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FRAUD

How the New York Court of Appeals' Limitation on Martin Act Liability Affects Fund Managers

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The Martin Act, N.Y. General Business Law Article 23-A, §§ 352 et seq. (Act), is New York's broad "blue sky law." It has been used extensively by the New York Attorney General (NY AG) to investigate and combat securities fraud occurring in New York. Although the Act may only be enforced by the NY AG – as there is no private right of action under the Act – it authorizes both criminal and civil charges and, importantly, does not require proof of scienter or reliance to successfully bring a claim. As a result, the Act has been a favored tool of past Attorneys General in targeting members of the financial services community.

Although not affecting the substance of the Act, a recent decision by the New York Court of Appeals (Court) in *Schneiderman v. Credit Suisse Securities (USA) LLC*[1] imposed an important new limitation on how the Act can be wielded by the NY AG by holding that New York's three-year statute of limitations applies to civil enforcement actions brought under the Act, rather than the six-year statute of limitations applicable to common law fraud that the NY AG had argued was applicable. This article provides background on the Act, its notable uses and the likely consequences that the *Credit Suisse* ruling will have on the financial services community.

Martin Act

The Martin Act was enacted in 1921 with the intention of preventing fraud in the sale of securities and commodities in New York State.[2] Since its inception, the Act has gradually expanded.[3] Broadly speaking, the statute applies to "[t]he offer, sale or purchase of securities and commodities within or from New York" and "[r]eal estate offerings involving condominiums and cooperative apartments within or from New York."[4] Indeed, the Act vests the NY AG with the authority to commence "[i]nvestigations (either confidential or public) into fraudulent practices," as well as bring "[c]ivil proceedings for injunctive relief or restitution" and criminal prosecutions for violations of the Act's broad anti-fraud mandate.[5]

Among the broad investigative powers that the Act confers on the NY AG, it authorizes the NY AG's Office to:

- "require sworn written statements concerning the subject matter of an investigation and other data deemed relevant";
- issue subpoenas statewide to "compel attendance of witnesses and examine them under oath in connection with an investigation" or "require production of documents deemed relevant or material to an investigation";
- "seek a court order to compel the appearance of witnesses to answer questions or produce documents in connection with an investigation"; and
- grant immunity to witnesses.[6]

Successive NY AGs have reinvigorated the Act over the past two decades and used its broad powers in a wide array of civil and criminal cases affecting the financial community in general and investment managers in particular.[7] To name but a few of the more famous examples:

- In 2003, Attorney General Eliot Spitzer obtained $1.4 billion in settlements from various investment banks, alleging that they violated the Act by purportedly misleading investors with biased research from research analysts employed by those investment banks.[8]
- Between 2003 and 2005, Spitzer brought numerous civil and several criminal cases against mutual fund complexes, broker-dealers and private fund managers alleging violations of the Act through various short-term investment strategies involving mutual fund investments, referred to as "market timing" and "late trading." Those cases resulted in settlements totaling over $3 billion (including amounts paid in connection with settlements of parallel SEC enforcement actions).[9] See "Statute of Limitations Bars Market Timing and Late Trading Claims Against Hedge Fund" (Nov. 12, 2008).
- In 2005, Spitzer targeted American International Group, alleging that the company and its former CEO Maurice Greenberg had "used accounting tricks to mislead regulators and investors."[10]

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- Andrew Cuomo picked up where Spitzer left off when Cuomo became NY AG. In 2009, Attorney General Cuomo targeted Charles Schwab, alleging that it had engaged in fraudulent sales of auction rate securities.[11] The following year, his office alleged that Ernst & Young had purportedly facilitated a "major accounting fraud" at Lehman Brothers.[12] During his tenure as NY AG, Cuomo also targeted hedge fund managers.[13]
- Eric Schneiderman, who succeeded Cuomo as NY AG, used the Act to target what his office termed "Insider Trading 2.0," which he claimed involved high-frequency trading and purported early access to market information.[14] In addition, central to the case that gave rise to the recent Court's decision in *Credit Suisse* regarding the proper statute of limitations to apply to Martin Act civil enforcement actions, in 2012 then-Attorney General Schneiderman targeted Credit Suisse in an action related to residential mortgage-backed securities (RMBS).[15]

For more on the Act, see "Newly Appointed Chief of New York's Investor Protection Bureau Describes Its Enforcement of the Martin Act and How Managers Can Avoid Prosecution" (Oct. 20, 2016); and "New York Court of Appeals Holds That the Martin Act, New York's 'Blue Sky' Law, Does Not Preempt Common Law Claims for Breach of Fiduciary Duty and Gross Negligence" (Jan. 12, 2012).

