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WHITE-COLLAR CRIME

Expert Analysis

The Ever-Expanding Martin Act: Has It Reached Its Limit?

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Perhaps lost on all but the most astute observers of local criminal justice in recent years is the fact that the jurisdiction of the Attorney General of the State of New York in the enforcement of the criminal law is strictly circumscribed. The Attorney General has "no general prosecutorial authority and, except where specifically permitted by statute, has no power to prosecute criminal actions."[1] Indeed, the Attorney General's criminal law enforcement authority derives essentially from one statute—the Martin Act, New York's securities fraud statute.

According to common lore, the Martin Act was "rediscovered" by the current Attorney General's predecessor, who aggressively pressed its enforcement to the point of seemingly general acceptance of its broad applicability, primarily by defendants who were steamrollered to accept guilty pleas. This broad acceptance of its applicability tended to obscure the notion that, to paraphrase the United States Supreme Court in an analogous context, while the Martin Act had come to be aptly described as a catchall provision, what it catches must be fraud. The expanding bubble of enforcement success fueled a prosecutorial exuberance supported less by legal precedent than by guilty pleas and public relations. The bubble may be about to burst.

In a highly publicized case currently pending in the New York County Supreme Court before Justice L. Bart Stone, the prosecution appears to be resting its Martin Act prosecution on a theory—honest services fraud—which is currently under review by the Supreme Court in no fewer than three cases and the continued survival of which is open to very serious question. In *People v. Henry "Hank" Morris*, Indictment No. 25/2009, that theory is under attack by the defendant, who argues that it is unprecedented, has no foundation in New York law, and cannot sustain criminal charges under the Martin Act based on the mere non-disclosure of a conflict of interest and absent a deprivation of property rights.

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Ascendancy of the Martin Act

Enacted in 1921, the Martin Act initially was confined mostly to "improper securities offerings and boiler-room frauds involving individual defendants and low market capitalization stocks."[2] A 1978 report indicates that in the pre-Spitzer era, the act had been used only to go after "small-time fraud." Indeed, one of Mr. Spitzer's predecessors, Oliver Koppell, observed that during his term, no one on his staff proposed a Martin Act case to him, stating "I didn't know it had all these powers."[3] Recent history has demonstrated that Mr. Koppell's successors have taken a different view.

The Attorney General's powers under the Martin Act have been referred to as "inquisitorial" in nature.[4] The scope of activity covered by the Martin Act is broader than federal securities law. First, the state statute includes a misdemeanor provision which has been construed as a strict liability crime.[5] Second, a violation of the Martin Act need only concern or involve a security, where a federal violation involves the purchase or sale of a security. There are two felony provisions in the statute. The first prohibits anyone from engaging in any fraud, deception, concealment or false representation with respect to stocks, bonds and other securities with criminal intent.[6] A second felony provision prohibits a person form intentionally committing a scheme to defraud 10

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or more persons in relation to a securities transaction.[7]

The Attorney General has relied on the Martin Act to initiate numerous high-profile white collar investigations and cases in recent years. Many of these cases were resolved before criminal charges were brought, typically through the execution of an Assurance of Discontinuance (AOD) by the investigated party. Others have resulted in guilty pleas. Few have been tested in a court of law.

Indictment of Hank Morris

Hank Morris, a well-known political consultant, managed the successful campaigns of former New York City and New York State Comptroller Alan Hevesi for those offices, and he remained active as a paid political adviser to Hevesi thereafter. From 2003 to 2006, Hevesi served as State Comptroller and, in that capacity, was the sole trustee of the New York Common Retirement Fund (CRF), one of the largest public pension funds in the country.

The allegations of the indictment primarily concern activities of a division of CRF that managed a highly profitable investment program, placing money primarily with real estate funds, private equity funds, funds-of-funds, and hedge funds. During the period at issue in the indictment it was common industry practice for such firms to retain "finders" and "placement agents," who helped them obtain access to large institutional investors such as the CRF. Mr. Morris went into business as a finder and consultant to private equity and hedge funds seeking to manage money for the CRF. Mr. Morris was retained by a number of private funds and finders. He received fees from those firms— not from the CRF— contingent on the firms successfully obtaining CRF investments.

