How Litigation Funding Is Bringing Champerty Back To Life

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Law360, New York (January 20, 2017, 12:05 PM EST) -- Most law school students have probably never heard the term champerty. It's more likely to be found in the writings of Charles Dickens than a modern textbook. For those unfamiliar with the term, champerty is the doctrine that prohibits someone from funding litigation in which he or she is not a party. It is intended to prevent courts from becoming trading floors where people buy and sell lawsuits based on their perceived merit. In more recent years, champerty was becoming a moribund concept, but the recent rise of third-party litigation funding is bringing this doctrine back to life.

However, while some courts have declined to apply the common-law doctrine of champerty to invalidate third-party litigation funding (TPLF) agreements, a pair of recent rulings by appellate courts in New York and Pennsylvania has brought renewed attention to champerty principles, casting doubts on the legality of certain forms of the TPLF business model, at least in some jurisdictions. Interestingly, the timing of these rulings coincides with dramatic growth of the TPLF industry, as evidenced by Burford Capital's recently announced acquisition of top rival Gerchen Keller.

The first case, Justinian Capital SPC v. WestLB AG, centered on a New York champerty statute (Judiciary Law Section 489(1)) that prohibits purchasing notes, securities or other instruments "with the intent and for the purpose of bringing an action or proceeding thereon." The statute has a "safe harbor" section, providing that if the purchaser pays $500,000 or more for the financial instruments, the champerty prohibitions do not apply. In Justinian Capital, DPAG (a German bank) bought notes from defendant WestLB that subsequently lost substantial value. DPAG wanted to sue West LB for fraud and malfeasance, but feared adverse reactions by German regulators. Thus, DPAG agreed to provide the notes to plaintiff Justinian Capital (a Cayman Islands company) so that it could sue West LB — and it did so. West LB argued that the case should be dismissed because the plaintiff's behavior was champertous under Section 489(1) and therefore illegal. The plaintiff argued that it was subject to the safe-harbor provision because it had committed to pay DPAG $1 million (plus interest) for the notes.

The New York Court of Appeals sided with the defendant, holding that the acquisition was champertous. The court explained that "because Justinian did not pay the purchase price or have a binding and bona file obligation to pay the purchase price of the Notes independent of the successful outcome of the lawsuit, Justinian is not entitled to the protection of the safe harbor." As the court explained, the agreement was simply a "a sham transaction" to avoid the champerty law and thus was illegal. Based on this reasoning, New York's highest court affirmed the trial court and intermediate appellate court rulings dismissing the action brought by Justinian.

In a statement issued immediately after the ruling, Christopher Bogart, the head of Burford Capital, touted Justinian as a victory for the TPLF industry, reaffirming New York "as a leading jurisdiction for litigation finance transactions." Christopher P. Bogart, New York Court of Appeals Affirms Burford-Style Litigation Finance Transactions, Burford, Oct. 28, 2016. That statement is difficult to square with the fact that Burford filed an amicus brief supporting Justianian's losing position on appeal. Indeed, the Court of Appeals explicitly rejected the two legal arguments in Burford's brief: (a) that Justinian's acquisition of the notes at issue was not champertous under Section 489(1) and (b) that Justinian qualified for the "safe harbor" even though it had not paid for the notes.

Another recent appellate decision, this one from Pennsylvania, also can be seen as a setback for TPLF. In WFIC LLC v. Labarre, No. 1985 EDA 2015, (Pa. Super. Ct. Sept. 13, 2016), an attorney entered into a contingency fee agreement with his client under which a TPLF company that had loaned money to pursue the litigation matter would be paid out of counsel's expected fees. When the litigation concluded, creditors got into a dispute about which entity should have priority in the distribution of available assets, and in the course of sorting that out, the appellate court concluded that the counsel's agreement to pay the funder out of his fees was invalid and therefore unenforceable.

In its ruling, the appellate court made clear that "champerty remains a viable defense in Pennsylvania." The court then proceeded to find that the elements of champerty existed in the TPLF arrangement because the investors were unrelated parties who did not have a legitimate interest in the lawsuit. As the court explained, the investors lent money to advance the lawsuit hoping to recover their investment — and more — if the suit was successful. Thus, the court concluded that the TPLF arrangement counsel had entered into was champertous and invalid.

To be sure, some state courts have declined to find TPLF agreements to be champertous.

For example, in March 2016, the Delaware Superior Court rejected claims of champerty with respect to a third-party litigation funding agreement entered into by Charge Injection Technologies Inc. and Burford Capital. CIT brought suit, alleging that DuPont wrongfully used and disclosed CIT's proprietary and confidential technology. CIT entered into a funding agreement with Burford, which DuPont then challenged on champerty grounds. The court dismissed the champerty argument, reasoning that the agreement at issue expressly provided that Burford lacks "any rights as to the direction, control, settlement, or other conduct" of the litigation. But the ruling certainly suggests that TPLF agreements may be subject to champerty challenges where there is evidence of actual control by the funder, as one might expect to find.

The potential revival of state-law champerty principles is welcome news in light of the recent growth of TPLF. Like traditional champerty, TPLF undermines our civil justice system by encouraging the filing of dubious claims, turning our judicial system into an investment opportunity, and eroding the fundamental precept that the plaintiff and his attorney — not some stranger to the litigation — should drive the prosecution of a lawsuit. The resurgence of the champerty doctrine reflected in the New York and Pennsylvania rulings suggests that going forward, the industry will face more legal challenges that will draw needed attention to this troubling practice.

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