CHAMPERTY AND CLAIMS TRADING

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INTRODUCTION

> And it is to be observed, that by the ancient maxime of the common law, a right of entrie, or a chose in action, cannot be granted or transferred to a stranger, and thereby is avoyded great oppression, injurie, and injustice.[1]

The ancient legal principles that underlie champerty have historical roots in Greek and Roman law, and more familiarly, in English common law as it developed from the Middle Ages.[2] The doctrine is a subspecies of the offense of maintenance, which, at common law, comprised the unlawful upholding of quarrels by a stranger who, by assisting another's suit with monetary or other means, promoted unnecessary litigation.[3] "Put simply, maintenance is helping another prosecute a suit; champerty is maintaining a suit in return for a financial interest in the outcome; and barratry is a continuing practice of maintenance or champerty."[4]

It may come as a surprise to those trading in claims that they must be wary that their trades may be voided and their profits forfeited, if they should run afoul of this hoary old doctrine.[5]

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[1] Folio, SIR EDWARD COKE, THE FIRST PART OF THE INSTITUTES OF THE LAWS OF ENGLAND (COMMENTARIES ON LITTLETON) (leaf) 266 (1st ed. 1628).

[2] *See, e.g.*, Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.3d 363, 372 (2d Cir. 1999) (tracing doctrine to Greek law, Roman law, and English law of Middle Ages (citing Susan Lorde Martin, *Syndicated Lawsuits; Illegal Champerty or New Business Opportunity*, 30 AM. BUS. L.J. 485, 486–89 (1992))); Osprey v. Cabana Ltd. P'ship, 532 S.E.2d 269, 274 (S.C. 2000) (explaining origin of champerty); 14 AM. JUR. 2D *Champerty, Maintenance, and Barratry* § 1 (2000) (discussing development from English common law).

[3] *See Elliott Assocs*., 194 F.3d at 372; Noland v. Law, 170 S.E. 439, 442 (S.C. 1933) (depicting doctrine as opposition to maintenance); *Champerty, Maintenance, and Barratry*, *supra* note 2, § 1; *see also* Son v. Margolius, 709 A.2d 112, 120 (Md. 1998) (stating historical view of barratry).

[4] *In re* Primus, 436 U.S. 412, 424 n.15 (1978).

[5] In the Middle Ages the well connected found ways to keep the often-considerable profits of their champertous behavior. One dignitary in the reign of Edward I who traveled in the right circles was Bishop Walter Langton. In 1307, when faced with an accusation by John de Ferrers of champerty concerning complex land transactions in Northamptonshire and accompanying litigation, Langton conveniently produced a Royal Pardon, which purported to be "signed" by Chancellor William Hamilton more than one month after Hamilton's death. *See* MICHAEL PRESTWICH, EDWARD I 550 (Berkeley: University of California Press 1988) (1997). The typical claims trader will probably not be able to invoke such otherwordly pardon as a defense.

In the United States, the doctrine of champerty was adopted from the English common law, but in a modified (and greatly restricted) form, reflecting the vast change in the social and political fabric of society existing at the time of champerty's medieval antecedents and how they evolved in the New World.[6] In many jurisdictions the concept has never been adopted or has long since been declared obsolete and of no force and effect, especially with respect to the purchase of entire claims.[7] In other jurisdictions the doctrine is rarely used, or narrowly applied.[8] In some instances champerty is confused with the common law prohibition against the assignment of personal injury claims.[9] Louisiana and Puerto Rico use French and Spanish Civil law concepts regarding the transfer of "litigious rights" under which the claim is extinguished if the assignee refuses an obligor's tender of the "real price of the transfer."[10] In Louisiana this doctrine now appears to be extremely limited in scope, for it only applies if a legal proceeding has been commenced and the matter has been contested prior to transfer.[11] Moreover, the

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[6] *See* Saladini v. Righellis, 687 N.E.2d 1224, 1226–27 (Mass. 1997) (discussing variations in state acceptance of champerty); *Champerty, Maintenance, and Barratry*, *supra* note 2, § 1 (noting modern view that litigation is no longer viewed as social ill).

[7] *See In re* Mt. Rushmore Hotel Corp., 146 B.R. 33, 37 (Bankr. D. Kans. 1992) (deciding South Dakota courts would not view bondholders purchase of bonds as champertous, despite South Dakota's recognition of champerty doctrine); *In re* Resorts Int'l., Inc., 145 B.R. 412, 473 (Bankr. D.N.J. 1990) (proposing champerty doctrine is not recognized in New Jersey (citing Koro Co. v. Bristol Myers Co., 568 F. Supp. 280, 287 (D.D.C. 1983))); Osprey, Inc. v. Cabana, L.P., 532 S.E.2d 269, 276 (S.C. 2000) (abolishing champerty as defense in favor of modern principles of law that "prevent speculation in groundless lawsuits"); *Saladini*, 687 N.E.2d at 1226 (noting champerty excised from Common Law of Massachusetts); Rice v. Farrell, 28 A.2d 7, 8 (Conn. 1942) (stating champerty was never adopted in Connecticut); Matthewson v. Fitch, 22 Cal. 86, 95 (Cal. 1863) (finding first California legislature's decision to omit champerty statutes when organizing state is clear statement of doctrine's inapplicability).

[8] *See* Merlaud v. Nat'l Metro. Bank of Washington D.C., 84 F.2d 238, 240 (D.C. Cir. 1936) (holding champerty existed where payment to attorney consisted of one third of estate if attorney was able to establish clients rights' to such estate); Clark v. Cambria Co. Bd. of Assessment & Appeals, 747 A.2d 1242, 1246 (Pa. Commw. Ct. 2000) (stating doctrine may not be asserted against party with no stake in litigation and one who has no standing to prosecute action); Berlin v. Nathan, 381 N.E.2d 1367, 1371 (Ill. App. Ct. 1978) (noting Illinois trend to limit doctrine); Stanton v. Haskin, 8 D.C. 558 (1 MacArth. 1871) (deciding assignment to plaintiff's attorney case under relaxed rule).

