Legal Opinion Letter

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NEW YORK'S MARTIN ACT:
FEDERAL PREEMPTION MUST BE ADDRESSED

by
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My past commentaries for Washington Legal Foundation[1] and periodic other comments over the last nine years have expressed the increasing frustration of the securities litigation defense bar with the breadth and the basic unfairness of New York's Martin Act, N.Y. GEN'L BUS. LAW art 23-A. I have also argued that this 1922 law has been preempted by the intervening federal securities regulatory regime.

I had a dim hope that the New York Court of Appeals might actually have utilized a case recently before it, *Assured Guaranty (UK) Ltd. v. J. P. Morgan Investment Management Inc.*[2], to adopt this federal preemption theory. The case involved the Martin Act's own preemption of non-fraud claims fairly within the Act's prohibited practices. Sadly, this was not to be. Instead, the New York high court held that the Martin Act only preempted civil claims which relied only upon that law's specific proscriptions, and did not preempt other common law claims allegedly arising from the same facts, nor fraud claims, since it is not a "fraud" law.

So, assuming that Federal Courts under the *Erie Doctrine* must respect the New York Court of Appeals, and that other state courts will do the same, the world of Martin Act preemption is now as follows:

1. The Martin Act preempts only civil claims based solely upon the Martin Act itself.
2. The Martin Act does not preempt fraud claims, because it is not a fraud law.
3. The Martin Act does not preempt other common law claims.

Assured Guaranty sued J.P. Morgan for breach of fiduciary duty, gross negligence, and breach of contract, for allegedly mismanaging investments of an entity guaranteed by Assured Guaranty in assets which collapsed in the mortgage meltdown. The N.Y. Supreme Court dismissed the complaint as preempted by the Martin Act, but the Appellate Division reversed, and the Court of Appeals affirmed the Appellate Division, despite its earlier holdings in *CPC Int'l Inc. v. McKesson Corp.*, 70 NY2d 268 (1987), and *Kerusa Co. LLC v. W10Z/515 Real Estate LP*, 12 NY3d 236 (2009), which held that the Martin Act did not *create* a private cause of action (CPC), even for disclosures which it specifically required and which were not made (*Kerusa*).

The Court of Appeals said that the proper preemption corollary to *CPC Int'l* and *Kerusa* was that the Martin Act only precluded civil claims based *exclusively* on the Martin Act's own specific requirements, and that properly pled independent common law claims could proceed. While the Martin Act vested the

[1]Robert A. McTamaney, *New York's Martin Act: Preemption Delayed is Justice Denied*, WLF LEGAL BACKGROUNDER, Vol. 26, No. 6 (Mar. 25, 2011); Robert A. McTamaney, *New York's Martin Act: Expanding Enforcement in an Era of Federal Securities Regulation*, WLF LEGAL BACKGROUNDER, Vol. 18, No.5 (Feb. 28, 2003).
[2]2011 N.Y. Slip Op. 09162, 2011 WL 6338898 (N.Y. Dec. 20, 2011).

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Attorney General with exclusive Martin Act enforcement authority, that was *cumulative* with common law complaints arising from the same facts but based on predicates beyond the Martin Act's specific provisions. If the N.Y. Legislature wished to preempt non-fraud civil claims based on Martin Act-analogous facts, it should have said so specifically, and it didn't.[3]

The N.Y. Court has now spoken, and that, as they say, is that. While the Martin Act did not create a private cause of action, neither did it prohibit it.

But there is an elephant in the room. In my earlier writings for WLF on the topic, I argued that Congress has preempted the field of securities litigation by the comprehensive federal legislative regime enacted subsequent to the Martin Act's adoption and periodic amendments.[4] These laws established an all-pervasive national solution to securities regulation, except for "fraud and deceit" cases which are left for the states and private litigants to regulate and pursue under the very limited exception in the NSMIA.

In my judgment, Congress could never have intended to leave it to each state to define for itself the elements of the "fraud" that was saved for the states to continue to regulate. Instead, the "fraud" left for the states to regulate must logically have been "fraud" *as defined at the federal level*. Presumably, that is what Congress meant when it said "fraud," and not some different, diluted, New York or other state version.

Federal securities "fraud" requires *scienter, an intent to defraud*, proof that someone was in fact defrauded, *reliance* on the fraud, and *proof of loss causation*. The Martin Act requires none of these, and has none of the pleading and proof protections[5] in the Federal laws condemning "fraud" in the securities realms.

Real securities fraud should be vigorously prosecuted, rooted out, eliminated, and punished to the full extent of the law. But that requires *far more strenuous enforcement* at the *federal* level of the *federal* laws that are entirely adequate tools for this purpose. It does not require fifty different state laws of the type and breadth of the Martin Act, with elements so feeble, penalties so severe, and procedures so draconian that unfair settlements are often the only rational business decision.

Before *Assured Guaranty*, defendants had the untenable choice of accepting the Martin Act as legitimate and relying on its preemption of common law claims, or challenging the Martin Act as being itself preempted, in which case the law's own preemption value would presumably fall with it. Now that *Assured Guaranty* has eliminated any defendant-positive protective effect, hopefully litigants will support and challenge whether this law itself can survive. As I said a decade ago, I believe the answer to that question is clearly no.

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[3]"[W]e believe that policy concerns militate in favor of allowing plaintiff's common-law claims….[T]he purpose of the 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. [T]o hold 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." Citing *Anwar v Fairfield Greenwich Ltd.*, 728 F. Supp 2d 354, 371 (SDNY 2010).

[4]The Securities Act of 1933; the Private Securities Litigation Reform Act of 1995 (PSLRA); National Securities Markets Improvements Act of 1996 (NSMIA); National Securities Markets Improvements Act of 1996 (NSMIA); and the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010.

[5]In order to prevent frivolous strike suits and "fishing expeditions," the PSLRA requires alleging fraud "with particularity," and a "strong inference" of scienter. When the Attorney General proceeds under the Martin Act, the entire case can be threatened, discovered and settled – for massive amounts – before any judge is involved. The dual, often concurrent enforcement proceedings create tremendous tension between the state prosecutors on the one hand and the federal enforcers on the other.

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