The Court's Decision in Schneiderman v. Credit Suisse Securities (USA) LLC

In this case, Schneiderman had brought a Martin Act claim against Credit Suisse alleging that defendants had committed multiple purportedly fraudulent and deceptive acts in connection with the creation and sale of RMBS.[16] Specifically, the complaint alleged that defendants "misrepresented the quality of the mortgage loans underlying the securities as well as the due diligence process."[17]

The defendant moved to dismiss the complaint, arguing that the three-year statute of limitations period contained in New York's Civil Practice Law and Rules (CPLR) 214(2) barred the Attorney General's claim.[18] Schneiderman responded by asserting that Martin Act claims are governed by the six-year limitations period of CPLR 213(1) applicable to fraud claims in New York.[19]

The Court rejected the then-Attorney General's argument, concluding that a Martin Act claim is not the same as a common law fraud claim and that the Act – because of its broad applicability and the significant differences between the Act and common law fraud – gives rise to liability that "would not exist but for a statute."[20] In concluding that CPLR 214(2)'s three-year statute of limitations – not the longer six-year statute of limitations for common law fraud – applied to Martin Act claims, the Court reasoned that the broad statutory scheme of the Act had gradually evolved to cover "fraudulent practices not prohibited elsewhere in statutory or common law."[21]

By way of example, the Court explained that the Act:

- "incorporates concepts found in federal Blue Sky statutes";
- contains a definition of fraudulent practices which has repeatedly evolved and that imposes registration requirements on dealers and brokers;
- includes registration and disclosure requirements relating to real estate sales;
- "'dramatically altered the common-law rule' of caveat emptor";
- contains a federal objective test relating to material omissions; and
- does not require the attorney general to prove scienter or reliance.[22]

Moreover, the Court acknowledged that the Act does not create a private right of action, nor does it preempt common law causes of action, "except where predicated on violations of the Act itself or its implementing regulations."[23]

Accordingly, because the Court found that these obligations would not exist but for the statute itself, it concluded that the three-year statute of limitations period of CPLR 214(2) was applicable and rejected the longer limitations period sought by the Attorney General.[24] The majority opinion, written by Chief Judge DiFiore, was joined by Judges Stein, Fahey and Feinman.[25] Judges Garcia and Wilson took no part in the opinion.

In a lengthy dissent, Judge Rivera criticized the Court's ruling, contending that the majority "misread the Court's precedent and conflate[d] the elements a private party must establish to be granted a remedy with the Attorney General's authority to seek a wide range of relief on behalf of the State for an 'old and common type of fraud'" in arguing for application of the longer six-year statute of limitations which applies to common law fraud claims in New York.[26]

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Practical Implications of the Decision and the Shorter Limitations Period

Although the Court's decision deals only with how quickly the NY AG must bring a civil enforcement action under the Act – and leaves intact the Act's broad prohibitions, as well as the NY AG's sweeping investigative powers – by imposing a shorter limitations period than the Attorney General had argued for, the decision has important potential implications for the financial services industry.

Impact on Tolling Agreements

Particularly for complex alleged frauds involving securities and commodities, it often takes considerable time for the NY AG to learn about the conduct that it seeks to investigate and then even more time to conduct a careful investigation. Often, there will be hundreds of thousands – if not millions – of pages of documents for the NY AG to review, as well as numerous witnesses to interview or from whom to take testimony.

One consequence of the decision is that, because of the shorter limitations period, there may be conduct which the NY AG might have challenged in an enforcement action that it will no longer be able to pursue. To ameliorate this concern, the NY AG may start asking for tolling agreements – *i.e.*, agreements to suspend or extend the running of the statute of limitations – as a matter of course and far earlier in investigations than has been the practice to date. In instances where the statute of limitations is close to expiring, a refusal by a target or subject of an investigation to enter into a tolling agreement may result in the NY AG limiting certain advocacy tools that may otherwise be available – including the opportunity to submit "white papers" and to hold meetings with more senior personnel from the NY AG's office – for fear that the time required to engage in these efforts will "run out the clock," thereby preventing the NY AG from pursuing an enforcement action against the target or subject.

Although there may be instances where it is appropriate to refuse to enter into a tolling agreement, an investment adviser faced with this request often would be well-advised to enter into a tolling agreement with a regulator. Doing so both enables the fund manager to seek "credit for cooperation," but also may be beneficial by removing artificial deadlines from the process. That time could then be spent seeking to persuade the NY AG not to bring charges, or to bring charges that are less serious than might otherwise be asserted; engage in settlement negotiations and otherwise seek to affect whether a claim will be brought, what sort of claim might be brought and, even more importantly, what sort of allegations might be avoided; and position the matter in the most positive light in the event some sort of enforcement action is unavoidable.

Increased Risk of Criminal Liability

Another possible effect of the decision is that it might result in the NY AG turning to the statute's criminal liability provisions more readily than it might do otherwise. The decision left an important question unanswered: namely, whether the three-year statute of limitations also applies to criminal prosecutions under the Act or only to civil enforcement actions.[27] An unintended consequence of the decision, therefore, is that it may result in the NY AG bringing more criminal prosecutions for securities and commodities fraud touching New York in instances where the statute of limitations for civil enforcement actions has already expired.