[9] *See* Casino Cruises Inv. Co. v. Ravens Mfg. Co., 60 F. Supp. 2d 1285, 1287 (M.D. Fla. 1999) (mistakenly using term "champerty" when referring to common law prohibition against selling personal injury claims); Hosp. Serv. Corp. v. Pa. Ins. Co., 227 A.2d 105, 109 (R.I. 1967) (incorrectly noting that reason for rule prohibiting assignment of personal injury claims is avoidance of evils of champerty).

[10] *See* LA. CIV. CODE ANN. art. 2652 (West 2002) (allowing debtors to extinguish obligation by redeeming lawsuit for same amount assignee paid for it); 31 P.R. LAWS ANN. § 3942(a) (2002) ("A debtor who, before having knowledge of the assignment, should pay the creditor shall be released from the obligation."); *see also* Pritzker v. Yari, 42 F.3d 53, 72 (1st Cir. 1994) (explaining debtor must tender to assignee cash equivalent of both cash and non-cash consideration); Clement v. Sneed Bros., 116 So. 2d 269, 272–73 (La. 1959) (discussing exceptions to debtor's right to redeem if debtor is untimely in its request or continues to defend suit); Bruce v. Schewe & Kent A. Lambert, *Developments In The Law 1993-1994: A Faculty Symposium: Article: Obligations*, 55 LA. L. REV. 597, 601 (1995) (discussing how Louisiana discourages speculation in lawsuits but generally does not forbid sale of litigious rights).

[11] FSLIC v. Mmahat, 89 B.R. 573, 575 (E.D. La. 1988) ("[T]ransfer of a claim is the sale of a litigious right if a legal proceeding has been instituted and the matter has been contested prior to the transfer."); Hawthorne v. Humble Oil & Ref. Co., 210 So. 2d 110, 112 (La. Ct. App. 1968) ("It is also clear that a right

Louisiana Legislature's statutory equivalent of common law champerty limits it only to purchasers of claims who are "Officers of the Court,"[12] namely, attorneys.

Nevertheless, in some states the common law doctrine clings to life. For example, one Delaware court has pronounced that it may *sua sponte* dismiss an action when the evidence discloses that the assignment is "tainted" with champerty.[13] The harshness of such a rule is mitigated by the court's statement that it did not intend to diminish the *ability* of an assignee to enforce assignments of contracts and financial instruments in general[14] under title 6, section 2702 and title 10, section 3902 of the Delaware Code. Since these statutes apply only to assignments of bonds, specialties, and notes, or to assignments of express or implied contracts, and not to a chose-in-action, champerty remains an obstacle to collection.[15]

The champerty defense under New York law is particularly important in the claims trading context, since it is the governing law for so many indentures and corporate securities transactions.[16] In New York, the champerty defense has been

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transferred after suit is instituted and an answer filed thereto, and before the judgment thereon is final, is a litigious right, since there is a suit and contestation thereon.").

[12] *See* LA. CIV. CODE ANN. art. 2447 ("Officers of a court, such as judges, attorneys, clerks, and law enforcement agents, cannot purchase litigious rights under contestation in the jurisdiction of that court."); *see also* Martin v. Morgan Drive Away, Inc., 665 F.2d 598, 605 (5th Cir. 1982) ("It has long been settled in Louisiana that this prohibition does not apply to persons who are not 'officers of the court.'" (citing Gilkerson-Sloss Comm'n Co. v. Bond, 11 So. 220, 221 (La. 1892))).

[13] *See* Hall v. State, 655 A.2d 827, 829 (Del. Super. Ct. 1994) (defining champerty as "an agreement between the owner of a claim and a volunteer that the latter may take the claim and collect it, dividing the proceeds with the owner, if they prevail; the champertor to carry on the suit at his own expense." (citing Gibson v. Gillespie, 152 A. 589, 593 (Del. Super. Ct. 1928) (quoting Hamilton v. Gray, 31 A. 315, 315 (Vt. 1894)))).

[14] *See Hall*, 655 A.2d at 831 ("It should be noted that this decision in no way affects an assignee's ability to enforce contracts, notes, mortgages and financial instruments in general."); *see also* Drake v. Northwest Natural Gas Co., 165 A.2d 452, 454 (Del. Ch. 1960) (explaining common law champerty has never been totally adopted in Delaware).

[15] *See* DEL. CODE ANN. tit. 6, § 2702 (2002) ("[A]ssignees, or indorsees, or their executors, or administrators, may, in their own name, sue for and recover the money due on the bonds, specialties, or notes."); DEL. CODE ANN. tit. 10, § 3902 (2002) ("A person to whom a contract, express or implied, has been transferred or assigned, either in accordance with a statute or with the common law, may sue thereon in his or her own name."); *see also* Hannigan v. Italo Petroleum Corp. of Am., 178 A. 589 (Del. Super. Ct. 1935) (discussing obstacle in collecting on lawsuit when future rights have been assigned to another individual). *But see* Scholl v. Murphy, Civil Action No. 2025-S, 2001 Del. Ch. LEXIS 73, at *10 (Del. Ch. January 31, 2001) (finding status as interested party kills champerty claim); Drake v. Northwest Natural Gas Co., 165 A.2d 452, 454 (Del. Ch. 1960) (explaining common law champerty has never been totally adopted in Delaware).

[16] *See* J. Kirkland Grant, *Securities Arbitration:Is Required Arbitration Fair to Investors?*, 24 NEW ENG. L. REV. 389, 506 (1989) ("Many brokerage firms have a governing law provision in their customer's agreement using New York law."); Michael Gruson, *Governing–Law Clauses in International and Interstate Loan Agreements – New York's Approach*, 1982 U. ILL. L. REV. 207, 208 (1982) ("Relying on New York City's status as a leading international banking and commercial center, parties to international commercial transactions having little or no connection with New York often agree to submit to the jurisdiction of the New York courts and stipulate New York Law as the governing law."); *see also* A. Martin Erim, et al., *Financing Sources for Trade & Investment in Latin America*, 13 AM. U. INT'L. L. REV. 815, 836 (1998) ("Commercial bank[s] will want New York law as the governing law").

codified (in greatly modified form) in the Judiciary Law at section 489.[17] While strict construction of the statutory language would void numerous purchases of defaulted debt, the recent Second Circuit Court of Appeals decision in *Elliott Associates, L.P. v. Banco de la Nacion*,[18] and the New York Court of Appeals decision in *Bluebird Partners, L.P. v. First Fidelity Bank, N.A.*,[19] (*"Bluebird III"*) provide some comfort for those trading in debt instruments governed by New York law. Nevertheless, these cases still leave open a number of issues that must be considered by those who advise purchasers of bankruptcy claims.

