

# Foreign-cubed case rejected

**The Second Circuit Court of Appeals has ruled that US securities laws have no extraterritorial application to a foreign corporation**

In *Morrison v National Australia Bank Ltd*, the US Court of Appeals for the Second Circuit held in a matter of first impression that foreign plaintiffs suing a foreign issuer based on losses the foreign plaintiffs allege they suffered in connection with securities transactions made on foreign exchanges could not assert claims under the Securities Exchange Act of 1934 (1934 Act), and Rule 10b-5 in particular, in a US District Court.

Rather than adopting a bright line rule that would have created a blanket prohibition on subject matter jurisdiction by a US court over these so-called foreign-cubed cases, however, the Second Circuit instead affirmed the District Court for the Southern District of New York's dismissal of plaintiffs' case using long-standing rules for determining the extraterritorial application of US securities laws.

The *Morrison* decision provides assistance in anticipating how a court would determine whether to exercise subject matter jurisdiction

over a foreign-cubed litigation. Subject matter jurisdiction generally refers to a court's power to render judgment over the general subject matter in an action. Despite the Second Circuit's rejection of a bright-line rule, the *Morrison* decision provides guidance because the Second Circuit set forth a number of factors to be considered. For example, the court emphasised the importance of the location where the false statements were disseminated to investors as opposed to where the underlying false information was generated.

The court also placed emphasis on whether American investors and America's capital markets were negatively affected by the fraudulent conduct, and found that where there was no such impact, this factor weighed against the exercise of subject matter jurisdiction. Finally, the court also indicated the need for the alleged fraudulent conduct to be the direct cause of harm to investors and capital markets, and the more tenuous and lengthy the causal chain between the alleged

fraudulent conduct and the harm, the less likely that it would be inclined to exercise jurisdiction.

## The facts

The facts of this case involve a class action initiated by foreign plaintiffs, against a foreign company, as a result of securities purchases on a foreign exchange, and present a typical foreign-cubed setting. The defendant, National Australia Bank (NAB), incorporated in Australia, refers to itself as Australia's largest bank and, in 2000, over half of its assets and revenues stemmed from its Australian business. NAB's ordinary shares trade on the London Stock Exchange, the Australian Securities Exchange, the Tokyo Stock Exchange and the New Zealand Stock Exchange. Although none of its ordinary shares trade on a US exchange, its American Deposit Receipts (ADRs) trade on the New York Stock Exchange. The court explained that "ADRs are issued by US depository banks and represent one or more shares of foreign stock or a fraction of a share. If you own an ADR, you have the right to obtain the foreign stock it represents". In 1998, NAB acquired HomeSide Lending, an American mortgage service provider located in Florida. In the first year after the acquisition, HomeSide earned A\$313 million (\$210 million) in mortgage servicing fees. In 1999, HomeSide earned A\$153 million in profits, amounting to approximately 5.4% of NAB's A\$2.82 billion in profits. In 2000, NAB reported that 4.1% of its total profits of A\$3.37 billion were attributable to A\$141 million in profits earned by HomeSide.

The *Morrison* decision was that the blame for failed disclosure lay in Australia (Sydney, right), not the US (New York, below)



However, all was not rosy. In 2001, NAB disclosed that certain assumptions underlying the valuation model used by HomeSide resulted in an overstatement in the value of HomeSide's mortgage servicing rights (MSR). These overstatements caused NAB to incur a \$450 million writedown as a result of its recalculation of HomeSide's MSR. Consequently, the value of NAB's ordinary shares and its ADRs dropped by more than 5%. Later that year, NAB disclosed a second writedown of \$1.75 billion of the value of HomeSide's MSR, which caused NAB's shares to fall by 13% and its ADRs to fall by over 11.5%. In December 2001, NAB filed an amended form 10-Q with the US Securities and Exchange Commission restating its previously issued financial statements in light of its prior adjustments.

