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NATIONAL AUSTRALIA BANK—NOT THE LAST WORD ON FOREIGN-CUBED SECURITIES LITIGATION

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In a recent decision by Justice Antonin Scalia in *Morrison v. National Australia Bank* ("*NAB*") (June 24, 2010), the U.S. Supreme Court answered a question with which lower courts have struggled for more than 40 years—whether section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") provides a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges—so called foreign-cubed litigation. The Court answered that question with an unequivocal "No" and drew a bright line around the borders of the U.S., bidding adieu to foreign-cubed cases as well as to the method used by the lower courts to analyze that issue. But this decision may not be the death knell for suits involving foreign frauds that it has been purported to be.

The decision not only precludes the ability of foreign and domestic plaintiffs to seek relief in U.S. Courts for transactions conducted on foreign exchanges, but also appears to curtail the ability of the SEC to bring actions based on such transactions. The impact is likely to be felt immediately in pending foreign-cubed cases in the form of renewed motions seeking dismissal or challenges to certification of classes that include plaintiffs who purchased their securities abroad.

The *NAB* Case

In the Second Circuit's *NAB* decision, the court framed the issue as one of subject matter jurisdiction and, while declining to propound a bright-line rule that there is never subject matter jurisdiction in such cases, held that jurisdiction did not exist in this case.

The action involves National Australian Bank ("NAB"), the largest bank in Australia. NAB's ordinary shares were traded on securities exchanges in Australia, London, Tokyo, and New Zealand, but not on U.S. exchanges. Its American Depository Receipts ("ADRs"), however, traded on the New York Stock Exchange. NAB had a subsidiary, HomeSide Lending, Inc. ("HomeSide"), a mortgage service provider, based in Florida. In July of 2001, NAB disclosed that it would incur a $450 million dollar write-down due to a recalculation of HomeSide's mortgage servicing rights. A second write-down of $1.75 billion was announced in September of 2001.

After these disclosures, NAB shares and ADRs declined significantly, and investors filed a class action securities fraud action in the Southern District of New York. The suit was originally brought by four investors, three of whom represented foreign investors who purchased their shares abroad, and one domestic investor. The District Court granted defendant's motion to dismiss the claims of the foreign plaintiffs for lack of subject matter jurisdiction and those of the domestic plaintiff for failure to state a claim. Only the foreign plaintiffs appealed.

In considering the extraterritorial reach of the U.S. securities laws, the Second Circuit applied the conduct test, which the Court articulated as follows: "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." Relying on two 1975 decisions by Judge Henry Friendly—*Bersch v. Drexel Firestone, Inc. and IIT v. Vencap, Ltd.*, the Court sought to identify which actions constituted the fraud and directly caused harm, or as the Court stated elsewhere in the opinion "what is central or at the heart of a fraudulent scheme."

The conduct test is, coupled with the effects test, part of a dual inquiry for the determination of subject matter jurisdiction in which the court asks (1) whether the wrongful conduct occurred in the United States, and (2) whether the conduct had a substantial effect in the United States or upon

United States citizens. The Second Circuit discussed only the conduct test in its decision, however, because the foreign appellants relied solely on the conduct component of the test in their appeal. Moreover, because the domestic plaintiff's claim had been dismissed, there was no occasion to apply the effects test to those claims.

Thereafter, the Supreme Court granted *certiorari*.

Subject Matter Jurisdiction and Transnational Fraud Claims

For more than the last 40 years, every court that has considered whether U.S. securities laws apply to claims of transnational fraud have analyzed the issue as one of subject matter jurisdiction. Because section 10(b) does not expressly state that it applies extraterritorially, courts of appeal formulated the cause and effects tests to determine whether and when the limited resources of U.S. courts should be used to address alleged frauds occurring in part outside the United States. Thus, the courts sought to prevent fraudulent actors from exporting their conduct outside U.S. borders and also to prevent foreign actors from having a fraudulent effect on U.S. investors and markets within those borders.

However, several circuits have articulated standards for the cause test that appear to be different. For example, in *NAB*, the Second Circuit articulated the standard as when "activities in this country were more than merely preparatory to a fraud and culpable acts or omissions occurring here directly caused the losses to investors abroad." In contrast, in *Zoelsch v. Arthur Anderson & Co.*, the D.C. Circuit held that domestic conduct must comprise "all the elements of a defendant's conduct necessary to establish a violation of Section 10(b) and Rule 10b-5." In *SEC v. Kasser*, the Third Circuit required at least some activity designed to further a fraudulent scheme occurring within the U.S. Yet other circuits mandated that domestic conduct be "in furtherance of a fraudulent scheme" and "significant with respect to its accomplishment." *See Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.* (8th Cir. 1979), *accord Gruenthal GmbH v. Hotz* (9th Cir. 1983).

Not surprisingly, such differently articulated standards led to criticism that the conduct test produced inconsistent results. It is also possible, however, that the fact-intensive nature of the inquiry into causation led to fine factual distinctions notwithstanding how the test was articulated. Regardless of the reason, the result of the application of the test in a given case was unpredictable.

Nevertheless, the circuits had uniformly framed the issue as one of subject matter jurisdiction. Recently, in *Arbaugh v. Y&H Corp.* and *Union Pacific Railroad Co. v. Brotherhood of Locomotive Engineers*, however, the Supreme Court held that "a threshold limitation on a statute's scope shall count as jurisdictional" only when the legislature has clearly stated that it is jurisdictional.