The indictment's fundamental theory rests on the allegation that Mr. Morris did not disclose to the CRF his participation in the charged transactions, including that he had various conflicting roles, such as acting as a political consultant to the comptroller and also as a finder or placement agent for various investment funds. The indictment alleges that Mr. Morris was not acting "solely in the best interests" of the CRF, but also "at least in part because" particular investments would benefit Mr. Morris and his associates. The prosecution claims that Mr. Morris "controlled," "influenced" and "corrupted" the process by which the CRF chose investments.

There appears to be no allegation that anyone was at risk of any economic loss as a result of these alleged conflicts of interest. Nor does the indictment allege that the CRF—or any other party— suffered any property loss or economic harm as a result of the alleged corruption. Based on these allegations, Mr. Morris was charged with multiple offenses arising from 23 separate investment transactions, including securities fraud in violation of various provisions of the Martin Act, falsification of business records, offering a false instrument for filing and money laundering.

The Martin Act Under Attack

In March of this year, Mr. Morris filed a motion to dismiss the indictment as part of an omnibus pretrial motion. With regard to the Martin Act allegations, Mr. Morris argued that the indictment lacked any allegation that the New York State pension fund was "cheated in any investment made," that Mr. Morris caused the fund to invest in any transaction that was not in its economic interest or to pay any more money for its investments as a result of Mr. Morris' personal connections, or that the fund did not get the value for which it bar-gained.[8] Rather, Mr. Morris asserted that the Attorney General was seeking to hold him criminally liable for what might be called, at most, mere breaches of fiduciary duty, stating:

> No New York court has ever found a violation of the Martin Act under such circumstances. And there is no support either in the statutory language or the legislative history for grounding a Martin Act prosecution solely on the deprivation of an intangible right to honest services. Put another way, an undisclosed conflict of interest or breach of duty without specter of injury to property rights does not violate the Martin Act.[9]

Mr. Morris contends that, in the absence of any alleged economic injury to the participants in the deals, the Attorney General has created a new Martin Act theory based on the fact that Mr. Morris allegedly profited from multiple roles with respect to the CRF and its staff, thus creating a conflict of interest that he was obligated to disclose. According to Mr. Morris, no New York court has ever found a violation of the Martin Act under such circumstances, and there is no support either in the statutory language or the legislative history for grounding a Martin Act prosecution solely on the deprivation of an intangible right to honest services.

> To the extent that the Martin Act sees its reflection in the federal honest services fraud statute, the impending fate of the latter at the hands of the Supreme Court may signal the demise of the Martin Act's all-purpose application.

Honest Services Fraud

Historically, federal prosecutors used a theory of "honest services" fraud under the federal mail fraud statute-not that the alleged fraud deprived the state interests in its property, but that it deprived the state of the "intangible right" to the honest services of its employees. The U.S. Supreme Court invalidated so called "honest services" fraud under the federal mail fraud statute in *McNally v. United States*, 483 U.S. 350 (1987), on facts not unlike those in the Morris case. In McNally, the Supreme Court

held that an honest services theory was inconsistent with the purpose of the mail fraud statute, and with the basic concept of fraud as an offense affecting the property rights of another.

For reasons that are arguably applicable in interpreting the Martin Act, the Court held that a prosecution based solely on an undisclosed conflict of interest exceeded the scope of a fraud statute intended to protect members of the public in their property. The Court refused to conclude that the statute was intended to apply to a mere deprivation of "honest services." According to Mr. Morris, a fair reading of the Martin Act's criminal fraud provisions and their legislative history leads to the same conclusion and demands the dismissal of the Martin Act counts.

Revived by congressional enactment after the *McNally* decision, the honest services theory is the subject of three cases currently pending before the U.S. Supreme Court in which the defendants contend, consistent with the analysis in *McNally*, that a law prohibiting "the deprivation of the intangible right to honest services" is unconstitutionally vague.[10] Although the outcome of these cases is impossible to predict, commentators have suggested that the government's arguments in support of the "honest services" theory met with substantial resistance by the Court.

