

RECENT NEW YORK DECISION PROVIDES CLARITY ON THE APPLICATION OF CHAMPERTY LAW TO SECONDARY MARKET TRANSACTIONS

The New York Court of Appeals clarified on October 15, 2009 that litigation to assert rights associated with a purchased claim is not prohibited under state law. This clarification provides comfort to secondary market purchasers of distressed syndicated loans, trade claims and other forms of debt, that it is not impermissible under New York state law for a party to acquire a debt instrument for the purpose of enforcing it, simply because the party intends to do so by litigation.

In *Merrill Lynch Mortg. Investors, Inc. v. Love Funding Corp.* 2009 WL 3294928 (Oct. 15, 2009 Ct. App. N.Y.), the New York Court of Appeals responded to a request by the U.S. Court of Appeals for the Second Circuit for clarification of New York's champerty law. Champerty law, the origin of which can be traced back to the middle ages, generally prohibits the selling of interests in litigated claims. Judiciary Law § 489, New York's champerty statute, states that a corporation or association may not "solicit, buy or take an assignment of, or be in any manner interested in buying or taking an assignment of a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon."

The multi-billion dollar secondary loan trading market, most notably through an amicus curiae brief filed by the Loan Syndication and Trading Association, had expressed concern that a ruling finding that New York's champerty laws prohibited the assignment of litigation rights would severely disrupt this important market and threaten future liquidity. Loan trading in the secondary market is based on the premise that the "entire bundle" of rights held by a lender is transferable – including "all mechanisms for enforcing rights and protecting the holder's interests." Accordingly, an "essential component of the value" of the traded instrument is the ability to assert a claim to protect the buyer's investment and recover to the greatest extent possible for any losses.

In *Merrill*, the appellant, a trust, held a pool of commercial mortgage-backed securities, some of which were fraudulent. It initially commenced an action against UBS, AG, the successor-in-interest to the entity which securitized the loans. The appellant and UBS eventually settled all but one of the appellant's claims, for which UBS assigned to the trust litigation rights against the loan originator, the respondent. The respondent argued, and, earlier, the U.S. District Court for the Southern



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District of New York had agreed, that the appellant was not entitled to collect any damages from the respondent because the assignment of litigation rights to appellant was void for champerty. Appellant appealed, and the U.S. Court of Appeals for the Second Circuit requested the New York Court of Appeals to clarify the proper interpretation of New York's champerty laws.

The Merrill Court noted that in New York, the prohibition on champerty historically has been "limited in scope and largely directed toward preventing attorneys from filing suit merely as a vehicle for obtaining costs." It explained that the purpose of New York's champerty statute "was to prevent attorneys and solicitors from purchasing debts, or other things in action, for the purpose of obtaining costs from a prosecution thereof, and was never intended to prevent the purchase for the honest purpose of protecting some other important right of the assignee."

The Merrill Court wrote 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." It concluded that the champerty statute does not apply "when the purpose of an assignment is the collection of a legitimate claim." What the statute does prohibit is the "purchase of claims with the intent and for the purpose of bringing an action that [the purchaser] may involve parties in costs and annoyance, where such claims would not be prosecuted if not stirred up ... in [an] effort to secure costs." The Merrill court concluded that an assignment does not violate the champerty statute "if its purpose is to collect damages, by means of a lawsuit, for losses on a debt instrument in which it holds a pre-existing proprietary interest."

The Standard Terms and Conditions to the Purchase and Sale Agreement for Distressed Trades (as published by the LSTA), which is governed by New York law, contemplate that a Seller

sells to a Buyer not only the underlying loans but also all of Seller's right, title and interest in any and all accompanying "Transferred Rights." The definition of the term "Transferred Rights" includes all claims, suits and causes of action of Seller that in any way are based upon, arise out of or are related to the debt.¹ Other LSTA form agreements, and most market forms of agreement for the purchase and sale of trade claims, contain similar language, i.e., the purchaser acquires all claims, suits and causes of action held by Seller arising from or related to the underlying transferred obligation.²

The Merrill decision should ease any uncertainties secondary market participants may have regarding the application of champerty law in actions involving bank debt or trade claims transactions. Secondary market purchasers accustomed to settlement using LSTA standard documentation should continue to rely on the validity and enforceability of the assigned claims in evaluating and managing their investments. Purchasers of trade claims and other types of financial instruments using non-LSTA documentation should make sure New York law governs all agreements and that each party thereto consents to jurisdiction in New York courts.

¹ The definition includes "all claims (including 'claims' as defined in Bankruptcy Code §101(5)), suits, causes of action, and any other right of Seller or any Prior Seller, whether known or unknown, against Borrower, any Obligor, or any of their respective Affiliates, agents, representatives, contractors, advisors, or any other Entity that in any way is based upon, arises out of or is related to any of the foregoing, including, to the extent permitted to be assigned under applicable law, all claims (including contract claims, tort claims, malpractice claims, and claims under any law governing the purchase and sale of, or indentures for, securities), suits, causes of action, and any other right of Seller or any Prior Seller against any attorney, accountant, financial advisor, or other Entity arising under or in connection with the Credit Documents or the transactions related thereto or contemplated thereby... ."

² The LSTA standard form of Assignment and Assumption contemplates the assignment, to the extent permitted to be assigned under applicable law, of "all claims, suits, causes of action and any other right of Assignor... ." The LSTA form of Participation Agreement for Distressed Trades contains identical language to the Purchase and Sale Agreement.

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