

Second Circuit Affirms Debt Assignee's Enforcement Rights in Champerty Decision

In a significant decision affecting the secondary debt markets, the Second Circuit Court of Appeals in *Trust for Certificate Holders v. Love Funding Corp.* held on January 11, 2010, that the acceptance by an investor — here, a CMBS trust — of an assignment of claims related to a debt instrument (the “claim”) did not violate the New York champerty statute. In effect, the Second Circuit confirmed that an assignee who takes assignment of a claim may enforce its rights thereunder, even if enforcement consists of litigation. The *Love Funding* decision should give comfort to investors in the secondary debt markets that are seeking to monetize their acquired debt through litigation, which, in turn, should further promote liquidity in these markets.

The champerty statute in New York¹ appears on its face to prohibit the assignment of a debt or other claim for the purpose of suing on it. In the *Love Funding* case, the defendant, Love Funding Corporation, argued that the New York champerty statute barred the trust from prosecuting a breach of representation claim against it. Love Funding contended that the trust violated the champerty statute when it accepted assignment of the claim as part of a settlement with UBS, the conduit lender for Love Funding, for the alleged purpose of bringing a lawsuit on such claim.² The Second Circuit, following an opinion by the New York Court of Appeals clarifying the scope of the champerty statute, rejected Love Funding's contention, finding that a champerty defense was inapplicable, and entered judgment for the trust.

Background Facts

In April 1999, Love Funding entered into a conduit-lending arrangement under which UBS agreed to purchase commercial real estate loans originated by Love Funding. This 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 the Love Funding loan to Merrill Lynch Mortgage Investors, Inc. (“Merrill”) pursuant to a master purchase agreement (the “UBS MLPA”). In the UBS MLPA, UBS represented to Merrill that the loans were not in default. Merrill then bundled the loans and assigned them, along with all rights under the UBS MLPA, to the trust.

¹ N.Y. Judiciary Law § 489(1).

² UBS Real Estate Securities, Inc. was the successor in interest to Paine Webber Real Estate Securities Inc., the original conduit lender to Love Funding. For purposes of this update, such entities are collectively referred to as “UBS.”

The underlying borrower defaulted on the Love Funding loan.³ 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 already was 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 agreed-upon repurchase price under the Love MLPA, and expenses. In response, Love Funding argued that the trust violated the New York champerty statute by taking assignment of the claim for the purpose of pursuing a lawsuit.

The District Court agreed with Love Funding that the assignment of the claim to the trust violated the champerty statute. 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 as to the interpretation thereof. On October 15, 2009, the Court of Appeals entered an opinion⁴ holding that the champerty statute bars only lawsuits initiated for the purpose of recovering from the defendant the costs of the lawsuit itself. 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."⁵ 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.⁶

Second Circuit Decision

Applying the New York Court of Appeals' interpretation of champerty, 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 this 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 underlying the claim. 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.⁷ Simply put, because the record did not demonstrate any intent on the part of the trust to generate new litigation fees and costs, the Second Circuit determined that Love Funding's champerty defense was fatally flawed.

³ The loan was a \$6.4 million mortgage loan made by Love Funding to Cyrus II Partnership in July 1999.

⁴ *Trust v. Love Funding*, 14 N.Y.2d 190 (2009).

⁵ *Id.* at 200-201.

⁶ Moreover, according to the Court of Appeals, it is not champerty (i) to acquire a claim for previously incurred attorneys' fees or (ii) to accept from a settling party a claim that has a larger potential recovery than the amount of cash that the settling party would otherwise pay.

⁷ The Second Circuit did not discuss whether an assignee's attempt to recover attorney's fees and costs that were not previously incurred would provide some basis for a champerty defense; however, it seems unlikely that a court would allow for the mere seeking of reasonable fees related to the enforcement of a claim as a basis for the champerty defense.

The *Love Funding* decisions likely have resolved contrary New York precedent holding that an assignee could be liable for champerty if its “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 the New York champerty statute. 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.⁸ Such reasoning, however, should not be read to mean that an assignee without a pre-existing interest in the debt or claim (take, for instance, an arms-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 an 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 *Loan 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 intend to pursue litigation to monetize their investments.

⁸ The Second Circuit’s reference to the trust’s pre-existing interest in the loan as support for its conclusion borrows from the New York Court of Appeals’ decision, in which it stated that the trust’s taking of the claim by assignment did not violate the New York champerty statute because the trust had a “pre-existing proprietary interest” in the underlying loan.

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