I. *ELLIOTT* – CHAMPERTY WILL NOT SHIELD SOVEREIGN DEBTORS WHERE COLLECTION SUIT WAS CONTINGENT AND INCIDENTAL TO CLAIMS PURCHASER'S TRUE PURPOSE

In *Elliott* the plaintiff/creditor had purchased, at a discount, distressed debt of two insolvent Peruvian banks, which had been guaranteed by the government of Peru.[20] The guarantee provided that New York law governed.[21] After some communications between counsel, the Peruvian government refused to pay the debt so as to avoid jeopardizing a voluntary arrangement entered into with many of its other senior creditors.[22] The Peruvian government asserted the champerty defense under New York law, when Elliott sued upon the guarantee in the Southern District

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[17] N.Y. JUD. LAW § 489 (McKinney 2000) states in relevant part:

> No person or co-partnership, engaged directly or indirectly in the business of collection and adjustment of claims, and no 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; provided however, that bills receivable, notes receivable, bills of exchange, judgments or other things in action may be solicited, bought, or assignment thereof taken, from any executor, administrator, assignee for the benefit of creditors, trustee or receiver in bankruptcy, or any other person or persons in charge of the administration, settlement or compromise of any estate, through court actions, proceedings or otherwise . . . .

Id. Section 488 of the New York Judiciary Law is similar but prohibits only attorneys from purchasing bonds, notes or other things in action with the intent and for the purpose of suing thereon. N.Y. JUD. LAW § 488. While both sections 488 and 489 are penal statutes (violations of the former by an attorney is a misdemeanor while a violation of the latter by a corporation is punishable by a fine of not more than $5,000), the more serious consequence of a violation for the claims trader is based on the long-established rule that contracts made in violation of a penal statute are void and unenforceable. *See* Lee v. Cmty. Capital Corp., 324 NYS 2d 583, 585 (Sup. Ct. 1971) (noting court will not lend its aid or grant relief to a party whose cause of action is predicated on an illegal transaction). Under 11 U.S.C. § 502(b)(1), a claim that is unenforceable under applicable law cannot be an allowed claim and therefore does not share in distributions from the bankruptcy estate. 11 U.S.C. § 520(b)(1) (2000).

[18] 194 F.3d 363 (2d Cir. 1999).

[19] 709 N.Y.S.2d 865 (2000) (*"Bluebird III"*).

[20] *Elliott*, 194 F.3d at 366–67.

[21] *Id.* at 367.

[22] *Id.* at 379.

of New York.[23] The Peruvian government argued that the plaintiff had purchased its claim "with the intent and for the purpose of bringing an action or proceeding thereon" as barred by section 489.[24] The District Court agreed, and dismissed the action.[25]

On appeal, the Second Circuit reversed.[26] The Court of Appeals reviewed a long line of New York cases holding that the statute is to be applied narrowly in order to remedy only the evil that section 489 was originally designed to prevent.[27] In eighteenth and nineteenth century New York, it was the practice of attorneys to purchase small claims.[28] By filing suits thereon in order to collect costs (which, in the era before the 1848 Field Code in New York, included attorneys' fees), they could conduct a business grounded in fomenting litigation.[29] New York's champerty law was thus devised to stop this practice.[30] The court concluded its review by summarizing the rule of law it extracted from the cases as a "violation of Section 489 turns on whether 'the primary purpose of the purchase [was] . . . to bring a suit,' or whether 'the intent to bring a suit [was] . . . merely incidental and contingent.'"[31]

The Second Circuit then held:

> Elliott's "primary goal" in purchasing the debt was to be paid in full. That Elliott had to bring suit to achieve that "primary goal" was therefore 'incidental' to its achievement. Elliott's suit was also "contingent" because, had the Debtors agreed to Elliott's request for the money . . . then there would have been no lawsuit . . . .[32]
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> . . . In particular, we hold that Section 489 is not violated when . . . the accused party's "primary goal" is found to be satisfaction of a valid debt and its intent is only to sue absent full performance . . . .[33]

While the *Elliott* decision provides immediate comfort for those trading in the distressed debt of a sovereign which cannot file bankruptcy, and will not overtly disavow its valid obligations, the decision does not necessarily validate trading in bankruptcy claims where litigation is ordinarily required to establish the validity

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[23] *Id.* at 368.
[24] *Id*. at 369.
[25] *Elliott*, 194 F.3d at 369.
[26] *Id.* at 372.
[27] *Id.* at 372–73.
[28] *Id*. at 373–74
[29] *Id.* at 372–73. In New York the statutory predecessors of section 489 of the Judiciary Law go back to 1813. *Id*. The current version was enacted in 1965. N.Y. JUD. LAW § 489.
[30] *Elliott*, 194 F.3d at 373–74.
[31] *Id*. at 378 (citing Moses v. McDivitt, 88 N.Y. 62, 65 (1882) (alterations in original)).
[32] *Id*. at 379 (emphasis added).
[33] *Id*. at 381 (emphasis added).

and priority of a disputed claim.[34] Unlike sovereign Peru in the *Elliott* case, a chapter 11 or chapter 7 debtor cannot immediately pay its creditors. The automatic stay prevents a creditor from seeking payment of even valid debts following the commencement of a case under the Bankruptcy Code,[35] and subject to certain very limited exceptions, section 549 of the Code makes voidable post-petition transfers of estate property.[36] Moreover, the filing of a proof of claim is considered the equivalent of a complaint in a civil action.[37] The purchase of a bankruptcy claim, particularly one that is listed as disputed, contingent or unliquidated, is effectively the purchase of a suit seeking the allowance of such claim. In many cases, this allowance will only occur as the result of litigation whose sole purpose is to maximize the recovery. The *Elliott* court summarized its review of the case law in language that bespeaks a cautious approach when one applies its analysis to the world of bankruptcy claims: "[T]he critical factors that bring such cases within [the protection of] *Moses* are the absence of any purpose for the assignment except bringing legal action and the nondiscretionary obligation to bring suit."[38]

