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NEW YORK'S HIGHEST COURT DECIDES IMPORTANT MARTIN ACT PREEMPTION QUESTION

At the end of 2011, the New York Court of Appeals handed down *Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management, Inc.*, an important decision that could have a broad impact on securities litigation in New York state and federal courts.[1] The case presented New York's highest court with an opportunity to resolve a significant and unsettled issue in New York securities law—whether the Martin Act, New York's securities statute, preempts private common-law tort claims arising from securities transactions. On December 20, 2011, the Court of Appeals held that the Martin Act *does not* preempt common-law claims, contrary to numerous federal and state court decisions that had held such claims were precluded.

THE MARTIN ACT

The Martin Act (the "Act") is New York's "blue sky" law, so called because these laws were designed to stop schemes involving fraudulent securities "which have no more basis than so many feet of 'blue sky.'"[2] The Act prohibits "[a]ny fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale" in "the issuance, distribution, exchange, sale, negotiation or purchase … of any securities or commodities."[3] In 1960, the Act was amended to also cover fraudulent practices in the offering of condominiums and cooperatives.[4]

Widely considered the most severe blue sky law in the country, the Martin Act grants the New York Attorney General extraordinarily broad power to investigate and prosecute suspected violators of its antifraud provisions. The Act, for instance, contains no scienter requirement. The Attorney General need not prove a defendant's intent to defraud or deceive to recover civil damages. The Act was used to great effect by former New York Attorney General Eliot Spitzer in a series of lawsuits against banks and investment firms. New York Governor Andrew Cuomo

continued to use the Martin Act against financial institutions during his tenure as New York Attorney General.

PRIVATE SECURITIES CLAIMS AND THE MARTIN ACT

The Martin Act does not expressly provide a private right of action for claims that fall within the Attorney General's enforcement authority. Some courts initially allowed private litigants to bring claims pursuant to the Act.[5] That practice stopped when the New York Court of Appeals held, in *CPC International Inc. v. McKesson Corp.*,[6] that only the Attorney General can bring an action under the Act, because "an implied private action is not consistent with the legislative scheme underlying the ... Act." The *CPC* decision set the Martin Act apart from other states' blue sky laws, the majority of which had been held to provide an implied private right of action.[7] While dealing with private actions under the Martin Act itself, the *CPC* decision left open the question of the extent to which the Martin Act, under the doctrine of preemption, precluded common law claims asserted in New York securities cases.

MARTIN ACT PREEMPTION

Following *CPC*, many state and federal courts in New York held that the Martin Act preempts private common law claims based on facts that would also allow the New York Attorney General to bring an action under the Act. An exception was made for common law fraud, which requires proof of deceitful intent, an additional element not required by the Act.

For example, a line of condominium and cooperative cases in New York state court found that common law negligence, breach of fiduciary duty, and constructive fraud claims were preempted by the Martin Act, because allowing the claims "would effectively permit a private action under the ... Act, which would be inconsistent with the Attorney-General's exclusive enforcement powers thereunder."[8]

In *Independent Order of Foresters v. Donaldson, Lufkin & Jenrett*, the Southern District of New York applied these real estate cases to the securities context, holding that "[a]ny claim that is covered by the Martin Act is ... not actionable by a private party," and dismissed common law claims for negligence and breach of fiduciary duty.[9] The Second Circuit reached a similar result in *Castellano v. Young & Rubicam Inc.*,[10] relying on the New York state court real estate cases to dismiss a common law breach of fiduciary duty claim. Although the courts were not uniform on the issue, the majority of federal courts within the Second Circuit have followed *Foresters* and *Castellano* in finding Martin Act preemption of nonfraud tort claims.[11]