Mr. Morris contends effectively that the argument against an "honest services" theory is even stronger in the case of the Martin Act than in *McNally*. He asserts that both decisional law and legislative history establish that the Martin Act, and General Business Law §352-c in particular, were enacted to protect interests in property, not to protect intangible rights in the integrity of governmental administration. He characterizes the case as a pure "honest services" prosecution, based on nothing more than the failure to disclose alleged conflicts of interest, as the indictment contains no allegation of any tangible harm to the CRF as a result of the non-disclosures: "Where, as here, the harm alleged is to the intangible rights in the "process" and not tangible rights in the property, it is the quintessential 'honest services' case. It is not fraud."[11]

Unconstitutional as Applied

Mr. Morris argues that, unless Martin Act fraud remains tethered to the concept of economic harm, the statute would be void for vagueness, and unconstitutional as applied here because it fails the notice test, which requires that the ordinary person could have reason to understand that a consumer protection law directed against fraud in the sale and purchase of securities applies also to intangible wrongs against the integrity of governmental administration, as well as the discriminatory enforcement test.

Notably, the prosecution theory appears to be that, by failing to disclose material facts, Mr. Morris breached what the indictment describes as a "de facto fiduciary duty" that he owed to the CRF, with which he had no contractual relationship.[12] Mr. Morris argues that the prosecution's reliance on a de facto fiduciary duty to create a duty to speak in a criminal case violates due process because that theory fails to provide the requisite notice of the prohibited conduct.

Mr. Morris contends that the People's novel theory requires that the Court "take several giant steps away from the text of the Martin Act" by finding a de facto fiduciary duty, using that undefined duty to impose a particular duty to make specific disclosures, and then defining the scope of those disclosures. This, he argues, is "tantamount to delineating a new crime,"[13] depriving defendants of the requisite notice that certain conduct is criminal and opening the floodgates for standardless prosecutions.[14] Just what steps the court will take in this interesting case will have to await, among other things, the Attorney General's response and the Supreme Court's decisions in the honest services cases.

Conclusion

Until now, though many have complained about the especially long reach of the Martin Act, few have been successful in challenging its validity Rather, the Attorney General's Office has continued to rely on the act to aggressively investigate and prosecute a wide range of conduct connected to securities. Now the Attorney General's Office has taken the bold step of using the Martin Act to apply to those types of fiduciary breaches and undisclosed conflicts of interest historically prosecuted under federal honest services fraud law. To the extent that the Martin Act *sees* its refection in the federal honest services fraud statute, the impending fate of the latter at the hands of the Supreme Court may signal the demise of the Martin Act's all-purpose application and, in turn, the erosion of the theory underlying the Attorney General's pending case against Hank Morris.

1. *Della Pietra v. State of New York,* 71 N.Y.2d 792, 796-97 (1988).
2. Dietrich L. Snell and Wendy T. Wu, "New York State's Martin Act: An Outline of the New York Attorney General's Powers and Practices," PLI (Jan. 16, 2008).
3. Nicholas Thompson, "The Sword of Spitzer," Legal Affairs (May/June 2004).
4. *Gonkjar Associates v. Abrams,* 88 A.D.2d 854, aff'd, 58 N.Y.2d 878 (1982).
5. N.Y. GBL §352(c)(1)-(4).
6. N.Y. GBL §352-c(6).
7. N.Y. GBL §352-c(5).
8. Memorandum of Law in Support of Defendant Henry Morris' Omnibus Pretrial Motion, *People v. Hank Morris,* Indictment No. 25/2009 ("Memo") at p. 4.
9. Id.
10. See *United States v. Skilling,* 554 F.3d 529 (5th Cir. 2009), cert. granted 130 S. Ct. 393; *United States v. Black,* 530 F.3d 596 (7th Cir. 2008), cert. granted 129 S. Ct. 2379 (2009); *United States v. Weyhrauch,* 548 F.3d 1237 (9th Cir. 2008), cert. granted 129 S. Ct. 2863 (2009).]
11. Memo at p. 29.
12. Indictment at 12.
13. Memo at p. 48.
14. Memo at pps. 47-48.

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