New York Law Journal

WWW.NYLJ.COM

An ALM Publication

VOLUME 244—NO. 4 WEDNESDAY, JUNE 7, 2010

Outside Counsel

Expert Analysis

F-Cubed=0: Supreme Court's Decision In 'Morrison v. National Australia Bank'

By **Sarah L. Cave**

On June 24, the U.S. Supreme Court decided in *Morrison v. National Australia Bank Ltd.*,[1] that §10(b) of the Securities Exchange Act of 1934 does not provide a cause of action to foreign plaintiffs to recover investment losses relating to foreign-issued securities traded on foreign exchanges (colloquially known as "F-cubed" claims). The opinion for the Court by Justice Antonin Scalia—with his typical flair for the acerbic—delivered a more far-reaching ruling than many anticipated.

The Court threw out the analytical approach that the lower courts had followed for many years, and adopted a simpler, easier-to-administer standard that limits the statute's application to securities transactions that occurred within the United States and renders irrelevant the location of the underlying deceptive conduct. In doing so, the Court rejected the standard that the Solicitor General had advocated on behalf of the Securities and Exchange Commission, thus not only limiting the threat of claims by classes of foreign investors, but also the reach of U.S. regulators.

Background

National Australia Bank Ltd. chartered under Australian law and based in Melbourne, is the largest bank in Australia, where the majority of its operations occur. Its 1.5 billion ordinary shares trade on the Australian, London, Tokyo, and New Zealand stock exchanges, but only its American Depository Receipts trade on the New York Stock Exchange.

In 1998, as part of a global diversification effort, the bank acquired HomeSide Lending, an American mortgage servicing company based in Jacksonville, Florida. While HomeSide's operations were initially profitable, in 2001 HomeSide discovered errors in its accounting practices that resulted in an overstatement of the value of its mortgage servicing rights. This discovery led to the bank's announcement of a write-down first in the amount of $450 million, and then several months later a second write-down of $1.75 billion, resulting in the bank's restatement of its previously issued financial statements.

The stock price declined and class action lawsuits followed. In the suit that became known as *Morrison*, four plaintiffs sued the bank and certain of its officers and directors in the U.S. District Court for the Southern District of New York. The plaintiffs asserted claims under §§10(b) and 20(e) of the Exchange Act and SEC Rule 10b-5, based on allegedly false statements in the bank's annual financial statements, public filings and press releases regarding HomeSide's profitability.

> Multinational corporations, when considering whether to enter a new market, will have greater certainty about which laws will govern their conduct.

The plaintiffs, three of whom purchased the bank's ordinary shares on foreign exchanges and one of whom purchased ADRs on the NYSE, alleged that HomeSide transmitted its false financial information from Florida to the bank's personnel in Australia, from which the bank disseminated the information in its public statements.

In the District Court, Judge Barbara S. Jones dismissed the foreign plaintiffs' claims for lack of federal subject matter jurisdiction and the domestic plaintiff's claim for failure to state a claim in that he had not alleged any damages.[2] The foreign plaintiffs appealed the dismissal of their claims to the U.S. Court of Appeals for the Second Circuit.

In analyzing the jurisdictional question, the Second Circuit focused on the "conduct [that] comprises the heart of the alleged fraud" and agreed with the district court that federal subject matter jurisdiction was lacking because "[t]he actions taken and the actions not taken by [the bank] in Australia were, in our view, significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of the numbers in Florida."[3] The foreign plaintiffs then sought review in the U.S. Supreme Court.

In the Global Spotlight

At the Supreme Court, the case received more than the usual level of attention from abroad. Of the eighteen amicus briefs that were submitted, fifteen of them, including briefs by the Australian, U.K. and French governments, the International and U.S. Chambers of Commerce, and securities industry groups, supported the argument that the Exchange Act did not extend to F-cubed claims. At oral argument, six justices of the Supreme Court of Canada were in attendance, seated in the gallery.

The foreign governments made their voices heard in particular to protect their sovereign choices regarding securities regulation and litigation practices and procedures, which, in many cases, "reflect a balancing of interests and policies that differs from the balances that have been struck in the United States."[4]

In their view, the case presented the Court with the opportunity to adopt a standard for liability under §10(b) that would acknowledge

SARAH L. CAVE *is a partner at Hughes Hubbard & Reed. She is chair of the New York City Bar's Federal Legislation Committee.*

the very important policies of (1) the sovereignty of other nations; (2) the development of sophisticated regulation of the issuance and trading of securities within numerous markets; (3) the globalization of capital markets; (4) the increasing interdependence of national economies; and (5) the principles of comity and international relations.

