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F-Cubed gets an F Grade from US Supreme Court

Multinationals can breathe much easier. The Supreme Court has decided that US securities laws only apply to claims arising from the purchase of securities within the United States. Investors, whether American or foreign, who buy securities abroad may have claims under the laws of the place where they made their purchases, but they cannot now run to the United States in order to take advantage of US laws or the favourable features of the United States' court system. Foreign cubed litigation has been squarely defeated.[1]

***Morrison v National Australia Bank* is a landmark case that reduces significantly the US litigation risk faced by multinational corporations. 561 U.S. __ (June 24, 2010) No. 08-1191, Slip Op. at 24 ("*Morrison*"). The Supreme Court established a bright line rule that Section 10(b) of the Securities Exchange Act of 1934 (and, by implication, the Securities Act of 1933) only applies to claims based on the purchase of securities in the United States, including securities bought or sold on American stock exchanges. The Supreme Court rejected the more flexible conduct and effects test previously applied by the lower courts, deciding that securities legislation has no extra-territorial effect. Even if claims arise from fraudulent conduct within the United States, no proceedings can be brought in US courts unless the securities were bought in the United States.**

THE FACTS

In 1998, defendant National Australia Bank ("NAB" or the "Bank") acquired a Florida based mortgage service company, HomeSide Lending, Inc. HomeSide's financial statements were incorporated into NAB's annual reports. Three years later, NAB announced that its financial statements would be written down by $2 billion because the valuation model used by HomeSide overstated the value of certain assets. Predictably, the market price of NAB's stock declined sharply in the wake of these disclosures and, as night follows day, securities class action lawsuits were promptly filed in the United States.

NAB's common shares traded on the Australian Stock Exchange and other foreign exchanges, but not on any exchanges in the United States. However, NAB did list American Depositary Receipts (ADRs) on the New York Stock Exchange. These ADRs provided holders with the right to receive a specified number of NAB's common shares.

Australian investors who purchased NAB's common shares (not its ADRs) sued NAB in New York, alleging that the Bank's inclusion of the fraudulent HomeSide financials in its SEC and foreign exchange filings violated Section 10(b).[2] The trial court held that there was insufficient domestic conduct to establish subject matter jurisdiction over the investors' claims and the Second Circuit affirmed. The appellate court focused on the fact that the "main part" of the fraud occurred in Australia, where NAB issued its inaccurate annual reports.

Key Issues

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[1] Litigation is deemed "foreign cubed" where foreign investors sue a foreign corporation for conduct largely occurring outside the United States. A great deal of commentary has recently been published on whether US courts have jurisdiction over such litigation.

[2] This provision – and Rule 10b-5 enacted under it – prohibit corporations from making untrue statements of material fact in connection with certain purchases or sales of securities.

THE SUPREME COURT'S DECISION

Justice Scalia delivered the opinion of the Court. Although all eight justices who heard the case concurred in the judgment affirming the Second Circuit's dismissal,[3] Justices Breyer, Stevens, and Ginsburg dissented from certain aspects.

In an expansive ruling, the Court held that "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States," and thus does not extend to transactions by investors on foreign exchanges. (Slip Op. at 24.)

In reaching this conclusion, the Court rejected the well-established conduct and effects tests, which lower courts have used to determine whether they may exercise jurisdiction over securities transactions involving activity occurring abroad. Under the conduct test, a court could exercise subject matter jurisdiction if conduct occurring inside the United States directly contributed to a securities fraud occurring outside the United States. This test was typically used to determine whether a court had jurisdiction over the claims of non-US investors. Under the effects test, a court could exercise jurisdiction if conduct outside the United States had a substantial impact on US markets or US investors.

The conduct and effects tests are flawed because they fail to take into account the presumption against extraterritoriality. Rejecting the position advanced by the Solicitor General, the Court found that neither the text of the Exchange Act, nor its legislative history, reflects a congressional intent for the statute to apply to foreign activity.

The Court also disagreed with the investors' back-up argument that their claims were viable notwithstanding the presumption against extraterritoriality because much of NAB's conduct occurred in the United States. The Court emphasized that the focus of the Exchange Act is "not upon the place where the deception originated, but upon purchases and sales of securities in the United States." (Slip Op. at 17.)

THE CONCURRING OPINIONS

In the principal concurrence, Justice Stevens – joined by Justice Ginsburg – disagreed with much of the Court's decision. He noted that the now discarded "conduct and effects" tests had been established by the Second Circuit over thirty years ago, and were followed with slight variations by virtually all other federal courts. In Justice Stevens' view, the presumption against extraterritoriality would only "provide[] a sound basis for concluding that Section 10(b) does not apply when a securities fraud with no effects in the United States is hatched and executed entirely outside this country." (Stevens, J., concurring, Slip Op. at 8.)

Justice Stevens was quick to point out that the Court's broad ruling would bar an American investor who bought shares in a company listed on a foreign exchange from seeking relief under Section 10(b), even if the investor complained of a fraud that occurred at the company's US subsidiary. He called such an outcome an "oddity" that would "alarm generations of American investors." (Stevens, J., concurring, Slip Op. at 13.)

In a brief concurrence, Justice Breyer stated that he agreed with the decision because Petitioner's purchases of securities "took place entirely in Australia *and involved only Australian investors*." (Breyer, J., concurring, Slip Op. at 1) (emphasis added).) This language indicates that Justice Breyer might have found that Section 10(b) applied if the Petitioners had been US investors who purchased their securities abroad.

RAMIFICATIONS

On its face, *Morrison* applies only to actions brought under Section 10(b). It seems likely, however, that *Morrison* will be extended to actions brought under other provisions of the Exchange Act as well as those brought under the Securities Act. The Court's reasoning regarding the presumption against extraterritoriality applies equally to both statutes because they are both silent as to their extraterritorial application. *See SEC v. Berger*, 322 F.3d 187, 189 (2d Cir. 2003).

Given its broad scope, the decision may put an end to plaintiffs' lawyers solicitation of investors who purchase shares of foreign stock on foreign exchanges.[4] However, the ruling does not appear to bar suits by investors (foreign or domestic) who purchase ADRs of a foreign corporation in the United States.

Congress might also step into the fray as it did in 1991 after the Supreme Court decided *EEOC* v. *Arabian American Oil Co.*, 499 U.S. 244 (1991) ("*Aramco*"), which limited the extraterritorial application of Title VII of the Civil Rights Act of 1964. There, the Court held that the Act did not apply to US citizens working for US companies abroad. But Congress quickly passed the Civil Rights Act of 1991, which repudiated *Aramco* and restored the Act's protection for overseas workers. It remains to be seen what action Congress will take with respect to *Morrison*, but for now at least, it is the law.

[3] Justice Sotomayor took no part in the decision.

[4] For examples of actions arising from such solicitations, see *In re European Aeronautic Defence & Space Co. Sec. Litig.,* 2010 WL 1191888 (S.D.N.Y. Mar. 26, 2010); *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005); and *In re Alstom*, 406 F. Supp. 2d 346 (S.D.N.Y. 2005).