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'Ultimate' Prosecution Weapon Deployed in Mortgage Probes

By [Beth Bar](#)

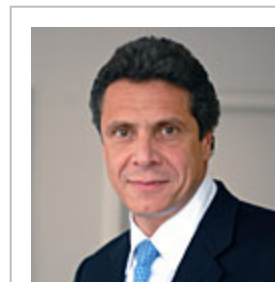
February 7, 2008

As Attorney General Andrew Cuomo has turned his attention to the subprime mortgage scandal, he increasingly has deployed one of the most powerful legal weapons in his office's arsenal: the Martin Act.

According to news reports last week, Mr. Cuomo has issued Martin Act subpoenas to several Wall Street investment banks seeking information about the packaging and selling of mortgage securities.

In November, he filed a lawsuit against First American, the nation's largest title issuer, accusing the company of inflating home values in reports to banks.

He also has issued subpoenas to Fannie Mae and Freddie Mac.



Andrew Cuomo
Image: Rick Kopstein /
New York Law Journal

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THE MARTIN ACT, General Business Law Article 23-A, was enacted in 1921. It was named for Assemblyman Louis M. Martin, the Oneida County Republican who

The 86-year-old act, General Business Law Article 23-A, grants the attorney general the power to investigate any "fraudulent practice" in connection with the "issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution within or

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sponsored it. The statute addresses the offer and sale of securities in and from New York state.

Section 352 grants the attorney general the power to investigate any "fraudulent practice" in connection with the "issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution within from (New York) state."

Fraudulent acts include "any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation, or promise."

They also include those that involve the use of "any deception, misrepresentation, concealment, suppression, fraud, false pretense or false promise," as well as the engaging in any "practice or transaction or course of business relating to the purchase, exchange, advice, or sale of securities...which is fraudulent in violation of law and which has operated or which would operate as fraud upon the purchaser."

Section 352-c prohibits "any fraud, deception, concealment, suppression false pretense or fictitious or pretended purchase or sale" and any "promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances."

It also prohibits any "representation or statement which is false, where the person who made such representation or statement (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made."

with [the Martin Act] and has used the law to branch into other areas."

from [New York] state." (See sidebar.)

The attorney general does not have to specify whether he is investigating criminal or civil charges, and does not have to prove fraudulent intent on the part of the defendants.

The law is unusual in its scope among state "Blue Sky" securities laws. Robert J. Giuffra Jr., a partner at Sullivan & Cromwell, called the act the "ultimate" prosecutorial weapon. Mr. Cuomo's use of the law duplicates the aggressive tactics of his predecessor, now-Governor Eliot Spitzer, who used the law to pry large settlements from investment banks and mutual funds.

"The Martin Act is an effective tool for the attorney general [because] its scope and limitations have not been clearly defined," said Mark Zauderer, a partner at Fleming Zulak Williamson Zauderer.

Mr. Giuffra said the Martin Act is so potent because the attorney general can "cite to it, say it is really old, say [he does not] need to prove fraudulent intent, and then can use it to reach a settlement."

The statute was originally used in New York to go after boiler room securities operations in which penny stocks were being sold to unsophisticated investors. Mr. Spitzer's use of the statute, which had been moribund for years, marked "the broadest and most successful utilization" of the law, said Barry Kamins, a partner at Flamhaft Levy Kamins & Rendeiro and criminal procedure expert.

"Mr. Spitzer's office investigated and brought actions against Wall Street brokerage firms for providing investment advice to investors they knew to be false in order to obtain more business," he said in [a Dec. 13, 2007 Law Journal column](#).

Beginning in 2002, Mr. Spitzer's office used the Martin Act to "force" 10 of New York's biggest investment firms, including Merrill Lynch and Goldman Sachs, to pay a total of \$1.4 billion in fines and settlements, Mr. Kamins said. Mr. Spitzer followed that success with investigations of mutual funds that resulted in criminal convictions and a total of \$3 billion in fines, penalties and restitution.

Mr. Cuomo has used the law in an "even more far-reaching" way, Mr. Kamins said in an interview. "Mr. Cuomo has built on what Mr. Spitzer did

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New Uses of Law

As an example, Mr. Kamins cited Mr. Cuomo's investigation of whether former state comptroller Alan Hevesi misused his position by helping campaign contributors gain access to business from New York's \$154 billion pension fund, which he oversaw.

The investigation apparently is the first use of the act in connection with the investigation of possible government corruption.

Mr. Hevesi resigned and pleaded guilty in December 2006 to defrauding the government after it was discovered that state workers were acting as drivers for his ill wife. He was fined \$5,000.

Bradley D. Simon, a partner at Simon & Partners in Manhattan who represents Mr. Hevesi, said in an interview that the Martin Act should not be applied against his client.

"The allegations do not have anything to do with securities violations," Mr. Simon said.

He added that the statute is not "to be used in all seasons and for all reasons," and stressed that the allegations must involve securities violations.