At least superficially, the legal obligation to file a claim in the bankruptcy case and to notify the court of a transfer of claim, resembles a non-discretionary obligation to bring suit with a properly named plaintiff as the real party in interest.[39] Unlike Peru, the typical chapter 11 debtor cannot legally accede to a claims purchaser's demand for payment in violation of the automatic stay.[40]

Nevertheless, the authors believe that a more reasoned analysis of *Elliott* effectively endorses the "take no prisoners" approach claims traders often adopt in bankruptcy cases. Most importantly, we believe that both the facts at issue and the language used by the court in reaching the result in *Elliott* have significantly undermined the use of a champerty defense by a debtor in a chapter 11 case. It is significant that the *Elliott* court reversed the district court's application of section 489 to a claims purchaser that *chose to proceed to court* instead of signing onto a

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[34] *See* 11 U.S.C. § 502 (providing rules on validation of disputed claims through litigation); 11 U.S.C. § 507 (stating frame work for priority of claims); 4 COLLIER ON BANKRUPTCY ¶ 502.01, at 502-9 (Alan N. Resnick and Henry J. Sommer eds., 15th ed. Rev. 2002) (adjudicating allowability of claims is "core proceeding of the bankruptcy court"); *see also In re* Petition of Caldas, 274 B.R. 583, 587 (Bankr. S.D.N.Y. 2002) (acknowledging difference in Peruvian system in adjudicating validity of disputed claims).

[35] *See* 11 U.S.C. § 362 (stating operative effect of automatic stay).

[36] *Id*. § 549 (stating how transfers of estate property are voidable when taking place after "commencement of case" subject to certain exceptions).

[37] *See* Smith v. Dowden, 47 F.3d 940, 943 (8th Cir. 1995) ("Courts have traditionally analogized a creditor's claim to a civil complaint"); Simmons v. Savell (*In re* Simmons), 765 F.2d 547, (5th Cir. 1985) ("Filing a proof of claim is tantamount to filing a complaint in a civil action."); Nortex Trading Corp. v. Newfield, 311 F.2d 163, 164 (2d Cir. 1962) (applying analogy of proof of claim to complaint in holding); 4 COLLIER, *supra* note 35, ¶ 502.02[3][c], at 502-16 (discussing how from procedural standpoint, filing complaint is tantamount to filing claim).

[38] Elliott Assocs. v. Banco de la Nacion, 194 F.3d 363, 376 (2d Cir. 1999).

[39] *See* FED. R. BANKR. P. 3001(e) (providing rules for transferring claim); 11 U.S.C. § 501 (discussing rules for filing of proofs of claims).

[40] *See* ICC v. Holmes Transp., Inc., 931 F.2d 984, 987 (1st Cir. 1991) (discussing actions taken in violation of automatic stay are generally void); *In re* Lett, 238 B.R. 167, 168 (Bankr. W.D. Mo. 1999) ("[A]ctions taken in violation of the automatic stay are voidable.").

voluntary out-of-court plan being negotiated by Peru's senior lenders, noting: "[T]he district court's interpretation of Section 489 *effectively forces creditors such as Elliott to participate in an involuntary 'cram-down' procedure and makes the debt instruments unenforceable in the courts* once the Bank Advisory Committee has reached an 'agreement in principle' . . ."[41] The parallel with the chapter 11 bankruptcy process is striking — and a good argument can be made that the use of the bankruptcy jargon "cram-down" was intentional. Thus, it is arguable after *Elliott*, at least in a chapter 11 context, that the purchase of a claim with the intention of engaging in litigation over a reorganization plan that will treat the class in which the claim is placed more favorably than other classes (via subordination, classification, or "grease" to quiet a vocal, potentially dissenting class), is the bankruptcy equivalent of seeking the full enforceability of an instrument, and thus, not a violation of section 489.[42]

II. BLUEBIRD – APPLICABILITY OF CHAMPERTY DOCTRINE TURNS ON BUYER'S PRIMARY PURPOSE

In *Bluebird III* [43] the New York Court of Appeals focused its interpretation of section 489 not on whether the "primary purpose" of the assignee was to be paid in full, but rather on whether the "primary purpose" of the acquisition was to bring suit upon the claim.[44] Although this approach ignores the obvious fact that the result sought by such a suit is, of course, to be paid in full, the *Bluebird III* court concluded that in order to violate section 489:

> [T]he foundational intent to sue on that claim must at least have been the primary purpose for, if not the sole motivation behind, entering into the transaction. The words, "sole" and "primary," are not synonymous generally or in law. A purpose that is the sole purpose is, by necessity, the primary purpose. However, a purpose that is primary is not necessarily the sole purpose . . . . Yet, the distinction is one without a legal difference when the "primary" element is present. The bottom line is that Judiciary Law § 489 requires that the acquisition be made with the intent and for *the*

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[41] *Elliott*, 194 F.3d at 380 (emphasis added).

[42] Elliott's hardball approach appears to have finally paid off. The *Wall Street Journal* reported that Peru eventually settled with Elliott for $58 million, virtually the entire amount Elliott was demanding. David I. Oyama, *Peru Settles Dispute*, WALL ST. J., Oct. 2, 2000, at A21.

[43] Bluebird Partners v. First Fid. Bank, 709 N.Y.S.2d 865, 865 (2000). The New York courts have hatched numerous decisions with respect to the bond claims against Continental Airlines purchased by Bluebird Partners from various original holders and in particular on Bluebird's rights against the indenture trustees and their counsel. We have referred herein to six published decisions at the appellate level, whose histories are chronicled in footnotes 61 and 62, as well as a jury verdict in Bluebird's favor cited in note 62. *See Airline Bondholders Win $54 Million Award*, N.Y.L.J., Dec. 16, 2002, at 1 col. 1 (stating Bluebird Partners eventually obtained jury award, which with interest amounted to over $70 million).

[44] *Id*. at 870 (citing Moses v. McDivitt, 88 N.Y. 62, 65 (1882)).

