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Client Alert

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The Latest Word on the Extraterritorial Reach of US Securities Fraud Litigation

> "...it will be more difficult for non-US plaintiffs to satisfy the 'conduct' test of subject-matter jurisdiction against a non-US entity if the challenged statements were made outside the US based on information that was evaluated abroad."

On October 23, 2008, the United States Court of Appeals for the Second Circuit decided *Morrison v. National Australia Bank*, the latest pronouncement regarding the extraterritorial reach of United States securities fraud litigation.[1] The case represents the first time the Second Circuit has considered a so-called "foreign cubed" case—securities fraud claims brought by non-US investors against non-US defendants based on securities transactions outside the US.

Declining invitations to adopt a "bright line" rule barring such cases in US courts where there is no impact on US investors, the Second Circuit instead reaffirmed its prior decisions requiring a case-by-case analysis to decide whether US courts have subject-matter jurisdiction over securities fraud claims.[2] Under this analysis, courts consider whether (i) the alleged wrongful conduct occurred in the US, and (ii) the wrongful conduct had a substantial effect in the US or upon US investors. Applying this analysis to the facts of the case before it, the Second Circuit in *Morrison* held that, where the entity making the alleged misstatements to investors was located outside the United States and where there was no effect on US investors, plaintiffs did not meet their burden to establish jurisdiction. In so doing, the court also set forth important considerations for other non-US entities assessing whether their conduct may bring them within the reach of US securities fraud lawsuits.

Background

National Australia Bank (NAB) is a large Australian financial institution whose ordinary stock trades on the Australian Stock Exchange, the New Zealand Stock Exchange, the London Stock Exchange and the Tokyo Stock Exchange. NAB's American Depository Receipts (ADRs), but not its stock, trade on the New York Stock Exchange.[3]

In 1998, NAB paid US $1.22 billion to buy HomeSide Lending, Inc., a Florida-based mortgage service company. Following the acquisition, HomeSide became a wholly owned subsidiary of NAB and contributed to NAB's reported profits in 1998, 1999 and 2000. By 2000, HomeSide was the sixth largest mortgage service company in the United States. During this time, HomeSide used a valuation model to calculate the present value of the fees it would generate from servicing mortgages in future years, and recognized certain amortized amounts on its balance sheet as an asset called a "Mortgage Service Right" (MSR). In 2001, NAB revealed that HomeSide's valuation model used incorrect interest assumptions and had resulted in an overstatement of the value of the MSRs. NAB took two write-downs to adjust for these overstatements and, in December 2001, filed an Amended Form 10-Q with the US Securities and Exchange Commission (SEC) restating NAB's financial statements. NAB's stock price and the price of NAB's ADRs declined.

Following those declines, a number of investors filed a lawsuit against NAB, HomeSide and HomeSide executives in the United States District Court for the Southern District of New York, alleging securities fraud under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act). The plaintiffs included three investors who purchased NAB ordinary stock outside the US and who sought to represent a class of non-US purchasers of NAB ordinary shares (Foreign Plaintiffs). A fourth plaintiff sought to represent a class of US purchasers of NAB's ADRs (Domestic Plaintiff). In response to defendants' motion, the district court dismissed the action. The court dismissed the Foreign Plaintiffs' claims for lack of subject matter jurisdiction and dismissed the Domestic Plaintiff's cause of action for failure to demonstrate that the alleged fraud had caused any damages. Only the Foreign Plaintiffs appealed, raising the subject matter jurisdiction to the Second Circuit.

The Second Circuit's Analysis

Federal courts are courts of limited jurisdiction, and only the US Congress can determine a federal court's subject-matter jurisdiction. In *Morrison*, Foreign Plaintiffs' claims arose under the Exchange Act, which is silent about the statute's application to securities transactions taking place outside the US. Indeed, in its opinion, the Second Circuit pointedly noted that this was a "significant omission" that it "respectfully urge[d] . . . receive the appropriate attention of Congress and the Securities and Exchange Commission."[4] With no express Congressional guidance on the limitations on federal courts' subject-matter jurisdiction in cases such as *Morrison*, the court was left to answer that question for itself.

The Foreign Plaintiffs argued that the district court wrongly dismissed their action for lack of subject-matter jurisdiction because the alleged fraud occurred primarily in Florida: they argued that HomeSide was located there, the false valuations of the MSRs were created there and the violation of the US securities laws therefore occurred there. According to the Foreign Plaintiffs, there would have been no harm to investors and no claims of fraud under the US securities laws if HomeSide had not, in Florida, created and transmitted artificially inflated valuations to NAB.

The defendants, on the other hand, argued that the district court had been correct in holding that it did not have jurisdiction because the alleged fraud required the making of allegedly false and misleading statements. Because those statements were prepared and made outside the US by the non-US parent company (NAB), and because the securities transactions occurred outside the US, defendants argued that there was insufficient conduct in the US to justify exercising jurisdiction over the Foreign Plaintiffs' claims.

