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# Litigation & Arbitration Group Client Alert: New York State Supreme Court Finds Litigation By Proxy Impermissible Under Ancient Champerty Doctrine

The New York State Supreme Court last week dismissed a lawsuit at the summary judgment stage in a rare instance of a U.S. court dismissing a case on the grounds of champerty.[1] The doctrine of champerty was "developed hundreds of years ago to prevent or curtail the commercialization of or trading in litigation."[2] Although champerty has been repealed in many states, New York continues to embrace the doctrine.[3] The case, captioned *Justinian Capital SPC v. WestLB AG*, is an important one because it brings greater clarity to an obscure legal doctrine and the circumstances under which participants in the distressed debt market cannot transfer litigation rights.

## BACKGROUND OF THE CASE

The case arose out of an investment by non-party bank, Deutsche Pfandbriefbank AG ("DPAG"), in two special purpose companies that were sponsored and managed by the defendants, WestLB AG and WestLB Asset Management (US) LLC (collectively, "WestLB").[4] DPAG had purchased two series of mortgage notes issued by the special purpose companies and, in the wake of the U.S. housing market crisis, suffered substantial losses from these investments.[5] Despite having potential claims against WestLB for alleged misconduct, DPAG was reluctant to sue WestLB for political reasons: DPAG relies heavily on the German government for funding, and the German

[1] *See Justinian Capital SPC v. WestLB AG*, Index No. 600975/2010, 2014 N.Y. Slip. Op. 24046 (Sup. Ct. N.Y. County Feb. 24, 2014).
[2] *Bluebird Partners, L.P. v. First Fidelity Bank, N.A.*, 94 N.Y.2d 726, 733 (2000).
[3] *Justinian Capital*, 2014 N.Y. Slip. Op. 24046, at *1.
[4] *Id.* at *2.
[5] *Id.*

government partially owns WestLB.[6] DPAG, however, "still wanted to recoup the hundreds of millions of dollars it lost due to WestLB's alleged fraud."[7]

The plaintiff, Justinian Capital SPC ("Justinian"), was a fund that, as the Court described, "identified inefficiencies in the market for financial crisis litigation and sought to capitalize on such inefficiencies."[8] Justinian never invested with WestLB and never purchased the mortgage notes from DPAG.[9] Instead, Justinian and DPAG entered into a "Sale and Purchase Agreement" pursuant to which Justinian agreed to file suit against WestLB, retain 15% of any litigation recovery, and remit the remainder to DPAG.[10] Although the Sale and Purchase Agreement had a stated purchase price of $1 million for the subject notes ($500,000 for each note), Justinian did not pay anything to DPAG and did not actually acquire the notes as part of the transaction.[11] DPAG simply hired Justinian to prosecute DPAG's claims against WestLB in exchange for a fee in the event of a successful outcome.

Justinian thereafter filed a complaint against WestLB asserting claims for, among other things, breach of contract and fraud. WestLB moved to dismiss the complaint on champerty grounds. The Court found questions of fact with respect to the champerty issue and instructed the parties to conduct discovery on that issue. When this discovery was completed, WestLB moved for summary judgment.

### COURT GRANTS SUMMARY JUDGMENT ON CHAMPERTY GROUNDS

Justice Kornreich's decision focused on the legislative intent and history of New York's champerty statute, which is codified in Section 489 of the New York Judiciary Law. The statute provides that:

> [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 . . . any claim or demand, *with the intent and for the purpose of bringing an action or proceeding thereon. . ..* [12]

[6] *Id*.
[7] *Id*. at *4.
[8] *Id*.
[9] *Id*. at *2.
[10] *Id*.
[11] *Id*. at *2-*3.
[12] N.Y. Judiciary Law § 489(1) (emphasis added).

In connection with the distressed debt market, the Court said "the champerty inquiry turns on 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.'"[13] While the latter is permissible under New York law, the former is prohibited, although the exact parameters of the champerty doctrine have not always been clear.

In 2004, the New York Legislature narrowed the champerty doctrine by adding a "safe harbor" provision, eliminating the champerty defense for the transfer of litigation claims with an aggregate purchase price of at least $500,000.[14] Relying primarily on the legislative history of the safe harbor provision, the Court concluded that, for the safe harbor to apply, *actual payment* of the purchase price is required.[15] The Court reasoned that "requiring actual payment is necessary to avoid the safe harbor effectively doing away with champerty."[16]

Justice Kornreich first addressed whether the Sale and Purchase Agreement between DPAG and Justinian was covered by the safe harbor provision. Relying on the $1 million purchase price listed in the Sale and Purchase Agreement, Justinian argued that the safe harbor applied. The Court disagreed, and found that the Agreement "cannot merely recite a nominal amount equal to the monetary threshold."[17] Because Justinian was a shell company with no assets that did not pay the purchase price to DPAG, the Sale and Purchase Agreement was not covered by the safe harbor.[18]

The Court next addressed whether the Sale and Purchase Agreement was prohibited under the champerty doctrine. The Court analyzed and reaffirmed recent New York Court of Appeals and Second Circuit precedents, which permit the purchase of distressed debt "for the purpose of enforcing such debt through litigation."[19] Put another way, "if an investor *buys* worthless mortgage backed securities, it can sue the issuer for fraud and, if it wins, it can keep the money."[20]

[13] *Justinian Capital*, 2014 N.Y. Slip. Op. 24046, at *1-*2 (quoting *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc. Mortgage Pass-Through Certificates v. Love Funding Corp.*, 13 N.Y.3d 190, 200 (2009)).
[14] *See* N.Y. Judiciary Law § 489(2).
[15] *Justinian Capital*, 2014 N.Y. Slip. Op. 24046, at *3.
[16] *Id*.
[17] *Id*.
[18] *See id*.
[19] *Id*. at *6.
[20] *Id*. (emphasis added).

In the following ways, Justice Kornreich distinguished that situation from the facts of *Justinian*, which demonstrated that "[n]o reasonable finder of fact could conclude that Justinian was making a bona fide purchase of securities":

- Justinian was a shell company formed exclusively for the purpose of litigating DPAG's claims.
- Justinian paid nothing for the mortgage notes.
- DPAG would receive 85% of any judgment or settlement.
- DPAG still effectively controlled the mortgage notes.
- Justinian could not sell the mortgage notes without DPAG's consent.
- DPAG imposed significant restrictions on Justinian's ability to settle the action without input from DPAG.[21]

Under these facts, the Court held, Justinian was engaged in "litigation by proxy," which is prohibited under New York's champerty statute.[22] Providing clear guidance for participants in the distressed debt market, Justice Kornreich concluded: "[I]t is not champerty to sue on behalf of debt that you buy for yourself, but it is champerty to sue, on behalf of another and for a fee, for debt that is not really your own."[23]

## CONCLUSION

Justice Kornreich's decision is significant for participants in the distressed debt market that conduct business under New York law. While the decision breathes life into the ancient champerty doctrine, it also brings clarity in defining when the transfer of a litigation claim is champertous and therefore prohibited under New York law.

[21] *Id*. at *6-*7.
[22] *Id*. at *7.
[23] *Id*.

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