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Expert Analysis

New York's Martin Act: Investor Sword or Fraudster Shield?

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State laws that regulate the offer and sale of securities are known as "blue sky" laws because they were enacted to protect investors from predatory offerings that "would sell building lots in the blue sky."[1] Unlike the federal securities acts that are disclosure driven and designed to complement the blue sky system, the predecessor blue sky laws adopted a "merit regulation" approach in which judges and state regulators would examine the transactions' substantive fairness. Current blue sky laws in effect in the 50 states range from ones that adopt a pure disclosure philosophy to merit-based models that examine the quality of the securities offered.

No matter the philosophy that informs the state regulation of the securities markets, their importance in providing investors an added layer of protection is apparent in light of the savings clause in the federal securities laws, and is underscored by the enduring prevalence of blue sky laws almost a century after their inception.[2] Part and parcel of this layer of protection is that most states' blue sky laws also provide for a private right of action and, where a private right of action is not available, long-standing common law claims are themselves powerful tools in providing redress to injured investors.

Until 1987, New York's blue sky law, the Martin Act, was interpreted by courts as allowing for a private right of action.[3] Since then, some New York courts have not only held that the Martin Act does not allow for a private right of action, but have gone so far as to hold that it preempts common law tort claims (e.g., breach of fiduciary duty or negligent misrepresentation) that "sound in fraud" or are predicated on a defendant's failure to disclose some material fact.[4]

In two recent decisions from the Southern District of New York, Judges Paul Crotty and Shira Scheindlin interpret the Martin Act to surprising effect by dismissing the common law claims of two plaintiffs, neither of whom reside in New York. Yes, the same Martin Act that made Eliot Spitzer the sheriff of Wall Street[5] and that Andrew Cuomo[6] is brandishing to address Wall Street excesses in light of the recent market meltdown has yet again been interpreted to leave investors in private litigation out in the cold.

On Sept. 30, 2009, Judge Crotty, in *Bank of America et al. v. Bear Stearns Asset Management Inc., et al.*, No. 08 Civ. 09265 (PAC), held that a count for breach of fiduciary duty against the defendants was preempted by the Martin Act given that the lawsuit related to securities purchased or sold in New York, in this case mortgage backed assets known as collateralized debt obligations (CDOs).

On Sept. 2, 2009, Judge Scheindlin, in *Abu Dhabi Commercial Bank, King County, Washington v. Morgan Stanley & Co. Inc., et al.*, No. 08 Civ. 7508 (SAS), employed a contacts analysis in reaching the conclusion that New York law, and hence the Martin Act, applied to the plaintiffs' common law tort claims because a substantial portion of the events giving rise to a claim occurred in New York.

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Abu Dhabi involved institutional investors residing outside New York who sought class-wide relief in connection with losses stemming from the liquidation of notes issued by a structured investment vehicle (SIV), Cheyne Finance PLC. The defendants are, inter alia, the arranger and placement agents, Morgan Stanley and Bank of New York, and the rating agencies, Moody's Investors Service and Standard and Poor's Ratings Services, that were retained to rate the notes.

The far-reaching and startling implication of these decisions is thrown into stark relief when one considers that New York is one of only five states in the nation that do not permit an implied private right of action under its blue sky law. That being said, one would be hard pressed to imagine a New York attorney general's office so far reaching in its Martin Act prosecutions that it would act on behalf of a non-domiciliary such as King County, Washington or Delaware-incorporated and North Carolina-based Bank of America, let alone a far-flung Abu Dhabi Commercial Bank. In fact, the recent revelation of Bernard Madoff's massive Ponzi scheme, to name but one example, demonstrated that the enforcement resources at the attorney general's disposal could conceivably be spread thin even just when pursuing the potential Martin Act violators who played a role in that fraud. Madoff caused devastating losses to countless New Yorkers and New York union and pension funds.

This does not address the myriad other non-New York victims and the countless other cases that New York would be the epicenter of under a contacts analysis. These pragmatic limitations aside, whether it is the best use of the state's coffers to charge the attorney general's office to champion every infraction of the Martin Act through taxpayer subsidized litigation is dubious particularly in these times of taxpayer strain. Moreover, it leaves the entire enforcement effect of the private bar untapped. The need for private attorney generals is especially compelling when, at the federal level, the Securities & Exchange Commission has proven less than effective in detecting and preventing widespread fraud. The concurrent and resulting lack of remedy for private investors is, in this financial crisis—Madoff era, palpably troubling.

The decisions of some courts interpreting the Martin Act seemingly sound the death knell for common law tort claims that do not require proof of scienter. The conclusions reached by the courts in this regard are neither inevitable nor controlling. The question is still open with some favorable precedent on plaintiffs' side.

Background

The Martin Act, enacted in 1921 and codified in Article 23-A of the General Business Law,[7] is New York's "blue sky" securities law. It provides the regulatory framework governing the offer and sale of securities, commodities and other investment vehicles in and from the state. In 1987, however, the Court of Appeals, contrary to decades of prior rulings by state and federal courts, held that there is no private right of action under the Martin Act.

