Client Alert: Supreme Court Ruling Limits Ability of Investors to Recover Damages in Connection With Losses on Securities Purchased on Non-US Exchanges

On June 24, 2010, the Supreme Court affirmed the dismissal of all securities fraud claims brought by aggrieved investors in Morrison v. National Australia Bank, Ltd., No. 08-1191 (“Morrison”) (slip opinion available at www.supremecourt.gov/opinions/09pdf/08-1191.pdf). The Court’s decision effectively eliminates the ability of foreign (non-US) investors who purchase shares of foreign companies on foreign exchanges (so-called “F-cubed” plaintiffs) to bring securities fraud claims in the United States under Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”). The rationale of the Supreme Court’s decision will also try to be used by foreign companies and their counsel to limit the ability of U.S. investors to recover under §10(b) for losses suffered in connection with their purchases of shares on foreign exchanges – even when the underlying fraud otherwise has a substantial nexus to unlawful conduct that took place in the United States.

The Lower Court’s Decision

The plaintiffs in Morrison consisted solely of Australian investors who purchased “ordinary shares” of National Australia Bank (“NAB”) on the Australian Stock Exchange.¹ In brief, the plaintiffs alleged that, between 1998 to 2001, NAB had published financial statements that had fraudulently overstated the value of the stream of income that the bank derived from certain “mortgage servicing rights.” These mortgage servicing rights were generated by the bank’s US-based subsidiary, HomeSide Lending Inc. (“HomeSide”). Plaintiffs conceded their status as “F-cubed” plaintiffs (i.e., their status as foreign purchasers of a foreign company’s shares on a foreign exchange), but asserted that they had the ability to bring their claims under §10(b) in the United States because the fraudulent conduct at issue – namely, the fraudulent

¹ One of the original plaintiffs had been an American, who had purchased “American Depository Receipts” (ADRs) of NAB on the New York Stock Exchange. However, the American plaintiff’s claims were dismissed because he had not suffered any damages. Accordingly, on appeal, the only claims at issue were those of the Australian plaintiffs who had purchased NAB “ordinary shares” (not ADRs) on the Australian exchange.
doctoring of the results of NAB’s US-based HomeSide subsidiary – took place in the United States.

In *Morrison*, the Second Circuit held that despite some alleged fraudulent activity at NAB’s US-based subsidiary, the more critical alleged fraudulent conduct occurred in Australia, where NAB executives generated the false financial statements that were distributed to the public. For that reason, the Second Circuit held that the “conduct test” was not satisfied. The plaintiffs petitioned to appeal the case to the Supreme Court.

**Issues Presented**

Before the Supreme Court, the defendants argued that the lower court’s decision dismissing the claims (which were “F-cubed” claims brought by foreign investors) could be affirmed on two independent grounds. First, defendants argued that the plaintiffs, as F-cubed investors, had failed to allege sufficient relevant activity by the defendants in the United States to satisfy the Second Circuit’s traditional “conduct test.” Second, however, the defendants also argued that the Second Circuit’s traditional conduct test should be overturned, and replaced with a *transaction test* that focuses more narrowly on where the securities transactions at issue (*i.e.*, the plaintiffs’ purchases of NAB ordinary shares) took place.

**The Supreme Court’s Ruling**

Unfortunately for investors, a majority of the Supreme Court – over the objections of two Justices -- accepted defendants’ invitation to repudiate the “conduct test” with a much narrower transaction-oriented test.³

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² The Second Circuit’s conduct test requires a showing of significant, not merely preparatory, fraudulent conduct in the United States. *See Morrison* at 8.

³ The majority opinion was written by Justice Scalia, and joined by five other Justices. Justice Stevens (joined by Justice Ginsburg) concurred in the judgment affirming dismissal on the grounds that the plaintiffs had failed in any event to meet the traditional “conduct test” -- but wrote separately to vigorously object to the majority’s repudiation of the Second Circuit’s prior case law. Justice Breyer wrote a one page concurrence, which simply noted that the Court’s opinion should not be construed as implying any view as to whether or not *other* state or federal laws governing fraudulent conduct may apply extraterritorially. Justice Sotomayor did not participate in the case.

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The Supreme Court reviewed the relevant text of the Exchange Act, and found no evidence of any Congressional intent to apply §10(b) of the Act extraterritorially. *Morrison*, at 12-16. For example, although the Court found that §30(a) and (b) of the Act *did* include a “clear statement of extraterritorial effect” as to those two provisions, it used this fact as support for its conclusion that the lack of any similar language in §10(b) *undermined* any argument that §10(b) should be similarly construed. *Id.* at 14-16. “In short,” the Supreme Court held, “there is no affirmative indication in the Exchange Act that §10(b) applies extraterritorially, and we therefore conclude that it does not.” *Id.* at 16.

