



## Are Madoff victims out of luck?

### *Bringing private causes of action against feeder funds in light of the Martin Act*

In the aftermath of Bernard Madoff's bankruptcy and the liquidation of his firm, fund participants are seeking recourse against their former investment advisors or "feeder" funds, in the hopes of recovering some of their losses. The victims of Mr. Madoff and his firm may find the Martin Act impeding their recourse.

The Martin Act,<sup>1</sup> is New York's version of the Federal Blue Sky Laws. While Federal Blue Sky Laws prohibit various fraudulent and deceitful practices in the distribution, exchange, sale, and purchase of securities; the Martin Act does not require proof of intent to defraud or scienter. In all states except New York and Rhode Island, the legislature has expressly recognized a private cause of action for violations of each state's blue sky law; the Martin Act does not expressly authorize (nor does it prohibit) a private action.<sup>2</sup> Significantly, New York case law permits a private cause of action where it is shown that the plaintiff belongs to the class of legislatively intended beneficiaries and that a right of action would be clearly in furtherance of the legislative purpose.<sup>3</sup>

The Martin Act provides that the Attorney General shall regulate and enforce New York's securities laws. Accordingly, most New York courts have held that there is no private right of action for claims that are within the purview of the Act, and have dismissed such claims on the ground that permitting them to proceed would be equivalent to permitting a private claim under the Act. More specifically, courts have generally held that a claim that does not require proof of intent or scienter is preempted by the Martin Act.<sup>4</sup>

New York courts have dismissed claims such as negligent misrepresentation, breach of fiduciary duty, and constructive fraud on the ground that such claims fall under the Martin Act and, accordingly, there is no private right of action for these claims.<sup>5</sup> Contrarily, New York courts have upheld claims of fraud, breach of contract, breach of warranty, breach of the implied covenant of good faith and fair dealing, and unjust enrichment as constituting

permissible private rights of action, because these claims require a showing of intent or scienter.<sup>6</sup>

In one First Department case, *Horn v. 440 East 57th Co.*, 151 AD2d 112 [1st Dept. 1989], the court held that the parties had written into their private contract (through a clause warranting against any material omissions or misrepresentations in the Offering Statement) defendant's right to bring a private action under the Martin Act in the event the warranty proved false. Thus, the court upheld plaintiff's claim for breach of warranty arising out of defendant's material omissions and misrepresentations. This appears to be one way to get around the preemption of the Martin Act: bring a cause of action for negligent misrepresentation under the guise of breach of contract or breach of warranty.

In further support of artful pleading to avoid the Martin Act's implied preemption, the court in *Ansonia Tenants' Coalition, Inc. v. Ansonia Associates*, 151 Misc 2d 213 [NY Sup Ct, NY County 1991], aff'd 179 AD2d 594 [1st Dept. 1992], noted that "the denial of a private right of action under the Martin Act in no way precludes a plaintiff from ... alleging actionable wrongs inde-

pendent of any requirements of the Martin Act, wrongs such as any plaintiff may have raised prior to enactment of the Martin Act."

In 2003, in *Nanopierce Technologies, Inc. v. Southridge Capital Management LLC*, 2003 WL 22052894 [SDNY Sept. 2, 2003], the Southern District of New York discussed – but distinguished – two cases that did permit private causes of action brought under New York's blue sky law where such claims did not require a showing of intent. First, in *Scalp & Blade, Inc. v. Advest, Inc.*, 281 AD 882 [4th Dept. 2001], the Fourth Department rejected defendant's challenge to claims for breach of fiduciary duty and negligent misrepresentation, because "[n]othing in the Martin Act, or in the Court of Appeals cases construing it, precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney General a basis for proceeding civilly or criminally against a defendant under the Martin Act."

