

Litigation Funding and The Law of Champerty

BY LAZAR EMANUEL

Does the exchange of questions and answers between the Second Circuit Court of Appeals and the New York Court of Appeals in *Trust v. Love Funding*, decided in January, 2010, put at jeopardy the burgeoning litigation finance industry, at least in New York? In their exchange, both Courts were so careful to limit their comments to the precise facts before them, that we are left to wonder how they would respond to a commercial transaction by a company in the business of arranging alternative litigation financing (ALF), i.e., a company of investors with no proprietary interest in the matter but which funds the costs of a litigation by an unrelated plaintiff with a claim for patent infringement, or by a patient with a claim for medical malpractice; in other words, a company in the business of acquiring a financial interest in a litigation, other than the plaintiffs, the defendants, their lawyers, and their insurers.

The facts of *Trust v. Love Funding* are critical to our discussion. Love Funding made a loan of \$6.4 million dollars to one of its customers, secured by a mortgage on property in Louisiana. The loan was assigned by Love Funding to Paine Webber Real Estate Securities, Inc. Paine Webber sold the Louisiana loan to Merrill Lynch Mortgage Investors, Inc., as part of a larger securities transaction involving numerous mortgage loans. Paine Webber made a series of representations to Merrill Lynch, including a representation that payments on the Louisiana loan were current. (Love Funding had made the same representation to Paine Webber) The Paine Webber loans were securitized by Merrill Lynch under a pooling and service agreement which created a Trust for the holders of pass-through Merrill Lynch certificates.

UBS then acquired the interests of Paine Webber in all the loans purchased by Merrill Lynch.

When UBS defaulted on some of the loans, the Trust sued UBS. UBS settled the suit by agreeing to take two separate steps. First (of no concern to us here), UBS agreed to pay the Trust \$19,375,000 million for 32 Paine Webber loans unrelated to Love Funding. Second, on the Love Funding loan, UBS assigned to the Trust the right to sue Love Funding for the misrepresentations in Love Funding's original loan application. Thus, the sole consideration from UBS to the Trust for the Love Funding loan was the assignment to the Trust of the UBS rights under the original mortgage loan. Armed with the assignment, the Trust commenced a suit for misrepresentation against Love Funding.

Reducing these facts to their essentials, we have:

1. The right of Paine Webber to sue for fraud by Love Funding;
2. The purchase of multiple Paine Webber loans by the Merrill Lynch Trust;
3. Acquisition by UBS, successor to Paine Webber, of the right to sue Love Funding;
4. Suit by the Merrill Lynch Trust against UBS for defaults on the Paine Webber loans;
5. Settlement of suit in part by assignment to Trust of UBS right to sue Love Funding.

None of these facts involves a party in the business of arranging litigation financing. All of the parties were in the business of arranging and supplying loans and financing in the ordinary course of business. Why then, all the attention to the law of champerty and to § 489 of the Judiciary Law?

In the suit by the Trust against Love Funding, *Trust v. Love Funding*, 499 F. Supp. 2d 314 (S.D.N.Y. 2007), District Court Judge Shire A. Scheindlin determined that the assignment to Merrill Lynch by Paine Webber of the Louisiana loan was champertous and entered judgment in favor of Love Funding.

On appeal by the Trust, the Second Circuit Court of Appeals confronted the need to review and apply New York's law on champerty and maintenance. New York's Judiciary Law § 489 provides (in pertinent part):

§ 489. Purchase of claims by corporations or collection agencies.

[N]o corporation or association, directly or indirectly, itself or by or through its officers, agents or employees, shall 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.

Confronting a statute which is the epitome of legal obfuscation and ambiguity, the Second Circuit demurred and lateraled the issue over to the New York Court of Appeals for clarity and direction. (*Trust v. Love Funding*, 556 F.3d at 114.)

Because of ambiguities in the scope of New York's statutory proscription of champerty, see N.Y. Judiciary Law § 489, we certified certain questions to the New York Court of Appeals.

