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July 19, 2010

U.S. Supreme Court Greatly Restricts Extraterritorial Application Of Civil Securities Fraud Actions

On June 24, 2010, the Supreme Court of the United States unanimously held in *Morrison v. National Australia Bank Ltd.* that the private right of action under the antifraud provisions of the Securities Exchange Act of 1934 — Section 10(b) — "reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."

In a decision authored by Justice Scalia, the Court rejected the venerable "conducts" and "effects" tests, which required courts to analyze the nexus of the alleged wrongful conduct to the United States, in favor of a bright line "transactional test" based on whether the traded security is listed on an American stock exchange and, if not, whether the purchase or sale of the security occurred in the United States.[1] In reaching this holding, the Court explained that the presumption against the extraterritorial application of domestic laws, based on the "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," applies equally to Section 10(b). The Court concluded that Section 10(b) expressed no such contrary intent.[2] Numerous circuit courts of appeal — including the Second Circuit known as the "Mother Court" of securities laws — had weighed in on the issue, each with varying results that district courts recognized became a difficult and amorphous standard to apply. The Supreme Court in *Morrison* has now stepped in to provide clarity where it was very much needed.

Morrison involved claims by foreign investors who purchased shares in one of Australia's largest banks on the Australian Stock Exchange. Claims by a purchaser of certain NYSE-listed American Depository Receipts (ADRs), representing the right to receive a specified number of bank shares, previously had been dismissed on unrelated grounds and were not part of the appeal to the U.S. Supreme Court. The plaintiffs alleged that the bank's financial statements were false and misleading because its Florida-based subsidiary purportedly falsified the value of its future income from mortgage servicing rights. The lower court in the Southern District of New York applied the Second Circuit's longstanding "conduct test," which looks to whether the alleged fraudulent conduct — as opposed to conduct merely prepatory to the alleged fraud — occurred in the United States. The court

1 The Court also rejected, as a threshold matter, the notion, long adopted by the Second Circuit and other courts, that this issue was one of subject-matter jurisdiction: "to ask what conduct §10(b) reaches is to ask what conduct §10(b) prohibits, which is a merits question. Subject-matter jurisdiction, by contrast, refers to a tribunal's power to hear a case."

2 This holding reflects the views expressed by various *amicus* briefs, including one authored by Skadden on behalf of various law school professors.

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concluded that it did not, and dismissed the action. The Second Circuit affirmed on similar grounds, explaining that the bank's issuance of fraudulent consolidated financial statements in Australia, and not the preparation of the subsidiary's fraudulent financials in the United States, "compris[ed] the heart of the alleged fraud."

Relying on the presumption against the extraterritorial application of U.S. laws and the text of the statute, the Supreme Court expressly repudiated the need to consider whether any or which aspects of the alleged conduct took place on United States soil, as "it is a rare case of prohibited extraterritorial application that lacks all contact with the territory of the United States." The Court also rejected the Second Circuit's reliance in other cases on the "effects test," which examines whether the wrongful conduct had a substantial effect in the United States or upon United States citizens. As the Court explained, "[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.'" In colorful language, Justice Scalia explained that "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 the Court emphasized, "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." Therefore, according to the Court, it is those "transactions that the statute seeks to 'regulate,'" and "it is parties or prospective parties to those transactions that the statute seeks to 'protec[t].'" As a result, the Court concluded it is "only transactions in securities listed on domestic exchanges, and domestic transactions in other securities" to which Section 10(b) applies.

We believe that this new bright-line rule will provide substantial guidance not only to foreign issuers but to investors as well. Although *Morrison* was a so-called "F-Cubed" case (an action involving foreign purchasers or sellers of shares of a foreign issuer on a foreign exchange), the application of the bright-line transactional test established by the Court also should foreclose claims by U.S. investors of foreign securities on a foreign exchange (a so-called "F-Squared" case) as well. As Justice Stevens in his concurrence explains, "[r]epudiating the Second Circuit's approach in its entirety, the Court establishes a novel rule that will foreclose private parties from bringing §10(b) actions whenever the relevant securities were purchased or sold abroad and are not listed on a domestic exchange." Thus, even American investors who purchase and sell securities abroad on foreign exchanges no longer will be able to invoke the securities laws of the United States, which, as Justice Scalia suggests, "has become the Shangri-La of class action litigation for lawyers representing those allegedly cheated in foreign securities markets." As the Court observed, "foreign countries regulate their domestic securities exchanges and securities transactions occurring within their territorial jurisdiction. And the regulation of other countries often differs from ours as to what constitutes fraud, what disclosures must be made, what damages are recoverable, what discovery is available in litigation, what individual actions may be joined in a single suit, what attorney's fees are recoverable and many other matters." Now, rather than having to await a complex analysis under which courts have often disagreed, both issuers and those U.S. investors who avail themselves of the foreign markets will know in advance of a transaction which country's laws govern.

We note several other interesting issues arising from this decision:

- Some have suggested that Congress may pass legislation to overturn *Morrison* and reinstitute some version of the conducts and effects test. We believe that the submission of

amicus briefs by the governments of France, the United Kingdom and Australia and the conflicts with the laws of foreign jurisdictions that the Court noted makes this unlikely, at least in the near future.

- Although Justice Stevens' concurrence states that the decision does not apply to actions by the SEC, Justice Scalia's reliance on the text of the statute and the presumption against extraterritoriality may leave Justice Stevens' conclusion in doubt. However, the recently enacted Dodd-Frank Act provides for U.S. jurisdiction over actions brought by the SEC under the federal antifraud provisions of the securities laws based on a similar standard to the now rejected "conducts and effects test." The Dodd-Frank Act also directs the SEC to conduct, among many other studies, a study on whether there should be extraterritorial application of the federal antifraud provisions of the securities laws to private actions.

- This decision does not directly impact the application of the Section 10(b) to ADRs, which generally would be applicable at least to sponsored ADR programs. We also note that there are likely additional defenses and arguments that can be made in defense of a securities fraud action brought by purchasers of ADRs, especially in unsponsored programs.

- Foreign issuers making offers for foreign targets may be encouraged to exclude U.S. investors from participating in cross-border tender offers or mergers. In cases where excluding the United States is either inadvisable or impractical, foreign issuers could nonetheless take advantage of the bright-line rule by taking measures to minimize purchases and sales in the United States over time. For example, a foreign issuer may seek to de-list and de-register its securities after a cross-border exchange offer involving U.S.-registered securities as soon as U.S. rules permit.

- While the decision certainly brings clarity to an area where it was very much needed, we envision further litigation as issues relating to the phrase "domestic transactions in other securities" percolate through the courts. We already have seen plaintiffs taking creative positions in an attempt to avoid the impact of *Morrison*, including arguing that U.S. investors of foreign exchange-traded securities are not covered; relying on off-exchange products, such as equity-based swaps; and examining the application of foreign law claims in U.S. courts.