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Client Alert
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In *Justinian Capital*, New York's Champerty Statute Is Back from the Dead

By Paul B. Haskel, Steven R. Paradise and John A. Clark

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Since 2009, the loan market has largely set aside concerns regarding the arcane legal doctrine of "champerty," on the basis of what appeared to be straightforward guidance from the New York Court of Appeals. The generally held view was that champerty risk – *i.e.*, the risk a court may deny a buyer of legal claims the right to file suit on such claims – was limited to (relatively unorthodox) purchases undertaken by a buyer specifically for suing and profiting from the additional legal costs or fees resulting from that litigation. A new decision from that same court, *Justinian Capital SPC v. WestLB AG*, 2016 NY Slip Op 07047 (2016), indicates that the champerty doctrine applies more broadly and remains a pertinent issue in the distressed debt and claims market.

By virtue of a statutory exemption for transactions with an aggregate purchase price above $500,000, the *Justinian Capital* decision primarily affects trades in relatively small positions. Nonetheless, this decision also indicates that all buyers who wish to rely on this safe harbor should proceed with care any time the purchase price is not paid upfront or is otherwise contingent or revocable. The court's holding indicates that a buyer intending to enjoy the benefits of the safe harbor should be confident it has genuine "skin in the game" related to the economic value of the applicable debtor's original, underlying obligation.

A buyer of relatively small debts and claims (or a manager who subdivides a purchased claim across numerous funds) will want to be particularly cautious. Going forward, any such buyer should examine several aspects of a contemplated transaction, including:

- Its pre-trade motives and investment rationale for acquiring a particular claim;
- Its internal procedures for documenting and retaining evidence of such motives;
- The relative likelihood of earning investment returns from a debtor's restructuring or bankruptcy, on the one hand, versus from enforcement of a claim in litigation, on the other; and
- Whether it is likely to pursue litigation shortly after the closing of its claim purchase.

We discuss New York's evolving law of champerty and its consequences for debt and claims transactions in further detail below.

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THE LAW OF CHAMPERTY

Generally speaking, champerty under the common law prohibited the transfer of litigation rights from potential plaintiffs to unrelated third parties under certain circumstances. In New York, this doctrine was codified in Section 489 of the N.Y. Judiciary Law, which criminalizes 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 the purpose of bringing an action or proceeding thereon*." To determine whether a transaction is champertous, New York courts typically have focused on the buyer's intent – an amorphous concept that can be difficult to prove, particularly in the case of complex sales between legal entities.

To support liquidity in New York's debt-trading markets and to clarify the scope of the statute, the state legislature amended the champerty statute in 2004. Since then, Section 489(2) of the Judiciary Law has provided an exemption for sales of debt instruments "having an aggregate purchase price" of at least $500,000. Accordingly, for most larger transactions, champerty ceased to be a concern.

The New York Court of Appeals seemed to provide additional comfort to the debt-trading market with its decision in *Trust for Certificate Holders of Merrill Lynch Mtge. Invs., Inc. Mtge. Pass-Through Certificates, Series 1999-C1 v. Love Funding Corp.*, 13 N.Y.3d 190 (2009). The court held in *Love Funding* 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." Rather, the court drew a distinction between a party that acquires a right "in order to enforce it" and another who, in violation of champerty laws, acquires it "in order to make money from litigating." Citing opinions dating to the 1840s, the court explained that "the champerty statute does not apply when the purpose of an assignment is the enforcement and collection of a legitimate claim. What the statute prohibits…is the purchase of claims with the intent and for the purpose of bringing an action…in an effort to secure costs."[1]

After *Love Funding*, debt and claims traders and legal commentators viewed New York's champerty doctrine as, in practical effect, a dead letter – at least, for typical claims transactions where the primary purpose is not "to secure costs." Based on *Justinian Capital*, however, it appears that that view may have oversimplified the high court's position on champerty.

JUSTINIAN CAPITAL SPC v. WESTLB AG

In its most recent champerty opinion, the Court of Appeals held that Section 489's scope is *not* limited to the purchase of claims made with the intent to obtain costs or fees. Rather, the court indicated that Section 489 applies any time a party purchases instruments or claims "with the intent and for the primary purpose of bringing a lawsuit," *irrespective of* the purchaser's reason for the lawsuit itself.

Though we believe *Justinian Capital* provides lessons for market participants, it is important to note that the facts of the case are not typical of ordinary debt or claims trades and so the decision is likely distinguishable from most such transactions.

The *Justinian Capital* dispute arose out of one German bank's transfer of its litigation rights against WestLB, another German bank, to Justinian Capital SPC. The assigning bank was reluctant to sue WestLB directly because WestLB was partially owned by the German government and because both received substantial state support. The assigning bank therefore resolved to assign the litigation rights and related defaulted notes to Justinian, which in exchange agreed to pay $1,000,000 in cash consideration and remit a portion of any proceeds received on the assigned debt. The assignment, however, was not contingent on Justinian's

1. Richards Kibbe & Orbe LLP, as counsel for the Loan Syndications & Trading Association, Inc., filed an *amicus curiae* brief before the New York Court of Appeals in support of the assignee of the indemnification rights in the *Love Funding* case. The brief sought a narrow interpretation of New York's champerty statute – a position the court largely followed in finding for the assignee.

payment of the purchase price and failure to pay was not a defined event of default. Justinian also was not capitalized in any meaningful way and would not have been able to pay the purchase price unless it recovered on the claims. Moreover, evidence showed that Justinian's business plan depended on commencing litigation to recover on defaulted debts. Within days of the parties' assignment, Justinian did, in fact, commence litigation against the note issuer's management company, alleging fraud. In response, the defendant asserted that Justinian lacked standing to sue because it had violated Section 489(1)'s prohibition on champertous assignments. The court sided with the defendant, finding both that (i) Justinian's sole purpose in acquiring the notes was to bring a legal action, thus violating Section 489(1), and (ii) its agreement to pay the aggregate $1,000,000 purchase price was not a *bona fide* expense incurred by the buyer, therefore leaving Section 489(2)'s safe harbor beyond reach.

THE SAFE HARBOR FOR BUYERS WITH "SKIN IN THE GAME"

For parties to transactions involving a binding and *bona fide* purchase price of $500,000 or more, the *Justinian Capital* decision does not disturb Section 489(2)'s exemption. The Court of Appeals reiterated the importance of the statutory safe harbor to buyers in the debt markets, with the qualification that the statute is intended to apply to buyers with "skin in the game." Accordingly, any irrevocable sale of one or more claims conditioned on the purchaser's delivery of $500,000 or more in cash (for example) remains within the safe harbor regardless of the purchaser's intent. Closer analysis is still warranted, however, for transactions involving complex financing arrangements, disallowance provisions, delivery of consideration without obvious value, profit-sharing arrangements or other provisions or circumstances that suggest a buyer may not genuinely hold at least a $500,000 position in its investment.

BUYERS' MOTIVES MATTER

In the context of smaller claims trades, all buyers should take note. Prior to purchasing any claim for an amount less than $500,000, buyers should carefully analyze the transaction's "primary intent." The court's opinion makes clear that claims may continue to be purchased for a wide array of valid reasons, such as the expectation of earning returns in a restructuring or insolvency proceeding. The decision does not categorically forbid a buyer from filing an action after a completed assignment *so long as* that was not the primary intent at the outset. Since buyers' motives matter, market participants will want to consider procedures for documenting and retaining records of their investment rationale.

QUESTIONS

If you have questions regarding this case, the evolving law of champerty or any consequences of that law for particular transactions, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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