New York Law Journal
Real Estate Update
Wednesday, February 8, 2012

The Martin Act 'Shield' and Private Fraud Actions

BY ADAM LEITMAN BAILEY AND JOHN M. DESIDERIO


Adam Leitman Bailey


John M. Desiderio

On Dec. 20, 2011, the New York Court of Appeals, in Assured Guaranty (UK) LTD v. J.P. Morgan Investment Management Inc.1 finally put to rest a see-saw controversy that, for nearly a quarter century, had engendered much litigation in both the lower state courts and in the federal courts in New York over the proper interpretation of the Court's 1987 holding in CPC International v. McKesson Corporation2 in which the Court barred private plaintiffs from asserting private causes of action based on violations of the Martin Act, New York State's "blue sky" law that regulates the public sale of securities and real estate investment offerings.

'Assured Guaranty'

The Court reconfirms its holding in CPC that "a private litigant may not pursue a common-law cause of action where the claim is predicated solely on a violation of the Martin Act3 or its implementing regulations and would not exist but for the statute." However, it now also holds—contrary to several lower court decisions rendered in the interim since 1987—that "an injured investor may bring a common-law claim (for fraud or otherwise) that is not entirely dependent on the Martin Act for its viability," and that "[m]ere overlap between the common law and the Martin Act is not enough to extinguish common-law remedies."

Assured Guaranty's complaint alleged common-law causes of action for breach of fiduciary duty and gross negligence against defendant J.P. Morgan for alleged mismanagement of an investment portfolio that plaintiff had guaranteed. The Supreme Court granted the defendant's motion to dismiss holding that these common-law claims were preempted by the Martin Act because "their prosecution by the plaintiff would be inconsistent with the Attorney General's exclusive enforcement powers under the Act."

The First Department reversed, holding 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."4 The Court of Appeals agreed and affirmed the Appellate Division ruling, noting that:

The plain text of the Martin Act, while granting the Attorney General investigatory and enforcement powers and prescribing various penalties, does not expressly mention or otherwise contemplate the elimination of common-law claims. Certainly the Martin Act, as originally conceived in 1921 with its limited relief, did not evince any intent to displace all common-law claims in the securities field. Nor can J.P. Morgan point to anything in the legislative history of the various amendments that demonstrates a "clear and specific" legislative mandate to abolish preexisting common-law claims that private parties would otherwise possess. True, we have held that the Martin Act did not "create" a private right of action to enforce its provisions. But the fact that "no new per se action was contemplated by the Legislature does not…require us to conclude that the traditional…forms of action are no longer available to redress injury." Hence, we agree with the plaintiff that the Martin Act does not preclude a private litigant from bringing a non-fraud common-law cause of action. (Internal citations omitted).

J.P. Morgan relied upon the Court's prior decision in CPC and its more recent decision in Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. Partnership5 to argue that it would be inconsistent to allow private investors to bring common-law claims that overlapped with Martin Act violations. The Court noted that nothing it had said, in either CPC or in Kerusa, supported J.P. Morgan's contentions.

'CPC' and Its Progeny

In CPC, which involved the admitted misrepresentation of a firm's revenues in connection with the acquisition of the firm by the plaintiff through a stock purchase, the Court had held that there is no implied private cause of action for violations of the antifraud provisions of the Martin Act. At the same time, while ruling that the plaintiff could not recover damages under the Martin Act, the Court also held, on defendants' motion to dismiss, that the plaintiff's allegations, "given their most favorable intendment," stated a valid cause of action for common-law fraud, thereby permitting the plaintiff the opportunity to prove its reliance upon defendants' fraudulent misrepresentations without reference to any possible violation of the Martin Act.

In 1991, the Court restated its conclusion, that there is no private right of action under the Martin Act, in Vermeer Owners v. Guterman,6 where the Court also held that the complaint was nevertheless properly dismissed because the plaintiffs did not prove common law fraud.

The rulings in CPC and Vermeer were hardly extraordinary statements of law. While barring the use of the Martin Act as a basis for privately litigating statutory violations that are subject to enforcement solely by the Attorney General, the Court, in CPC, upheld that part of the plaintiff's complaint that was based on sufficiently pleaded common-law fraud allegations; but, in Vermeer, a case involving an apartment house conversion, where, at trial, the plaintiffs did not prove by clear and convincing evidence that they had in fact relied upon demonstrably false statements contained in an offering plan, the Court dismissed the action because plaintiffs had "failed to establish common law fraud."