> purpose (as contrasted to *a* purpose) of bringing an action or proceeding . . . .[45]

The decision by the Court of Appeals in *Bluebird III* arose out of the Appellate Division's dismissal of a claims purchaser's breach of fiduciary duty claims against an indenture trustee on the basis that they were barred as a matter of law by the champerty defense.[46] The New York Court of Appeals reversed this dismissal, holding that factual issues needed to be resolved before a court could make the crucial determination whether the acquisition of claims against the trustee was "an incidental part of purchasing the second series certificates or the driving force behind the purchase."[47] In effect, the New York Court of Appeals converted the section 489 issue from a defense determinable on a motion to dismiss, into one requiring at a minimum, discovery, and possibly a plenary trial.[48]

To its credit, the Court of Appeals did not automatically equate the decision to sue with champerty, for it recognized that "litigation can be an appropriate and commonly used strategy."[49] It also counseled that courts must follow "a prudent approach consistent with the limited scope of the champerty doctrine as it originally appeared and developed in the Anglo-American legal system."[50] Yet the court's rationale creates some practical difficulties for attorneys in the trenches. It is next to impossible to counsel a claims trading client on the propriety of its conduct where the rule of law is that the purchase complies with the law if litigation is an "incidental part" of the strategy, but champertous if litigation is the "driving force behind the purchase."

Instructing the lower court to look for the existence of a primary purpose to bring suit does not supply a workable standard for identifying behavior prohibited by section 489.[51] On its face, the "foundational intent" to bring suit is surely

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[45] *Id*. at 871 (citations omitted).

[46] *Id*. at 866 (noting Appellate Division found primary purpose was champertous and dismissed on that ground).

[47] *Id*. at 872. The assignments in question occurred after confirmation of the chapter 11 plan when it was clear that the original bondholders were only going to recover a small fraction of their claims from the estate of the issuer and litigation against third parties such as the indenture trustee and their attorneys for their alleged failure to act promptly during the bankruptcy case to protect the collateral looked like a promising avenue for recovery. *Id*. at 867–68.

[48] *Id*. at 873 (rejecting champerty-based motion to dismiss and stating matter cannot be summarily resolved at this procedural juncture).

[49] *Bluebird III*, 709 N.Y.S.2d at 872.

[50] *Id*.

[51] For example, foreclosure claims brought by an assignee of a note and mortgage against a defaulting borrower demonstrates how interpretation of the primary purpose standard can vary. *Compare* Sygma Photo News, Inc. v Globe Int'l Inc., 616 F. Supp. 1153, 1157 (S.D.N.Y. 1985) (holding action not barred by § 489 even though assignment was accepted to pursue litigation because purpose in doing so was not for "mercenary reasons" but to help non-resident assignor pursue legitimate interests), *with* Ehrlich v. Rebco Ins. Exch., Ltd., 649 N.Y.S.2d 672, 674 (App. Div. 1996) (holding defendant violated section 489 even though assignment was made after plaintiff asserted other claims because assertion of additional claims based on assignment was "the very mischief the statute seeks to avoid"); *see also* Susan Lorde Martin, *Financing*

supplied by a party's authorization of the filing of a complaint. Left unanswered by the *Bluebird III* court is the means of discerning just when such suit is intended as a "strike" type action sufficient to bring it into the ambit of section 489's prohibition. We may be guided to a limited extent by the court's stated reluctance to broaden the application of section 489 in such a way as to "engender uncertainties in the free market system . . . in connection with untold numbers of sophisticated business transactions."[52] This statement may be interpreted as a caution to trial courts to require a high standard of proof from a defendant claiming champerty, particularly in the context of a series of transactions effectuated by a purchaser as part of a complicated investment strategy.[53] Nevertheless, since proving the primary purpose of a claims purchaser will almost always raise factual issues of motive and knowledge that cannot be determined in motion practice, champerty's effectiveness as a defense to knock out a suit on the pleadings has been undermined.[54] As a consequence, *Bluebird III*'s focus on the "primary purpose" of the person acquiring the claim now requires establishing the objective of any lawsuit, and opens up the champerty litigation to discovery on such issues as the motivation of the buyer, what it knew about the obligor's financial condition, the timing of the purchase of the claim when compared with the commencement of the lawsuit, and the strategy being pursued in the suit.[55] All of this evidence will be grist for the finder of fact and will make it time-consuming and expensive for parties to litigate a champerty defense.

III. THE INTERPLAY BETWEEN SECTION 489 OF THE JUDICIARY CODE AND SECTION 13-107 OF THE GENERAL OBLIGATIONS LAW

The Court of Appeals decision in *Bluebird III* is notably silent on the possible conflict between the champerty rules and New York General Obligations Law (GOL) section 13-107 permitting free transferability of bondholders' claims for

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Plaintiffs' Lawsuits: An Increasingly Popular (and Legal) Business, 33 U. MICH. J.L. REFORM 57, 64–65 (1999) (comparing *Ehrlich* and *Sygma Photo*).

[52] *Bluebird III*, 709 N.Y.S.2d at 873.

[53] *See* Turkmani v. Republic of Bolivia, 193 F. Supp. 2d 165, 177–81 (D.D.C. 2002) (construing champerty narrowly and denying summary judgment on champerty defense since possibility existed that bonds were acquired for trade); *In re* Lynn, 285 B.R. 253, 864 (Bankr. S.D.N.Y. 2002) (finding policy to protect debt trading markets applies to non-institutional investors).

[54] *See Bluebird III*, 709 N.Y.S.2d at 870 ("[W]hile this Court has been willing to find that an action is *not* champertous as a matter of law, it has been hesitant to find that an action is *champertous as a matter of law*.") (citations omitted).

[55] *See* MLE Realty Assocs. v. Handler, 93 Civ. 0668, 2000 U.S. Dist. LEXIS 1788, at *23 (S.D.N.Y. Feb 23, 2000) (holding as matter of New York law assignment was not champertous after considering evidence at hearing as to purchaser's motive in purchasing judgment and *bona fides* of his belief that obligor could satisfy judgment); Cavendish Traders, Ltd. v. Nice Skate Shoes, Ltd., 117 F. Supp. 2d 394, 402 (S.D.N.Y. 2000) (noting honesty of buyer's purpose in acquiring promissory notes); Hill Int'l., Inc. v. Town of Orangetown, 736 N.Y.S.2d 77, 78 (App. Div. 2002) (allowing plaintiff's claim because "intent to litigate was incidental and contingent").

