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F-CUBED SUITS AFTER RECENT U.S. SUPREME COURT DECISION

Companies and their executives often justifiably dread U.S. courts and juries. This is certainly true when it comes to securities class actions. Now, at least those outside the U.S. can sleep somewhat more soundly after the recent Supreme Court decision in the closely watched F-cubed securities class action, *Morrison v. National Australia Bank Ltd.*[1] Given the facts in this case, even some U.S. executives may rest more comfortably.

FACING THE FACTS

An Australian company purchased a U.S. firm and subsequently had to take a substantial write-down in the value of its investment. This caused the price of the parent company's stock to fall, which led to a securities class action suit being filed in the U.S. by holders of its American Depository Receipts (ADRs) on behalf of the company's shareholders. The defendants in the securities class action included the U.S. subsidiary and some of its executives as well as the foreign parent and its executives. The suit alleged financial fraud by the U.S. executives with the awareness of the foreign parent. At a later date, the U.S. lead plaintiff dropped out of the suit, leaving the complaint to be continued solely by Australian shareholders who had purchased National Australia Bank's (NAB) shares on an Australian stock exchange.

In rejecting this case, the Supreme Court made much of the fact that the foreign company didn't have any "ordinary shares" traded in the U.S., so this decision may apply specifically to those foreign companies that are **not** directly or dual listed on any U.S. stock exchanges; the existence of ADRs don't help the foreign investors unless they purchased them here in the U.S. Specifically, the Court held that foreign plaintiffs suing foreign and domestic defendants for misconduct in connection with securities traded on foreign

F-Cubed refers to securities class actions that are brought in the U.S. 1) against foreign companies and their executives, 2) by foreign shareholders and 3) involving shares that were purchased on foreign (non-U.S.) exchanges. This same suit may also include U.S. plaintiffs (but this decision does not apply to them).

Section 10(b) of the U.S. Securities and Exchange Act of 1934 contains antifraud provisions relating to securities trading on U.S. stock exchanges. Together, § 10(b) and Rule 10b-5, created by the SEC, prohibit any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security.

exchanges have no cause of action, can't bring or maintain a securities class action suit in the U.S. under § 10(b) of the U.S. Securities and Exchange Act of 1934.

ET GO HOME: THE PRESUMPTION AGAINST THE EXTRATERRITORIAL REACH OF U.S. LAWS

With stunning brevity and succinctness, the highest Court in the land sited a "longstanding principle of American Law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.'"[2] How will a court know this *contrary intent* when it sees it? Silence will not be golden for the plaintiffs. If a statute doesn't clearly indicate that it should have extraterritorial application, it will have none. Foreign plaintiffs will have to keep their disputes in their relevant foreign jurisdictions.

EFFECTS TEST: What was the substantial effect of the challenged behavior in the U.S.?

CONDUCT TEST: Did the alleged substantive illegal conduct take place in the U.S.?

The Court held that both the "effects test" and the "conduct test" that previous (lower) courts had applied to similar claims are simply the wrong tests to apply. The applicable test is: Where were the shares purchased? Where foreign investors purchased their interests via foreign exchanges, these foreign markets and their enforcement entities are the ones legally entitled to decide disputes by foreign investors.

Understand that this decision does **not** address whether U.S. shareholders should be allowed to continue their lawsuit under U.S. law, especially when they purchased their interest in the company through a U.S. securities exchange. Specifically, it is the legal action by or on behalf of the foreign investors (the F-cubed claim) that is being rejected here.

IMPACT ON THE SEC?

On the surface, this decision doesn't speak to right and power of the U.S. securities regulator, the Securities and Exchange Commission (SEC), to bring a similar legal action as that brought by the plaintiffs in NAB, as the Commission itself is not a "foreign plaintiff." But a closer look reveals that many if not most SEC securities enforcement actions are *based on the same statute and rule as the plaintiffs'* in NAB – § 10(b) and Rule 10b-5. This means that even the SEC's greatest supporters have to believe that there is potentially some impact on the SEC, especially with the Court's focus on the language of the statute. In his concurring opinion,[3] Justice Stevens tried to create an exception for the SEC on the ground that "they...pose a lesser threat to international comity," or the respect that one nation pays to the rules of another. But this decision does not end this debate,rather, it heats it up.

Meanwhile, the current proposed financial reform bill[4] pending in the U.S. addresses the extraterritorial question and *specifically authorizes* action by the SEC based on "conduct within the United States in furtherance of the violation," in effect allowing the SEC to take enforcement action based on conduct in the U.S. even if the illegal transaction took place outside the U.S. (if all

of the provision's other conditions are met).[5] The bill then goes on to direct the SEC to study whether private rights of action should be allowed on the same basis as authorized for the SEC (see "Study of Extraterritorial Private Rights of Action").[6] So, if the Bill is enacted in its current form, in the financial arena, the SEC *will* have the express ability to bring cases involving foreign companies, even involving transactions outside the U.S., if the conduct meets the standards defined in the provision.

WHAT ABOUT DERIVATIVE CLAIMS?

Shareholder derivative claims generally arise under state law (rather than federal law, such as the Securities Exchange Act of 1934) and they don't allege § 10(b) and Rule 10-b5 violations, which were the focus in the NAB decision. So, again, a surface reading of this case is that it does **not** apply to shareholder derivative actions. But the language in this case relating to the limited extraterritorial reach of U.S. laws may still be found to be determinative.

However, unlike securities class actions, which seek recoveries going directly to a group of shareholders (which can be divided into subgroups), derivative claims seek a recovery for the company as a whole; so potentially a single U.S. shareholder could obtain relief for the entire company. Dividing a derivative claim into shareholders who bought their shares in the U.S. and those that did not would therefore have little substantive effect. Only further litigation will tell.

WHAT THE FUTURE MAY BRING

Once they stopped cheering upon the publication of this decision,[7] non-U.S. firms fighting claims in the U.S under U.S. law involving non-U.S. shareholders who bought their shares on non-U.S. markets, began drafting motions to dismiss the charges against them, or, at the very least, to remove the non-U.S. shareholders from the action. The result might well be to divide and multiply the litigation into the markets where the shares were originally purchased, a situation which will likely lead to the best overall, eventual outcome for the defendants. In the short run, however, it could also lead to more uncertainty and a fractured defense strategy. We can expect to see action in these cases in the very near future.

The current financial reform bill awaits approval or revision in the U.S. If passed, as mentioned above, it would expressly allow the SEC, under certain conditions, to bring suit against foreign companies and their executives under U.S. securities laws.

Few derivative suits involving foreign companies are currently proceeding in the U.S. (see July 2010 ER *Alert* "Derivative Claim Study"). We expect that the defendants here *may* also try to have claims by or on behalf of any non-U.S. claimants dismissed. But this may not lead to the desired result: lower (or zero) damages.

The language in this decision relating to the potential extraterritorial reach of U.S. laws may be felt in areas far afield from securities litigation.

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[1] No. 08-1191. Argued March 29, 2010, decided June 24, 2010.

[2] The Court was referencing the 1991 decision in *EEOC v Arabian American Oil Co.*, 499 U.S. 244, 248 (Aramco).

[3] In a simple concurring opinion, as in this case, a judge will agree with the outcome of the majority, but have something to add.

[4] Also known as the "Dodd-Frank Wall Street Reform and Consumer Protection Act."

[5] § 929P(b)

[6] § 929Y

[7] And who can blame them?