**The decision and appeal**

Plaintiffs included four individual purchasers of NAB shares. Three of the plaintiffs purchased their shares abroad and sought to represent a class of non-Americans who purchased NAB ordinary shares at alleged inflated prices. The fourth plaintiff purchased ADRs in America and sought to represent a class of American purchasers. His claims were dismissed by the District Court for failure to allege that he suffered damages. The appeal however did not concern his claim. Plaintiffs brought claims in the Southern District of New York against NAB, HomeSide and various individual officers and directors. Plaintiffs alleged violations of Sections 10(b) and 20(a) of the 1934 Act, 15 USC, Sections 78j(b) and 78t(a), and Rule 10b-5

promulgated thereunder. In essence, plaintiffs alleged that "NAB's subsidiary HomeSide knowingly used unreasonably optimistic valuation assumptions or methodologies" and made materially false and misleading public statements concerning HomeSide's profitability and economic health with respect to its profit contributions to NAB. Plaintiffs alleged that HomeSide falsified its MSR in Florida and then sent the misleading data to NAB in Australia where it was then disseminated via public filings and statements. Defendants filed a motion to dismiss the complaint for lack of subject matter jurisdiction under Rule 12(b)(1) of the Federal Rules of Civil Procedure, and the District Court granted the motion. The foreign plaintiffs appealed only the portion of the decision dismissing their claims for lack of subject matter jurisdiction.

In addressing the appeal, the Second Circuit acknowledged that the 1934 Act does not address "its application to transactions taking place outside the United States". Therefore, the court stated that, when confronted with securities law claims with an extraterritorial component, it must consider the underlying purpose of the securities anti-fraud provisions and whether "Congress would have wished the precious resources of the United States courts and law enforcement agencies to be devoted to such transactions". To this end, the court stated that case law makes clear that Congress would seek to redress harms that, though perpetrated abroad, affect US investors or markets. The court then turned to its earlier decision in *Psimeons v EF Hutton & Co*, where it decided that when determining

the extraterritorial reach of Section 10(b) it must decide whether the harm was perpetrated in the US or abroad, and whether it substantially affected US markets and investors. These dual inquiries are referred to as the conduct test and effects test, and are applied to determine "whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court". However, plaintiffs only relied on the conduct test and did not argue on appeal that the alleged fraud affected American investors.

Under the conduct test, the court stated that "subject matter jurisdiction exists if activities in this country were more than merely preparatory to a fraud and culpable acts or omissions occurring here directly caused losses to investors abroad". Therefore, the court's determination of whether activities within the US directly cause losses to foreigners will depend on what and how much of the fraud occurred in the US and what and how much of the fraud occurred abroad.

**Bright-line rule rejected**

The court acknowledged that determining what is central to a fraudulent scheme as opposed to what is ancillary or merely preparatory can be a complicated undertaking. As such, defendants and certain *amici* urged the court to forego its analysis and adopt a bright-line rule "that in so-called foreign-cubed securities actions, showing domestic conduct should never be enough and subject matter jurisdiction cannot be established where the conduct in question has no effect in the United States or on American investors". In fact, they argued that the general



## “Defendants argued that the general presumption against foreign application of American law actually bars US courts from exercising subject matter jurisdiction”

presumption against foreign application of American law actually bars US courts from exercising subject matter jurisdiction over such foreign-cubed cases. In support of their argument, defendants and *amici* claimed that unless a bright-line rule prohibiting American courts from exercising subject matter jurisdiction over foreign-cubed cases were adopted it would bring American securities laws into conflict with the laws of other countries, undermine the competitiveness and effectiveness of the American securities markets, cause duplicative litigation and discourage cross-border economic transactions.