Until this past December, the New York Court of Appeals had not directly addressed the issue. The closest it came was in *Kerusa Co. LLC v. W10Z/515 Real Estate LP*,[12] where the court dismissed a common law fraud claim involving a condo development because it was based entirely on disclosure requirements imposed solely by the Martin Act. The *Kerusa* court held that, on those facts, a common law fraud claim based on a defendant's failure to comply with the Martin Act cannot be meaningfully distinguished from a private right of action under the Act.[13] However, the Court of Appeals did not address the question of whether plaintiffs could bring a common law cause of action that was premised on facts that would support a valid Martin Act claim by the Attorney General, but whose elements were not based on the particular requirements of the Act itself. Certain decisions by the New York Appellate Division, New York's intermediate appellate court, had rejected arguments for such broad preemption, finding that private common law claims "may rest upon the same facts that would support a Martin Act violation ... as long as they are sufficient to satisfy traditional rules of pleading and proof."[14]

ASSURED GUARANTY

In *Assured Guaranty*, the plaintiff brought negligence and breach of fiduciary duty claims against an investment manager for investing funds in mortgage-backed securities. The trial court dismissed the claims, finding that they were preempted by the Martin Act. The Appellate Division, First Department, reversed. Construing *Kerusa* narrowly, the Appellate Division held that a private common law claim is not preempted by the Act unless it also "cast[s] what is clearly an obligation under the ... Act as a common-law

cause of action."[15] The court was persuaded by the New York Attorney General's amicus brief, which asserted that "there is nothing in the act or its legislative history, despite a number of amendments, that indicates any intention [by] the Legislature to replace common-law causes of action," and that allowing common law claims furthers the purpose of the Act, which is to combat fraud in securities transactions.[16] The court also cited as persuasive *Anwar v. Fairfield*, a decision by Southern District of New York Judge Marrero, which criticized the *Foresters* and *Castellano* decisions for reading the early state court real estate cases too broadly.[17]

The Appellate Division applied the same reasoning in *CMMF, LLC v. J.P. Morgan Investment Management Inc.*,[18] decided the same day as *Assured Guaranty*. In *CMMF*, the trial court declined to find common law negligence and breach of fiduciary duty claims preempted by the Martin Act, and the Appellate Division affirmed, voicing its opposition to the majority federal court view. These cases appeared to settle the issue, at least in the New York state courts. Even after the Appellate Division's decision in *Assured Guaranty* was handed down, however, the dissonance continued in the federal courts. In one case, another judge in the Southern District found that common law claims were still preempted by the Martin Act.[19] In doing so, the court followed *Castellano* without addressing the comprehensive analysis of this issue in *Anwar*, and noted that the Appellate Division's decision in *Assured Guaranty* was not the "last word" on the subject because the New York Court of Appeals had not addressed the issue.[20]

Meanwhile, the bank defendant moved for leave to further appeal the First Department's decision in *Assured Guaranty* to the New York Court of Appeals, noting this conflict among the state and federal courts on Martin Act preemption, and the Court of Appeals' failure to address the issue directly. The Appellate Division granted the bank defendant leave to further appeal, setting the preemption question up for decision by New York's highest court.

THE COURT OF APPEALS' OPINION

In a unanimous opinion, the Court of Appeals rejected the argument that the Martin Act preempts nonfraud common-law claims. Relying on *CPC* and *Kerusa*, as well as the court's prior cases on common law preemption, the court held that, as a general rule, the Martin Act does not preclude a private litigant from bringing a nonfraud common-law cause of action. The court stated that, read together, *CPC* and *Kerusa* stand only for the proposition that a private litigant may not pursue a common-law cause of action where the claim is based on a violation of the Martin Act itself and would not exist but for the statute. Hence, the court held, there is no "preemption" based merely on the fact that the common-law claim brought by a private litigant could also be styled as a Martin Act claim. As the court put it, "mere overlap between the common law and the Martin Act is not enough to extinguish common-law remedies."[21]

The Court of Appeals stated that its conclusion was supported by the plain text of the Act, as well as the legislative intent, legislative history, and policy considerations underlying the Act. The court agreed with the New York Attorney General's position that the purpose of the Martin Act is not impaired by private common-law actions that have a legal basis independent of the statute, because "proceedings by the Attorney General and private actions further the same goal—combating fraud and deception in securities transactions."[22]