damages against both obligors and indenture trustees.[56] This silence is particularly noteworthy, since the impact of GOL section 13-107 was specifically raised in the lower courts in *Bluebird I* and *Bluebird II*. In *Bluebird I* the Appellate Division affirmed the dismissal of legal malpractice claims asserted by assignees of bond claims against the indenture trustee's counsel due to the lack of privity. The *Bluebird I* court specifically stated "General Obligations Law § 13-107 gives plaintiff [a purchaser of certificates from an original holder] a derivative claim against the indenture trustees, but makes no mention of an ancillary right of action against the trustee's attorneys, with whom plaintiff had no privity."[57]

In subsequent proceedings, the Supreme Court denied a motion to dismiss claims against the indenture trustee on the ground that the purchaser's acquisitions of such claims was champertous. In *Bluebird II*,[58] the Appellate Division reversed the trial court and dismissed, on grounds of champerty under section 489, the claims against the indenture trustee which the same Appellate Division in *Bluebird I* had previously held were validly transferred to the purchasers under GOL section 13-107.[59] The Court of Appeals in *Bluebird III* did not consider or cite GOL section 13-107, in part, no doubt, because the point was not before it.[60] However, shortly before *Bluebird III*, the Second Circuit held that GOL section 13-107 "expressly permits a bondholder to sue an indenture trustee for breaches of duty that occur prior to his purchase of the bond, regardless of the bondholder's knowledge of these breaches."[61] Three years later, in another chapter of the *Bluebird* saga, the New York Court of Appeals in *Bluebird V*, finally ruled that such claims are, indeed, subject to automatic assignment under GOL section 13-107 and no proof of the purchasers' own loss was required, while leaving open the question of federal preemption of the New York statute by the Trust Indenture Act.[62]

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[56] N.Y. GEN. OBLIG. LAW § 13-107 (McKinney 2002). The statute reads in relevant part:

> Unless expressly reserved in writing, a transfer of any bond shall vest in the transferee all claims or demands of the transferrer, whether or not such claims or demands are known to exist, (a) for damages or rescission against the obligor on such bond, (b) for damages against the trustee or depositary under any indenture under which such bond was issued or outstanding, and (c) for damages against any guarantor of the obligation of such obligor, trustee or depositary.

[57] Bluebird Partners v. First Fid. Bank, 671 N.Y.S.2d 7, 11 (App. Div. 1998) (*"Bluebird I"*).

[58] Bluebird Partners v. First Fid. Bank, N.A., 686 N.Y.S.2d 5, 6 (App. Div. 1999) (*"Bluebird II"*).

[59] *Bluebird II*, 686 N.Y.S.2d at 6.

[60] Bluebird Partners v. First Fid. Bank, 709 N.Y.S.2d 865, 865 (2000) (appealing from order granting motion to dismiss made by one of Indenture Trustees solely on champerty grounds; motion for leave to appeal was denied with respect to Appellate Division's disposition of other motions to dismiss).

[61] LNC Invs., Inc. v. First Fid. Bank N.A. New Jersey, 173 F.3d 454, 462 (2d Cir. 1999) (stating purchasers of bonds with knowledge of trustee's allegedly imprudent conduct were not required to prove reliance on trustee as element of causation). *But see* Bluebird Partners v. First Fid. Bank, 721 N.Y.S.2d 3007 (App. Div. 2001) (holding plaintiff with standing under 13-107 still required to prove it had sustained a loss) (*"Bluebird IV"*).

[62] Bluebird Partners v. First Fid. Bank, N.A., 741 N.Y.S.2d 181, 184–85 (2002) (*"Bluebird V"*) (reversing *Bluebird IV*). Subsequently, in *Bluebird Partners v. First Fidelity Bank, N.A.*, 746 N.Y.S.2d 475 (App. Div. 2002) (*"Bluebird VI"*), the intermediate appellate court concluded that the Trust Indenture Act did not pre-empt New York law. In December 2002, a jury in New York Country awarded the plaintiff $54 million ($70 million with interest included) against First Fidelity Bank for its breach of duty as the Indenture Trustee for

The question remains open, after the *Bluebird* cases and *LNC*, as to whether under New York law, breach of fiduciary duty, negligence or breach of contract claims against indenture trustees automatically assigned by GOL section 13-107 may be barred in turn by section 489 of the Judiciary Law. In the authors' view, a clear conflict exists between section 489 of the Judiciary Law and GOL section 13-107, because, unlike the debt instruments in *Elliott*, a lawsuit is effectively the only way to assert one's rights to collect upon an assigned chose-in-action such as a fiduciary's breach of duty, negligence, or fraud. It may also be argued that if GOL section13-107 is to be effective, it should insulate from a champerty defense those who purchase bonds when they bring the tort claims of their assignors that automatically passed to them by operation of this statute.

A brief review of the legislative history of GOL section 13-107 provides some support for this interpretation.[63] The statute was enacted in 1950 in order, *inter alia*, to change the common law rules encountered in *Smith v. Continental Bank & Trust Co.*, [64] which held that, unless expressly assigned, a transferor of corporate bonds reserved to himself accrued causes of action for damages against the indenture trustee.[65] It is doubtful if the Legislature considered the effect that enactment of this repeal of common law would have on New York's champerty statutes.[66]

Now that the Court of Appeals has spoken in *Bluebird III* (and recognizing that the issue of federal preemption remains open after *Bluebird V*), the resolution of this apparent conflict in New York's own statutes is still a question of some importance to the numerous bondholders and trustees whose indentures are governed by New York law.[67] The problem presented by the conflicting statutes could be resolved in a number of ways. One rule of construction would hold that GOL section 13-107, which was enacted subsequent to the codification of champerty rules in the

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the Continental Airlines bondholders. *Airline Bondholders Win $54 Million Award*, N.Y.L.J., Dec. 16, 2002, at 1 col. 1.

[63] 1950 Leg. Doc. 63(D); 1950 Report Recommendations and Studies, pp. 23–47.

[64] 54 N.E.2d 823, 823 (N.Y. 1944).

[65] *Id*. at 825.

[66] GOL section 13-107 does appear to have effectively overruled a line of pre-1950 New York cases that voided assignments which contravened statutory prohibitions against assignments similar to section 489 and its predecessors. *See, e.g.*, Frank H. Zindle, Inc., v. Friedman's Express, Inc., 17 N.Y.S.2d 594, 594 (App. Div. 1940) (assignment of insurance claim to bring suit was champertous); Bennett v. Supreme Enforcement Corp., 293 N.Y.S. 870, 870 (App. Div. 1937) (assignment to corporation to bring suit was champertous); Seth-Howard Corp. v. Schupner, 77 N.Y.S.2d 892, 892 (Sup. Ct. 1948) (assignment to corporation to bring suit was champertous).