Accordingly, these amici urged the Court not to adopt a rule that would validate "the U.S. taking on the role of international securities policeman" simply out of a misguided "concern that some jurisdictions may not have regulatory and legal systems that are perceived as adequate."[5]

The Supreme Court's Decision

Justice Scalia wrote the opinion for the Court, in which Chief Justice John G. Roberts and Justices Anthony Kennedy, Clarence Thomas and Samuel Alito joined. Justice Stephen Breyer filed a brief opinion concurring in part, and Justice John Paul Stevens, writing for himself and Justice Ruth Bader Ginsburg, concurred only in the judgment. They agreed with the result the Court had reached, but would have done so under the analytical approach followed by the lower courts. Justice Sonia Sotomayor, who was on the Second Circuit at the time the case was heard, although not a member of the panel, did not participate at the Supreme Court level.

The Court—in a point that the parties did not dispute—disagreed with the Second Circuit that the question presented was one of jurisdiction, but rather found it to be a question of the merits, that is, whether §10(b) prohibited the conduct at issue in the case. The Court went on, though, to conclude that dismissal was still proper because the foreign plaintiffs failed to state a claim on which relief could be granted.

In doing so, the Court adopted a much simpler test for determining the extraterritorial application of §10(b)—whether the alleged misconduct was "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."

The Court proceeded from the "longstanding principle of American law" that absent a contrary intent of Congress, federal statutes apply only within the territory of the United States. Following a caustic review of the tortured history of the difficult-to-administer "conduct" and "effects" tests that the lower courts had employed in various formulations over the years to analyze whether §10(b) applied to securities frauds with foreign elements, the Court concluded, based on an examination of the text of the Exchange Act itself, that the Act provided simply no indication that §10(b) should apply extraterritorially.

The Court then turned to the investors' argument that §10(b) nevertheless applied because the alleged fraud in the *Morrison* case was generated in the United States in the form of the accounting errors at the bank's Florida subsidiary that in turn were incorporated in the bank's public filings.

Noting that "the presumption against extraterritorial application would be a craven watchdog if indeed it retreated to its kennel whenever some domestic activity is involved in the case," the Court explained 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." The Court noted several sections within the Act and its accompanying regulations that confirmed that the focus is on domestic transactions.

In rejecting the investors' arguments, the Court took notice of the policy arguments the foreign amici had raised in their briefs. The Court found the "probability of incompatibility with the applicable laws of other countries" to be "so obvious" and the interference with foreign securities regulation regimes to be so probable, that if Congress had intended such far-reaching foreign consequences, it would have addressed in the statute itself the potential for conflict with foreign law.

The Court likewise rejected the Solicitor General's argument that a "significant and material conduct" test was necessary to keep the U.S. from becoming "the Barbary Coast for those perpetrating frauds on foreign securities markets." The greater fear, the Court explained, was that the U.S. "has become the Shangri-La of class action lawyers representing those allegedly cheated in foreign securities markets."

In conclusion, applying the simpler "domestic transaction" standard, the Court held that because the case "involve[d] no securities listed on a domestic exchange, and all aspects of the purchases complained of by [the Australian investors] occurred outside the United States," the Australian investors failed to state a claim.

What 'Morrison v. NAB' Means

The Supreme Court's decision is likely to have several effects:

• The potential for liability—both in private civil actions and regulatory proceedings—of foreign companies under U.S. securities laws, and the corresponding costs of litigation, will decrease.

• Multinational corporations, when considering whether to enter a new market, will have greater certainty about which laws will govern their conduct.

• More immediately, the Court's decision will impact in the numerous F-cubed cases pending throughout the federal courts. For example, Vivendi,[6] which a federal jury held liable under the Exchange Act earlier this year for misstatements in its public filings between 2000 and 2002, may now be able to narrow significantly the damages it will have to pay to the class of investors, three quarters of whom were foreign.

1. No. 08-1191, 2010 WL 2518523 (June 24, 2010).

2. *In re Nat'l Australia Bank Ltd. Sec. Litig.*, 2006 WL 3844465 (SDNY Oct. 25, 2006).

3. *Morrison v. Nat'l Australia Bank Ltd.*, 547 F.3d 167, 176 (2d Cir. 2008).

4. Brief for United Kingdom of Great Britain and Northern Ireland as amicus curiae, at 1.

5. Id. at 27.

6. *In re Vivendi Universal, S.A. Securities Litigation*, No. 02 Civ. 5571 (RJH) (SDNY).