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New York Court of Appeals to Determine Whether the Martin Act Preempts Securities-Related, Non-Fraud Common Law Claims

Introduction

The frequently litigated question of whether New York's Martin Act, General Business Law Art. 23-A, §§ 352-359 (2011), preempts securities-related, non-fraud common law causes of action is now before the New York Court of Appeals in *Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management Inc.*, 80 A.D.3d 293, 915 N.Y.S.2d 7 (1st Dep't 2010), *leave to appeal granted*, M-6308, slip op. at 1-2 (1st Dep't Feb. 17, 2011). The Court of Appeals has been asked to review whether the First Department correctly held that the Martin Act does not preempt the plaintiff's claims for breach of fiduciary duty and gross negligence arising out of defendant's alleged mismanagement of plaintiff's investment account. *Id.* at 299-303; *see also CMMF, LLC v. J.P. Morgan Inv. Mgmt, Inc.*, 78 A.D.3d 562, 563-64, 915 N.Y.S.2d 2 (1st Dep't 2010); *Silver Oak Capital L.L.C. v. UBS AG*, 2011 N.Y. App. Div. LEXIS 2473, at *3 (1st Dep't Mar. 31, 2011). [1]

Assured Guaranty is in conflict with the Second Circuit and the majority of New York federal district courts which have held that securities-related, non-fraud common law claims are barred by the Martin Act. *See, e.g., Castellano v. Young & Rubicam*, 257 F.3d 171, 190 (2d Cir. 2001); *In re J.P. Jeanneret Assoc., Inc.*, 2011 U.S. Dist. LEXIS 9630, at **103-05 (S.D.N.Y. Jan. 31, 2011); *Nanopierce Techs., Inc. v. Southridge Capital Mgmt., LLC*, 2003 U.S. Dist. LEXIS 15206, at * 6 (S.D.N.Y. Sept. 2, 2003); *Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc.*, 919 F. Supp. 149, 153 (S.D.N.Y. 1996), *aff'd in part and rev'd in part*, 157 F.3d 933 (2d Cir. 1998). *Castellano*, which is the leading decision on this subject in the Second Circuit, does not offer any independent analysis to support its conclusion that the plaintiff's claim for breach of fiduciary duty was preempted by the Martin Act. Instead, the Second Circuit relied exclusively on *Eagle Tenants Corp. v. Fishbein*, 182 A.D.2d 610, 582 N.Y.S.2d 218, 219 (2d Dep't 1992) and *Horn v. 440 East 57th Company*, 151 A.D.2d 112, 547 N.Y.S.2d 1, 5 (1st Dep't 1989), two appeals in which claims for breach of fiduciary duty and negligent misrepresentation based on alleged material omissions from real estate offering plan documents were found to be preempted by the statute. *Castellano*, 257 F.3d at 190.

The claims for breach of fiduciary duty and negligent misrepresentation in *Eagle Tenants* and *Horn* appear to be based entirely on alleged omissions from Martin Act filing requirements which are within the purview of the Attorney General's exclusive enforcement powers. By contrast, the claims for breach of fiduciary duty and gross negligence in *Assured Guaranty* do

1 In *CMMF*, the same panel that decided *Assured Guaranty* held that the plaintiff's claims against the defendant investment manager for negligence, breach of fiduciary duty and negligent misrepresentation were not precluded by the statute because these causes of action "fit within a cognizable legal theory without relying wholly on the provisions of the Martin Act." 78 A.D.3d at 563-64. The panel in *Silver Oak* similarly held that plaintiff's securities-related common law claims of negligent misrepresentation and unjust enrichment were not preempted by the Martin Act. *Silver Oak Capital*, 2011 N.Y. App. Div. LEXIS 2473 at *3.

...the claims for breach of fiduciary duty and gross negligence in *Assured Guaranty* do not "rely entirely on alleged omissions from filing required by the Martin Act and the Attorney General's implementing regulations."

not "rely entirely on alleged omissions from filing required by the Martin Act and the Attorney General's implementing regulations." *Assured Guaranty*, 80 A.D.3d at 301. This cogent analysis of the Martin Act preemption issue by the First Department appears to be more consistent with the statute than that of the federal courts.

