Litigation Funding Update – Abolishing Common Law Champerty

FIRST TUESDAY UPDATE
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Overview
First Tuesday Update is our monthly take on current issues in commercial disputes, international arbitration, and judgment enforcement.

This month we discuss litigation funding and the evolving US jurisprudence on champerty, an ancient legal doctrine that originated in France and was imported into the United States from England. The original purpose of the doctrine was to prevent speculation in litigation. In those jurisdictions which still have a champerty prohibition, the doctrine can create problems for litigation funding agreements. We examine a recent decision by the Minnesota Supreme Court that abandoned that state’s common law prohibition on champerty (Maslowski v. Prospect Funding Partners LLC). We also examine a 2016 decision from New York’s highest court (the Court of Appeals) and a more recent decision from the federal district court for the Southern District of New York that held assignments of claims under distressed notes violated that state’s champerty statute (Justinian Capital SPC v. WestLB AG and Phoenix SF Light, Ltd., et al v. U.S. Bank National Association and Bank of America NA). The cases demonstrate how different jurisdictions have treated champerty. They also illustrate the importance of checking the law of the relevant jurisdiction(s) before entering into a litigation funding arrangement so that you can enter into a lawful arrangement, which is feasible in most jurisdictions.

“Champerty” refers to an agreement under which a stranger to a lawsuit agrees to assist in its prosecution or defense in exchange for some of the proceeds of the action. 14 Am. Jur. 2d Champerty, Maintenance, etc. § 1 (2020). While the doctrine was originally two-headed, involving both maintenance (funding another’s lawsuit) and champerty (funding another’s lawsuit in exchange for a share of the proceeds), the modern statutes and case law have generally combined the two under the champerty rubric. While its origins were in feudal France, the doctrine was “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 law.” Id. The doctrine was based on a general mistrust of litigation and of money lending. See Osprey, Inc. v. Cabana Ltd. P’ship, 532 S.E.2d 269, 274 (S.C. 2000). Over the past two decades, several states have abandoned their anti-champerty laws, finding the prohibition no longer comports with a modern understanding of the benefits of litigation. Id. (rejecting the common law defense of champerty in South Carolina); Saladini v. Righelli, 887 N.E. 2d 1224 (Mass. 1997) (holding that the common law doctrine of champerty “no longer shall be recognized in Massachusetts”); see also Ohio Rev. Code Ann. § 1349.55 (effective August 27, 2008) (abrogating prohibition on champerty). Other states, such as New York have adopted “safe harbors” that exempt transactions above a certain dollar amount from the reach of the champerty laws. In common law jurisdictions, outside of the US, England, Canada, and Australia have abandoned their laws against champerty, but Ireland, New Zealand, and Hong Kong continue to prohibit certain transactions as champertous. However, a number of US jurisdictions, including New York, Delaware, and Florida prohibit champerty either by statute or common law, which can create uncertainty about the legality of third-party litigation funding agreements.
Last month, Minnesota became the latest state to abandon its champerty prohibition. In *Maslowski v. Prospect Funding Partners LLC*, the Minnesota Supreme Court considered whether a litigation-funding agreement between Pamela Maslowski and Prospect Funding Partners LLC was void because it violated Minnesota's common law prohibition against champerty. __ N.W. 2d __, No. A18-1906, 2020 WL 2893376 at *1 (Minn. June 3, 2020). Under the agreement, Prospect had paid Ms. Maslowski $6,000 in exchange for an interest in the proceeds of any settlement that she received from a personal injury lawsuit. Id. If Ms. Maslowski did not receive a settlement, she would owe Prospect nothing. Id.

The Minnesota Supreme Court held that the agreement between Ms. Maslowski and Prospect was champertous; however, it also held that champertous contracts of this kind no longer contravene “public policy as we understand it today.” Id. at *3. The court explained that the common law prohibition against champerty was originally based on a desire to prevent abuse of the court system by individuals wealthy enough to finance lawsuits, who would “play[] the game of writs” to increase their power and harass their rivals through the medieval court system. Id. at *2 (quoting R.D. Cox, *Champerty As We Know It*, 13 Mem. St. U. L. Rev. 139, 142 (1983)). Prohibiting third parties from intermeddling in lawsuits was intended to prevent the corruption of the judicial system and the “remedial process of the law.” Id. at *3. The court held that in the modern era the doctrine against champerty is no longer the only or best tool for achieving those goals. Instead, the modern “rules of professional responsibility and civil procedure address the abuses of the legal process that necessitated the common-law prohibition” against champerty. Id. While litigation financing may once have been seen as a perversion of the system of justice, it may now “increase access to justice” by enabling individuals who might not otherwise have the financial means to pursue their claims in court. Id. at *4. Accordingly, the court held that “changes in the legal profession and in society” have rendered the prohibition against champerty “no longer necessary.” Id. at *3.

Having found that there was no longer a sound public policy that supported a law against champerty, the Minnesota Supreme Court was able to abolish the doctrine because Minnesota’s prohibition was based in common law rather than a statute. The court explained that “the development of the common law is determined by the social needs of the community which it governs” and that, “as society changes, the common law must also evolve with it.” Id. (quotations omitted).


