Published by *Securities Law360*; *Appellate Law360; Contract Law360; Financial Services Law360*; & *New York Law360*

Preemption And The Martin Act

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Law360, New York (February 14, 2011) -- In a little-noticed decision that apparently flew under the radar right before the holidays, New York's Appellate Division, First Department, ruled that the Martin Act, New York's "blue sky" law, does not preempt common law claims for breach of fiduciary duty and gross negligence.

The decision, unless overruled by New York's Court of Appeals, threatens to upset what had become increasingly settled expectations that securities-type claims cannot be brought as common law claims in state court in New York. The decision may give new impetus to securities law plaintiffs who are increasingly trying to find ways to pursue their claims in state court.

The Appellate Division's decision was in Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management Inc.[1] The decision arose out of a now-common fact pattern, namely, an investment management defendant accused of investing funds in risky subprime securities. The Appellate Division reversed a trial court's decision that the plaintiff's breach of fiduciary duty and gross negligence claims were preempted by the Martin Act.

New York's Martin Act is the state's "blue sky" law.[2] It prohibits "fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale" in the distribution, exchange, sale or purchase of securities.[3] The statute permits the state's attorney general to pursue civil and criminal actions to enforce.

The Martin Act is the basis on which Andrew Cuomo brought his recent "Repo 105" claims against Ernst & Young LLP, before he moved from the attorney general's to the governor's office. The act was also the basis for Eliot Spitzer's multiple forays against Wall Street, before he (briefly) made the same move. Due to a historical curiosity of legislative drafting, the statute also applies to sale of co-ops and condominium apartment sales, which in part presents the problem.

A bit of background is required to understand the significance of the Appellate Division's decision. The New York Court of Appeals, the state's highest court, has held in CPC International Inc. v. McKesson Corp.[4] that there is no private right of action under the Martin Act, which is to be enforced exclusively by the attorney general. The Court of Appeals did not address the preemption effect of its decision, although it did rule that the plaintiff had adequately pled a fraud claim.

From that point, there arose a line of cases in co-op/condo offerings which ruled that permitting private parties to allege common law tort claims arising out of the offerings would circumvent CPC's ban on private causes of action under, as well as the attorney general's exclusive right to enforce, the Martin Act.[5]

These decisions, while not uniform and sometimes confusing, culminated in another Court of Appeals decision, in Kerusa Co. LLC v. W10Z/515 Real Estate LP,[6] where the court reiterated that there is no private right of action under the Martin Act, that the attorney general has the exclusive right to enforce the act, and that allegations of "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."

The effect of these decisions is to leave co-op and condo buyers to claims for breach of contract based on the offering circular and other materials. They cannot bring claims for common law fraud or other similar torts.

Because investment-related state law claims are often ancillary to federal securities law claims, in the investment arena it was usually the federal courts which were called upon to give the Martin Act preemptive effect. The Second Circuit so ruled in Castellano v. Young & Rubicam Inc.,[7] and the majority of Southern District decisions concurred,[8] although one recent decision disagreed.[9]

It was against this background that the First Department rendered its decision in Assured Guaranty. The court noted that "[t]he plain language of the Martin Act does not explicitly preempt all common-law claims."[10] The court also noted that the attorney general had filed an amicus brief in another case which took the position that common law claims were not preempted. And the court said that the goal of the Martin Act's drafters was not to make investors "less protected."[11]

The First Department dealt with the confusing and conflicting case law, unpersuasively, by trying to distinguish between "a prohibited private action based upon the provisions of the Martin Act [that] are preempted by the statute" from "properly pleaded common-law causes of action."[12]

The court gave only the slightest nod to its own decision, Horn,[13] which held that claims for negligent misrepresentation and breach of fiduciary duty were preempted. (Curiously, Horn allowed a claim for fraud, even though fraud and deceit are at the core of what the Martin Act prohibits.) The court was just as unpersuasive in its attempt to explain the Court of Appeals' decision in Kerusa.

The reason that Assured Guaranty is a significant decision is that, as the most recent state court word on preemption under the Martin Act, in the investment-related contest, federal judges who might have ruled in favor of preemption will not be able to ignore it under the Erie doctrine.

