underlying the claim to bolster its reasoning that the trust did not take the assignment merely to generate legal fees and costs. Such reasoning should not, however, be interpreted to suggest that an assignee without a pre-existing interest in the debt or claim (such as, for instance, an arm's-length loan purchaser in the secondary market) will be subject to the champerty defense, given the Second Circuit's seemingly clear pronouncement that champerty will not be found where a party takes assignment of a claim and commences litigation to enforce its rights thereunder.

Conclusion

Historically, assignees of debt instruments and claims in the marketplace have operated under the belief that they can enforce their rights against the borrower and third parties as if they stood in the shoes of the original assignor. The Second Circuit's decision in *Love Funding* affirms this expectation by limiting the use of the champerty defense in future New York proceedings, thereby providing additional comfort to investors in the secondary market that may need to pursue litigation to monetize their investments.

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¹ *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc., Mortgage Pass-Through Certificates, Series 1999-C1 v. Love Funding Corp.*, No. 07-1050-cv, [2010 BL 5746](#) (2d Cir. Jan. 11, 2010).

² N.Y. Judiciary Law § 489.

³ *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc., Mortgage Pass-Through Certificates, Series 1999-C1 v. Love Funding Corp.*, [13 N.Y.3d 190](#), [2009 BL 225895](#) (2009).

⁴ *Id.* at 6.

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