It should be noted, however, that the NY AG is subject to a higher standard of proof for criminal prosecutions and will also need to persuade the court that the statute of limitations for criminal violations of the Act is longer than the three-year limitations period for civil enforcement actions decreed by the Court in this case. While this possible consequence may apply to a very small number of cases – and may ultimately be foreclosed if the courts conclude that the same three-year limitations period applies to criminal prosecutions under the Act as well as civil enforcement actions – the risk cannot be discounted entirely.

Increased Risk of Private Rights of Action

The Court's holding in *Credit Suisse* may also shift enforcement responsibility from the NY AG to private plaintiffs bringing common law fraud claims because they would enjoy a longer statute of limitations than the NY AG acting under the Act. Indeed, this was one of the dissent's criticisms of the majority opinion.[28] Although no hedge fund manager relishes the thought of having the firm accused of fraud – even in a civil suit by an investor – purely civil claims of this sort likely will have lower reputational concerns for a fund manager than an enforcement action alleging fraud by a governmental agency.

In addition, fund managers can influence the jurisdiction in which these types of claims would be adjudicated by including mandatory mediation or arbitration clauses in the funds' subscription documents, as well as confidentiality provisions. Doing so would position these types of claims for private adjudication rather than allowing allegations of wrongdoing

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to be filed on the public record, where they might generate adverse publicity.

Even in the absence of mandatory arbitration provisions, mandatory venue provisions in subscription documents can ensure that litigation is brought only in certain jurisdictions; choice-of-law clauses can ensure that claims are decided pursuant to the law of a jurisdiction that is favorable to the investment adviser; and jury waiver provisions can ensure that a judge, rather than a jury, will hear any resulting trial. Finally, private fund managers may find any shift from enforcement by the NY AG to claims by private investors to be more easily susceptible to pre-complaint settlement discussions and resolutions without the attendant publicity of a publicly filed fraud complaint by a governmental entity.

Although it is difficult to predict precisely how this decision will affect the NY AG's Office when it comes to rooting out what it perceives to be unfairness in the financial services industry, one thing that seems certain is that it will have some impact.

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[1] 2018 WL 2899299 (N.Y. June 12, 2018).

[2] *See* Harold K. Gordon, "Enforcement Proceedings Under New York's Martin Act," Practical Law Practice Note 4-582-1925 (citing N.Y. Gen. Bus. Law §§ 352, 352-c and 352-e to 352-eeee).

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *See* "Wall Street Has Unlikely New Cop in New York State's Eliot Spitzer" (Apr. 25, 2002), available at https://www.wsj.com/articles/SB101968249615728680.

[8] *See* "The Martin Act" (Nov. 10, 2015), available at https://www.bloomberg.com/quicktake/martin-act.

[9] *See* , *e.g.*, "Fund Scandal Ripples, Even a Decade Later" (Sep. 7, 2014), available at https://www.wsj.com/articles/mutual-fund-scandal-ripples-even-a-decade-later-1410120105; and "Federated Settles with SEC, Spitzer" (Nov. 29, 2005), available at http://www.washingtonpost.com/wp-dyn/content/article/2005/11/28/AR2005112801598.html.

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[10] *See* note 8, *supra.*

[11] *See* "Schwab settles NY lawsuit over auction-rate debt" (Feb. 17, 2015), available at https://www.reuters.com/article/lawsuit-charles-schwab/schwab-settles-ny-lawsuit-over-auction-rate-debt-idUSL1N0VR1QR20150217.

[12] *See* note 8, *supra.*

[13] *See, e.g.,* "Hedge Fund Executive Guilty of Securities Fraud" (Apr. 15, 2009), available at https://www.nytimes.com/2009/04/15/business/15indict.html.

[14] *See* "NY AG Sees 'Insider Trading 2.0' As Growing Fraud Threat" (Sep. 24, 2013), available at https://www.law360.com/articles/475159/ny-ag-sees-insider-trading-2-0-as-growing-fraud-threat.

[15] *See* note 8, *supra.*

[16] *See* note 1, *supra,* at *1.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id*. at *2-5.

[21] *Id.* at *2-3.

[22] *Id.* (internal citations omitted).

[23] *Id.* at *3.

[24] *Id.*

[25] *Id.* at *14 (Separately, Judge Feinman wrote a concurring opinion to expand on the majority's analysis of Executive Law § 63(12), which was relevant to a cause of action separate from the Attorney General's Martin Act claim and which the Court remanded for further proceedings.).

[26] *Id.* at *9 (quoting *State of New York v. Cortelle Corp.*, 38 N.Y.2d 83, 378 N.Y.S.2d 654, 341 N.E.2d 223 [1975]).

[27] *See id.* at *14, note 3 ("We did not decide whether CPLR 214(2) applies to criminal proceedings, or different types of civil claims, under the Martin Act.").

[28] *Id.* at *13.

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