In the second case, *Cromer Finance Ltd. v.*



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*Berger*, 2001 WL 1112548 [SDNY Sept. 20, 2001], the Southern District of New York declined to dismiss a negligence claim based upon Martin Act preemption, because nothing “in the text of the Martin Act itself indicate[d] an intention to abrogate common law causes of action.” Moreover, the *Cromer Finance Ltd.* court noted that there was no “basis in the Martin Act’s provisions for a distinction between claims of fraud and claims for negligent misrepresentation,” and that case law finding otherwise “overestim[ed] the reach of the Martin Act.” Even the United States District Court for the Southern District of Texas, applying New York law, noted this disagreement among courts as to the scope of the Martin Act’s preemption, stating, “the New York Court of Appeals has not addressed, and there is a split of opinion among New York’s lower courts, whether the [Martin] Act pre-empts claims by plaintiffs made under common law.”<sup>7</sup>

Alarming, there are countless state and federal actions pending in New York Courts brought against investment firms and feeder funds, following the December 2008 discovery of Madoff’s Ponzi scheme. Many of the complaints in these cases assert claims that do not require a plaintiff to establish defendant’s intent or scienter (seemingly in violation of the implied preemption of the Martin Act). Based upon the vast number of actions commenced under the blue sky laws since December 2008, the Attorney General’s limited resources, and the uncertainty in New York case law concerning the scope of private rights of action under the Martin Act, courts will undoubtedly find themselves in the uncomfortable position of considering requests to overturn case law that currently precludes certain private causes of action in light of the Martin Act.

Indeed, the dissenting opinion of the New York Court of Appeals case of *CPC International Inc. v. McKesson Corp.*, 70 NY2d

at 276 (Simons and Hancock, JJ.), asserts that “the underlying purposes of section 352-c is not to grant various powers to the Attorney-General. ... [but] deterrence of fraudulent practices in the offering and sale of securities and the protection of investors damaged by such practices.” Thus, the dissenting Justices voted to reinstate the private causes of action alleging violations of the Martin Act and “would hold that an implied private cause of action furthers that broader statutory purpose.”

If there was ever a time when courts would be justified in granting more leeway to the right of private citizens to bring causes of action pertaining to violations of blue sky laws, this would be it.

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1. N.Y. Gen. Bus. Law §§ 352 et seq.,
2. *Castellano v. Young & Rubicam, Inc.*, 257 F3d 171, 190 [2d Cir 2001]; *CPC Intl. Inc. v. McKesson Corp.*, 70 NY2d 268, 275-276 [1987].
3. *CPC Intl. Inc.*, 70 NY2d at 276.
4. NY Gen Bus Law § 352; *Spirit Partners, L.P. v. Audiohighway.com*, 2000 WL 685022, \*6 [SDNY May 25, 2000].
5. See, e.g., *Nanopierce Technologies, Inc. v. Southridge Capital Management LLC*, 2003 WL 22052894, \*6 [SDNY Sept. 2, 2003]; *Spirit Partners, L.P.*, 2000 WL 685022, \*4-6; *Independent Order of Foresters v. Donaldson, Lufkin & Jenrette Inc.*, 919 F. Supp. 149, 153-154 [SDNY 1996]; *Rego Park Gardens Owners, Inc. v. Rego Park Gardens Assocs.*, 191 AD2d 621, 622 [2d Dept. 1993].
6. See, e.g., *Castellano*, 257 F3d at 190; *CPC Intl. Inc.*, 70 NY2d at 276.
7. *Enron Corp. Securities, Derivative & “ERISA” Litigation v. Enron Corp.*, 2003 WL 23305555, \*12 [SD Tex Dec. 11, 2003]; see *Nanopierce Technologies, Inc.*, 2003 WL 22052894, \*5 [noting that many courts have precluded private claims under the Martin Act in order to avoid actions that were inconsistent with the Attorney General’s exclusive enforcement powers; however, in cases where the Attorney General has, by operation of statute, no enforcement power, it is difficult to see how permitting a common law claim to go forward would interfere with the state legislature’s enforcement mechanism].