



New York Court of Appeals Rejects Martin Act Preemption of Common Law Claims of Breach of Fiduciary Duty and Gross Negligence

December 21, 2011

I. INTRODUCTION

Yesterday in *Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management Inc.*, 2011 N.Y. Slip Op. 09162 (N.Y. Dec. 20, 2011), the New York Court of Appeals ruled that the Martin Act does not preempt common law claims of breach of fiduciary duty and gross negligence in the securities context. The Court also stated in dicta that common law fraud claims are not preempted.

II. BACKGROUND

In *Assured Guaranty*, plaintiff Assured Guaranty sued J.P. Morgan for breach of fiduciary duty, gross negligence, and breach of contract. Assured Guaranty alleged that the defendant invested the assets of Orkney Re II PLC (“Orkney”), an entity whose obligations Assured Guaranty guaranteed, in high-risk securities, failed to diversify Orkney’s portfolio, and improperly made investment decisions in favor of Scottish Re Group Ltd, Orkney’s largest equity holder and a client of the defendant, rather than for the benefit of Orkney or the plaintiff. Assured Guaranty alleged that, because of the purported investment mismanagement, Orkney suffered substantial financial losses that triggered Assured Guaranty’s obligations as guarantor.

The defendant moved to dismiss the complaint, arguing that New York’s Martin Act preempted Assured Guaranty’s claims of breach of fiduciary duty and gross negligence. The Martin Act “authorizes the [New York] Attorney General to investigate and enjoin fraudulent practices in the marketing of stocks, bonds and other securities within or from New York.” *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. Partnership*, 12 N.Y.3d 236, 243 (2009). (The Martin Act is codified as N.Y. Gen. Bus. Law Art. 23-A §§ 352-359.)

The trial court granted the motion to dismiss, holding that the breach of fiduciary duty and gross negligence claims fell “within the purview of the Martin Act and their prosecution by plaintiff would be inconsistent with the Attorney General’s exclusive enforcement powers under the Act.” *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, No. 603755/08, 2010 WL 2977934, at *8 (N.Y. Sup. Ct. Jan. 28, 2010). The Appellate Division, First Department disagreed and reinstated Assured Guaranty’s breach of fiduciary duty and gross negligence claims. The Appellate Division found “nothing in the plain language of the Martin Act, its legislative history or appellate level decisions in [New York] that supports defendant’s argument that the Act preempts otherwise validly pleaded common-law causes of action.” *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 80 A.D.3d 293, 304 (N.Y. App. Div. 1st Dept. 2010). The Appellate Division granted the defendant leave to appeal to the Court of Appeals to determine whether the Martin Act preempted Assured Guaranty’s common law breach of fiduciary duty and gross negligence claims.

The disagreement between the New York trial court and the Appellate Division paralleled the division of authority at the time as to whether the Martin Act preempts non-fraud common law claims in the

securities context. For example, in *Caboara v. Babylon Cove Development, LLC*, 54 A.D.3d 79, 82-83 (N.Y. App. Div. 2d Dept. 2008), the Appellate Division, Second Department held that no precedent from the Court of Appeals “abrogated or supplanted an otherwise viable private cause of action whenever the allegations would support a Martin Act violation” and that preemption would be contrary to basic tenets of statutory construction. Conversely, in *In re Herald, Primeo, and Thema Securities Litigation*, No. 09 Civ. 289, 2011 WL 5928952 (S.D.N.Y. Nov. 29, 2011), the district court noted that “[m]ost New York courts have . . . held that the Martin Act precludes a private right of action for common law claims the subject matter of which is covered by the Martin Act. The federal courts have, almost without exception, adopted the same position, and have, therefore, dismissed as preempted New York State law claims arising in the securities context for breach (and abetting breach) of fiduciary duty, conversion, negligence, gross negligence, and unjust enrichment.” *Id.* at *9 (quoting *Stephenson v. Citco Group Ltd.*, 700 F. Supp. 2d 599, 613-16 (S.D.N.Y. 2010) (internal quotations omitted)).

III. SUMMARY OF DECISION

In its opinion, written by Judge Victoria A. Graffeo, the Court of Appeals unanimously held that the “plaintiff’s breach of fiduciary duty and gross negligence claims are not barred by the Martin Act.” *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 2011 N.Y. Slip Op. 09162, at 11 (N.Y. Dec. 20, 2011).

The Court of Appeals first found that neither the history nor the text of the Martin Act evinced an unambiguous legislative intention to bar such claims. The plain language of the Martin Act “does not expressly mention or otherwise contemplate the elimination of common-law claims” and its legislative history “does not evince any intent to displace all common-law claims in the securities field.” *Id.* at 6-7.

Next, the Court of Appeals considered its prior decisions in *CPC International v. McKesson Corp.*, 70 N.Y.2d 268 (1987) and *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. Partnership*, 12 N.Y.3d 236 (2009). In *CPC International*, the Court of Appeals had concluded that the Martin Act did not explicitly authorize a private cause of action or create an implied private cause of action. The court did not explicitly address, however, whether the Martin Act preempted otherwise viable and independent common law claims. In *Kerusa*, the Court of Appeals held that a private litigant could not plead a common law fraud claim that was based entirely on a violation of obligations imposed by the Martin Act and/or regulations promulgated there-under. The court stated that recognizing such a claim “would invite a backdoor private cause of action to enforce the Martin Act in contradiction to [the] holding in *CPC Intl.*” In yesterday’s *Assured Guaranty* decision, the Court of Appeals stated that “[r]ead together, *CPC Intl.* and *Kerusa* stand for the proposition 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 Act or its implementing regulations and would not exist but for the statute.” *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 2011 N.Y. Slip Op. 09162, at 10 (N.Y. Dec. 20, 2011).

Finally, the Court of Appeals determined that policy considerations weighed against Martin Act preemption. The Court of Appeals stated that “the purpose of the Martin Act is not impaired by private common-law actions that have a legal basis independent of the statute because the proceedings by the Attorney General and private actions further the same goal – combating fraud and deception in securities transactions.” *Id.*

IV. IMPLICATIONS

In its decision, the New York Court of Appeals resolved the issue of whether the New York Martin Act preempts claims of breach of fiduciary duty and gross negligence in the securities context. The Court of Appeals also noted 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. Mere overlap between the common law and the Martin Act is not enough to extinguish common-law remedies.” Additionally, *Assured Guaranty* did not disturb the general rule that when plaintiffs seek to proceed as a class of fifty or more, state law securities fraud claims are precluded by the Securities Litigation Uniform Standards Act. *Id.*

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