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ENFORCEMENT

NSMIA Preemption and Its Impact on the New York Attorney General's Action Against Bank of America

BY JAMES CAVOLI AND MELANIE WESTOVER

In February, the New York Attorney General filed a civil lawsuit against Bank of America Corporation and two of its former executives arising out of BofA's 2008 acquisition of Merrill Lynch. The NYAG's complaint alleges that the defendants failed to properly disclose—in the proxy statement and other offering documents related to shareholder approval of the acquisition—Merrill's deteriorating financial condition and the plan to pay large bonuses to Merrill employees. These alleged failures, the NYAG claims, amount to violations of New York's Martin Act (N.Y. Bus. Law § 352 *et. seq.*) and Executive Law (N.Y. Exc. Law § 63(12)). The NYAG's claims, however, may be precluded by federal law.

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The National Securities Markets Improvement Act of 1996 (''NSMIA'') provides that no state may directly or indirectly impose restrictions on the use or content of proxy statements and other disclosure documents relating to ''covered'' securities. By its enforcement action, the NYAG arguably seeks to do just that. Although NSMIA allows states to ''bring enforcement actions with respect to fraud or deceit,'' this exclusion from NS-

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MIA's express preemption clause may well not apply to the NYAG's claims. ''Fraud'' and ''deceit'' denote conduct that is accompanied by an intent to defraud and/or scienter, and that meaning is presumed to apply to federal statutes like NSMIA. But the civil claims filed by the NYAG require no allegation or proof of wrongful intent.

The NYAG's Claims

After the September 15, 2008 announcement that BofA would merge with Merrill in a $50 billion all-stock transaction, BofA issued a proxy statement recommending that shareholders approve the merger. Shareholders did so on December 5, 2008.

According to the NYAG's complaint, Merrill was suffering massive losses as early as October 2008 and its financial condition continued to deteriorate through the merger's effective date (January 1, 2009), but the defendants ''failed to disclose'' Merrill's dire financial condition in the Proxy Statement or thereafter in supplemental disclosures. The Complaint also faults the defendants for failing to ''reveal the companies' actual bonus arrangements,'' including the amount or timing of Merrill bonuses, and Merrill's market-based compensation scheme generally. The NYAG alleges that, as a result, the disclosure documents ''contained material misstatements and omissions because it failed to disclose material facts.''

The Complaint contains five causes of action. Four of the five allege ''securities fraud'' in violation of the Martin Act. The other asserts that the defendants violated Executive Law § 63(12), which allows the NYAG to obtain certain remedies when a person has engaged in ''repeated fraudulent . . .acts'' or ''persistent fraud'' in the ''carrying on . . . of business.''

None of the NYAG's claims require it to allege or prove a culpable state of mind. New York courts have long held that civil liability under the Martin Act does not require scienter or intent to defraud.[1] As one court put it, Section 352-c of the Martin Act ''is directed at acts or practices, and not at any particular mental state on the part of the actor.''[2] The same is true with respect to ''fraud'' under Executive Law Section 63(12).[3]

The National Securities Markets Improvement Act of 1996

Congress enacted NSMIA to designate the federal government ''as the exclusive regulator of national offerings of securities.''[4] To achieve this goal, Congress amended the Securities Act of 1933 to preempt state regulation of ''covered securities,'' which include securities that are listed on the New York Stock Exchange.[5] NSMIA expressly provides that no state law, rule, regulation, order or action may: (1) require registration or qualification of covered securities; (2) ''directly or indirectly prohibit, limit, or impose any conditions upon the use of'' any disclosure document relating to a covered security, including proxy statements and reports to shareholders; *or* (3) ''directly or indirectly prohibit, limit, or impose conditions'' on the offer or sale of a covered security based on the merits of such offering. 15 U.S.C. § 77r(a)(1)-(3).