[67] If Delaware law applies, there may be a further complication. Delaware's counterpart to GOL section 13-107 is Title 6 section 2702 of the Delaware Code. Section 2702 does not apply to a chose in action such as a damage claim, thereby exposing transferees of tort claims to the broadly-stated Delaware rule on champerty. *See supra* notes 13–15 and accompanying text; *see also* Kingsland Holdings, Inc. v. Bracco, 1996 Del. Ch. LEXIS 28, at *13 n.2 (Del. Ch. Mar. 6, 1996) (differentiating for purposes of defense of champerty, assignee of claim who is prohibited from suing from assignor of judgment who is not). Therefore, an assignee of a tort claim governed by Delaware law may have a more difficult time with a champerty defense.

predecessors to section 489, implicitly repealed it to the extent of any conflict.[68] The argument would be that by specifically authorizing the automatic assignment of claims for damages against bond obligors or indenture trustees, New York State exempted such transfers from the ambit of section 489 of the Judiciary Law. The New York courts might also adopt a variant of the *Elliott* holding to the effect that a suit would be considered incidental and contingent, as long as the plaintiff made a pre-suit demand on the trustee for payment for the damages necessary to compensate it for the injury it suffered. Moreover, a suit against a trustee for damages based on negligence, fraud, or breach of duty could be deemed non-champertous, as a matter of law, if combined with appropriate actions to receive payments from the issuer on the defaulted debt instrument, because payment in full could, at least theoretically, come from a source other than the indenture trustee. Finally, it remains to be seen how the *Bluebird III* champerty analysis (which appears to deflect a finding that a claim was primarily purchased to bring suit if there exists any other business purpose), will be applied to transfers of proofs of claim in bankruptcy cases, since, as noted above, these proofs of claim are, in effect, pending litigation.

IV. JUDICIARY LAW CHAMPERTY CASES POST-*ELLIOTT* AND *BLUEBIRD III*

It appears that *Bluebird III* has given the lower courts the initial task of developing a test to accommodate the interests of the free market system in protecting sophisticated transactions with the medieval champerty doctrine's prohibition on enforcement of claims purchased primarily for the purpose of bringing suit.[69] In New York, the Appellate Division, First Department has constructed such a test in one post-*Bluebird III* case. In *Richbell Information Services, Inc. v. Jupiter Partners*,[70] the trial court had summarily dismissed a complaint prosecuted by a corporation formed solely to acquire and sue on claims.[71] The plaintiff entity was capitalized by shareholders and creditors of one company, which had an affiliation with a group of companies claiming that the defendants tortiously interfered and damaged its interests in a joint venture.[72] When a number of companies in the venture entered liquidation proceedings, these stakeholders formed the plaintiff entity to purchase the claims in exchange for sharing the

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[68] *See* Davis v. Supreme Lodge, 165 N.Y. 159, 166 (1900) (noting new laws do not repeal prior laws unless such is stated expressly in subsequent statute or "new law . . . is in terms so repugnant . . . that the prior law must be deemed to be repealed or so modified by the subsequent enactment [so] as to give room for the operation of both"); *see also* Konviser v. State, 687 N.Y.S.2d 877, 881 (Ct. Cl. 1999) ("Where two statutes conflict or are inconsistent with one another, an implication arises that the provisions of the prior law which are in conflict or inconsistent with a later enactment are repealed.").

[69] *See* Bluebird Partners v. First Fid. Bank, 709 N.Y.S.2d 865, 873 (2000) ("Finding of champerty as a matter of law might engender uncertainties in the free market system in connection with untold numbers of sophisticated business transactions" and remanding case for consideration of facts).

[70] 723 N.Y.S.2d 134 (App. Div. 2001).

[71] *Id*. at 137.

[72] *Id*. at 136.

proceeds of the litigation with the liquidators.[73] The Appellate Division, First Department reversed, refusing to find as a matter of law, that the acquiring corporation was an economic "stranger" to the action merely speculating on the suit.[74] The *Richbell* court could not infer the requisite "primary litigious intent" solely from the plaintiff's purchase of the chose-in-action with the investors' funds in exchange for a share of an expectation of a litigation recovery that would bring a return on their investment and a bonus.[75] In the Appellate Division's opinion, it was clear that the arrangement was designed to preserve the value of the investments previously made by the various members of the group that would be wiped out if the law suit were not prosecuted.[76] It is interesting to note that the determination as to whether the acquiring entity is a "stranger" to the legal action is a judge-created test, not found in the words of the statute, although perhaps harkening back to the excerpt from *Commentary on Littleton* cited at the beginning of this article.[77] *Richbell*'s reversal of the lower court's dismissal of the claim has been cited by a federal district court in New York for the proposition that the section 489 champerty proscription is a narrow one.[78]

One further interesting issue raised by the *Richbell* test lurking just beneath the surface could arise following confirmation of a chapter 11 plan establishing a litigation trust such as envisioned by section 1123(a)(5)(B) of the Bankruptcy Code.[79] While section 489 of the Judiciary Law by its terms appears to insulate the

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[73] *Id*. (explaining shareholders and creditors were invited to invest in company formed for this purpose in order to protect their interest in Richbell Group companies, which could result in loss if action were not successful).

[74] *Id*. at 141–42 (finding acquiring company had investment interests other than suit); *see* Loral Fairchild Corp. v. Victor Co. of Japan, 2002 U.S. Dist. LEXIS 6914, at *6 (E.D.N.Y. 2002) (showing acquiring corporation had economic interest other than suit because plaintiff's lawsuit was only one of twenty three assets transferred); *In re* Lynn, 285 B.R. 858, 861 (S.D.N.Y. 2002) (finding despite history of hostility between parties, claim was not brought only to harass defendant).

[75] *See Richbell*, 723 N.Y.S.2d at 141 (stating court could not conclude investors would have agreed to find suit absent importance of suit to viability of their interests); *see also* Fairchild Hiller Corp. v. McDonnell Douglas Corp., 321 N.Y.S.2d 857, 861 (1971) (holding plaintiff did not receive assignment of claim for sole purpose of bringing action, but to acquire assets).