The court cited approvingly to Southern District of New York Judge Marrero's opinion in *Anwar* when discussing the legislative intent and policy considerations underlying its interpretation of the Martin Act. The court stated that a finding that the Martin Act precludes properly pleaded common-law actions would leave the marketplace "less protected than it was before the Martin Act's passage, which can hardly have been the goal of its drafters."[23] For these reasons, the court concluded that the plaintiff's common-law claims of breach of fiduciary duty and gross negligence were not barred by the Martin Act and should be permitted to go forward.

THE IMPLICATIONS OF *ASSURED GUARANTY* FOR SECURITIES LITIGATION IN NEW YORK

The impact of this opinion on securities litigation in New York, in both the state and federal courts, is significant. Some commentators have already predicted that *Assured Guaranty* will result in a substantial increase in consumer fraud suits,

as well as suits for negligence and breach of fiduciary duty, in connection with the purchase and sale of securities.[24] It remains to be seen whether a greater number of suits will be filed, but at the very least, more actions are likely to survive motions to dismiss. *Assured Guaranty* opens the door for private litigants asserting federal securities law claims to plead state common-law claims that might previously have been considered preempted by the Martin Act.

While presenting a new opportunity for plaintiffs in securities litigation, *Assured Guaranty* ushers in new burdens for defendants. The decision will require financial institutions jurisdictionally connected to New York and their counsel to become more aware of New York common-law theories of recovery. To be sure, although Martin Act preemption is no longer one of them, viable defenses to such claims remain, which can be asserted in a motion to dismiss. For example, a plaintiff asserting a negligent misrepresentation claim must under New York law plead a special or privity-like relationship with the defendant. But *Assured Guaranty* eliminates a preemption defense to common-law claims that had given significant protection to defendants in the New York federal courts.

As noted in an *amicus* brief from the Securities Industry and Financial Markets Association, the overall effect of the New York Court of Appeals' decision may be to impose substantial new regulatory burdens, resulting in "higher costs, reduced returns, and narrower investment choices for investors."[25] Moreover, some legislators have interpreted this decision as a signal to the New York legislature that the Martin Act should itself be expanded to permit a private right of action.[26] In fact, one bill authorizing such a right has already been introduced in the State Assembly.[27]

New York remains a hub for the securities industry, and investment decisions worth billions of dollars are frequently governed by transactions and contracts controlled by New York law. For decades, securities professionals have had the comfort that these transactions and contracts would not be second guessed by common law negligence claims or other common-law claims should a wise investment perform poorly through no fault of the securities professional involved, unless plaintiffs were also prepared to assert that there was intentional misconduct. Based on the Court of Appeals' *Assured Guaranty* decision, the landscape appears to have changed, and the range of available causes of action has broadened.

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ENDNOTES

1 *Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management, Inc.*, No. 227, 2011 N.Y. LEXIS 3658 (December 20, 2011).

2 *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).

3 N.Y. Gen. Bus. Law § 352-c.

4 N.Y. Gen. Bus. Law § 352-e.

5 *See, e.g., Lupardo v. I.N.M. Indus. Corp.*, 36 F.R.D. 438, 439 (S.D.N.Y. 1965).

6 *CPC Intern. Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 277 (1987).

7 *Id.* at 276 (discussing the antifraud provisions of the Martin Act, and noting that "[i]n all the other states, except one, the Legislature has expressly recognized a private civil action for violations of the corresponding provision.").

8 *Eagle Tenants Corp. v. Fishbein*, 182 A.D.2d 610, 611 (2d Dep't 1992). *See also Horn v. 440 East 57th Co.*, 151 A.D.2d 112 (1st Dep't 1989); *Rego Park Gardens Owners, Inc. v. Rego Park Gardens Assoc.*, 191 A.D.2d 621, 595 N.Y.S.2d 492, 494 (2d Dep't 1993).