Item (1) precludes state action that requires registration (the process of state agency review and approval before a security is offered) or qualification (a particular method of gaining state approval) of covered security offerings. Items (2) and (3) were enacted ''to prevent an end run around the first preemption provision by states seeking to impose their own registration requirements.''[6] NSMIA's prohibitions ''appl[y] both to direct and indirect State action, thus precluding states from exercising indirect authority to regulate the matters preempted by'' NSMIA.[7] And they ''preclude states from imposing disclosure requirements on prospectuses, traditional offering documents, and sales literature relating to covered securities.''[8]

NSMIA also carves out certain areas that would otherwise be preempted, permitting state action within the carve-outs. One carve-out is labeled ''Fraud authority'' and provides that ''the securities commission . . . of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions *with respect to fraud or deceit*, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.''[9]

Does NSMIA Preempt the NYAG's Claims?

''Express preemption arises when a federal statute expressly directs that state law be ousted.''[10] ''If the statute contains an express pre-emption clause, the task of statutory construction must in the first instance focus on the plain wording of the clause, which necessarily contains the best evidence of Congress' pre-emptive intent.''[11]

There is a strong argument that the NYAG's enforcement action is expressly preempted by NSMIA. BofA's proxy statement related to ''covered securities'' because BofA's stock trades on the NYSE.[12] And the NYAG's claims are designed to limit, restrict, and condition the use and content of BofA's proxy statement by seeking injunctive and monetary awards and penalties for failing to disclose allegedly material facts. ''[S]tate regulation can be as effectively exerted through an award of damages as through some form of preventive relief.''[13]

Thus, the key question is whether NSMIA's ''fraud authority'' exception to express preemption applies to the NYAG's claims. It likely does not.

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[1] *State of New York v. Rachmani Corp.*, 71 N.Y.2d 718, 725 n.6 (N.Y. 1988).

[2] *People v. Barysh*, 408 N.Y.S.2d 190, 193-94 (N.Y. Supp. Ct. 1978).

[3] *State of New York v. Samaritan Asset Management Services, Inc.*, 874 N.Y.S.2d 698, 703 (Sup. Ct. 2008).

[4] H.R. Rep. No. 104-622, at 16 (1996), *as reprinted in* 1996 U.S.C.C.A.N. 3877, 3878.

[5] 15 U.S.C. § 77r(b).

[6] *Zuri-Invest AG v. NatWest Finance Inc.*, 177 F. Supp. 2d 189, 193 (S.D.N.Y. 2001).

[7] H.R. Rep. No. 104-622, at 30, *as reprinted in* 1996 U.S.C.C.A.N. 3877, 3892.

[8] *Zuri-Invest AG v. NatWest Finance Inc.*, 177 F. Supp. 2d 189, 192 (S.D.N.Y. 2001).

[9] 15 U.S.C. 77r (c)(1) (emphasis added).

[10] *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 95-96 (1983); *Air Transport Ass'n of America, Inc. v. Cuomo*, 520 F.3d 218, 220 (2d Cir. 2008).

[11] *CSX Transp., Inc. v. Easterwood*, 507 U.S. 658, 663-64 (1993).

[12] 15 U.S.C. § 78n ; 17 C.F.R. § 240.14a-6.

[13] *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 521 (1992).

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''Words in federal statutes reflect federal understandings, absent an explicit statement to the contrary, even if a state uses the word differently.''[14] This ''presumption reflects a preference for the uniform application of federal law irrespective of where within the United States an issue regarding the law arises.''[15] And when Congress legislates, it is presumed to know and adopt previous judicial interpretations of the words it uses unless it specifically says otherwise.[16]

In construing Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 issued thereunder—the core anti-fraud provisions in the securities arena—federal courts have repeatedly made clear that the terms ''fraud'' and ''deceit'' include an element of wrongful intent. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), decided by the Supreme Court some 34 years ago, is the seminal case on the issue. In *Hochfelder*, the Court concluded that Section 10(b)'s language suggested ''intentional or willful conduct designed to deceive or defraud investors.'' The Court also examined Rule 10b-5, which makes it unlawful to engage ''in any act . . . or course of business which operates or would operate as a *fraud or deceit* upon any person''—the exact terms that appear in NSMIA's ''fraud authority'' exception—and held that the rule ''was intended to apply only to activities that involved scienter.''[17] This meaning was deeply engrained in federal jurisprudence when Congress enacted NSMIA.[18]

