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U.S. Securities Litigation Against Non-U.S. Issuers by Non-U.S. Plaintiffs

Second Circuit Appellate Court Tightens Rules Governing “Foreign-Cubed” Claims

SUMMARY

Over the past several years, U.S. plaintiffs’ lawyers have increasingly recruited European and Asian investors to join U.S. securities fraud class actions against non-U.S. companies. In these actions, plaintiffs’ lawyers have brought claims in U.S. courts on behalf of non-U.S. investors who purchased shares of non-U.S. companies on non-U.S. exchanges (so-called “foreign-cubed claims”). Frequently, the substantial majority of the equity of such issuers is held by investors located outside the United States. The potentially significant litigation exposure to non-U.S. companies from suits brought on behalf of sizeable classes of non-U.S. investors contributes to concerns that commentators have raised about the maintenance of U.S. markets listings by non-U.S. companies.

In a unanimous opinion in *Morrison v. National Australia Bank*, No. 07-0853-cv, 2008 WL 4660742 (2d Cir. Oct. 23, 2008) (“*NAB*”), the United States Court of Appeals for the Second Circuit, which sits in New York City, limited the ability of U.S. courts to hear foreign-cubed claims. While declining to adopt a “bright-line rule” precluding the exercise of subject matter jurisdiction over such claims, the Second Circuit held that, in general, a U.S. court does not have subject matter jurisdiction over foreign-cubed claims when the acts that constituted the alleged fraud and directly caused the alleged harm emanated from outside the United States. Under this approach, the court concluded, subject matter jurisdiction does not exist over a foreign-cubed claim when the non-U.S. company’s executives (a) made decisions concerning the content of alleged misstatements to investors from abroad and (b) issued those statements from abroad.

BACKGROUND

In *NAB*, U.S. plaintiffs who purchased National Australia Bank (“NAB”) American Depository Receipts on the New York Stock Exchange and non-U.S. plaintiffs who purchased NAB ordinary shares on the Australian Stock Exchange brought a securities fraud class action against NAB in the Southern District of New York. To connect the alleged fraud to the United States, and thus to provide a basis for the U.S. court to exercise jurisdiction over their foreign-cubed claims, the non-U.S. plaintiffs alleged that employees of HomeSide, NAB’s U.S. mortgage service provider, knowingly created models that falsely inflated the value of its Mortgage Servicing Rights (“MSRs”). HomeSide employees then allegedly transmitted these inflated values to NAB executives in Australia, who allegedly participated in the fraud by including that information in NAB’s financial disclosures that they issued from Australia. When the inflated MSR values became apparent, NAB took large write-downs, allegedly causing a decline in NAB’s share price.

The district court dismissed the non-U.S. plaintiffs’ claims for lack of subject matter jurisdiction. In doing so, the court held that, because the claims concerned alleged public misstatements, the “heart” of the alleged fraud had occurred in Australia, where NAB executives determined the content of, and issued, NAB’s public disclosures. The court held that the underlying conduct by HomeSide employees, while part of the chain of events that ultimately caused the alleged losses, was insufficient to establish the right of the non-U.S. plaintiffs to bring suit in the United States. The court observed, “the domestic conduct would be immaterial to [non-U.S. plaintiffs’] claim but for (i) the allegedly knowing incorporation of [] false information; (ii) in public filings and statements made abroad; (iii) to investors abroad; (iv) who detrimentally relied on the information in purchasing securities abroad.” The court also dismissed the U.S. plaintiffs’ claims for failure to properly allege that the alleged fraud caused them damages. Only the non-U.S. plaintiffs appealed.

SECOND CIRCUIT OPINION

The Second Circuit affirmed. It set the tone for its decision by stating that “we are 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.” The court then reaffirmed that a U.S. court generally has jurisdiction to hear foreign-cubed claims only if activities in the United States “were more than merely preparatory to a fraud and culpable acts or omissions occurring here directly caused losses to investors abroad.” As the court acknowledged, this determination is not mechanical, and it “depends on what and how much was done in the United States and on what and how much was done abroad.”

Nevertheless, and while rejecting “rigid bright-line rules” (including the rule for which defendants had advocated barring subject matter jurisdiction over all foreign-cubed claims), the Second Circuit made clear that, because the U.S. securities laws focus on disclosures, a U.S. court should not exercise

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jurisdiction where the primary responsibility for the content of the disclosures and the issuance of the disclosures occurred abroad:

The actions taken and the actions not taken by NAB in Australia were . . . significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of the numbers in [the United States] . . . [Plaintiffs'] claims [focus] on the accuracy of statements to the public and to potential investors. Ensuring the accuracy of such statements is much more central to the responsibility of NA[B]'s corporate headquarters, which issued the statements, than those of the [U.S. subsidiary], which did not.

In doing so, the Second Circuit rejected the proposition that a U.S. court can exercise jurisdiction over foreign-cubed claims solely because certain conduct contributing to the creation of the alleged misstatements (in *NAB*, the creation of purportedly fraudulent valuation models) occurred in the United States.

The Second Circuit also noted that (1) because the U.S. plaintiffs had not appealed the district court's dismissal of their claims, there were no allegations of any effect on U.S. investors or U.S. markets, and (2) none of the alleged misstatements were made from the United States. The total "mix of factors," the court concluded, "add[s] up to a determination that we lack subject matter jurisdiction."

IMPLICATIONS FOR NON-U.S. COMPANIES

NAB has several implications for non-U.S. companies whose securities trade in the United States or that conduct extensive business here.

First, *NAB* should help limit non-U.S. companies' exposure to foreign-cubed claims in United States courts. *NAB* may have a particular impact on recent foreign-cubed claims brought by the plaintiffs' bar in the wake of the credit crisis and corresponding dramatic decline of worldwide share prices. Many of the non-U.S. plaintiffs in these lawsuits attempt to connect their claims to the United States by alleging that non-U.S. companies took large writedowns on U.S. assets traded by U.S. employees. This limitation of subject matter jurisdiction to claims by investors with the requisite U.S. nexus could be particularly significant given that, for many non-U.S. companies, most of their securities were acquired and are held by non-U.S. investors.

Second, *NAB* suggests that non-U.S. companies can reduce the risk of foreign-cubed claims by taking steps to ensure that the decisions about the content of their disclosures, as well as the issuance of those disclosures, occur outside the United States. Such steps might include centralizing the preparation and dissemination of their public disclosures and holding board or executive meetings concerning those disclosures outside the United States. In contrast, in a case against Vivendi in the Southern District of New York, the trial court exercised jurisdiction over foreign-cubed claims, because Vivendi's CEO and

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CFO conducted significant operations from New York, and from there approved the content of the alleged misstatements.

Third, *NAB* suggests that non-U.S. companies also could enhance their jurisdiction defenses against foreign-cubed claims by limiting public disclosures made by any high-ranking company officials within the United States. While *NAB* indicates that the jurisdictional inquiry should focus on the full relevant conduct, by limiting unnecessary links between their public disclosures and the United States, non-U.S. companies can correspondingly limit the bases on which non-U.S. investors could attempt to establish the requisite nexus between their claims and the United States.

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