NEW YORK COURT OF APPEALS ROUNDUP

MARTIN ACT 'OFFERING OR SALE' OF SECURITIES BROADLY CONSTRUED

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The Court of Appeals cases we discuss below involve how broadly the Martin Act phrase "offering or sale" of securities should be interpreted, when the state may avoid liability for negligence under the doctrine of sovereign immunity, and whether the agency defense to a charge of selling narcotics applies to the charge of facilitating the sale of narcotics.

Court News

We note the departure from the court of Judge Carmen Beauchamp Ciparick, who is retiring at the end of this month. Ciparick moves on to what we are sure will be further significant contributions to the law and the administration of justice. Her legal acumen and gracious demeanor will be missed by bench and bar alike.

On Dec. 1, the Commission on Judicial Nomination sent to Governor Andrew Cuomo a list of candidates to take Ciparick's seat. The list consists of associate justices of the Appellate Division, First Department, Sheila Abdus-Salaam and Rolando Acosta, and of the Fourth Department, Eugene Fahey, private practitioners Kathy Chin of Cadwalader, Wickersham & Taft and David Schulz of Levine Sullivan Koch and Schulz, City University of New York School of Law professor Jenny Rivera, and Director of the Grand Street Settlement, a non-profit advocacy organization, Margarita Rosa. On March 7, 2013, the commission will send to Cuomo a list of candidates to succeed Judge Theodore T. Jones who, sadly, died last month.

Martin Act 'Offering or Sale'

The Martin Act, Gen. Bus. Law art. 23-A, grants the Attorney General regulatory authority over the offer and sale of securities within or from New York, which includes

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the conversion of rental apartment buildings into cooperative buildings. The issue in *East Midtown Plaza Housing v. Cuomo* was whether the Martin Act applied to a transaction involving an existing cooperative, specifically the proposed privatization of a complex that had been operated by a limited-profit housing company pursuant to the Mitchell-Lama Law. In holding that the Attorney General had authority over the transaction, the court interpreted the Martin Act broadly.

Petitioner East Midtown Plaza Housing Company Inc. made two attempts to withdraw an apartment complex from the Mitchell-Lama program and convert it to private ownership. The first plan, submitted to a shareholder vote in 2004, would have dissolved East Midtown and transferred its assets to a new private cooperative that would issue shares. Although the company's certificate of incorporation provided that each household was entitled to one vote at a shareholders' meeting, East Midtown asserted that the proposal had been approved by the requisite two-thirds vote by counting votes on a per-share basis, rather than on a per-apartment basis.

Then-Attorney General Andrew Cuomo advised East Midtown that a new vote was required because the company had failed to file a cooperative offering plan with his office. The Attorney General further advised that a new proposal would have to be approved by two-thirds of the complex's dwelling units.

In response, East Midtown devised a new plan pursuant to which its certificate of incorporation would be amended with no shares having to be issued or transferred. East Midtown filed an offering plan, which the Attorney General's office approved in 2008. Two-thirds of the cooperative's shares but less than two-thirds of the households voted in favor of the privatization plan. The Attorney General took the position that the proposal had not received shareholder approval.

This time, East Midtown commenced an Article 78 proceeding seeking a declaration that the Attorney General lacked jurisdiction because the transaction merely involved the amendment of a certificate of incorporation. The Supreme Court, Appellate Division and Court of Appeals all rejected the argument.

Judge Victoria Graffeo's opinion for the unanimous court set the stage for interpretation of the phrase "offering or sale" of securities by making two observations. First, the Martin Act is a remedial statute and therefore should be liberally construed. Second, in applying the act, the court has always sought guidance from federal court interpretation of blue sky laws. Those courts look to the "economic reality of the transaction"[1] and have held that a change of rights of the holders of existing securities can be a "purchase or sale" if there has been such a "significant change in the nature of the investment or in the investment risks as to amount to a new investment."[2]

If the complex stayed in the Mitchell-Lama program, East Midtown would continue to be eligible for government-subsidized financing and property tax reductions, and cooperative share resale prices would remain limited to an amount permitting recovery of paid-in capital without any profit. If the complex became privatized, however, the company would no longer be eligible for such subsidy and tax reductions, and shares could be sold at market price.