Nevertheless, the lower courts, in several erroneous decisions over the years, misinterpreted CPC and Vermeer to deny standing to any plaintiff whose common-law fraud complaint could be characterized as prosecution, through "artful pleading," of a backdoor "private" Martin Act action.7

In a line of cases beginning with Whitehall Tenants Corp. v. Estate of Olnick,8 the First Department proscribed such "artful pleading" and interpreted CPC and Vermeer to mean that

the attorney general's exclusive right to enforce the Martin Act against fraudulent securities and real estate offerings barred private litigants from asserting a common-law fraud cause of action for any act or omission that the attorney general was otherwise authorized to prosecute.9

However, as in Vermeer, the plaintiff in Whitehall Tenants Corp. had failed to prove at trial any evidence of reliance or of intent to defraud by the sponsor defendant. Thereafter, in a series of subsequent decisions following Whitehall Tenants Corp., the First Department created a barrier against private securities and real estate syndication fraud actions that appeared to be nearly insurmountable.

In Thompson v. Parkchester Apartments Co. (Thompson I), the First Department held that plaintiffs must plead "a unique set of circumstances whose remedy is not already available to the Attorney General," in order to establish a viable independent claim for deception and false representation." The court reiterated the "unique circumstances" formula in Thompson II. However, the court did not explain just what "unique circumstances" would satisfy its criterion to support a common-law cause of action for a developer's affirmative misrepresentations, as opposed to a developer's failure to make Martin Act required disclosures.10

In 2007, in Kramer v. W10Z/515 Real Estate Ltd. Partnership,11 a panel of the First Department, sought to correct prior rulings of the court that, in the opinion of the panel, had extended the reasoning of Whitehall Tenants Corp. "to cases in which there is no legitimate reason to question at the pleading stage the ability of the plaintiff to prove all of the essential elements of common-law fraud."12

The Kramer court went on to say that decisions of the First Department after Whitehall Tenants Corp. appeared to regard as examples of the "artful pleading" first decried in Whitehall Tenants Corp. "every claim of common-law fraud arising out of conduct that could have been the basis for an action by the Attorney General," and "[c]ertainly none of those decisions suggest a principled basis for identifying those claims of common-law fraud that would not be regarded as such impermissible ploys." (Emphasis added).

The Kramer court said that it is no "end run" around the Martin Act for the plaintiff to have an opportunity to prove the truth of the allegations when all the elements of fraud have been properly pleaded. In such cases, the court said it "makes no sense" to "throw the plaintiff out of court merely because the Attorney General would be entitled to relief under the Martin Act."

In addition, the court reasoned that, as the Martin Act was enacted to protect the public from fraudulent exploitation and has a broad remedial purpose, to construe the act "to have abolished the right of purchasers of condominium and cooperative interests (and purchasers of other securities) to sue sellers for common-law fraud is to give the Martin Act a construction that is antithetical to its remedial purpose." Moreover, the court noted, there is not anything in the text of the Martin Act, nor in any decision of the Court of Appeals, that lends support to such a construction.13

Although the Kramer court had correctly identified the fatal flaw in the rule prior decisions of the First Department had adopted to dismiss private securities and real estate investment fraud actions—i.e., linking issues of affirmative fraudulent misrepresentations made in Attorney General regulated offering plans with sponsor failure to make required Martin Act disclosures—the Kramer court itself applied its illuminated reading of the CPC/Vermeer common-law fraud rule to facts that were the mirror opposite of those in the Whitehall-Thompson line of cases.

The Kramer plaintiffs' claim was based principally upon the fact that the sponsor had failed to disclose in the offering plan the transitory construction problems that were experienced while the building was under construction—information that the sponsor allegedly had intentionally withheld from the offering plan.14 Accordingly, as became clearly apparent in the Court of Appeals' Kerusa decision, the Kramer court panel's ardor in seeking to set right the First Department's long term misinterpretation of CPC and Vermeer had led it to apply the common-law fraud reasoning it espoused in Kramer to what was actually a case based entirely on a Martin Act violation—the precise situation that both CPC and Vermeer had held did not provide a basis for a private action.

'Kerusa'

In Kerusa, on which the appeal from the Kramer decision was taken, the Court of Appeals noted that the plaintiff alleged that the sponsor defendants had not disclosed various construction and design defects in the offering plan amendments while representing therein that there were no "material changes of facts or circumstances affecting the property or the offering" when, in fact, problems arising during construction had alerted them to the existence of major defects, which were either ignored or inadequately remedied.

The Court said that, "[b]ut for the Martin Act and the Attorney General's implementing regulations, however, the sponsor did not have to make the disclosures in the amendments. Thus, to accept Kerusa's pleading as valid would invite a backdoor private cause of action to enforce the Martin Act in contradiction to our holding in CPC Intl. that no private right to enforce the statute exists." The Court also noted that "[n]othing contained in Kerusa's proposed second amended complaint supports active concealment unrelated to alleged omissions from Martin Act disclosures."

