

Securities Litigation Alert

Supreme Court Protects Foreign Issuers from Securities Class Actions

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In an important victory for all foreign public companies that have some operations or business dealings in the United States, the Supreme Court has rejected an attempt by foreign shareholders to sue a foreign company in the United States under U.S. antifraud laws. In *Morrison v. National Australia Bank*, the Court affirmed the dismissal of fraud claims brought in New York court by Australian shareholders against the Melbourne, Australia-based National Australia Bank, Ltd. (NAB). The claims were based on alleged acts of fraud committed by NAB's United States subsidiary, Homeside Lending, Inc. In rejecting plaintiffs' claims, the Supreme Court held that Section 10(b) of the Securities Exchange Act of 1934¹ ("Exchange Act") and SEC Rule 10b-5 issued thereunder, applied only to fraud in connection with a security listed on an American stock exchange or otherwise purchased in the United States. In reaching its decision, the Court overruled over 40 years of appellate precedent, largely created by the 2nd Circuit, and rejected the test proposed by the solicitor general. The decision confirms the Court's strict approach to the implied cause of action under Rule 10b-5 that is apparent in its other recent decisions in this area.

As alleged by the plaintiffs, Homeside, a mortgage service provider, intentionally overvalued its mortgage portfolio in order to achieve overinflated earnings targets and then transmitted its allegedly fraudulent financial information to NAB. NAB, in turn, incorporated this information into reports it filed with the Australian Securities and Investments Commission (ASIC), pursuant to Australian laws and rules governing the Australian Stock Exchange, thus rendering the reports false and misleading. After NAB disclosed problems with Homeside's mortgage portfolio and ultimately wrote down its value, NAB's shares declined in value, allegedly causing loss to its shareholders. NAB's ordinary shares trade exclusively on Australian and other foreign securities exchanges, and 99.97 percent of NAB's ordinary shares were held by investors from Australia and other places outside the United States. Nonetheless, the Australian named plaintiffs, purporting to represent a worldwide class of investors who have no connection to the United States, sought to have their claims adjudicated in U.S. courts under U.S. law.

The District Court dismissed the complaint on the basis that it lacked subject-matter jurisdiction over their claims. The District Court concluded that all of the elements of plaintiffs' claims took place outside the United States, and the United States' conduct "amounts to, at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad." The court of appeals affirmed, holding that it was NAB's executives and advisors in Australia who bore "primary responsibility" for NAB's disclosures, and, therefore, the actions in Australia were "significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of numbers in Florida." The Supreme Court, in a majority opinion written by Justice Scalia, affirmed the court of appeals but on much more sweeping grounds than the court of appeals.

Justice Scalia first noted that Section 10(b) is silent regarding any extraterritorial application, and there is no clear indication elsewhere in the Exchange Act that it is meant to apply outside the United States. Applying the "presumption against extraterritoriality"—the longstanding canon of statutory interpretation that legislation applies only within the territorial jurisdiction of the United States unless Congress intends otherwise—the Court held that Section 10(b) has no application outside of the United States. Justice Scalia then analyzed how this applies to the claims against NAB. Because Section 10(b) only prohibits fraud "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered," its reach was limited to fraud in connection with securities listed on American exchanges or

¹ 15 U.S.C. § 78j.



otherwise bought or sold in the United States. It was not enough that some fraudulent activity occurred in the United States, even if that was a material part of the fraudulent scheme. Justice Scalia wryly noted “the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever some domestic activity is involved in the case.” As NAB’s securities were not listed on an American exchange or sold elsewhere in the United States, Section 10(b) did not apply to NAB and Homeside’s alleged fraud.

The decision has several important ramifications.

First, the biggest immediate impact is on so-called “foreign-cubed” cases: claims brought in federal courts under Section 10(b) and Rule 10b-5 by foreign investors who purchased securities in foreign companies on foreign exchanges. These lawsuits had become increasingly popular, and while many had been dismissed, as the complaint in this case was, some had been permitted to proceed. These claims are now categorically beyond the reach of federal securities laws and the federal courts.

Second, the decision prohibits any claim by any investor who purchased securities on a foreign exchange. Securities class actions involving multinational companies frequently include in the plaintiff class investors who purchased their shares on foreign exchanges, as well as investors who purchased shares in the United States. Under this ruling, anyone who purchased a security outside the United States must now be excluded from the class. Furthermore, foreign issuers that have not listed on a United States exchange can be confident that they will not be named in a securities class action in federal court even if they have substantial operations in the United States.

Third, the decision is a blow to the U.S. Securities and Exchange Commission (SEC). In the amicus brief submitted by the solicitor general, it argued that Section 10(b) reached international fraud where there is “significant conduct in the United States that is material to the fraud’s success.” The SEC argued that Section 10(b) applied to this conduct and, therefore, the SEC could investigate and bring enforcement proceedings even if foreign investors may not be able to recover for losses suffered as a result of this fraud. The Court categorically rejected this argument as unsupported by either the statute or precedent. While it is likely that other provisions of the Securities Exchange Act could apply to such fraudulent conduct, and the SEC may still have some jurisdiction, the inapplicability of Section 10(b), the primary antifraud provision in the Act, is a severe loss to the SEC with regard to international fraud. This result may be reversed by Congress in the upcoming financial reform legislation, but in the meantime, this decision is a setback for the SEC.

Finally, Justice Scalia was scathing in his criticism of previous appellate authority that found some extraterritorial application of Section 10(b). Justice Scalia dismissed these opinions, which date back to 1967, as “judicial-speculation-made-law.” Justice Scalia reaffirmed the primacy of the statutory text in determining the scope of Section 10(b) and Rule 10b-5. But, as Justice Stevens notes in his concurrence, the entire area of Section 10(b) jurisprudence consists almost entirely of “judge-made rules, which give concrete meaning to Congress’ general command.” Many of the criticisms that Justice Scalia made regarding the previous authority on extraterritoriality can also be made regarding other securities law precedent. Ever since its decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court has consistently limited the scope of section 10(b) and rejected the expansive versions of its reach advocated by private plaintiffs and the SEC. While it is unlikely to ever reverse its decision to imply a private cause of action under Section 10(b), the decision in *Morrison* continues the Court’s somewhat hostile approach to liability under Section 10(b) and confirms the Court’s intentions to keep it within its current limits. Indeed, Justice Scalia noted that, instead of becoming a “Barbary Coast for those perpetrating frauds on foreign securities markets, some fear that [the United States] has become the Shangri-La of class-action litigation.”

Akin Gump Strauss Hauer & Feld LLP submitted an amicus curiae brief in support of the defendants in this case.

CONTACT INFORMATION

If you have any questions concerning this alert, please contact —

James J. Benjamin Jr.
jbenjamin@akingump.com
212.872.8091
New York

David L. Comerford
dcomerford@akingump.com
215.965.1324
Philadelphia

AKIN GUMP
STRAUSS HAUER & FELD LLP

Jeffery A. Dailey
jdailey@akingump.com
215.965.1325
Philadelphia

Steven Kaufhold
skaufhold@akingump.com
415.765.9562
San Francisco

Nicholas I. Porritt
nporritt@akingump.com
202.887.4019
Washington, D.C.

William E. White
wwhite@akingump.com
202.887.4036
Washington, D.C.

Orrin L. Harrison III
oharrison@akingump.com
214.969.2860
Dallas

Mary L. O'Connor
moconnor@akingump.com
214.969.2818
Dallas

Douglas A. Rappaport
darappaport@akingump.com
212.872.7412
New York