News brief

US securities fraud litigation

How long is the extraterritorial reach?

On 23 October 2008, the influential US Court of Appeals for the Second Circuit (Second Circuit) considered for the first time a so-called "foreign-cubed" case; that is, a securities fraud claim brought by non-US investors against non-US defendants based on securities transactions outside the US (*Morrison v National Australia Bank Ltd, 2008 WL 4660742 (2d. Cir. 23 October 2008)*).

The Second Circuit declined to find jurisdiction in this case, which will be reassuring to non-US companies concerned about the long arm of US securities litigation, but bad news for the non-US plaintiffs in this case. However, the court refused to adopt a "bright line" rule barring such cases in US courts.

The court's careful analysis provides important guidance on activities that could bring non-US entities within the reach of US securities fraud litigation.

The facts

National Australia Bank's (NAB) ordinary stock trades on the Australian Stock Exchange, the New Zealand Stock Exchange, the London Stock Exchange, and the Tokyo Stock Exchange. A small number of NAB's American Depository Receipts (ADRs), but not its stock, trade on the New York Stock Exchange.

In 1998, NAB acquired HomeSide Lending, Inc., a Florida-based mortgage service company. HomeSide calculated the present value of the fees it would generate from servicing mortgages in future years, and recognised certain amortised amounts on its balance sheet as a "Mortgage Service Right" (MSR) asset.

In 2001, NAB disclosed that HomeSide's valuation model had used incorrect interest assumptions, resulting in an overstatement of the value of the MSRs. Following two write-downs to adjust for these overstatements, NAB's stock price and the price of NAB's ADRs declined.

A number of investors filed a lawsuit against NAB, HomeSide and HomeSide executives in the US District Court for the Southern District of New York (District Court), alleging securities fraud under Section 10(b) of the Securities Exchange Act of 1934. The plaintiffs included three investors who purchased NAB ordinary stock on foreign exchanges and who sought to represent a class of non-US purchasers (the foreign plaintiffs).

The claims

The foreign plaintiffs argued that US jurisdiction existed because the alleged fraud occurred primarily in Florida where HomeSide was located, the false valuations of the MSRs were created, and therefore the violation of the US securities laws occurred.

The defendants argued that, because the alleged misrepresentations in NAB's financial statements were prepared and made outside the US by the non-US parent company (NAB), and because the foreign plaintiffs' purchases of NAB's securities occurred outside the US, there was insufficient conduct in the US to justify exercising jurisdiction over the foreign plaintiffs' claims.

Second Circuit's analysis

The Second Circuit found that, in assessing whether a US court has subject matter jurisdiction, it is necessary to ask whether:

- The alleged wrongful conduct occurred in the US (conduct test).
- The conduct had a substantial effect on US investors or markets (effects test).

It noted that, where appropriate, the two tests should be 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."

Here, 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 not demonstrated any damage to US investors).

The Second Circuit noted that the conduct test requires material activities in the US that were "more than merely preparatory to a fraud" and "directly caused losses to investors abroad." Whether US conduct "directly" caused 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."

The Second Circuit found that NAB's actions in Australia, that is, the preparation and disclosure of NAB's financial statements, were significantly more central to the alleged fraud and more directly responsible for the harm to investors than HomeSide's actions in Florida because:

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- The statements in question were made by NAB, not HomeSide.

- There were no allegations that the alleged fraud had affected US investors or US capital markets.

- There was a lengthy chain of causation between the US contribution to the alleged misstatements and the harm to investors: the 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.

Lessons from *Morrison*

The risk of having to defend against potentially "global" securities fraud litigation in the US involving classes of investors from all over the world, even where only a small fraction of the shares are traded on US exchanges, has contributed to non-US companies' concerns about maintaining US market listings (*for general background, see feature article "SEC deregistration: a growing trend?", www.practicallaw.com/5-200-5475*).

However, while the existence of subject matter jurisdiction will depend on the specific facts of any case and it is important to note that *Morrison* involved no allegations of negative effects on US investors, the decision suggests that it will be more difficult for non-US securities fraud plaintiffs to establish subject matter jurisdiction in a US court against a non-US entity if the challenged statements were made outside the US based on information that was evaluated abroad.

The Second Circuit's analysis is therefore consistent with a number of recent decisions in other federal courts that displayed similar caution in exercising jurisdiction over securities fraud claims brought by non-US plaintiffs (for example, *In re SCOR Holding (Switzerland) AG Litigation, Master File No. 04 Civ. 7897 (DCL), 2008 WL 608606 (SDNY 6 March 2008); In re Royal Dutch/Shell Transport Securities Litigation (Royal Dutch II), Civ. No. 04-374(JAP), 2007 US Dist. LEXIS 84434 (DNJ 13 November 2007); and In re Vivendi Universal, SA Securities Litigation, 2007 WL 1490466 (SDNY, 21 May 2007)*).

The decision is particularly noteworthy given the deference courts sometimes give to the US Securities and Exchange Commission's position on the application of the federal securities laws.

In seeking to strike the correct balance between the extraterritorial application of US 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".

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