The court rejected the adoption of a bright-line rule. In doing so, it found that the potential for conflict with the laws of other jurisdictions did not require abandoning the conduct and effects tests in connection with foreign-cubed securities cases and adopting a hard rule. The court further found that adopting a blanket rule declining jurisdiction over all foreign-cubed securities fraud actions “would conflict with the goal of preventing the export of fraud from America”. The court also stated that the US should not be viewed as a safe haven for those who seek to violate the securities laws, and that those who operate from within American borders should not be given a greater degree of protection from American securities laws just because they happen to have a foreign passport and victimise foreign shareholders: “[The court] is an American court, not the world’s court, and we cannot and should not expend our resources resolving cases that do not affect Americans or involve fraud emanating from America.” Also, the court stated that the conduct test serves to balance these concerns adequately, and refused to place special limits on foreign-cubed securities cases. Therefore, regarding NAB, the court held that the issue before it required an analysis of what conduct comprised the core of the alleged fraud, and where that conduct occurred.

In this regard, plaintiffs argued that the heart of the fraud was HomeSide’s

manipulation of its MSR in Florida, and that NAB’s creation and dissemination of the fraudulent public statements, which occurred in Australia, merely consisted of NAB’s insertion of HomeSide’s incorrect statements into NAB’s filings. Therefore: “the locus of the improper conduct (Florida) and not the place of compilation (Australia) should determine jurisdiction”. Defendants argued that the fraud primarily consisted of the allegedly false and misleading statements made by NAB in Australia, because in the absence of those statements the misinformation would not have been disseminated, no investors would have been defrauded and no claims actionable under Rule 10b-5 would have existed. Therefore, defendants contended that the only conduct that directly harmed investors happened in Australia.

The court agreed with the defendants and concluded that it did not have subject matter jurisdiction. The court acknowledged the following facts in support of its finding that the actions taken by NAB in Australia were more central to the fraud and more directly caused the harm to investors than HomeSide’s manipulation of its numbers in Florida: (i) HomeSide reported to NAB in Australia, as NAB’s wholly-owned subsidiary; (ii) though HomeSide’s responsibilities included running a profitable business, NAB’s Australian corporate headquarters oversaw its subsidiaries’ operations and disseminated reports to shareholders and the financial markets concerning the same; and (iii) NAB is a publicly-traded company, unlike HomeSide, and NAB’s executives, with the assistance of lawyers, bankers and accountants, are required to take primary responsibility for NAB’s public filings and for its public statements. Also, plaintiffs’ claims were brought under Rule 10b-5(b), which deals with the accuracy of statements made to the public and investors. The court held that ensuring the accuracy of such statements is far more central to NAB’s Australian headquarters – which issued the statements –

than HomeSide, which made no statements to the public. Therefore, because NAB’s executives are responsible for presenting correct information to the public and to shareholders, the responsibility for inaccuracies lies with Australia, not Florida.

### The impact factor

The court stated that another factor contributing to its holding was the striking absence of allegations that the purported fraud affected America’s capital markets or its investors. Plaintiffs only brought their appeal on behalf of foreign investors who made purchases on foreign exchanges, and did not even raise the effects test to show that the fraud had any meaningful effect in America or on Americans. This factor weighed against the court’s exercise of subject matter jurisdiction over the action.

The last factor contributing to the court’s holding that it lacked subject matter jurisdiction was what it termed “the lengthy chain of causation between the American contribution to the misstatements and the harm to investors”. Plaintiffs never alleged that HomeSide communicated any falsified information to investors: rather, plaintiffs only alleged that HomeSide provided incorrect information to NAB. However, if NAB’s corporate headquarters had properly monitored the accuracy of the information HomeSide provided to them before disseminating it to the investors, the harm could have been prevented. Therefore, the court found that HomeSide may have been the source of the incorrect numbers but that “those numbers had to pass through a number of checkpoints manned by NAB’s Australian personnel before reaching investors”. Therefore, although HomeSide initially contributed to the misinformation, a number of events had to occur before this misinformation was disseminated to and harmed investors. Accordingly, the court found that this chain of causation between HomeSide’s actions and the harm experienced by investors further warranted against the court exercising subject matter jurisdiction.

In short, the combination of the fraudulent statements being disseminated from NAB’s Australian headquarters, the lack of any effect felt in America or by Americans and the long chain of causation between HomeSide’s conduct and the information disseminated to investors by NAB all contributed to the court’s determination that it lacked subject matter jurisdiction and affirmance of the District Court’s dismissal.

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