The decision may also have a significant tactical impact. Federal securities claims have become harder and harder to bring. Enhanced pleading requirements under Iqbal,[14] and the Private Securities Litigation Reform Act,[15] restrictions on secondary liability under the Supreme Court's decision in Stoneridge,[16] and closer scrutiny of defenses like causation and reliance, have all prodded plaintiffs to look more closely at state law claims in state court. In New York at least, whether those claims are preempted by the Martin Act therefore assumes critical importance.

There are good reasons to believe that state common law investment-related claims should in fact be preempted. First, preemption will correctly align the results in the real estate and investment lines of cases arising under the Martin Act. Second, without preemption, federal-state forum shopping may become rampant. Third, without preemption, uniformity of standards, which the federal securities laws were enacted to achieve, will fail. Fourth, if the state legislature in New York wants to rewrite the Martin Act to overhaul its remedies, it is free to do so, but that is a job for the legislature, not the courts.

Finally, contrary to the suggestions of some, preemption is consistent with investor protection. New York has historically been hostile to all class actions, and in any event, investment-related class actions are preempted as a matter of federal law under the Securities Litigation Uniform Standards Act

(SLUSA).[17]

Thus, the investment claims that will be at issue in state court will typically be private in nature. That was the case in Assured Guaranty, where a reinsurance company engaged an investment manager to invest the reinsurer's excess reserves.

The parties to a private transaction or relationship can protect themselves as a matter of contract, including representations, warranties and covenants, due diligence prior to the investment, and monitoring and supervision of the investment during its life. Preemption of private claims under the Martin Act will also achieve consistency with preemption under SLUSA.

It seems clear that clarification from the Court of Appeals is in order. There was no dissent in Assured Guaranty, so review of this particular decision will be at the Court of Appeals' discretion (although one can also expect the Second Circuit to certify this question to the Court of Appeals in view of the confusion in the cases). One can only hope that the Court of Appeals will not want to leave investors in the high level of uncertainty in which the First Department's decision places them.

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[1] No. 603755/08, 2010 WL 4721590 (N.Y. App. Div. 1st Dep't Nov. 23, 2010).

[2] N.Y. Gen. Bus. Law §§ 352-59.

[3] § 352-c(a).

[4] 70 N.Y.2d 268, 514 N.E.2d 116 (1987).

[5] See, e.g., Vermeer Owners Inc. v. Guterman, 78 N.Y.2d 1114, 585 N.E.2d 377 (1991); Rego Park Gardens Owners, Inc. v. Rego Park Gardens Assocs., 191 A.D.2d 621, 595 N.Y.S.2d 492 (2d Dep't 1993); Horn v. 440 East 57th Co., 151 A.D.2d 112, 547 N.Y.S.2d 1 (1st Dep't 1989).

[6] 12 N.Y.3d 236, 247, 906 N.E.2d 1049, 1055 (2009).

[7] 257 F.3d 171 (2d Cir. 2001).

[8] See Stephenson v. Citco Group Ltd., 700 F. Supp. 2d 599 (S.D.N.Y. 2010); Sedona Corp. v. Ladenburg Thalmann & Co., No. 03 Civ. 3120(LTS)(THK), 2005 WL 1902780 (S.D.N.Y. Aug. 9, 2005); Nanopierce Techs. Inc. v. Southridge Capital Mgmt. LLC, No. 02 Civ. 0767(LBS), 2003 WL 22052894 (S.D.N.Y. Sept. 2, 2003); Bibeault v. Advanced Health Corp., No. 97 Civ. 6026 (MJL)(RJW), 1999 WL 301691 (S.D.N.Y. May 12, 1999); Indep. Order of Forresters v. Donaldson, Lufkin & Jenrette Inc., 919 F. Supp. 149 (S.D.N.Y. 1996).

[9] See Anwar v. Fairfield Greenwich Ltd., No. 09 Civ. 0118(VM), 2010 WL 3022848 (S.D.N.Y. July 29, 2010).

[10] 2010 WL 4721590, at *3.

[11] Id. at *5 (citation and internal quotation marks omitted).

[12] Id. at *4.

[13] 151 A.D.2d 112, 547 N.Y.S.2d 1.

[14] Ashcroft v. Iqbal, 129 S. Ct. 1937 (2009).

[15] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

[16] Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).

[17] Securities Litigation Uniform Standards Act, Pub.L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. § 78bb).