The questions certified by the Circuit Court to the Court of Appeals were:

1. Is it sufficient as a matter of law to find that a party accepted a challenged assignment with the "primary" intent proscribed by New York Judiciary Law § 489(1), or must there be a finding of "sole" intent?
2. 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?
3. (a) 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?
(b) Is the answer to question 3(a) 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 Second Circuit asked the New York Court of Appeals specifically whether, assuming the truth of the facts alleged by the Trust in its complaint against Love Funding, the assignment to the Trust could be construed as champertous. The Second Circuit's instructions to the N.Y. Court were:

The Court of Appeals may answer these questions in whatever order it deems best to assist this court in determining whether the facts of this case demonstrate champerty. ...

The Law of Champerty

The law of champerty and maintenance traces its origin to the earliest periods of English history. It was the practice for men of title and wealth to buy up and collect the claims of the poor and indigent. To protect the interests of the rightful claimants, Parliament declared champerty a crime and all agreements of champerty void. As one modern English judge has defined it:

In modern idiom maintenance is the support of litigation by a stranger without just cause. Champerty is an aggravated form of maintenance. The distinguishing feature of champerty is the support of litigation by a stranger in return for a share of the proceeds.

More recently, the Supreme Court of Ohio has said:

The doctrines of champerty and maintenance were developed at common law to prevent officious intermeddlers from stirring up strife and contention by vexatious and speculative litigation which would disturb the peace of society, lead to corrupt practices, and prevent the remedial process of the law. *Rancman v. Interim Settlement Funding Corp.*, 789 N.E.2d. 217, 219-220 (Ohio 2003).

No New York statute and no recent decision by a New York court has defined champerty in precisely this way. If such a restrictive definition were adopted, it might spell the end of the nascent business of litigation funding. Instead, the New York courts have skirted the litigation funding issue by focusing on a much narrower issue, which may be stated as follows: Does it constitute champerty to permit a party who purchases an existing interest in the outcome of a law suit to pursue his claim by bringing or funding the law suit?

In any event, the *Love Funding* case raised issues of champerty not in the context of litigation funding, but in the context of the assignment of claims in the distressed debt and secondary loan market. In view of the pressures on that market, the courts would obviously be chary of any decision to hinder the enforcement of rights by existing creditors.

The Court of Appeals Responds

Responding to the questions certified by the Second Circuit, the Court of Appeals (Pigott, J.) reviewed the facts of *Love Funding* in detail and announced:

We hold that a corporation or association that takes an assignment of a claim does not violate Judiciary Law § 489(1) 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 (emphasis added).

Further:

We answer the second certified question, and both parts of the third certified question, in the negative. Because — as the Second Circuit itself hinted — “the critical issue to assessing the sufficiency of the champerty finding is not the denomination of the Trust’s intent as ‘primary’ or ‘sole,’ but the purpose behind its acquisition of rights that allowed it to sue *Love Funding*” (556 F.3d at 111), we find it unnecessary to answer the first certified question.

Judge Pigott then discussed the impact of Judiciary Law § 489 on the enforcement of contractual and proprietary rights. We summarize Judge Pigott’s chain of reasoning as follows: (We have repeated (and/or paraphrased) and numbered his points for the reader’s convenience. Each of the points is supported by a string of cases cited by the Judge.)

1. The doctrine of champerty developed “to prevent or curtail the commercialization of or trading in litigation.”
2. Sections 488 and 489 of the Judiciary Law derive from Sections 274 and 275 of the former Penal Law.
3. Section 275 was intended to apply to corporations and associations restrictions on litigation that had always governed lawyers.
4. Neither a corporation or association – nor a lawyer (Section 488) – may “solicit, buy or take 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.”
5. The champerty statutes are directed at preventing the “strife, discord and harassment” that would be likely to ensue “from permitting attorneys and corporations to purchase claims for the purpose of bringing actions thereon.”
6. In describing champerty in terms of an acquisition made with the purpose of bringing a lawsuit, we (i.e., the Court of Appeals) intended to convey the difference between one who acquires a right in order to make money from litigating it and one who acquires a right in order to enforce it.
7. New York cases agree 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. The inquiry into purpose is a factual one.
8. The champerty statute does not apply when the purpose of an assignment is the collection of a legitimate claim. What the statute prohibits, as the Appellate Division stated over a century ago, “is the purchase of claims with the `intent and for the purpose of bringing an action’ that. ... may involve parties in costs and annoyance, where such claims would not be prosecuted if not stirred up . . . in [an] effort to secure costs.”
9. In the present case ... the Trust, as the holder of the ... Loan and the party that would directly suffer the damages of any default on that loan, had a pre-existing proprietary interest in the loan... If, as a matter of fact, the Trust’s purpose in taking assignment of UBS’s rights ... was to enforce its rights, then, as a matter of law, given that the Trust had a pre-existing proprietary interest in the loan, it did not violate Judiciary Law § 489(1).