The Assured Guaranty Decision

In *Assured Guaranty*, plaintiff life reinsurance company sued defendant investment manager to recover losses that it sustained during the course of defendant's management of its investment accounts. The trial court granted defendant's motion to dismiss plaintiff's causes of action for breach of fiduciary duty and gross negligence as preempted by the Martin Act. *Id.* at 298. In reversing the trial court's dismissal of these claims, the First Department reasoned that "[t]he plain language of the Martin Act does not explicitly preempt all common-law claims," noting the general rule that "when the common law gives a remedy, and another remedy is provided by statute, the latter is cumulative, unless made exclusive by the statute." *Id.* at 300 (citing *Burns Jackson Miller Summit & Spitzer v Lindner*, 59 N.Y.2d 314, 324, 464 N.Y.S.2d 712 (1983)). In that regard, the First Department noted that "there is nothing in the [Martin Act] or its legislative history, despite a number of amendments, that indicates any intention on the part of the Legislature to replace common-law causes of action by this legislation." *Assured Guaranty*, 80 A.D.3d at 303.

Moreover, the First Department observed that "a private action cannot be maintained based upon the provisions of the Martin Act" (citing *CPC Intl. v. McKesson Corp.*, 70 N.Y.2d 268, 276-77, 519 N.Y.S.2d 804 (1987) and *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. P'ship*, 12 N.Y.3d 236, 245, 879 N.Y.S.2d 17 (2009)) does not "require us to conclude that the traditional, though more limited, forms of action are no longer available to redress injury resulting from violation of the statute." *Assured Guaranty*, 80 A.D.3d at 300. Thus, the court reasoned, that there is no private right of action under the Martin Act "does not automatically mean that the statute preempts common-law causes of action." *Id.* In the view of the First Department, "many courts, particularly federal courts, have misinterpreted..." cases such as *CPC Intl.* and *Kerusa* "to find such preemption of common-law causes of action arising from facts which would support a Martin Act claim." *Id.* The *Assured Guaranty* panel acknowledged cases that have held that "where a pleading is drafted in such a way as to cast what is clearly an obligation under the Martin Act as a common-law cause of action, that complaint would constitute, in effect, a prohibited private action based upon the provisions of the Martin Act and are preempted by the statute" (*see Hamlet on Olde Oyster Bay Home Owners Assn., Inc. v Holiday Org., Inc.*, 65 A.D.3d 1284, 1287, 887 N.Y.S.2d 125 (2d Dep't 2009), *appeal dismissed* 15 N.Y.3d 742, 906 N.Y.S.2d 805 (2010)). Such cases, however, in the view of the First Department, "neither held nor implied that the Martin Act preempts properly pleaded common-law causes of action." *Assured Guaranty*, 80 A.D.3d at 301.

The First Department also noted decisions by the Second and Fourth Departments recognizing common law claims as not preempted by the statute. *See Board of Mgrs. of Marke Gardens Condominium v. 240/242 Franklin Ave., LLC*, 71 A.D.3d 935, 936, 898 N.Y.S.2d 564 (2d Dep't 2010); *Scalp & Blade v. Advest, Inc.*, 281 A.D.2d

882, 883, 722 N.Y.S.2d 639 (4th Dep't 2001).[2] The First Department also approvingly noted a number of Southern District decisions which departed from the majority approach in the Second Circuit and held that claims for gross negligence and breach of fiduciary duty are not preempted by the Martin Act. *Assured Guaranty*, 80 A.D.3d at 301-02 (*citing Louros v. Kreicas*, 367 F. Supp. 2d 572, 595-96 (S.D. N.Y. 2005) and *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 354 (S.D.N.Y. 2010)). The court found further that "there has been no convincing argument advanced that would warrant a finding that private litigation, properly pleaded, impinges on the otherwise exclusive prosecutorial authority of the Attorney General." *Assured Guaranty*, 80 A.D.3d at 301-02.

As defendant "conceded that common-law fraud claims are not preempted by the Martin Act, and that such litigation, however voluminous, does not impair the Attorney General's ability to perform his mission under the act," the First Department reasoned that "it flies in the face of logic to preclude other valid common-law causes of action in the securities area, most of which would rely on the same facts and documents required for a successful fraud action." *Id.* at 303-04. Concluding that "there is nothing in the plain language of the Martin Act, its legislative history or appellate level decisions in this State that supports defendant's argument that the act preempts otherwise validly pleaded common-law causes of action," *id.* at 304, the First Department reinstated plaintiff's breach of fiduciary duty and gross negligence claims (to the extent such claims accrued on or after June 26, 2007, or within the 90-day period provided in the parties' investment management agreement for objecting to any of the investments purchased by defendant).