Given such high court precedent, the *NAB* parties essentially abandoned the jurisdictional analysis and focused on whether section 10(b) and the Exchange Act in general applied to extraterritorial transactions. Plaintiffs and the Solicitor General, as amicus, asserted that references to "interstate commerce" in the statute included commerce between foreign countries and any state. The Solicitor General also argued that the issue of domestic conduct that caused fraud in foreign transactions should be analyzed as an element of the private cause of action rather than as part of a jurisdictional inquiry. The Court rejected these contentions.

The *NAB* Decision

The Court began its analysis by noting the Second Circuit's "threshold error" in addressing the question as one of subject matter jurisdiction, which deals with a court's power to hear a case, noting that the Exchange Act expressly grants district courts exclusive jurisdiction over violations of the Act. Instead, the Court observed that "to ask what conduct § 10(b) reaches is to ask what conduct § 10(b) prohibits, which is a merits question," to be addressed under Federal Rule 12(b)(6). Thus, the Court proceeded to consider whether the *NAB* plaintiffs had stated a claim.

In addressing this question, the Court applied the longstanding presumption against extraterritoriality, stating: "'legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.'"

Thus, "when a statute gives no clear indication of an extraterritorial application it has none." The Court then reviewed the basis for the Second Circuit's conduct and effects tests, observing that the "Second Circuit never put forward a textual or extratextual basis for these tests." Moreover, in rejecting the above-mentioned arguments by the plaintiffs and the Solicitor General, the Court ruled tersely that "there is no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially, and we therefore conclude that it does not."

The Court also considered criticisms of the inconsistent application of the conduct and effects tests, which it characterized as "the result of judicial-speculation-made-law—divining what Congress would have wanted if it had thought of the situation . . . ."

The Court then held that "[s]ection 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." Finding no domestic securities transaction by the remaining plaintiffs, the Court dismissed their complaint for failure to state a claim.

The most obvious beneficiaries of the decision will be foreign corporations who will now face exposure to U.S. securities class action litigation only with respect to securities they list on U.S. exchanges. Foreign corporations may therefore choose to forego U.S. listings to avoid exposure to U.S. class actions. More immediately, the decision's impact should be seen in cases currently pending against foreign issuers on behalf of plaintiffs whose securities transactions occurred abroad.

More broadly, however, the Court did not limit its test to foreign plaintiffs or foreign issuers. The touchstone of the Court's test is transactions on U.S. exchanges or within U.S. borders. Thus, the holding appears to preclude all claims by any purchaser or seller, whether foreign or domestic, premised on securities of any issuer, foreign or domestic, regarding transactions executed on a foreign exchange or other transactions in securities conducted abroad.

In addition, because the Court held unequivocally that section 10(b) lacks any extraterritorial application, its holding also appears to bar any enforcement action premised on foreign securities transactions. Justice Stevens noted in his concurrence that the decision does not foreclose enforcement actions because the Commission's authority was not before the Court. The Court's holding, however, does not appear to leave room for any 10b-5 action based on foreign securities transactions. Moreover, if the decision precludes the SEC from bringing an action for a primary violation, it does not appear that the Commission could pursue domestic actions, such as an action against the executives at HomeSide, on an aiding and abetting theory.

The above conclusions appear to apply notwithstanding the existence, as in the *NAB* case, of conduct in the United States. The Court's decision, therefore, firmly forecloses federal securities litigation over foreign securities transactions.

Possible Legislative Response

The Court also appears to have anticipated that its decision might prompt a legislative response. In noting the past inconsistent application of the conduct test resulting from judicial speculation about what Congress would have wanted, the Court observed that its transactional test would provide "a stable background against which Congress can legislate with predictable effects."

Indeed, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* recently passed by Congress includes a provision granting federal courts jurisdiction over actions by the SEC and DOJ alleging violations of section 10(b) involving (1) domestic conduct constituting significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

Thus, Congress would reimpose a version of the conduct and effects tests for extraterritorial application of section 10(b) by the SEC and DOJ. The bill also contains a provision requiring the SEC to study "the extent to which private rights of action" should extend to such situations, analyzing, among other things, the implications on international comity.

With respect to the issue of comity, the *NAB* Court observed that "the regulation of other countries often differs from ours as to what constitutes fraud, what disclosures must be made, what damages are recoverable, what discovery is available in litigation, what individual actions may be joined in a single suit, what attorney's fees are recoverable, and many other matters." The Court also noted that the United Kingdom, Australia and France, as well as a number of international and foreign organizations submitted amicus briefs in the *NAB* case, complaining of the interference with foreign securities regulation that extraterrestrial application of section 10(b) would produce.

Therefore, although the *Dodd-Frank* bill, if enacted, would allow the SEC and DOJ to pursue certain securities frauds involving foreign transactions, it may be difficult for the Commission or Congress to conclude that foreign-cubed private litigation should be revived.

Conclusion

The Supreme Court's decision in *NAB* provides an unequivocal answer to the longstanding issue of whether section 10(b) of the Exchange Act applies extraterritorially. It does not. The decision certainly will help defendants in a number of pending foreign-cubed cases. Moreover, given the increasing globalization of financial markets, *NAB* should eliminate a growing category of securities actions going forward. However, although *NAB* as applied to private litigation seems unlikely to be modified legislatively, it appears likely that Congress will grant the SEC and DOJ authority to pursue primarily foreign frauds having some quantum of domestic conduct or effect. Of course, inconsistencies in determining what conduct or effect is sufficient is what landed the *NAB* case before the Court. Thus, it may eventually be required to revisit these issues in a regulatory context.

This article recently appeared in Securities Law360 and Finance Law360. Angelo G. Savino is a Member of Cozen O'Connor concentrating in the area of Directors and Officers Liability Insurance. For further analysis of the issues involved in this case please contact Angelo G. Savino, in our New York office (asavino@cozen.com, 212-908-1248).