Back to the Circuit Court of Appeals

After the New York Court of Appeals answered the Second Circuit’s questions, all parties to the action in the Second Circuit agreed that Judge Scheindlin had “applied a more expansive definition of champerty than was warranted.” Defendant Love Funding, which wanted to preserve Judge Scheindlin’s original finding of champerty, urged the Second Circuit to remand the matter to the trial court with instructions to determine whether any of the answers by the New York Court of Appeals would support a finding of champerty. Plaintiff Trust, on the other hand, asked the Second Circuit to reverse Judge Scheindlin’s decision entirely, as a matter of law. The Second Circuit agreed with the Trust and stated, “This effectively rejects the district court’s finding of champerty.”

However, in the process of answering the Second Circuit, the New York Court of Appeals injected a few words and phrases which make unclear how it would respond to a set of facts describing succinctly a dispute arising out of an instance of alternative litigation funding. Judge Pigott wrote, at various places in his opinion (with emphasis added):

[New York's champerty statute] "does not apply when the purpose of an assignment is the collection of a legitimate claim."

"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."

"if, as a matter of fact, the Trust's purpose in taking assignment of UBS's rights. ... was to enforce its rights, then, as a matter of law, given that the Trust had a pre-existing proprietary interest in the loan, it did not violate Judiciary Law § 489(1)."

"In describing champerty in terms of an acquisition made with the purpose of bringing a lawsuit, we intended to convey the difference between one who acquires a right in order to make money from litigating it and one who acquires a right in order to enforce it."

By inserting the words and phrases we have emphasized, did the Court of Appeals mean to say:

Does the fact that a claim is legitimate insulate an assignment of the claim from a claim of champerty?

Is a party's intent to enforce a claim through litigation always irrelevant to a claim of champerty?

Is litigation to collect a pre-existing proprietary interest always immune from a claim of champerty?

Does the intent to make money by acquiring a right and then litigating it for profit always constitute champerty?

We may not know the answers to these questions definitively until some litigant claims the defense of champerty against a source of alternative litigation financing. But decisions from the Nassau County Supreme Court and the Ohio Supreme Court, to which I now turn, are instructive.

Litigation Financing – Is It Champerty

In a 2003 issue of the *ABA Journal*, a commentator on litigation financing described the growth of the industry in this way:

The past several years have seen a dramatic increase in companies that extend funding to plaintiffs. ...during the course of litigation. ... What they offer is 'non-recourse' funding, meaning that if the case loses at trial or is overturned on appeal, the client is not obligated to reimburse the funder. The loan usually is at a very high rate of interest. Some companies collect a flat sum; others receive a percentage of any final award or settlement.

Since that report, of course, the industry has grown even more, especially because large insurers and investors continue to enter the market.

LawCash, a typical source of litigation funding, has offices in New York and Florida, and calls itself “The Nation’s Leading Provider of Litigation Financing, Plaintiff Funding, and Attorney Funding.” Its web site (www.lawcash.net) describes LawCash’s services as follows:

- Pre-Settlement Litigation Financing... Advances for plaintiffs and attorneys including Case Cost Funding
- One Hour Funding[®] – Litigation Financing for plaintiffs and attorneys who have reached a settlement in any lawsuit
- Pre- and Post-Settlement funding is non-recourse. If you lose your case, you owe us nothing
- Structured Attorneys Fees
- Law Firm Loans, Attorney Lines of Credit, and Case Cost Line of Credit for attorneys
- No credit check for plaintiffs

The services supplied by LawCash were the focus of the court’s opinion in *Echeverria v. Estate of Lindner*, 2005 N.Y. Slip Op. 50675U, 2005 N.Y. Misc. LEXIS 894 (Mar. 2, 2005). That case, which was an inquest into the facts to determine plaintiff’s personal-injury damages, gave Nassau County Supreme Court Judge Ira B. Warshawsky an opportunity to discuss the relationship between champerty and litigation funding. In *Echeverria*, LawCash advanced the sum of \$25,000 to plaintiff Echeverria, a day laborer at a construction site who had sustained serious injuries in a fall from a scaffold.