On February 17, 2011, the *Assured Guaranty* panel granted defendant leave to appeal to the Court of Appeals from its order reinstating the breach of fiduciary duty and gross negligence claims that accrued on or after June 26, 2007. In granting leave to appeal, the First Department certified that the following question of law ought to be reviewed by the Court of Appeals: "Was the order of this Court, which modified the order of the Supreme Court to the extent of reinstating certain claims that accrued on or after June 26, 2007 properly made?" *Assured Guaranty*, M-6308, slip op. at 1-2. Defendant's appeal is currently in the briefing process; defendant's initial brief was filed on April 18, 2011, while plaintiff's responding brief is due on June 2, 2011, and any reply brief is due on June 17, 2011.

Second Circuit Law on Martin Act Preemption

The leading federal case on whether the Martin Act preempts securities-related, non-fraud common law claims is *Castellano*, where the Second Circuit affirmed the district court's dismissal of the plaintiff's securities-related claim for breach of fiduciary duty. Citing *Eagle Tenants* and *Horn*, the court held that "sustaining a cause of action for breach of fiduciary duty in the context of securities fraud 'would effectively permit a private action under the Martin Act, which would be

... "it flies in the face of logic to preclude other valid common-law causes of action in the securities area, most of which would rely on the same facts and documents required for a successful fraud action."

2 In *Board of Mgrs. of Marke Garden*, the Second Department held that where the facts alleged in a complaint "fit within a cognizable legal theory, and are not precluded by the Martin Act, as they do not rely entirely on alleged omissions from filing required by the Martin Act and the Attorney General's implementing regulations," such action will be permitted to proceed and a motion to dismiss predicated on a Martin Act preemption theory will be properly denied. 71 A.D.3d at 936. In *Scalp & Blade*, the Fourth Department held that there is nothing in the Martin Act which precludes a plaintiff from bringing a common law claim for breach of fiduciary duty "based on such facts as might give the Attorney General a basis for proceeding civilly or criminally against a defendant under the Martin Act" so long as generally accepted pleading standards are met. 281 A.D. 2d at 883.

inconsistent with the Attorney-General's exclusive enforcement powers thereunder." *Castellano,* 257 F.3d at 190. Rejecting the plaintiff's argument that "the common law cannot be abrogated by implication and that the New York Court of Appeals, in contrast to the New York Appellate Division, has never explicitly considered whether the Martin Act has preempted common law claims involving securities," the Second Circuit concluded that "principles of federalism and respect for state courts' interpretation of their own laws counsel against ignoring the rulings of those New York courts that have taken up the issue." *Id*.; *see also Nanopierce*, 2003 U.S. Dist. LEXIS 15206 at * 6 (finding plaintiff's securities-related claim for breach of fiduciary duty preempted by the Martin Act); *Independent Order of Foresters*, 919 F. Supp. at 153 (finding plaintiff's securities-related claims for breach of fiduciary duty and negligent misrepresentation preempted by the statute).

... "principles of federalism and respect for state courts' interpretation of their own laws counsel against ignorning the rulings of those New York courts that have taken up the issue."

Since *Assured Guaranty* was decided, at least one court in the Southern District has declined to follow it. In *J.P. Jeanneret*, plaintiffs asserted state law claims against defendant investment managers of feeder funds that invested plaintiffs' assets in the Bernard Madoff Ponzi scheme and the funds' accounting firm. The Honorable Colleen McMahon dismissed these claims on the ground that they were preempted by the Martin Act. In declining to follow *Assured Guaranty* and *CMMF*, the district court observed that "Appellate Division opinions are not the last word on the subject..." and that no "Court of Appeals decision changing the rule that has been applied 'almost without exception' . . . has been cited by Plaintiffs." *J.P. Jeanneret*, 2011 U.S. Dist. LEXIS 9630 at * 104. As a result, Judge McMahon concluded, until such time as the Court of Appeals rules that securities-related, non-fraud common law claims are not barred, "this Court is bound to apply the result in the only Second Circuit case that addresses the subject of Martin Act preemption: *Castellano v. Young & Rubicam*, 257 F.2d 171, 190 (2d Cir. 2001)." *J.P. Jeanneret*, 2011 U.S. Dist. LEXIS 9630 at 104-05.

