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Love Funding: Appeals Court Could Resolve Champerty Uncertainty

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Introduction

The recent decision of the US Court of Appeals for the Second Circuit in *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc Mortgage Pass-Through Certificates v Love Funding Corp*(1) presented unanswered questions with respect to the application of champerty to an assignment of claims in connection with transfers of debt instruments. Creditors often utilize litigation to collect debts or enforce other rights under debt instruments. In the case of secondary market debt transactions, the purchaser of the debt instrument may require an assignment of potential litigation claims from the original lender in order to enforce rights under the original debt instrument. The law of champerty may affect the ability of the purchaser of the assigned claims to enforce those claims.

The law of champerty was originally intended to prevent the buying and selling of lawsuits in order to obtain costs and attorney's fees. In New York, the champerty rule was codified under Section 489(1) of the Judiciary Law, which states that a company may not:

"*solicit, buy or take an assignment of, or be in any manner interested in buying or taking an assignment of... any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon.*"

Although modern courts have not always been clear on the application of the champerty law, assignments of litigation claims in connection with transfers of debt instruments were thought to be permitted under the New York champerty law even where litigation was possible at the time of the transfer.(2) Inasmuch as mortgage loans may involve the enforcement of claims following a default by a mortgage borrower, the case could have an impact on the buying and selling of defaulted mortgage loans.

Love Funding Case

Love Funding Corp, an originator of commercial mortgage loans, entered into a conduit lending arrangement with UBS Real Securities, Inc (successor in interest to Paine Webber Real Estate Securities, Inc) pursuant to a mortgage loan purchase agreement governed by New York law. In the purchase agreement Love Funding represented that none of the loans that were being sold was in default. The purchase agreement provided that in the event of a breach of a representation by Love Funding, Love Funding would cure such breach or repurchase any such mortgage loan. Love Funding also indemnified UBS from all costs and expenses, including reasonable attorneys' fees, incurred in connection with the breach of any representation.

Subsequently, more than 30 mortgage loans, three of which were covered by the purchase agreement, were sold by UBS to Merrill Lynch Investors, Inc pursuant to a separate mortgage loan purchase agreement, wherein UBS provided representations that mirrored those provided by Love Funding in its purchase agreement. Merrill Lynch placed the mortgage loans into a trust which then sold commercial mortgage-backed securities (CMBS) certificates to investors.

Among the loans covered by both purchase agreements was a mortgage loan secured by property in Louisiana that eventually went into foreclosure. In the foreclosure proceedings a Louisiana court noted that the mortgage had been procured by fraud,

which meant the loan was in default and the representations in the purchase agreements had been breached.

The Merrill trust representing the CMBS holders could not sue Love Funding for breach under the Love Funding purchase agreement because the Merrill trust was not a party to that agreement. Instead, the Merrill trust sued UBS for breach of representations under the Merrill purchase agreement with respect to 33 of the loans. The Merrill trust and UBS reached a settlement whereby (i) with respect to 32 of the loans, UBS paid approximately $20 million to the Merrill trust, and (ii) with respect to the Louisiana mortgage, UBS assigned to the Merrill trust its rights under the Love Funding purchase agreement, which included the right to bring suit against Love Funding for breach of representation under the Love Funding purchase agreement and the right to be held harmless, including costs and attorneys' fees, from litigation arising from a breach by Love Funding.

The Merrill trust brought suit against Love Funding for breach of representations contained in the Love Funding purchase agreement. The trial court found that Love Funding had breached its representations. However, the court entered judgment for Love Funding after holding that the assignment of interest from UBS to the Merrill trust was void as champertous because the Merrill trust's primary purpose in obtaining the assignment of UBS's rights was to sue Love Funding.

On appeal, the appellate court found that the New York champerty law was unclear on whether an intent to acquire a lawsuit in the current circumstances, where the assignee had interest in the debt, constituted champerty. Therefore, the appellate court reserved judgment and certified the following questions to the New York Court of Appeals:

- Is it sufficient as a matter of law to find that a party accepted a challenged assignment with the 'primary' intent proscribed by Section 489(1) of the New York Judiciary Law or must there be a finding of 'sole' intent?
- As a matter of law, does a party commit champerty when it 'buys a lawsuit' that it could not otherwise have pursued if its purpose is thereby to collect damages for losses on a debt instrument in which it holds a pre-existing proprietary interest?
- As a matter of law, does a party commit champerty when, as the holder of a defaulted debt obligation, it acquires the right to pursue a lawsuit against a third party in order to collect more damages through that litigation than it had demanded in settlement from the assignor? And is the answer to that question affected by the fact that the challenged assignment enabled the assignee to exercise the assignor's indemnification rights for reasonable costs and attorneys' fees?

The New York Court of Appeals recently agreed to consider the certified questions during its September 2009 session.

Comment

The New York Court of Appeals now has an opportunity to resolve uncertainty with respect to New York's champerty law. The decision may also provide guidance on the safe harbour recently added to the champerty law. Pursuant to a 2004 amendment, the champerty law provides a safe harbour for assignments which include debt instruments and where the purchase price exceeds $500,000.(3) The safe harbour has not yet been discussed in case law and the appellate court in *Love Funding* did not address the provision because the Merrill trust did not seek the shelter of the safe harbour. In a decision subsequent to *Love Funding*, *SCR Joint Venture LP v Warshawsky*,(4) the US Court of Appeals for the Second Circuit stated that:

"*if 'the accused party's primary goal is found to be satisfaction of a valid debt,' and the party only intends to bring suit absent full performance of the valid debt, the [champerty] statute is not violated.*"

The upcoming New York Court of Appeals decision in *Love Funding* might provide further clarity to purchasers of distressed debt which seek to rely on the ability to enforce rights under a debt instrument when deciding whether to make debt purchases.

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Endnotes

(1) No 07-1050 (2d Cir, February 13 2009).

(2) *Elliott Assocs, LP v Banco de la Nacion*, 194 F 3d 363 (2d Cir 1999).

(3) New York Judiciary Law § 489(2).

(4) 559 F 3d 133 (2d Cir 2009).