Section 489 of New York’s Judiciary Law prohibits persons and corporate entities from “buy[ing] or tak[ing] an assignment of . . . a bond, promissory notes, 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.” N.Y. Jud. Law § 489. It also contains a safe harbor for transactions “having an aggregate purchase price of at least five hundred thousand dollars.” Id. § 489(2). As early as 1882, the state’s highest court interpreted the statutory language “with the intent and for the purpose” to mean that, in order for an agreement to be champertous, the “primary purpose of the purchase must be to enable [one] to bring a suit.” *Moses v. McDivitt*, 88 N.Y. 62, 65 (1882) (interpreting the predecessor statute to N.Y. Jud. Law § 489). The court has explained that, “in order to constitute champertous conduct . . . the foundational intent to sue on that claim must at least have been the primary purpose, if not the sole motivation behind, entering into the transaction.” *Bluebird Partners, L.P. v. First Fidlity Banks*, N.A., 731 N.E. 2d 581, 587 (N.Y. 2000).

Prior to the Court of Appeals’ 2016 decision in *Justinian Capital SPC v. WestLB AG*, 65 N.E. 3d 1253 (2016) the vast majority of New York courts that had interpreted the statute held that the challenged arrangement was not champertous. Indeed, in two relatively recent decisions before *Justinian*, the Court of Appeals had rejected champerty defenses. *See Trust for Certificate Holders of Merrill Lynch Mtge. Invs., Inc. Mtge. Pass-Through Certificates, Series 1999-C1 v Love Funding Corp.* (13 NY3d 190, 198-199 [2009]); *Bluebird Partners v First Fidl. Bank* (94 NY2d 726, 736 [2000]).

While the Court of Appeals decisions in *Merrill Lynch* and *Bluebird Partners* did not involve litigation funding, in *Echeverria v. Estate of Lindner*, 801 N.Y.S. 2d 233, 2005 WL 1083704 (N.Y. Sup. Ct. 2005) (unreported), the New York Supreme Court for Nassau County found that a litigation-funding agreement did not constitute champerty under N.Y. Jud. Law § 489 because the transaction was not made for the primary purpose of bringing suit. 2005 WL 1083704 at *4. Plaintiff Juan Vincente Echeverria had sued his employer for medical expenses resulting from a workplace injury. Id. at *1. *5. After filing suit, he obtained a $25,000 loan from LawCash to pay his medical expenses and agreed to re-pay the loan out of any proceeds from his lawsuit. Id. at *5. If Echeverria did not prevail, he would owe $200 million.

But in 2016, the Court of Appeals held in *Justinian Capital SPC v. WestLB AG*, 65 N.E. 3d at 163–64 that a litigation funding arrangement, albeit an unusual one, violated New York’s champerty statute and affirmed the dismissal of claims of approximately $200 million.
Justinian and non-party Deutsche Pfandbriefbank had entered into an agreement that provided for Justinian's purchase of notes in structured investment vehicles for the explicit purpose of bringing a lawsuit against the vehicles' manager, WestLB. Justinian, 65 N.E. 3d at 164–65. Justinian and Deutsche Pfandbriefbank agreed that if Justinian prevailed in its suit against WestLB, it would remit 80–85% of the proceeds to Deutsche Pfandbriefbank and keep the rest. Id. at 165. Although the agreement recited a $1 million purchase price, Justinian had never actually paid this amount to Deutsche Pfandbriefbank and Justinian’s failure to pay was not a default or breach of the agreement. Id.

The Court of Appeals held that the assignment of the notes to Justinian was champertous because Justinian’s sole purpose in acquiring the notes was to sue WestLB. Id. at 167. Moreover, because Justinian had no genuine obligation to pay the purchase price, the court held the transaction was not within the champerty statute’s safe harbor. The court did not consider whether the statutory prohibition on champerty continued to benefit New York’s public policy goals.

In a more recent decision earlier this year, the US federal district court for the Southern District of New York, relying on Justinian, held that assignments of the right to sue under trust certificates in various collateralized debt obligations violated New York’s champerty statute. Phoenix SF Light, Ltd., et al. v. U.S. Bank National Association and Bank of America NA. The assignment had been consummated while the litigation was pending in response to a motion to dismiss for lack of standing. The court held that it violated the champerty statute because its sole purpose was to enable litigation. The court rejected plaintiffs’ arguments that, because they were already noteholders in the underlying investment vehicles and only needed the assignment to proceed directly against the indenture trustees, they had a pre-existing interest that put them outside the statute.

The recent case law on champerty in Minnesota and New York illustrates that while this ancient doctrine is waning, it can still be a trap for the unwary. Litigation funding agreements governed by New York law or providing for litigation in the New York courts must be structured to avoid violating New York’s champerty statute. Litigants in Minnesota and the other jurisdictions that have abandoned their champerty prohibitions have no such concerns. The ability to enter into a lawful litigation funding arrangement depends on each jurisdiction’s law and, while in most jurisdictions it is possible to enter into an acceptable arrangement, one must consider the particulars of the relevant law.

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