Fundamentally remedial in character and

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broadly construed,[8] the Martin Act confers upon the attorney general sweeping investigative and prosecutorial powers in the securities, commodities and other investment arenas.[9] The Martin Act, like the federal securities laws, is silent, however, on whether a private right of action is conferred.[10] For many years, New York state and federal courts were divided on whether or not the Martin Act implied a private right of action for members of the investing public.[11] By the early 1970s, however, the prevailing view was that a private right of action did exist.[12] This interpretation was consistent with the blue sky laws of every state that, with the sole exception of Rhode Island, expressly recognized a private right of action as of 1987.

No Private Right of Action

In 1987, to the surprise of virtually every securities lawyer in New York, the Court of Appeals held in *CPC International Inc. v. McKesson Corporation*[13] that no express or implied private right of action exists under the Martin Act. As such, the Court shut the courthouse doors to aggrieved New York investors victimized by fraudulent and other wrongful conduct, and relegated those investors (except for investors participating in certain class actions) to arbitration fora.

A majority of the Court found that the civil enforcement scheme was specific in granting the attorney general, and only the attorney general, broad remedial powers to prevent securities fraud.[14] However, Judge Stewart Hancock (the author of the Court's opinion) and Judge Richard Simons were of the differing view that "the underlying purpose of section 352-c is not to grant various powers to the attorney general. Rather, as we see it, the ultimate aim to be achieved by the statute is the deterrence of fraudulent practices in the offering and sale of securities and the protection of investors damaged by such practices. *Accordingly, we would hold that an implied private cause of action furthers that broad statutory purpose [.]*"[15]

Preemption

Subsequent to the *McKesson* decision, a number of lower courts in New York have held that the Martin Act also preempts certain traditional common law claims arising out of facts that would provide the attorney general with grounds to commence an action under that statutory scheme. See *Rego Park Gardens Owners Inc. v. Rego Park Gardens Associates*, 191 A.D.2d 621, 595 N.Y.S.2d 492, 494 (2d Dept. 1993) (dismissing a negligent misrepresentation claim upon finding that "this cause of action sought, in essence, to pursue a private cause of action under the Martin Act"); *Horn v. 440 East 57th Co.*, 151 A.D.2d 112, 547 N.Y.S.2d 1 (1st Dept. 1989) (dismissing claims for negligent misrepresentation and breach of fiduciary duty where plaintiff substituted allegation of deceitful intent with existence of fiduciary relationship with defendant).

Accordingly, plaintiffs face a formidable challenge in bringing a claim for breach of fiduciary duty along with other common law tort claims predicated on the same set of facts because a court could characterize this as "artful pleading" designed to circumvent Martin Act preemption. *Whitehall Tenants Corp. v. Estate of Olnick*, 213 A.D.2d 200, 623 N.Y.S.2d 585 (1st Dep't 1995).

This rationale is applied expansively to cover conduct that arguably does not relate to, and post-dates the actual securities transaction. See e.g., *Heller v. Goldin Restructuring Fund, L.P.*, 590 F.Supp.2d 603, 611 (SDNY 2008) (rejecting plaintiff's argument that defendants' conduct occurred after plaintiff's subscription to the Fund and thus should survive Martin Act preemption).

However, several New York courts have come out on the other side and held that the Martin Act does not, nor was it ever intended to preempt viable common law claims. See, e.g., *Cromer Finance Ltd. v. Berger*, No. 00 Civ. 2498, 2001 WL 1112548, at 4 (SDNY Sept. 19, 2001) (upholding plaintiff's negligence claims and finding that "there is nothing in either of the New York Court of Appeals cases [addressing the Martin Act] or in the text of the Martin Act itself to indicate an intention to abrogate common law causes of action."); *Scalp & Blade Inc. v. Advest Inc.*, 281 A.D.2d 882, 883, 722 N.Y.S.2d 639, 640 (4th Dep't 2001) ("nothing in the Martin Act, or in the Court of Appeals cases construing it, precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the attorney general a basis for proceeding civilly or criminally against a defendant under the Martin Act.")

Accordingly, in *Suez Equity Investors, L.P. v. Toronto Dominion Bank*, 250 F.3d 87 (2d Cir. 2001), the Second Circuit rejected a Martin Act preemption argument raised by defendants for the first time on appeal. In doing so, the court declined to follow the *Horn* and *Rego Park* decisions given that "they did not explore the issue with a level of depth that would justify a ruling [...] in the first instance." Id. at 104.

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Interestingly, where the complaint does not allege violations of any securities law, the analysis weighs against a finding of preemption. See e.g., *Xpedior Creditor Trust v. Credit Suisse First Boston (USA) Inc.*, 341 F.Supp.3d 258, 272 (SDNY 2004) (relying on *Cromer*, Court upholds plaintiff's claim for breach of fiduciary duties).