A plain-meaning approach also supports this view. Fraud is defined in the dictionary as a ''knowing misrepresentation of the truth . . . to induce another to act to his or her detriment.'' ''Deceit'' is defined as the ''act of intentionally giving a false impression.''[19]

In short, ''fraud'' and ''deceit'' clearly include an element of wrongful intent, and that meaning is presumed to apply to federal statutes like NSMIA. Thus, NSMIA's ''savings clause'' likely does not preserve the NYAG's ability to maintain its action—at least to the extent that it seeks to establish liability without also establishing intent to defraud.

To date, two federal district court cases—*Zuri-Invest AG v. Natwest Finance Inc.* and *Houston v. Seward & Kissell, LLP*—have rejected NSMIA preemption arguments, but both were arguably wrongly decided, and neither addressed the question raised in this article.

In *Zuri-Invest,* the court held that NSMIA did not preempt New York common law fraud claims brought by a private plaintiff, relying largely on legislative history stating that it was the Commerce Committee's '' 'intention not to alter, limit, expand, or otherwise affect in any way any State statutory or common law with respect to fraud or deceit . . . .' ''[20] This rationale, however, ignores NSMIA's clear directive to preempt *any* state action that would ''directly or indirectly prohibit, limit, or impose any conditions upon the use of . . . any . . . disclosure document relating to a covered security,'' and thus runs counter to the cannon of construction that, where a statute is clear, resort to legislative history is improper.[21] In *Houston*, the court refused to find that NSMIA preempted a private plaintiff's claim for aiding and abetting securities fraud under Oregon's securities laws, relying primarily on NSMIA's ''fraud authority'' exception.[22] But that exception, on its face, clearly applies *only* to state law enforcement bodies, not private plaintiffs. In any event, neither court was presented with the question posed here—*i.e.*, does the phrase ''fraud or deceit,'' as used in the ''fraud authority'' exception, encompass claims that require no proof of wrongful intent?—and neither decided that question.

Conclusion

While, to date, courts have been less than hospitable toward NSMIA preemption arguments, serious questions exist as to whether the NYAG's claims against BofA and its former executives can survive. On its face, NSMIA's savings clause reserves to states the power to bring enforcement actions only with respect to fraud and deceit, which require wrongful intent. Thus, to the extent that the NYAG seeks to establish liability for ''fraud'' under the Martin Act and Executive Law 63(12) without also establishing intent to defraud—as it is permitted to do under New York law—its claims may be preempted.

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[14] *United States v. Ayala-Gomez*, 255 F.3d 1314, 1319 (11th Cir. 2001).

[15] *United States v. Savin*, 349 F.3d 27, 35 (2d Cir. 2003).

[16] *Wheeler v. Pilgrim's Pride Corp.*, 591 F.3d 355, 366 (5th Cir. 2009).

[17] *Id.* at 212-213.

[18] *Aaron v. Securities & Exchange Commission*, 446 U.S. 680, 695 (1980); *Rubinstein v. Collins*, 20 F.3d 160, 169 (5th Cir. 1994); *Michaels v. Michaels*, 767 F.2d 1185, 1198 (7th Cir. 1985).

[19] *Black's Law Dictionary* 465, 731 (9th ed. 2009).

[20] 177 F. Supp. 2d 189, 193 (S.D.N.Y. 2001) (quoting H. R. Rep. No. 104-622, at 34, reprinted in 1996 U.S.C.C.A.N. 3877, 3897).

[21] *Gully v. Nat'l Credit Union Administration Board*, 341 F.3d 155, 164 (2d Cir. 2003); *Lewis Family Farm, Inc. v. Adirondack Park Agency*, 868 N.Y.S.2d 481, 490 (N.Y. Sup. 2008).

[22] 2008 WL 818745, * 2, 4-5 (S.D.N.Y. Mar. 27, 2008).