Accordingly, the Court held in Kerusa "that a purchaser of a condominium apartment may not bring a claim for common-law fraud against the building's sponsor when the fraud is predicated solely on alleged material omissions from the offering plan amendments mandated by the Martin Act (General Business Law, art 23-A) and the Attorney General's implementing regulations (13 NYCRR part 20)." (Emphasis added). As the Court explained, "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."

In a Kerusa footnote, the Court left for another day the issue of "whether the alleged misrepresentation of an item of information that the Martin Act or the Attorney General's implementing regulations require to be disclosed would support a cause of action for fraud, so long as the elements of common-law fraud are pleaded." That issue seemingly has now finally been settled by the Court by its holding in Assured Guaranty that the "[m]ere overlap between the common law and the Martin Act is not enough to extinguish common-law remedies."

Adam Leitman Bailey *is the founding partner and* ***John M. Desiderio*** *is a partner of Adam Leitman Bailey.*

Endnotes:

1. —NY3d—, 2011 WL 6338898 (N.Y.).
2. 70 NY2d 268, 275 (1987).
3. General Business Law, Article 23-A.
4. 80 AD3d 293 (1st Dept. 2010).
5. 12 NY3d 236 (2009).
6. 78 NY2d 1114 (1991).
7. See, e.g., Hamlet on Olde Oyster Bay Home Owners Association Inc. v. Holiday Organization Inc., 65 ad3D 1284 (2d Dept. 2009); Keh Hsin Shen v. Astoria Federal Savings & Loan Assn., 295 AD2d 319 (2d Dept. 2002);Thompson v. Parkchester Apartments Co., 271 AD2d 311 (1st Dept. 2000) (Thompson II); Thompson v. Parkchester Apartments Co., 249 AD2d 68 (1st Dept. 1998), leave dismissed, 92 NY2d 946 (1998) (Thompson I); 167 Housing Corp. v. 167 Partnership, 252 AD2d 397 (1st Dept. 1998); contra Caboara v. Babylon Cove Development LLC, 82 AD3d 1141 (2d Dept.

2011); Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management Inc., 80 AD3d 293 (1st Dept. 2010); Board of Managers of Marke Gardens Condominium v. 240/242 Franklin Avenue LLC, 71 AD3d 935 (2d Dept. 2010); Caboara v. Babylon Cove Development LLC, 54 AD3d 79 (2d Dept. 2008); Scalp & Blade v. Advest Inc., 281 AD2d 882 (4th Dept. 2001); Bridge Street Homeowners Association v. Brick Condominium Developers, LLC, 18 Misc.3d 1128(A), 856 NYS2d 496 (2008).

8. 213 AD2d 200 (1st Dept. 1995), leave denied, 86 NY2d 704 (1995).

9. See Thompson I and Thompson II, supra, n.7.

10. The "unique circumstances" pleading requirement established by the court in Thompson I and Thompson II was actually derived from an earlier decision, 15 East 11th Apartment Corp. v. Elghanayan, 220 AD2d 295 (1st Dept. 1995), in which the plaintiffs had alleged fraud based solely on the sponsor's failure to make certain disclosures in the offering plan, but not upon any affirmative misrepresentations in the plan itself. In Elghanayan, the court affirmed summary judgment dismissing the plaintiffs' complaint while noting that the complaint alleged fraud in connection with defendants' failure to disclose certain dangerous structural conditions from the purchasers. In this context, the court said there was "nothing unique about the pleading of a common law remedy in Action No. 1 that is not already available to the Attorney-General under the statute. It would thus appear that plaintiff in Action No. 1, rather than pleading common law fraud, is in reality alleging nothing more than a private cause of action which is prohibited under the Martin Act."

11. 44 AD3d 457 (1st Dept. 2007).

12. The Kramer court also noted that the "artful pleading" reasoning in Whitehall Tenants Corp. makes good sense when one considers that "[t]o prevail on a claim of fraudulent practices under the Martin Act, the Attorney General need not allege or prove either scienter or intentional fraud. [citing State of New York v. Rachmani, 71 NY2d 718 (1988)]. Accordingly, to prevent an end run around the rule prohibiting a private right of action under the Martin Act, a private plaintiff cannot be permitted to bring a cause of action that, although styled as one for common-law fraud, lacks proof of an essential element of common-law fraud."

13. See also Anwar v. Fairfield Greenwich Ltd., 728 F.Supp.2d 354 (SDNY 2010) for a decision in which Judge Victor Marrero reached similar conclusions concerning the Martin Act based on his scholarly and comprehensive review of the see-saw State and federal case law between 1987 and 2010.

14. See 10 Misc.3d 1056A, 809 NYS2d 482 (2005).