Conclusion

New York's Martin Act is now being construed to provide "a one-two punch" strictly to the benefit of defendants. This assault was first achieved by the interpretation of the law reaching the conclusion that there is no private right of action; an anomaly among state laws. Then, in the face of that decision, private plaintiffs in New York sought to invoke long-established common law remedies recognized in all states. These claims are now deemed by many New York courts, despite the disfavor of preemption generally, to be preempted.

Now this knockout combination is being applied to the detriment of plaintiffs who have allegedly been defrauded by defendants by virtue of a contacts analysis. The troika of no private right of action; preemption and its expansive application are a startling evisceration of private enforcement on the heels of the financial collapse and threaten to render New York State, the epicenter of the financial world, a safe haven for individuals engaged in unscrupulous and fraudulent conduct.

Although Martin Act preemption has gained a toehold in New York courts, it is not a proper, inevitable, or inescapable conclusion. Indeed, considering the sobering ramifications of this conclusion for injured investors who have, in no uncertain terms, lost their life's savings due to fraudsters like Madoff and the investment managers that enabled him, the public need for a better model of enforcement cannot be denied.[16]

1. See Brian J. Fahrney, Comment—Blue Sky Laws: a Stronger Case for Federal Preemption Due to Increasing Internalization of Securities Markets, 86 N.W.U.L.Rev. 753, 758 (1992) quoting Mulvey, Blue Sky Law, 35 Can. L.T. 37 (1916).

2. The first blue sky law was enacted in Kansas in 1911 with similar versions quickly adopted in the Midwest, west and Southwest. Id.

3. See discussion infra at p. 4.

4. See discussion infra at pp. 5-6.

5. Rebecca Leung, "The Sheriff of Wall Street," CBSNEWS.COM, May 25, 2003 available at http://www.cbsnews.com/stories/2003/05/23/60minutes/main555310.shtml, last visited Sept. 24, 2009.

6. See Mary W. Walsh, Inquiry Asks Why A.I.G. Paid Banks, NYTIMES.COM, March 26, 2009 (Cuomo's use of the Martin Act to subpoena A.I.G.).

7. N.Y. Gen. Bus. Law §§352 to 359-h.

8. See, e.g., *People v. Federated Radio Corp.*, 244 N.Y. 33, 38-39, 154 N.E. 655, 657 (1926) (scope and purpose of Martin Act: "[T]o prevent all kinds of fraud in connection with the sale of securities and commodities and to defeat all unsubstantial and visionary schemes in relation thereto whereby the public is fraudulently exploited," and stating that "fraud" and "fraudulent practices" should be given a "wide meaning so to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public"); *In re Gardner*, 97 Misc.2d 806, 812-13, 412 N.Y.S.2d 740, 746 (Sup. Ct. New York County 1978) (Martin Act, like federal Acts, must "be given a pliable yet resilient construction" in order to "be effective in providing a remedy to those who have fallen prey to the exploitation of the public by unscrupulous individuals").

9. See N.Y. Gen. Bus. Law §352 (investigation by attorney general), 352-c (prohibited acts and practices), 353 (action by attorney general).

10. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917 (1975) (establishing an implied private right of action under the Exchange Act).

11. Compare, e.g., *Schumann v. 250 Tenants Corp.*, 65 Misc. 2d 253, 317 N.Y.S.2d 500 (Sup. Ct. New York County 1950) (no private right of action under the Martin Act) with *Barnes v. Peat, Marwick, Mitchell & Co.*, 69 Misc. 2d 1068, 332 N.Y.S.2d 281 (Sup. Ct. New York County 1972) (Martin Act creates a private right of action), aff'd as modified, 42 A.D.2d 14, 344 N.Y.S.2d 645 (1st Dep't 1973), and *Lupardo v. I.N.M. Indus. Corp.*, 36 F.R.D. 438 (SDNY 1965) (same).

12. See, e.g., *In re Investors Funding Corp. of N.Y. Sec. Litig.*, 523 F.Supp. 533 (SDNY 1980); *Superintendent of Ins. of the State of N.Y. v. Freedman*, 443 F.Supp. 628 (SDNY 1977), aff'd without op., 594 F.2d 852 (2d Cir. 1978); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F.Supp. 112 (SDNY 1974), aff'd in part, rev'd in part on other grounds, 540 F.2d 27 (2d Cir. 1976).

13. 70 N.Y.2d 268, 278, 519 N.Y.S.2d 804, 808, 514 N.E.2d 116, 120 (1987).

14. Id. at 276-77, 807, 119.

15. Id. at 277, 807, 119 (citations omitted) (emphasis added).

16. In June 2009, Senator Eric T. Schneiderman (D-Manhattan/Bronx) and Assemblyman Richard Brodsky (D-Westchester) introduced legislation to clarify the power of the Martin Act and to give express authority to institutional investors, including the state's retirement fund, to recover damages resulting from violations of the State's securities laws. It has the formal support of New York's two Comptrollers, State Comptroller Thomas P. DiNapoli and City Comptroller William C. Thompson, Jr., 1199SEIU United Healthcare Workers East, the New York State Public Employee Conference, New York State Public Employees Federation AFL-CIO, New York State United Teachers, and the Teamsters Local 237.

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