Under its contract with Echeverria, LawCash would receive nothing if Echeverria’s claim was unsuccessful. If his claim succeeded, however, LawCash would receive interest on its advance of \$25,000 at 3.85% per month, compounded monthly. Judge Warshawsky called this agreement “obviously usurious”, as well as one that “may or may not also constitute Champerty.”

In the end, however, Judge Warshawsky decided that the LawCash advance did not constitute champerty as defined in § 489. “[T]he primary purpose and intent of funding Mr. Echeverria the \$25, 000 and charging 3.85% interest,” the judge said, “was not to take action on their claim to the judgment, but to make a profit from their loan/investment.”

Judge Warshawsky also analyzed the case of *Rancman v. Interim Settlement Fund*, 99 Ohio St. 3d 121 (Ohio 2003), *supra*. *Rancman* began as a law suit by a woman against her insurance company. After starting her suit, the woman asked a company named Interim Settlement Funding Corp. for an advance secured by her claim. Interim gave her an advance of \$6,000, to be repaid by the sum of \$16,800 if she recovered within 12 months, and an additional sum if her recovery were delayed. The Ohio Supreme Court held the agreement void under Champerty and maintenance. Judge Warshawsky distinguished *Rancman* as follows (with all citations omitted):

While the facts and the agreements made by Interim and LawCash are very similar, it is not the facts that account for the differences of opinion, but rather it is the different law of the different states which allow us to differ in our conclusions. ... [T]he Ohio decision is based on Ohio precedent that the assignment of rights in a lawsuit can be void as Champerty. Under New York law these assignments are allowed as long as the primary purpose and intent of the assignment was for some reason other than bringing suit on that assignment. Therefore under Ohio law, taking an assignment of a judgment for profit by itself is enough to constitute Champerty, while under New York law the primary purpose and intent of taking the assignment would be to profit, and not to bring suit, which would prevent this action from being Champerty. Resting on the language of Judiciary Law 489 and the purpose and intent requirement, the Court is comfortable finding that the instant agreement is not Champerty.

All this being said, the court feels that the Ohio Supreme Court would agree with the statement that Champerty law was not written to deal with the situation that has developed from this modern form of business which advances plaintiffs' funding for their lawsuit in exchange for a portion of the judgment. The Ohio court in *Rancman* noticed that Champerty law has historically been used in cases where attorneys themselves have been Champertors.

I disagree with Judge Warshawsky's perception of the history and purpose behind the law of champerty.

It was indeed written to deal with the situation that results when an otherwise uninvolved but profit-driven third-party agrees to fund a law suit.

As a commentator on issues affecting lawyers, I regret that our courts have skirted the issues raised by "alternative" or third-party litigation funding. As the capital of the legal profession, New York has become also the capital for companies offering litigation funding.

Here are some of the questions I would ask. These questions have been answered in a variety of ways in other states (see, *Rancman*, supra), but not in New York.

1. Is litigation funding by a source which is not a party to a litigation legal? (This question was dodged by the NYSBA in Opinion 769, 11/4/03.)
2. Is litigation funding that provides a return to the source of funding in excess of the legal usury rate lawful and/or proper?
3. Is usury an element in champerty?
4. Recognizing that some plaintiffs (e.g., plaintiffs with claims for personal injury or for malpractice) may not have the funds to recover on their claims, shall we authorize litigation funding only in specified causes of action?
5. In the funding of litigation, is there a difference between loans to litigants with a specified interest rate and the purchase of a contingent interest in the recovery or settlement of the litigation?
6. If the source of the litigation funding purchases a contingent interest, is that interest limited to a specified portion of the lawyer's contingent fee, or can it extend to a specified portion of the client's recovery?
7. What is the proper relationship between the lawyer for a litigant and a potential source of litigation funding? (This has many elements and requires careful analysis and rule-making.)

The pressures for litigation funding are increasing. Some observers have suggested that funding be permitted in all civil cases requiring help for a litigant without sufficient funds to sustain the action himself, or even in those cases in which the costs of litigation cannot be estimated.

In any event, we need to impose some limits and standards before the litigation funding industry grows beyond our control. Who will take the lead – the courts, the legislature, the State Bar? Or is this a subject requiring extended debate and agreement on public policy?

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