9 *Independent Order of Foresters v. Donaldson, Lufkin & Jenrett*, 919 F.Supp. 149, 153 (S.D.N.Y. 1996).

10 *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171 (2d Cir. 2001).

11 *See, e.g., In re Beacon Associates Litig.*, 745 F.Supp.2d 386 (S.D.N.Y. Oct. 5, 2010); *Stephenson v. Citco Group Ltd.*, 700 F.Supp.2d 599 (S.D.N.Y. 2010). *But see, e.g., Cromer Finance Ltd. v. Berger*, No. 00 CIV 2498., 2001 WL 1112548, at *4 (S.D.N.Y. Sept. 19, 2001) (finding plaintiff's negligence claims not precluded by the Martin Act); *Anwar v. Fairfield Greenwich Ltd.*, 728 F.Supp.2d 354, 371 (S.D.N.Y. 2010) (predicting that Court of Appeals would hold that the Martin Act does not preclude state law causes of action that do not derive from or rely upon the Act to establish a required element of the claim).

12 *Kerusa Co. LLC v. W10Z/515 Real Estate LP*, 12 N.Y.3d 236, 906 N.E.2d 1049 (2009).

13 12 N.Y.3d at 247 ("That Kerusa alleged the elements of common-law fraud does not transmute a prohibited private cause of action to enforce Martin Act disclosure requirements into an independent common-law tort.").

14 *Caboara v. Babylon Cove. Dev.*, 862 N.Y.S.2d 535, 537 (2d Dep't 2008). *See also Scalp & Blade, Inc. v. Advest, Inc.*, 281 A.D.2d 882 (4th Dep't 2001).

15 *Assured Guar. (UK) Ltd. V. J.P. Morgan Inv. Management Inc.*, 915 N.Y.S.2d 7, 13 (1st Dep't Nov. 23, 2010).

16 *Id.* at 15.

17 *Id.* at 14. *See also Anwar*, 728 F.Supp.2d at 356-72 (S.D.N.Y. 2010) (declining to follow *Castellano* after fully examining the history and purpose of the Martin Act, and tracing the genesis of the split between the New York state and federal courts on the issue of preemption).

18 *CMMF, LLC v. J.P. Morgan Investment Management Inc.*, 915 N.Y.S.2d 2 (1st Dep't 2010).

19 *In re J.P. Jeanneret Assocs.*, 769 F.Supp.2d 340 (S.D.N.Y. 2011).

20 *Id.* at 378 (applying *Castellano*, after noting that the First Department is not "the last word" on the subject of Martin Act preemption and that the Court of Appeals had not squarely addressed the issue of whether nonfraud common law claims are preempted by the Act).

21 *Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management, Inc.*, No. 227, 2011 N.Y. LEXIS 3658, at *12 (December 20, 2011).

22 *Id.*

23 *Id.* at 10-11.

24 *See* Steven Mayerowitz, "Avalanche of Consumer Fraud Suits to Follow NY Court's Ruling," *Financial Fraud Law* (December 21, 2011), http://www.financialfraudlaw.com/lawblog/avalanche-consumer-fraud-suits-follow-ny-court%E2%80%99s-ruling/3130 (last visited January 14, 2012).

25 Brief for Securities Industry and Financial Markets Association et al. as Amici Curiae Supporting Defendant-Respondent-Appellant, *Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management, Inc.*, No. 227, at 3 (December 20, 2011), *available at* http://www.theclearinghouse.org/index.html?f=072970.

26 John Caher, "Private Actions Are Not Precluded Under Martin Act, Panel Decides," N.Y.L.J., Dec. 21, 2011, at 6. (reporting that Assemblyman Rory I. Lancman and Senator Thomas Libous are sponsoring a bill that would expand the Martin Act to permit public retirement systems and multiemployer health and welfare plans to bring actions, and quoting Assemblyman Lancman as reading the decision "as an invitation to the Legislature to expand the Martin Act itself and allow investors to recoup losses as a result of fraud or malfeasance.").

27 *Id.*