[76] *See Richbell*, 723 N.Y.S.2d at 141 (suggesting shareholders and creditors stood to lose their interests in Richbell companies if not they did not invest in new company formed for that purpose).

[77] *See supra* note 1; s*ee also* Hill Int'l., Inc. v. Town of Orangetown, 736 N.Y.S.2d 77, 78 (App. Div. 2002) (holding assignment of unrelated cause of action by one plaintiff to another was not champertous because assignee had independent business purpose in obtaining assignment); FDIC v. Suffolk Place Assocs., 704 N.Y.S.2d 300, 302 (App. Div. 2000) (holding plaintiff took assignment as "legitimate business purpose" rather than solely to bring suit); Home Ins. Co. v. United Servs. Auto. Ass'n., 692 N.Y.S.2d 121, 123 (App. Div. 1999) (holding plaintiff did not take assignment for exclusive purpose of bringing suit).

[78] *See Loral Fairchild Corp*., 2002 U.S. Dist. LEXIS 6914, at *4 (citing Richbell's proposition that section 489 prevents attorneys and companies from buying claims to initiate suit); *see also In re Lynn*, 285 B.R. at 864 (refusing chapter 7 debtor's motion to invalidate claim assignment and holding that narrow proscription on champerty under Judiciary Law was not limited to institutional trading of distressed claims).

[79] *See* 11 U.S.C. § 1123(a)(5)(B) (2000) ("[A] plan shall . . . provide adequate means for . . . implementation, such as . . . transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan"); *see also* Holywell Corp. v. Smith, 503 U.S. 47, 55 (1992) (explaining § 1123(a)(5)(B) allows arrangement to create separate trust holding property of estate and giving trustee control of that property); Universal Suppliers, Inc., v. Reg'l Bldg. Sys. (*In re*

original transfer of a chose-in-action from a bankruptcy trustee (or a debtor in possession acting with a trustee's powers) to the trust,[80] the question of whether the champerty defense may void the repayment arrangements that the trust uses to finance its litigation strategy (particularly where these arrangements are based on transferring a significant portion of the claim to those advancing litigation expenses) has not yet been determined. In such a case, it is conceivable that a federal bankruptcy court would rule that even if these financiers of the litigation are strangers, the Bankruptcy Code overrides state-based champerty rules in accordance with the Supremacy Clause of the Constitution and permits innovative financing techniques for litigation trusts.

CONCLUSION

Given all of this uncertainty, the present state of the law may be viewed as far from optimal for the claims-trading community. An argument may be made that a complete repeal of section 489 is desirable if New York wishes to retain its luster as world financial capital, particularly since the primary reason for the enactment of section 489 and its predecessors no longer exists.[81] Following the institution in New York of the Field Code, and the application of the "American Rule" to New York litigation, the loser no longer pays the victor's counsel's fees as an item of costs. It may be argued that any abusive, harassing, and vexatious litigation that would be forbidden by an expansive reading of section 489 is better handled in modern times by specific statutes as well as the rules governing attorney and litigant conduct.[82]

The New York legislature or courts will ultimately have to balance the public policy concerns in deciding whether to repeal section 489, or modify it to make it inapplicable to claims trading. The policy choices are starkly presented, particularly in the context of suits against the indenture trustee: 1) should the judicial process protect a fiduciary from claims by a subsequent holder of a note or bond, seeking a recovery for losses suffered by prior owners (losses that were presumably reflected in the purchase price of the claim)? or 2) is it necessary to provide the claims purchaser with recourse against a trustee whose conduct may be

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Reg'l Bldg. Sys.), 254 F.3d 528, 532 (4th Cir. 2001) (stating § 1123(a)(5)(B) expressly considers reorganization will result in sale of parts of debtor's estate).

[80] *See supra* note 17 and accompanying text.

[81] *See* Elliott Assocs. v. Banco de la Nacion, 194 F.3d 363, 380 (2d Cir. 1999) ("[I]ncreased risks could be expected to increase the costs of trading in high-risk debt under New York law and thereby encourage potential parties to such transactions to conduct their business elsewhere."); Samuel E. Goldman, Note, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring*, 5 UCLA J. INT'L. L. & FOREIGN AFF. 159, 195 (2000) (positing not holding debts enforceable will reduce New York's appeal as global financial center).

[82] In the summer of 1999, prior to the decisions in *Bluebird III* and *Elliott*, bills to amend section 489 were introduced in the New York Legislature (A 6641-1 and S. 4218-A) to provide a safe harbor for ordinary commercial claims trading not involving consumer debt obligations where the consideration paid was more than $500,000. While S. 4218-A passed the Senate, it stalled in the Assembly and was never approved.

at least partially responsible for investor losses and thereby avoid a chilling effect on the markets for distressed debt in bonds, notes and negotiable instruments?

The *Elliott* court noted that a secondary market will only develop and flourish if the free transferability of all financial instruments, including those already in default, is maintained.[83] In other words, the Second Circuit believes the market should function without artificial impediments such as champerty. It may, in the final analysis, be uneconomic and unwise to permit an indenture trustee to invoke the champerty defense, ultimately grounded in both medieval concerns over the corruption of justice by the powerful and nineteenth century abuses by attorneys seeking their fees as part of an award of costs, because: (1) adequate alternative means exist to police harassing or frivolous suits by attorneys or by non-attorney parties to extort settlements from a trustee for injuries which the plaintiffs did not suffer, and (2) attorney disciplinary rules are a more focused and reasoned approach to any perceived problem of lawyers inciting baseless litigation than are broadly-drafted penal statutes, such as the champerty laws.

At present, the champerty doctrine remains deeply embedded in New York law and will no doubt be raised defensively by knowledgeable practitioners in suits whenever a claim purchaser resorts to legal action to collect on a chose-in-action. Discovery and an evidentiary hearing will probably be required before the courts in New York will be able to adjudicate the issue of what was the primary purpose of the transaction. In the absence of legislative action or further judicial exposition, the champerty defense will continue to be a concern to claim traders and their attorneys because it has the potential, at one fell swoop, to wipe out not only the profits from claims trading but the original investment as well.

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[83] 194 F.3d at 380.