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Supreme Court Limits Reach of Securities Fraud Actions Against Foreign Companies

In an opinion issued last week, *Morrison v. National Australia Bank Ltd.*, 559 U.S. ___ (2010), the Supreme Court held that foreign plaintiffs cannot use the U.S. Securities laws to sue foreign issuers based on foreign stock purchases: a ruling that sounds the death knell for these so-called “foreign cubed” cases. Rejecting decades of lower-court case law on the extraterritorial reach of the U.S. securities fraud laws, the Supreme Court adopted a new “transactional” test, limiting the applicability of Section 10(b) of the Exchange Act of 1934 to transactions in securities either listed on domestic exchanges or otherwise purchased in the United States.

Background

National Australia Bank Limited (National) was, during the relevant time, the largest bank in Australia. Although National’s American Depositary Receipts (ADRs), which represent the right to receive a specified number of National’s shares, are listed on the New York Stock Exchange, National’s stock is not traded on any United States exchange. In 1998, National bought HomeSide Lending, Inc., a mortgage servicing company headquartered in Florida.

In 2001, National announced that it was writing down the value of HomeSide’s assets by approximately \$2.2 billion. In response to these write-downs, three Australian citizens sued National and several of its executives in the United States District Court for the Southern District of New York for alleged violations of Sections 10(b) and 20(a) of the Securities and Exchange Act of 1934, claiming that the defendants had overstated the value of HomeSide’s mortgage-servicing rights in National’s financial statements.

The issue before the Supreme Court was the reach of Section 10(b). How much of a connection to the United States is required in order for a transaction to fall under the protections offered by Section 10(b)? More specifically, does Section 10(b) provide a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges?

Supreme Court Decision

The Court answered with a resounding “No,” affirming dismissal of the plaintiffs’ claims. In doing so, the Supreme Court adopted a bright-line “transactional” test for courts to use in determining the scope of Section 10(b). The Court held that Section 10(b) applies only to purchases or sales that occur on a domestic exchange or in the United States.

In fashioning this “transactional” test, the Supreme Court reiterated the importance of the general presumption that federal legislation only applies domestically unless Congress expressly states otherwise. According to the Court, “[w]hen a statute gives no clear indication of an extraterritorial application, it has none.” Yet despite this presumption, over the past 50 years, courts of appeals had interpreted the Exchange Act’s silence regarding its extraterritorial reach as an invitation to determine whether Congress would have wanted the statute to apply to foreign transactions. To that end, the courts of appeals developed various “judicially-created” tests, most notably the “conduct” test, which asked how much fraudulent conduct occurred in the United States, and the “effects” test, which looked to the effect of fraudulent conduct on American investors and exchanges. Finding these tests “complex in formulation” and “unpredictable in application,” the Supreme Court abolished them in favor of the bright-line “transactional” test. The focus of the Exchange Act, the Court found, “is not upon the place where the deception originated, but upon the purchases and sales of securities in the United States.”

Applying these principles in *National Australia Bank*, the Court agreed that plaintiffs could not satisfy the “transactional” test. National’s stock did not trade on a United States exchange, nor had plaintiffs purchased the stock in the United States. Accordingly, Section 10(b) did not apply, and the trial court properly dismissed the plaintiffs’ claims.

Implications of the Decision

The Court’s holding will have a significant impact on securities class action cases involving foreign issuers. Most clearly, the “transactional” test eliminates ambiguity in “foreign cubed” cases—providing clarity that was noticeably absent under the “effects” and “conduct” tests. As the Court noted regarding the “effects” and “conduct” tests, “[t]here is no more damning indictment of the ‘conduct’ and ‘effects’ tests than the Second Circuit’s own declaration that ‘the presence or absence of any single factor which was considered significant in other cases. . . is not necessarily dispositive in future cases.’” Application of the “transactional” test should both eliminate pure “foreign cubed” cases and reduce the number of potential class members in cases that seek to include foreign investors who purchased on foreign exchanges. The Court’s holding does not, however, necessarily preclude all securities fraud class actions against foreign companies. It remains to be seen how lower courts will apply the “transactional” test outside of the “foreign cubed” context, such as to claims brought by purchasers of foreign company ADRs listed on U.S. exchanges or by U.S. purchasers of stock on foreign exchanges.

The Court’s holding may also impact the SEC’s enforcement efforts. The government’s amicus brief in *National Australia Bank* urged the Court to adopt a test based on the amount of fraudulent conduct occurring in the U.S. and to instead affirm dismissal based on plaintiffs’ failure to show their injury was directly caused by the U.S. component of the alleged fraud. A ruling on causation grounds would not have impacted the SEC’s ability to enforce perceived violations of 10(b). In contrast, the Court’s ruling on the scope of the conduct covered by 10(b) arguably impacts both SEC enforcement and private litigation. The impact may be obviated, however, by provisions in financial regulatory reform legislation currently being debated in Congress.

For more information, please visit the [Securities Class Action Defense and Shareholder Litigation](#) page of the [Haynes and Boone, LLP](#) Web site, or contact:

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