ALERT MEMORANDUM

New York Court of Appeals Holds Securities Fraud Claims Under the Martin Act Must Be Brought Within Three Years

June 18, 2018

On June 12, 2018, in *People v. Credit Suisse Sec. (USA) LLC*[1] the New York Court of Appeals dismissed the Attorney General's Martin Act claim against Credit Suisse Securities (USA) LLC and affiliated entities ("Credit Suisse") on the grounds that this claim was barred by a three year statute of limitations. The Court of Appeals thus overruled various lower court decisions that had previously applied a six year statute of limitations to Martin Act claims, halving the time prosecutors have to commence actions under New York's expansive blue sky statute.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or any of our partners and counsel listed under Banking and Financial Institutions, Litigation and Arbitration and White-Collar Defense and Investigations in the "Our Practice" section of our website.

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Background

The Martin Act

Originally passed nearly a hundred years ago, the Martin Act, New York's "blue sky" statute, "authorizes the Attorney General to investigate and enjoin fraudulent practices in the marketing of stocks, bonds and other securities within or from New York State" and grants the Attorney General "broad authority to investigate, to secure a permanent injunction against any person or entity that has engaged in fraudulent practices and to obtain restitution of money or property wrongfully obtained." Notably, and in contrast to common law fraud, the Attorney General need not allege scienter, intentional fraud or reliance in order to state a claim under the Martin Act.

While the Martin Act was primarily used to police Ponzi schemes and other smaller-scale frauds for decades, New York prosecutors, starting with Eliot Spitzer, have transformed it into a powerful tool of broad application, leveraging it to collect billions from financial institutions. In recent years, the Attorney General has even used the Martin Act to address climate change, focusing on the disclosures of fossil-fuel producers Peabody Energy and Exxon Mobil.

[1] __ N.E.3d __, 2018 WL 2899299 (N.Y. June 12, 2018).

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Factual Background and Procedural History

In November 2012, the Attorney General filed a complaint against Credit Suisse alleging that the issuance of residential mortgage-backed securities by Credit Suisse in 2006 and 2007 violated the Martin Act. The complaint also asserted a claim under Executive Law § 63(12) based on the alleged violation of the Martin Act or other alleged persistent fraud or illegality in the carrying on, conducting or transaction of business.

Credit Suisse moved to dismiss the complaint based upon *res judicata*, failure to timely commence suit under the applicable statute of limitations and failure to state a cause of action. With respect to the statute of limitations, Credit Suisse argued that the complaint was time-barred because it was an action to recover on a liability created by statute and therefore governed by the three year limitations period set forth in CPLR § 214(2).

The trial court rejected this argument, holding that the relevant inquiry is whether "plaintiff's claims under Executive Law § 63(12) and the Martin Act allege conduct that would not be illegal or fraudulent but for the Martin Act or whether they allege fraud that was cognizable at common-law" and ruling that the six year statute of limitations set forth in CPLR § 213 applied to Martin Act claims because "allegations of fraud are the heart of the State's complaint."[2] The Appellate Division affirmed,[3] adhering to its previous holding in *State of New York v. Bronxville Glen I Assocs.* that, while the Martin Act may "expand the definition of fraud so as to create new liability in some instances," it did not create liability for investor fraud, and so Martin Act claims are subject to the six year limitations period set out in CPLR § 213(8).[4]

The Court of Appeals' Decision

The Court of Appeals reversed on the Martin Act claim.

The Court distinguished between claims that are provided for in statutes that merely codify existing common law and those that, "although akin to common-law causes, would not exist but for the statute," explaining that CPLR § 214(2) applies to the latter category. The Court concluded that "the Martin Act imposes numerous obligations—or 'liabilities'—that did not exist at common law, justifying the imposition of a three-year statute of limitations under CPLR 214(2)."

As to the statute of limitations applicable to the Executive Law § 63(12) claim, however, the Court held that it is necessary to examine whether the conduct underlying the Executive Law § 63(12) claim amounts to a type of fraud recognized in the common law in order to determine whether a three or six year statute of limitations would apply and remitted the question to Supreme Court.

In a concurring opinion, Judge Feinman provided further guidance to Supreme Court, arguing that a six year statute of limitations should apply to Executive Law claims based on actual fraud—which requires a showing that the defendant made a material misrepresentation with scienter and intent to induce reliance, justifiable reliance, and damages—or equitable fraud—which requires only a showing of a material misstatement and justifiable reliance—while the three year statute of limitations would apply to Executive Law § 63(12) claims that do not amount to either actual or equitable fraud. Thus, Judge Feinman highlighted for the trial court his view that the statute of limitations question would turn on whether certain of Credit Suisse's disclaimers render reliance on the alleged misstatements unjustifiable so as to defeat a claim for equitable fraud.

[2] *People v. Credit Suisse Sec. (USA) LLC*, 46 Misc. 3d 1211(A), 6-8 (N.Y. Sup. 2014).

[3] *People v. Credit Suisse Sec. (USA) LLC*, 145 A.D.3d 533 (N.Y. App. Div. 2016).

[4] 181 A.D.2d 516, 516 (N.Y. App. Div. 1992).

In an impassioned dissent, Judge Rivera called on the legislature to overrule the majority's holding.

Key Impacts

The Court of Appeal's ruling overrules the decision of various lower courts and effectively halves the statute of limitations for Martin Act claims. While the Attorney General's Office has stated that the "decision will have no impact on [its] efforts to vigorously pursue financial fraud wherever it exists in New York,"[5] there is reason to question whether it will impact the success of those efforts. Three years is a short time. Frequently, frauds do not come to light for years after they are committed. Moreover, even after they come to light, as the Attorney General itself noted in its briefing to the Court, "[i]nvestor fraud cases are often complex, requiring considerable time and effort to investigate."[6] Perhaps in recognition of the latter fact, the United States Congress established a five-year statute of limitations for penalty actions by the U.S. Securities Exchange Commission ("SEC"). Even then, the SEC can pursue non-penal actions beyond the five-year period.

The Court of Appeals' decision thus puts significant handcuffs on the Office of the Attorney General's ability to pursue fraud cases and disadvantages it relative to the SEC. CPLR § 214(2), unlike CPLR § 213(8), does not extend the limitations period while an alleged fraud remains undiscovered. The Court's ruling may prevent the Attorney General from pursuing some cases at all and, in other cases, will force the Attorney General's Office to expedite investigations—if resources allow. While the shorter limitations period may encourage the Attorney General to seek agreements tolling the statute of limitations more frequently, subjects of investigations will now have more leverage to resist entering into such agreements.

Furthermore, while prosecutors are still broadly empowered to bring negligent securities fraud actions after three years under the Executive Law where the alleged fraud was repeated or persistent, they will now have to plead, at a minimum, the elements of equitable fraud, in order to do so. Otherwise, Executive Law § 63(12) claims that are exclusively based on underlying violations of the Martin Act must be brought within three years of the alleged fraud.

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[5] Jonathan Stempel, *New York top court narrows Martin Act in $11 billion Credit Suisse case*, REUTERS, June 12, 2018, https://www.reuters.com/article/us-credit-suisse-new-york/new-yorks-top-court-narrows-martin-act-in-11-billion-credit-suisse-case-idUSKBN1J81WK.

[6] Brief and Addendum for Respondent at 58, *People v. Credit Suisse Sec. (USA) LLC*, 46 Misc. 3d 1211(A) (N.Y. Sup. 2014) (No. APL-2017-00056).