Mr. Cuomo has not taken any action against Mr. Hevesi or anyone else in connection with the probe.

Mr. Cuomo also has used the statute to investigate whether plans by five energy companies (AES Corporation, Dominion, Dynegy, Peabody Energy and Xcel Energy) to build coal-fired power plants concealed financial risks to their investors.

The attorney general asked the companies in letters sent in September whether investors had been sent enough information about the potential financial liabilities of carbon dioxide emissions that could contribute to global warming.

"Any one of the several new or likely regulatory initiatives for CO2 emissions from power plants - including state carbon controls, E.P.A.'s regulations under the Clean Air Act, or the enactment of federal global warming legislation - would add a significant cost to carbon-intensive coal generation," the letters said.

It also said that "selective disclosure of favorable information or omission of unfavorable information concerning climate change" would be considered misleading.

Mr. Cuomo told The New York Times that "this is a very straightforward, consistent use of the act because it's about disclosure to investors."

Mary Sandok, a spokeswoman for Xcel, said in a statement that "the plant under construction in Colorado is being built under an agreement we reached with national, state and local environmental groups, including the Sierra Club and Environmental Defense. Our financial disclosures are adequate. We look forward to discussing this matter further with the New York attorney general."

Subprime Probes

Attorneys familiar with the act say Mr. Cuomo is on more familiar ground in using it to investigate the sale of mortgage-

backed securities that have resulted in significant losses to investors.

"The act deals with the sale and offering of securities," said Stuart D. Meissner, a Manhattan solo practitioner who was an assistant attorney general under Mr. Spitzer. "In this case, the sales [of] these mortgage investments opens the door for the Martin Act to be used."

Benjamin Lawsky, deputy counselor and special assistant under Mr. Cuomo, and Eric O. Corngold, executive deputy attorney general for economic justice, are leading Mr. Cuomo's subprime probes. Messrs. Lawsky and Corngold declined to comment.

Mr. Lawsky previously served as an assistant U.S. attorney in the Southern District of New York, where he prosecuted securities fraud, organized crime and terrorism cases.

He also has served as chief counsel to Senator Charles E. Schumer, D-New York, and as a trial attorney in the Department of Justice's civil division in Washington, D.C.

Mr. Corngold is a former chief assistant U.S. attorney in the Eastern District of New York. There he was the chief of the business and securities fraud unit.

The Wall Street Journal and The New York Times have reported that Mr. Cuomo is investigating whether investment banks violated the Martin Act in connection with their packaging and selling of mortgage-related securities.

Investment banks that purchase loans from originators hire due diligence companies to review the loans before they are transformed into securities and sold to investors.

Mr. Cuomo is reportedly looking into whether after the investment banks received information about loan problems, they used this information to negotiate a low prices but then withheld this information from rating agencies and investors when the banks were packaging and reselling the loans.

The Wall Street Journal reported last week that Mr. Cuomo has sent Martin Act subpoenas to Bear Stearns, Deutsche Bank, Morgan Stanley, Merrill Lynch, Lehman Brothers, and possibly others. Bear Stearns, Deutsche, Morgan and Lehman declined to comment on the investigation. A Merrill Lynch spokesman said his company "cooperates with regulators when they ask us to" but declined to say anything more.

Representatives from the attorney general's office have also declined to comment on the investigation.

Jerry D. Bernstein, a partner at Blank Rome, is outside counsel to Clayton Holdings, a large due diligence company. Mr. Bernstein said in an interview that Clayton was subpoenaed under the Martin Act several months ago and that the company "has provided documents and other information as would any other company that is directed to cooperate with the attorney general's office."

Meanwhile, in November Mr. Cuomo sued the real estate appraisal unit of First American, the nation's largest title issuer.

The lawsuit, which was filed in state court but has been removed to the Southern District of New York, alleges that First American and its subsidiary eAppraiseIT caved to pressure from Washington Mutual to use appraisers who provided inflated appraisals from homes. *State of New York v. First American*. 07 Civ. 10397. Such appraisals can make mortga

securities look more attractive than is justified by the facts.

Mr. Cuomo claimed that e-mails also show that executives at First American and eAppraiseIT knew their behavior was illegal, but intentionally broke the law to secure future business with Washington Mutual.

First American said in a Nov. 2, 2007 statement that the attorney general's allegations, "largely based on a handful of e-mails that have been taken out of context, or mischaracterized . . . belie our record of compliance with applicable law."

First American has asked the court to dismiss the suit, arguing that the federal government, not the state, has the authority to regulate its mortgage appraisal business. Washington Mutual did not immediately return a call for comment.

In connection with the First American case, Mr. Cuomo also issued Martin Act subpoenas to Fannie Mae and Freddie Mac, two of the nation's largest home mortgage financiers.

Fannie Mae and Freddie Mac both responded that they were committed to fighting mortgage fraud and pledged to cooperate with Mr. Cuomo. Freddie Mac also said it would appoint an independent examiner to review appraisal practices.

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