"Reimposing a Scienter Requirement in the Martin Act"

By Katya Jestin and Matthew Cipolla

New York Attorney General Eric Schneiderman's recent lawsuits against J.P. Morgan Securities LLC and Credit Suisse Securities (USA) LLC have refocused attention on the much feared Martin Act.[1] The Martin Act, New York's Blue Sky law, permits the attorney general to bring civil and criminal suits alleging "fraud" and "fraudulent practices," in connection with the offer, sale, or purchase of securities.[2] Over the years, the Martin Act has proved a powerful tool in addressing financial fraud, prodding federal agencies to begin their own investigations and resulting in enormous settlements from Wall Street, including those involving analyst conflicts of interest in 2002 for $1.4 billion,[3] and AIG for fraud, bidrigging and improper accounting in 2006 for $1.6 billion.[4] This past fall, Schneiderman took aim at JPMorgan and Credit Suisse for alleged fraud related to mortgage-backed securities packaged by its former Bear Stearns subsidiaries, with the promise that these lawsuits are a "template" for future cases against other mortgage-backed securities sponsors and underwriters.[5]

Much of the media attention and the agita in general counsels' offices has focused on the fact that, unlike federal securities laws or common law fraud actions, the Martin Act relieves the attorney general's office of the burden of proving reliance, damages, and importantly, scienter,[6] and it carries a relatively long statute of limitations of six years.[7] Yet in fact, as JPMorgan argues in its recently filed motion to dismiss,[8] a quirk of New York's Civil Practice Law and Rules (CPLR) arguably reimposes the requirements of scienter, reliance and damages in order to extend the statute of limitations beyond three years.

Proof Of Intent Not Required

To New York State prosecutors, the great benefit of the Martin Act is that it frees them from having to prove three of the five elements of common law fraud and federal securities fraud under Section10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. A federal prosecutor and private plaintiffs suing under New York common law would need to prove "(1) misrepresentation of a material fact; (2) the falsity of that misrepresentation; (3) scienter, or intent to defraud; (4) reasonable reliance on that representation; and (5) damages caused by such reliance." *The Pits, Ltd. v. Am. Express Bank Int'l.*, 911 F. Supp. 710, 719 (S.D.N.Y. 1996) (holding that in New York, "the elements of common law fraud are…essentially the same as those which must be alleged in order to establish a claim under Section 10(b) and Rule 10b-5").

By contrast, a suit by the attorney general pursuant to the Martin Act need not allege reliance, damages or scienter. *People v. Royal Sec. Corp.,* 5 Misc.2d 907, 909 (Sup. Ct. N.Y. Cnty 1955) (holding that "[a]lthough the complaint sounds in fraud, many of the requirements of an ordinary legal action for fraud need not be established by a plaintiff in an action brought pursuant to the provisions of the Martin Act"); see also *People v. Federated Radio Corp.*, 244 N.Y. 33, 41 (N.Y. 1926) (holding that scienter is not necessary under the Martin Act) and *State of New York v. Sonifer Realty Corp.*, 212

A.D.2d 366, 367 (1st Dept. 1995) (holding that "fraudulent practices targeted by the [Martin Act] need not constitute fraud in the classic common law sense, and reliance need not be shown").

As the Court of Appeals held, the Martin Act's remedial purpose means it should be interpreted broadly such that it applies to "all deceitful practices contrary to the plain rules of common honesty." *Federated Radio*, 244 N.Y. at 38. The Court of Appeals defined "[t]he words 'fraud' and 'fraudulent practice'…so as to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law." Id. at 38-39.

Thus, all that remains for a Martin Act violation is a misrepresentation of a material fact, and the falsity of that representation. Importantly, due to the remedial nature of the Martin Act, New York courts have imposed Martin Act liability for either a misrepresentation or an omission of a material fact. See, e.g., *People ex rel. Vacco v. World Interactive Gaming Corp.*, 185 Misc.2d 852, 864 (Sup. Ct. N.Y. Cnty 1999) (finding a Martin Act violation for an omission of a fact because "[it] is well settled that fraud exists not only where there has been an affirmative misstatement of a material fact, but also where there has been an omission of a material fact"). Given these comparatively lax requirements, it is no surprise the Martin Act has been called "the broadest and most easily triggered investigative and prosecutorial power[ ] of any securities regulator, state or federal." *State v. 7040 Colonial Road Associates Co.*, 176 Misc.2d 367, 372 n.1 (Sup. Ct. N.Y. Cnty 1998) (quoting Kaufmann, Introduction and Commentary Overview McKinney's Cons. Laws of New York, Book 19, General Business Law, Article 23–A at 9).

…Or Is It?

Properly considered, the statute of limitations has the potential to interfere with an otherwise straightforward claim by the attorney general. The Martin Act does not contain its own statute of limitations. Accordingly, a court must look to the CPLR to supply one. See *State v. Bronxville Glen I Associates*, 181 A.D.2d 516, 516 (1st Dept. 1992). The three options in the CPLR are:

• Six years from the commission of the fraud or two years from the date of discovery, whichever is later, based on CPLR §213(8), which applies to common law fraud claims;
• Six years based on CPLR §213(1), which is the residual statute of limitations for claims otherwise without one; or
• Three years based on CPLR §214(2), which applies to claims for a liability imposed by statute.

See *Loengard v. Santa Fe Industries*, 573 F.Supp. 1355, 1357 (S.D.N.Y. 1983) (discussing the three options).

Which Is A Court To Choose?

The "weight of authority" in New York is that the Martin Act borrows the statute of limitations for common law fraud actions, i.e., CPLR §213(8). *State v. 7040 Colonial Road Associates Co.*, 176 Misc.2d 367, 372 n.1 (Sup. Ct. N.Y. Cnty 1998). Thus, the statute of limitations is six years from the commission of the fraud or two years from the date of discovery, whichever is later. Id. (citing CPLR §213(8)). See also *State v. Bronxville Glen I Associates*, 181 A.D.2d 516, 516 (1st Dept. 1992) (citing CPLR §213(8)). This is the statute of limitations frequently reported by the media.

Yet, as JPMorgan argues, a more careful analysis reveals that the proper statute of limitations for a "true" Martin Act claim, i.e., one devoid of allegations of reliance, damages, and scienter would be three years pursuant to CPLR §214(2). Here's why: In attempting to select which statute of limitations applies, New York courts "look to the essence" of the complaint. See *State v. Cortelle Corp.*, 38 N.Y.2d 83, 86 (N.Y. 1975) (addressing the same issue in the context of Executive Law §63(12)). In *Cortelle*, the Court of Appeals determined that the shorter three-year limitations period under CPLR §214(2) for a claim arising from statutory law applies only if the liability did not exist at common law or otherwise would not exist but for the statute. Id. Further, where a statute merely provides a new remedy for a preexisting liability, the three-year limitations period does not apply. See *Loengard v. Santa Fe Industries*, 573 F.Supp. 1355, 1358 (S.D.N.Y. 1983) (citing *Cortelle*, 38 N.Y.2d at 86).
