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Supreme Court Affirms Dismissal of F-Cubed Class Action and Holds That There is No Extraterritorial Application of Section 10(b)

BY THE SECURITIES LITIGATION AND ENFORCEMENT PRACTICE

On Thursday, June 24, 2010, the Supreme Court affirmed the dismissal of *Morrison v. National Australia Bank Ltd.*, a so-called "F-Cubed" securities class action in which a foreign issuer was sued by foreign plaintiffs who bought their securities on a foreign exchange. *Morrison* is of major significance to multinational corporations, particularly those with subsidiaries in the United States, as the Supreme Court held that there is no extraterritorial application of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder. In so holding, the Supreme Court rejected the traditional "conduct" and "effects" tests previously employed by the Second Circuit and other courts, applied a presumption against extraterritorial application, and set forth a "clear" transactional requirement: a claim can only be brought in the United States when "the purchase or sale [of securities] is made in the United States, or involves a security listed on a domestic exchange. . . ."[1] Absent some further development, such as action by Congress, *Morrison* sounds the death knell for F-Cubed cases in the United States.

Background

Morrison involved a putative class action brought by Australian investors who purchased shares of National Australia Bank (National) and then claimed that the bank engaged in securities fraud. (The case originally included some U.S. ADR investors, but they were dismissed for failure to allege damages.) National is Australia's largest bank; it is organized under Australian law; and its ordinary shares (the equivalent of common stock in the U.S.) trade on Australian and other foreign exchanges, but not on any exchange in the United States.

In 1998, National acquired HomeSide Lending, a mortgage service provider located in Florida. Plaintiffs claimed that HomeSide deliberately overvalued its mortgage portfolio through inflated valuations, and then transmitted these false valuations to Australia, where they were incorporated into National's public filings. In 2001, National announced two massive write-downs (of $450 million and $1.75 billion) that led National's shares to fall by 5 and 13 percent, respectively. Plaintiffs claimed that they and other class members suffered economic loss as a result of the decline in value of National's stock, and that these losses were due to false and misleading statements made regarding HomeSide.

The district court dismissed plaintiffs' claims as lacking subject matter jurisdiction, and the Second Circuit affirmed. Applying its test for determining when the Exchange Act should apply to

transnational securities fraud, the Second Circuit examined whether sufficient wrongful conduct had occurred in the United States to trigger Section 10(b). The court of appeals concluded that the conduct central to the alleged fraud was that of National, which occurred entirely overseas, and that any falsification of information by HomeSide was too attenuated from plaintiffs' alleged injury. While HomeSide was the original source of allegedly erroneous numbers, the Second Circuit observed, those numbers were not disseminated directly to National's investors.

Plaintiffs successfully petitioned the Supreme Court for review, despite the Solicitor General's opposition, and the Supreme Court heard oral argument on March 29, 2010.

Summary of the Supreme Court's Holding

As predicted by Paul Hastings in a post-oral argument analysis of the case,[2] the Court affirmed dismissal of the case. In so doing, the Court addressed three issues: first, whether extraterritorial application of Section 10(b) of the Exchange Act implicates subject matter jurisdiction; second, whether the test utilized by the Second Circuit appropriately addresses the extraterritorial application of the Exchange Act; and third, if Section 10(b) has no extraterritorial application, whether plaintiffs' claims state a claim for relief, given plaintiffs' allegations that certain fraudulent statements were made in Florida with respect to a United States subsidiary and that the alleged deceptive conduct took place in Florida but where the securities were purchased on a foreign exchange.

Subject Matter Jurisdiction

The Supreme Court, in a majority opinion authored by Justice Scalia, first addressed the threshold issue of whether extraterritorial application of Section 10(b) is a jurisdictional question or not. Not surprisingly, given the parties' and Solicitor General's agreement on the issue, the Supreme Court found that the extraterritorial application of Section 10(b) is not a question of subject matter jurisdiction. The Court reasoned, "to ask what conduct §10(b) reaches is to ask what conduct §10(b) prohibits, which is a merits question."[3] It then specifically held that the district court had jurisdiction to hear the case under 15 U.S.C. § 78aa.

Test for Extraterritorial Application

After disposing of the threshold jurisdictional issue, the Court turned to the question of whether plaintiffs' allegations stated a claim. Against the backdrop of a "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,"[4] the Court ultimately disagreed with the malleable "conduct" test (whether the wrongful conduct occurred in the United States) and "effects" test (whether the wrongful conduct had a substantial effect in the United States or upon United States citizens) utilized by the Second Circuit and many other courts in determining the extraterritorial application of Section 10(b).[5] In coming to such a conclusion, the Court conducted an extensive historical analysis of the conduct and effects tests and how they developed within the Second Circuit.