The court found that these changes to shareholder interests were "substantial." It also rejected East Midtown's argument that the 2008 transaction simply consisted of amending a certificate of incorporation. The court characterized that argument as an attempt to elevate form over substance because the transaction sought to accomplish the same end as the 2004 transaction. As a result, the court held that the Attorney General's authority extended to the proposed transaction.

Finally, the court agreed that shareholder votes must be counted as provided in East Midtown's certificate of incorporation so that each apartment had only one vote. Under that method of counting, the privatization proposal had failed to garner the necessary votes.

Lake George Accident

In *Metz v. State of New York*, the court applied principles of governmental immunity to dismiss negligence claims against the state arising out of a tragic boat accident on Lake George finding, specifically, that the state could not be liable in the absence of a special duty to plaintiffs.

In 2005, a tour boat called the Ethan Allen capsized and sank on Lake George. Twenty passengers died, and others suffered severe injuries. At the time of the accident, the boat was carrying 47 passengers and a single crew member. Because the Ethan Allen was used for commercial purposes, it was deemed a "public vessel" and subject to annual inspection by the New York State Office of Parks, Recreation and Historic Preservation (OPRHP).

From the time of its construction until 1979, the Ethan Allen had been subject to inspection by the U.S. Coast Guard. The Coast Guard's last certificate of inspection provided for a maximum passenger capacity of 48 and a crew of two. When the OPRHP took over inspection of the Ethan Allen in 1979, its inspectors continued to certify the vessel at the same maximum capacity, even after the vessel was substantially modified in 1989. A post-accident investigation conducted by the National Transportation Safety Board concluded that the probable cause of the accident was instability of the vessel because it had been carrying more than 14 passengers, which the board found was the actual safe carrying capacity of the Ethan Allen.

Injured passengers and personal representatives of passengers who died in the accident brought suit against the state alleging, inter alia, that the OPRHP inspectors were negligent in certifying the Ethan Allen to carry more than 14 passengers. The parties sought summary judgment on the state's affirmative defense of sovereign immunity. The Court of Claims denied the motions, finding that there were issues of fact as to whether the OPRHP inspections were ministerial, in which case the state could be held liable, or discretionary, in which case the state would not be liable as a matter of law.

In ruling on the parties' respective cross-appeals, the Appellate Division, Third Department, found that the state was acting in a governmental capacity in inspecting the vessel and fixing the carrying capacity and that the inspectors theoretically had discretionary authority with respect to setting the maximum number of passengers. It also found, however, that the inspectors simply "rubber stamped" the existing certificate and did not undertake any independent verification of the number of passengers who could travel safely on board the Ethan Allen. Accordingly, the inspectors had not actually exercised any discretion and the state therefore was not entitled to a sovereign immunity defense, according to the Appellate Division.

The Court of Appeals reversed in an opinion by Chief Judge Jonathan Lippman for a unanimous court. It noted that a claimant cannot hold a state or municipality liable unless the claimant can establish it was owed a special duty. In the absence of a special duty for the benefit of particular individuals, the state cannot be held liable for negligent performance of a government function. In this case, the state's inspection of public vessels was not related to any special duty owed by the state to particular passengers; rather, it was part of the state's duty to protect all members of the general public. Accordingly, the court reversed the Third Department's decision and dismissed the claims.

The court noted that this result is further supported by the fact that recognizing a private right of action here would be incompatible with the governing legislative scheme. The Navigation Law, which mandates public vessel inspections, provides for fines and criminal penalties to be imposed on owners and operators of vessels, but it has no provision for government tort liability. And, when the Navigation Law was amended in response to the Ethan Allen tragedy, additional safety standards and enhanced penalties were added, but the Legislature still made no provision for a private right of action.