A number of "friends of the court" (*amicus curiae*) filed briefs as well. In its *amicus* brief, the SEC argued that the court should adopt a new test to determine whether it has subject-matter jurisdiction over actions alleging securities fraud outside the US. In this regard, the SEC argued that the court should find that "the antifraud provisions of the securities laws apply to transnational frauds that result exclusively or principally in overseas losses if the conduct in the United States is *material* to the fraud's success and forms a *substantial* component of the fraudulent scheme." Applying this test, the SEC argued that the district court was wrong in declining jurisdiction because the domestic conduct at HomeSide was a substantial part of the alleged fraud and material to its success.[5]

However, other *amici* such as the Washington Legal Foundation, the US Chamber of Commerce and the Association of Corporate Counsel expressed concern that the expansive exercise of US jurisdiction would deter foreign issuers from turning to US capital markets, discourage cross-border economic activity and cause duplicative litigation. For example, the Washington Legal Foundation asserted that the court should adopt a bright line rule that a civil action by non-US plaintiffs against non-US defendants alleging securities fraud with respect to securities that were purchased outside the United States do not involve conduct in the United States, so that there is no subject-matter jurisdiction to entertain such litigation.[6]

In considering these arguments, and because of the absence of express Congressional guidance on the issue, the Second Circuit began with the premise that "when faced with securities law claims with an international component, we turn to 'the underlying purposes of the anti-fraud provisions as a guide' to 'discern whether Congress would have wished the precious resources of the United States courts and law enforcement agencies to be devoted to such transactions.'" With respect to the anti-fraud provisions of the Exchange Act, that purpose is to remedy deceptive and manipulative conduct with the potential to harm the public interest or the interests of investors. Noting that this purpose is not limited to US investors, the court reiterated its "belie[f] that it is consistent with the statutory scheme to infer that Congress would have wanted 'to redress harms perpetrated abroad which have a substantial impact on investors or markets within the United States.'"[7]

In light of this purpose, the Second Circuit declined to adopt the "bright line" rules or other formulations urged upon it. Instead, it found that "the usual rules still apply," and cited the "conduct" and "effects" tests of subject matter jurisdiction that it had developed in earlier international securities fraud case law. That inquiry is based on (1) whether the alleged wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect on United States investors or markets. "Where appropriate, the two parts of the test are applied together because 'an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court.'"[8]

In *Morrison*, the Foreign Plaintiffs invoked only the "conduct" test (presumably because the district court had found that the US plaintiff—who did not appeal the decision—had failed to appropriately allege any damages to US investors). Under the conduct test, "subject-matter jurisdiction exists if activities in [the United States] were more than merely preparatory to a fraud" and "directly caused losses to investors abroad." The determination of whether American activities "directly" cause losses to non-US investors depends on "what and how much was done in the United States and on what and how much was done abroad." Animating these principles are the considerations that, "the United States should not be 'used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners," and so US jurisdiction will exist where the US conduct is more than merely preparatory to a fraud.[9]

The Second Circuit acknowledged that it can be difficult to determine which actions are "merely preparatory" and which actions are "central or at the heart of a fraudulent scheme." The court declined to adopt a "bright line" rule in part because a categorical denial of jurisdiction over allegations of securities fraud outside the US potentially would conflict with the goal of preventing the export of fraud from the United States. The court acknowledged, however, that it should not act as a "world court" and therefore also declined to adopt the SEC's more expansive language because it potentially would lead to the exercise of jurisdiction over cases that do not affect Americans and do not involve fraud emanating from the United States. Given the Second Circuit's historically quite deferential view to the SEC's positions articulated in amicus briefs, this is particularly noteworthy.

In seeking to strike the correct balance between the extraterritorial application of the securities laws and respecting foreign securities laws, the Second Circuit observed that "[t]he problem of conflict between our laws and those of a foreign government is much less of a concern when the issue is the enforcement of the anti-fraud sections of the securities laws than with such provisions as those requiring registration of persons or securities" because "while registration requirements widely vary, anti-fraud enforcement objectives are broadly similar as governments and other regulators are generally in agreement that fraud should be discouraged."[10]

Applying the conduct test to the facts of *Morrison*, the court focused on three factors and found that each weighed against a finding of subject-matter jurisdiction. First, the claims focused on the accuracy of financial statements to the public and investors by NAB—whereas HomeSide was a wholly owned subsidiary of NAB that did not make the challenged statements. Second, the Foreign Plaintiffs had made no allegations that the alleged wrongful conduct had affected US investors or US capital markets. Third, there was a lengthy chain of causation between the US contribution to the misstatements and the harm to investors—specifically, that the allegedly inaccurate information provided by HomeSide to NAB in Australia "had to pass through a number of checkpoints manned by NAB's Australian personnel before reaching investors."[11] Because each of these factors suggested that the actions of NAB in Australia were significantly more central to the fraud and more directly responsible for the harm to investors than HomeSide's actions in Florida, the Second Circuit held that US courts did not have subject-matter jurisdiction over this action and affirmed the decision of the district court.