Analysis

Ironically, while "Appellate Division opinions are not the last word on the subject..." of Martin Act preemption in the view of the *J.P. Jeanneret* court, the cases cited by the Second Circuit in *Castellano* as direct support for the dismissal of the plaintiff's claim for breach of fiduciary duty are, as noted above, Appellate Division opinions. Those decisions, *i.e., Eagle Tenants* and *Horn*, appear to be distinguishable from *Assured Guaranty*. In *Eagle Tenants*, the Second Department dismissed the claim for constructive fraud brought by a residential cooperative corporation against the sponsor of the cooperative offering plan. Finding that the cause of action for constructive fraud "attempts to premise liability for wrongful omission of the 'Continuing Maintenance Program' from the offering plan based upon a fiduciary's duty to disclose, regardless of the existence of deceitful intent...," the Second Department concluded that "to sustain that cause of action would effectively permit a private action under the Martin Act... which would be inconsistent with the Attorney-General's exclusive enforcement powers thereunder." *Eagle Tenants*, 182 A.D.2d at 611.

Similarly, in *Horn*, plaintiff purchased shares of stock allocated to 31 tenant-occupied apartments in a residential cooperative corporation whose conversion defendant had sponsored pursuant to an offering statement. The First Department

dismissed plaintiff's claims for negligent misrepresentation and breach of fiduciary duty. Observing that these causes of action "omit the element of a deceitful intent on defendant's part and substitute therefore the existence of a fiduciary relationship of trust and confidence," the court held that "[p]urportedly based on the fact of deception and defendant's position as sponsor of the conversion, to sustain them would be, in effect, to recognize a private right of action under the Martin Act contrary to case law" (citing *CPC Intl.*, 70 N.Y.2d at 275-78); *see also Rego Park Gardens Owners v. Rego Park Gardens Assocs.*, 191 A.D.2d 621, 622, 595 N.Y.S.2d 492 (2d Dep't 1993).[3]

Thus, in both *Eagle Tenants* and *Horn,* the claims for constructive fraud, breach of fiduciary duty, and negligent misrepresentation in effect sought to enforce an obligation to disclose in real estate offering plan documents that is within the purview of the Attorney General's enforcement powers. Such theory is different from the theory of liability in *Assured Guaranty*, where there is no alleged omission from a real estate offering plan document that implicates the Attorney General's enforcement powers. The Second Circuit's reliance on *Eagle Tenants* and *Horn* appears to be limited to omissions claims. As the *Castellano* court itself noted, "principles of federalism and respect for state courts' interpretation of their own laws counsel against ignoring the rulings of those New York courts that have taken up the issue." *Castellano*, 257 F.3d at 190.

Thus, *Castellano* was based entirely on the decisions of those New York courts which have addressed the issue of Martin Act preemption in the context of omissions claims. As a result, for purposes of the Court of Appeals' review of the *Assured Guaranty* decision, there is no independent analysis of preemption in the context of a pure mismanagement claim by the Second Circuit or by courts in the Southern District. The *Assured Guaranty* claims for breach of fiduciary duty and gross negligence do not "rely entirely on alleged omissions from filing required by the Martin Act and the Attorney General's implementing regulations." *Assured Guaranty*, 80 A.D.3d at 301 (citing *Board of Mgrs. of Marke Gardens*, 71 A.D.3d at 936)). By contrast, the negligent misrepresentation, breach of fiduciary duty and constructive fraud claims in cases such as *Eagle Tenants* and *Horn* do appear to be predicated on alleged omissions from Martin Act filing requirements. As such, they are seemingly distinguishable from cases arising out of the alleged mismanagement of an investment account, such as *Assured Guaranty*. It will be for the Court of Appeals to reconcile these two divergent lines of cases.

3 In *Rego Park Gardens*, the Second Department affirmed the trial court's dismissal of a claim for negligent misrepresentation against the sponsor of condominium and cooperative conversion by the plaintiff cooperative association arising out defendant's sale of condominium and cooperative units to plaintiff, holding that the trial court "properly dismissed the Cooperative's third cause of action to recover damages for negligent misrepresentation, because this cause of action sought, in essence, to pursue a private cause of action under the Martin Act." 191 A.D.2d at 622.

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

David J. Libowsky, Esq.
dlibowsky@bressler.com

BRESSLER, AMERY & ROSS

A PROFESSIONAL CORPORATION

17 State Street
New York, NY 10004
212.425.9300

325 Columbia Turnpike
Florham Park, NJ 07932
973.514.1200

2801 SW 149th Avenue
Miramar, FL 33027
954.499.7979

www.bressler.com