Facilitation of Drug Sale

In 1978, the court held in *People v. Lam Lek Chong*[3] that an agency defense could be raised against a charge of sale of a controlled substance. Until its decision last month in *People v. Watson*, however, the court had not had the occasion to determine whether the

defense applies to a charge of criminal facilitation of the sale of a controlled substance. In its 5-0 decision in *Watson*, the court ruled that it does not.

New York's "Rockefeller Drug Laws," enacted in the 1970s, were the most harsh and inflexible in the country. Pursuant to their statutory definition of "sell" as including not only sale for consideration but also to "give or dispose of to another, or to offer or agree to do the same," a transfer of even a miniscule quantity of a controlled substance for no profit could result in an indeterminate life sentence. Against this backdrop, the *Lam Lek Chong* court held that the "agency defense" theory invoked against criminal charges during Prohibition was also available in defense of sale of controlled substance charges when a defendant acted as a mere agent of a buyer and not as a middleman or broker, and did not profit or stand to profit from the transaction. The defense was held unavailable to possession charges.

The majority opinion in *Watson*, by Judge Graffeo, discussed at length the history of anti-narcotics laws in New York, in particular the Rockefeller Drug Laws, and noted that the harsh sentencing provisions of those laws were ameliorated by the Drug Law Reform Act of 2004. The discourse seemed to perhaps provide a rationale for the court finding the agency defense available in 1978 despite the broad language of the Rockefeller Laws, at least with respect to sale of a controlled substance. In contrast, the court's approach to the defense in the instant case relied heavily on language in the Penal Code.

The defendant in *Watson* was approached by an undercover officer who asked where he might find some cocaine. The defendant was unsuccessful in reaching a dealer by telephone and suggested to the officer that they go to the dealer's house, even offering to pay the officer's bus fare. Once at the house, the defendant asked for "two fat ones," handed over the $40 that the officer had given to him, took possession of the cocaine from the dealer but immediately handed it over to the officer, and then asked to smoke some of the cocaine with the officer. He was arrested and charged with sale, facilitation of sale and possession of a controlled substance.

During the bench trial, the defendant sought to invoke the agency defense. The judge dismissed the sale count pursuant to that defense, but convicted the defendant of facilitation and possession. In affirming the verdict, the court quoted the definition of criminal facilitation in the fourth degree as committed when a person "believing it is probable that he is rendering aid…to a person who intends to commit a crime…engages in conduct…which in fact aids such person to commit a felony," Penal Law §115.00(1), and pointed out that Penal Law §115.10(3) states that the fact a person was neither an accomplice to nor guilty of a crime does not provide a defense to facilitation.

As a result, the court held, a party who acts as the buyer's conduit to a drug seller and actively participates in consummation of the transaction may be held criminally liable for facilitation and possession, both Class A misdemeanors in the case before it, "so the 'calibration of punishment set by the legislature' is balanced and application of the agency doctrine is not required as a matter of fundamental fairness." (Citation omitted.)

Lippman dissented. He noted that the agency defense both pre-dated the Rockefeller Drug Laws and survived their mitigation by the Drug Law Reform Act, and argued that the fact that facilitation is a misdemeanor should not alter the analysis of whether the agency defense is applicable. Lippman reasoned that because a purchaser of drugs cannot be charged with aiding or facilitating sale of a controlled substance, one acting as the agent of the purchaser similarly should not be subject to such charges.

Endnotes:

1. Quoting *Keys v. Wolfe*, 709 F.2d 413, 417 (5th Cir. 1983).

2. Quoting *Gelles v. TDA Indus.*, 44 F.3d 102, 104 (2d Cir. 1994).

3. 45 N.Y.2d 64, cert. denied, 439 U.S. 935 (1978).