Lessons from *Morrison*

Given the substantial risks, costs and other potential liabilities of US class action securities litigation, it is critical for non-US entities to understand what activities will bring them within the reach of US securities fraud litigation. Although the Second Circuit did not adopt a "bright line" test as advocated by some, its decision in *Morrison* provides important insights in this regard. Its finding that subject-matter jurisdiction did not exist was influenced heavily by the fact that the allegedly misleading statements were not made in the United States, even though the subject of those statements concerned business activities in the United States (by NAB's US subsidiary, HomeSide). Indeed, the court emphasized that there was no contention that HomeSide communicated directly with investors at all and that the allegedly inaccurate information provided by HomeSide to NAB was required to be checked by NAB personnel in Australia before being communicated to investors by NAB.

While the existence of subject-matter jurisdiction will depend on the specific facts of any case and it is important to remember that *Morrison* involved no allegations of negative effects on US investors, a key takeaway is that it will be more difficult for non-US plaintiffs to satisfy the "conduct" test of subject-matter jurisdiction against a non-US entity if the challenged statements were made outside the United States based on information that was evaluated abroad. In this regard, the analysis of the Second Circuit is consistent with a number of recent decisions in other federal courts that displayed a similar caution in exercising jurisdiction over lawsuits brought by non-US plaintiffs.[12]

Endnotes

[1] *Morrison v. National Australia Bank Ltd.*, 2008 WL 4660742 (2d. Cir. Oct. 23, 2008).

[2] It is important to understand (and, as discussed below, it is fundamental to the Second Circuit's reasoning) that the issue in this and similar cases is not the extraterritorial application of US securities generally, but the extraterritorial application of one specific US securities law—the antifraud provisions of the Securities Exchange Act of 1934.

[3] An ADR represents the right to obtain one or more shares of non-US stock, or a fraction of such a share. ADRs are issued by US depository banks and traded on US markets. The price of an ADR corresponds to the price of the non-US stock in its home market, after adjusting for the ratio of ADRs to non-US company shares. *See,* Securities and Exchange Commission, International Investing, available at http://www.sec.gov/pdf/ininvest.pdf.

[4] *Morrison v. National Australia Bank Ltd.*, 2008 WL 4660742, at *2 n.4.

[5] *Morrison v. National Australia Bank Ltd.*, SEC Amicus Brief, 22-30 (Sept. 17, 2008) available at http://www.sec.gov/litigation/briefs/2008/nationalaustralianbank.pdf.

[6] *Morrison v. National Australia Bank Ltd.*, WLF Amicus Brief, 5-16 (July 12, 2007) available at http://www.wlf.org/upload/07-0583-cv,%20Morrison%20v.%20National%20Australia%20Bank,%20Brief%20of%20Amicus%20Curiae%20Washington%20Legal%20Foundation%20in%20Support%20of%20Defendants-Appellees%20and%20Affirmance,%20submitted%2007-12-2007.pdf.

[7] *Morrison v. National Australia Bank Ltd.*, 2008 WL 4660742, at *2, citing H.R. Rep. No. 1838, at 32-33 (1934).

[8] *Id.* at *3.

[9] *Id.* at *3-*5, *citing Alfadda v. Fenn*, 935 F.2d 475, 478 (2d. Cir. 1991) *and ITT, Int'l. Inv. Trust v. Cornfeld*, 619 F.2d 909, 920-21 (2d. Cir. 1980) *and*

[10] *Id.* at *5.

[11] *Id.* at *7 and *8, *citing Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (769) (2008) (finding that "deceptive acts [that] were not communicated to the public do not suffice to show reliance … except in an indirect chain that we find too remote for liability") (citations and internal quotation marks omitted).

[12] In a similar case, the US district court for the Southern District of New York recently denied subject-matter jurisdiction where each of the allegedly misleading statements had been issued, signed or spoken in Switzerland. *In re SCOR Holding (Switzerland) AG Litigation*, Master File No. 04 Civ. 7897 (DCL), 2008 WL 608606 (S.D.N.Y. Mar. 6, 2008); *see also, In re Royal Dutch/ Shell Transport Securities Litigation (Royal Dutch II)*, Civ. No. 04-374(JAP), 2007 US Dist. LEXIS 84434 (D.N.J. Nov. 13, 2007) discussed in Latham & Watkins *Client Alert* Number 656, December 6, 2007. Denying sufficient US conduct, the *Shell* court emphasized that the foreign defendant's public disclosures originated in Europe, that its New York investor relations office did not take part in preparing the public announcements and that none of the shareholder and analyst meetings in the United States were with foreign analysts or foreign investors. Notably the US district court for the Southern District of New York, however, recently assumed subject matter jurisdiction over foreign investors' securities fraud claims against a foreign issuer where a significant number of the alleged misrepresentations were made to analysts and investors in New York, but the court subsequently excluded certain foreign investors from the certified class. *See, In re Vivendi Universal, S.A. Securities Litigation*, 2007 WL 1490466 (S.D.N.Y., May 21, 2007) discussed in Latham & Watkins *Client Alert* Number 602, June 6, 2007.

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