The Court rejected these tests as textually – even extratextually – unsupported, relying on the Second Circuit's own admission that "if we were asked to point to language in the statutes, or even in the legislative history, that compelled these conclusions, we would be unable to respond."[6] Finding that the Second Circuit's tests ignored the presumption against extraterritorial application, the Court

clarified the rule and decided to "apply the presumption in all cases, preserving a stable background against which Congress can legislate with predicable effects."[7]

The Court applied the presumption here and found no "affirmative indication" in the statute that Congress intended Section 10(b) to apply extraterritorially, rejecting all of plaintiffs' and the Solicitor General's arguments to the contrary.

Availability of Domestic Application of Section 10(b)

The Court then turned to the final question of whether plaintiffs had adequately alleged domestic connections sufficient to warrant application of Section 10(b), regardless of the inability to apply the statute extraterritorially. To this end, Plaintiffs alleged deceptive conduct and fraudulent misstatements by individuals in Florida regarding a Florida company owned by National. The Court acknowledged that such facts highlight that even with the presumption against extraterritorial application, further analysis is required. But the Court observed that "it is a rare case of prohibited extraterritorial application that lacks *all* contact with the territory of the United States."[8] Reasoning that Section 10(b) only prohibits deceptive conduct "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered," the Court determined that the securities at issue here – all of which were listed on foreign exchanges – were not "securities listed on domestic exchanges," nor were they "domestic transactions in other securities, to which §10(b) applies."[9]

Taking note of the numerous *amicus curiae* briefs filed by foreign countries and foreign business associations, the Court addressed the "incompatibility" of extraterritorial application of Section 10(b) with the applicable regulations of foreign countries.[10] It agreed with these *amici* that the numerous differences in the laws (including what constitutes fraud, what damages are available to litigants, how litigation proceeds, etc.) could create interference with foreign laws.

The Court ultimately articulated a transactions-based test for application of Rule 10b-5: "whether the purchase or sale [of securities] is made in the United States, or involves a security listed on a domestic exchange." The Supreme Court found that this test was not only called for by the statutory text but would also alleviate concerns over interference with foreign law while providing domestic courts with the appropriate guidance in determining future extraterritorial application of Section 10(b).[11]

Conclusion

The *Morrison* decision is a welcome one for multinational corporations operating in the United States. The newly articulated test, "whether the purchase or sale [of securities] is made in the United States, or involves a security listed on a domestic exchange," appropriately limits the extraterritorial application of Section 10(b) and ends private F-Cubed securities litigation. Absent further legislative developments, securities fraud lawsuits now may only be brought in the United States for securities transactions occurring in the United States or for securities listed on a domestic exchange.

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[1] *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. __, No. 08-1191, slip op. at 21 (June 24, 2010).

[2] *See* Peter M. Stone, et al., *Oral Argument in the Supreme Court's "F-Cubed" Securities Class Action Case Offers Multinational Corporations Reason for Hope*, BLOOMBERG LAW REPORTS, May 10, 2010, at 23-25.

[3] *Morrison*, 561 U.S. __, slip op. at 4.

[4] *Id.*, slip op. at 5 (quoting *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991)) (internal quotations omitted).

[5] *Id.*, slip op. at 8 (citing *SEC v. Berger*, 322 F.3d 187, 192-93 (2d Cir. 2003)).

[6] *Id.*, slip op. at 8-9 (quoting *Bersch v. Drexel Firestone, Inc.*, 591 F.2d 974, 993 (2d Cir. 1975).

[7] *Id.*, slip op. at 12.

[8] *Id.*, slip op. at 17 (emphasis in original).

[9] *Id.*, slip op. at 17-18.

[10] *Id.*, slip op. at 20.

[11] All eight Justices who considered the case (Justice Sotomayor recused herself from this case) agreed in the judgment affirming dismissal. Justice Breyer concurred in part and concurred in the judgment, opining that, given the presumption against extraterritorial application, and given that the securities were not registered on a national securities exchange, nor were they purchased domestically, plaintiffs failed to state a claim. Justice Stevens, joined by Justice Ginsburg, authored a separate concurring opinion, joining in the judgment affirming dismissal, but on the grounds that the Second Circuit's conduct and effects tests were the appropriate rationale.