Instead, the majority articulated a new locus-of-the-transaction oriented test for the application of §10(b):

*[W]e think that the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States. Section 10(b) does not punish deceptive conduct, but only deceptive conduct “in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.” 15 U. S. C. §78j(b). See SEC v. *Zandford*, 535 U. S. 813, 820 (2002). Those purchase-and-sale transactions are the objects of the statute’s solicitude. It is those transactions that the statute seeks to “regulate,” see *Superintendent of Ins. of N. Y. v. Bankers Life & Casualty Co.*, 404 U. S. 6, 12 (1971); it is parties or prospective parties to those transactions that the statute seeks to “protec[t],” *id.*, at 10. See also *Ernst & Ernst v. Hochfelder*, 425 U. S. 185, 195 (1976). *And it is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which §10(b) applies.*

*Morrison* at 17-18 (emphasis added; footnote omitted). As the Court continued, “[t]he primacy of the domestic exchange is suggested” by prologue of the Exchange Act, “which sets forth as its object ‘[t]o provide for the regulation of securities exchanges . . . operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges . . . .’” *Id.* at 18, quoting 48 Stat. 881. Moreover, Justice Scalia wrote, “*We know of no one who thought that the Act was intended to ‘regulat[e]’ foreign securities exchanges—or indeed who even believed that under established principles of international law Congress had the power to do*
so. The Act’s registration requirements apply only to securities listed on national securities exchanges.” *Id.*, citing 15 U. S. C. §78l(a) (emphasis added).

With regard to securities *not* registered on a domestic US exchange, the Supreme Court’s opinion emphasized that the Exchange Act’s “exclusive focus” is “on *domestic* purchases and sales.” *Morrison*, at 19 (emphasis in original). Citing the only two provisions of the Exchange Act that contain express extraterritorial language, the Court noted that (1) §30(a) “extends the normal scope of the Exchange Act’s prohibitions to acts effecting, in violation of [SEC] rules, ... a ‘transaction’ in a United States security on [a foreign exchange];” and (2) that §30(b) provides that the Act does not apply to “‘any person insofar as he transacts a business in securities without the jurisdiction of the United States,’” unless he does so in violation of SEC regulations promulgated “to prevent evasion [of the Act].” *Morrison* at 19, quoting 15 U.S.C. §78dd(a) and (b). As the Court stated, “[u]nder both provisions it is the foreign location of the transaction that establishes (or reflects the presumption of) the Act’s inapplicability, absent regulations by the [SEC].” *Id.* at 19 (emphasis in original).

**(A) Implications for Foreign Investors.**

The Court’s decision eliminates what had, until now, been an important avenue of recovery under §10(b) for foreign investors in cases that involved significant wrongful conduct in the United States, and where the foreign investors had purchased their securities in the defendant company on a foreign exchange.

Accordingly, on a going forward basis, when non-US investors have the opportunity to choose between (a) purchasing “ordinary shares,” or other securities on a non-US exchange, or (b) purchasing American Depositary Receipts or Shares (ADRs or ADSs), or the US-traded analogs of other securities -- they will need to give serious consideration to choosing the latter approach in order to preserve their ability to recover damages under §10(b) for securities frauds having a meaningful connection to the United States.

Of course, as noted by Justice Breyer’s brief concurring opinion, *Morrison* does *not* purport to preclude foreign plaintiffs from potentially taking advantage of other U.S. laws – notably, the laws of the various 50 states (some of which have their own investor-friendly securities fraud statutes, in addition to “common law fraud” remedies.
available under state law). Every factual situation is different, and – notwithstanding *Morrison* -- case-by-case review of particular situations with experienced U.S. securities litigation counsel will almost certainly be warranted whenever a foreign investor has suffered losses as a result of fraudulent conduct that took place in (or otherwise has a potentially meaningful nexus with) the United States.

**(B) Implications for Domestic U.S. Investors.**

Although the Supreme Court did not expressly eliminate the ability of US investors to recover losses under §10(b) in connection with securities that they purchased on an overseas stock exchange (and that issue was arguably not presented to the Court), foreign companies will undoubtedly argue that *Morrison* negatively impacts the ability of U.S. investors to bring claims under §10(b) where they purchase securities on overseas stock exchanges. In short, foreign companies will argue that *Morrison* holds that only securities purchases made on US exchanges (in the case of publicly-traded securities) -- or private securities transactions that are otherwise effected within the United States -- will give rise to private civil claims under §10(b). There are a number of arguments that US investors may raise in opposition, including the fact that a purchase and sale of securities on a foreign stock exchange should be viewed as a domestic transaction regulated by §10(b) when purchase or sale orders are given by US investors from the US. That said, *Morrison* may have similar implications for US investors as it does for foreign investors. These include the need to re-evaluate existing investing policies to the extent they permit or encourage the purchase of certain types of securities overseas, when essentially the same securities (e.g., ADRs or ADSs) can often be acquired in a U.S. exchange. US investors will also want to consult closely with their US securities litigation counsel to assess litigation options under state law in situations where bringing §10(b) claims may no longer be an available option, or may provide only a questionable option for recovery, in the wake of future case law decisions construing *Morrison*. In this regard, US litigants may have somewhat fewer obstacles to obtaining alternative recoveries than their overseas counterparts; for example, US investors who sue in the United States will be less likely to encounter *forum non conveniens* challenges by defendants.
Further Information

We anticipate that both institutional investors and US and foreign corporations will be evaluating the implications of Morrison for some time to come. BLB&G clients with further questions about any of the matters discussed in this memorandum are encouraged to contact (a) BLB&G partners Gerald Silk, Steve Singer or Bill Fredericks, or any of the attorneys with whom they otherwise regularly work in our New York office, at (212) 554-1400, or (b) BLB&G partner Blair Nicholas, or any of the attorneys with whom they otherwise regularly work in our San Diego office, at (858) 793-0070.

In addition, BLB&G will be hosting a live "webcast" to discuss Morrison and its implications on Thursday, July 1, at 9 am (EST) and 2 pm (EST). Click here to register for this free event.

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