Second Circuit Limits Extraterritorial Application of U.S. Securities Laws in Benchmark "Foreign-Cubed" Class Action Decision

New York
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On October 23, 2008, the United States Court of Appeals for the Second Circuit issued an important decision on the extraterritorial application of the U.S. securities laws, affirming the dismissal for lack of subject matter jurisdiction of the first so-called "foreign-cubed" securities class action – a suit by foreign plaintiffs against a foreign issuer based on securities transactions in a foreign country. In *Morrison v. National Australia Bank Ltd*,[1] the Second Circuit refused to allow foreign shareholders of a foreign company to bring a class action in a U.S. court on the basis of information distributed by the company outside the United States, even though the allegedly fraudulent information related to the business of the company's U.S. subsidiary.

The decision could have important implications for publicly listed non-U.S. companies, particularly those with U.S. operations. The Second Circuit appeals court is one of the most influential in the United States, and its decisions are binding on District Courts in New York (where many securities class actions are brought), and they often carry significant weight elsewhere in the United States.

At the same time, the decision was quite fact-specific. The allegedly false information was prepared and distributed outside the United States, and the result might have been different if this had not been the case. As a result, companies may wish to review their internal procedures in light of the *National Australia Bank* decision in order to reduce their potential exposure to U.S. class action litigation.

In the remainder of this memorandum, we summarize the key points in the *National Australia Bank* decision, and we then discuss its potential implications for the internal procedures of non-U.S. companies.

[1] Docket No. 07-0583-cv (2d Cir. October 23, 2008).

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

1. The *National Australia Bank* Decision

In the *National Australia Bank* case, a group of plaintiffs filed a class action lawsuit against National Australia Bank ("NAB"), alleging that NAB's public disclosure contained fraudulent information relating to NAB's U.S. subsidiary, HomeSide Lending Inc. Three of the four plaintiffs were foreign, and the Second Circuit's decision related only to the foreign plaintiffs, who sought to represent a class of investors who purchased NAB shares in overseas markets (primarily Australia).[2]

The plaintiffs alleged that NAB's annual reports and press releases contained false and misleading information relating to HomeSide, a mortgage servicer headquartered in Florida, which NAB had acquired in 1998. According to the plaintiffs' allegations, NAB's public financial information included fraudulently overstated information relating to the present value of fees that HomeSide expected to generate from servicing mortgages. HomeSide allegedly furnished the present value information to NAB, knowing that the information was false, and NAB subsequently included the information in its annual reports and press releases issued in Australia. Subsequently, NAB announced substantial write-downs due to a recalculation of the present value of HomeSide's mortgage servicing rights, causing NAB's share price to fall significantly.

The plaintiffs filed suit in the United States District Court for the Southern District of New York, asserting that the actions of NAB and HomeSide violated Section 10(b) and 20(a) of the U.S. Securities Exchange Act of 1934, and Rule 10b-5 thereunder (all of which generally prohibit making fraudulent statements in connection with the purchase and sale of securities). They argued that it was appropriate for the suit to be brought in the United States, because the fraud was caused by the conduct of HomeSide in producing false accounting information, which occurred in the United States.

The argument of the plaintiffs was based on one of two tests that U.S. courts traditionally use in deciding whether to accept jurisdiction over securities fraud cases involving foreign issuers. Typically, U.S. courts accept jurisdiction where the fraudulent activity produces substantial "effects" in the United States, or where it results from "conduct" that takes place in the United States. The plaintiffs did not allege that the distribution of NAB's financial information overseas had any effects in the United States, but instead relied on the "conduct" test.

The District Court disagreed with the plaintiffs and dismissed the claims due to a lack of jurisdiction. It found that the fraud was caused primarily by the actions of NAB

[2] The claims of the U.S. plaintiff, Mr. Morrison, had been dismissed by the District Court for other reasons, and were not at issue in the appeal before the Second Circuit.

in Australia, including compiling the annual reports and press releases that included HomeSide's numbers, and distributing the information outside the United States.

The plaintiffs appealed the District Court's decision to the Second Circuit, arguing essentially that the District Court should have found that the fraud occurred primarily in Florida because HomeSide was located there and the allegedly false numbers were created there. The Second Circuit disagreed, and affirmed the District Court decision.

NAB and a number of interested third parties that submitted briefs as *amicus curiae* argued to the Second Circuit appellate court that U.S. courts should never accept jurisdiction over "foreign-cubed" securities fraud actions (meaning actions by foreign plaintiffs against a foreign issuer for damages suffered from purchases of securities on foreign exchanges). The Second Circuit did not go this far, ruling that the "conduct" test continued to apply. However, it upheld the District Court's decision that the facts did not warrant accepting jurisdiction over the present case under the "conduct" test, for three principal reasons:

- NAB's actions were more central to the fraud than HomeSide's manipulation of numbers in Florida. NAB is the publicly listed company, and it decides what information to communicate to the market, and is responsible for the distribution of that information. The actions of HomeSide were "merely preparatory" and did not constitute the direct communication of false information to investors.

- There was no allegation of any effect on American investors or the American market (while this factor would seem more relevant to the "effects" test than to the "conduct" test, the court nonetheless cited it in its decision).

- There was a lengthy chain of causation between the U.S. contribution to the misstatements and the harm to investors. HomeSide sent the numbers to Australia to be compiled into the annual reports and press releases of NAB, but HomeSide did not distribute them directly to investors. There would have been no harm to investors if NAB, acting in Australia, had monitored and corrected HomeSide's numbers before communicating them.

2. Implications for Foreign Issuers

The *National Australia Bank* decision, if followed in the future, could provide non-U.S. publicly listed companies with significant protection from U.S. securities class action litigation. The decision effectively excludes foreign shareholders from the class of potential plaintiffs in class action litigation in cases with similar pertinent facts. The potential reduction in exposure applies to companies that have American Depositary Receipts listed in the United States (as was the case for NAB, which has a New York Stock

Exchange listing), as well as companies with no United States listing. In recent years, a growing number of U.S. class action lawsuits against foreign issuers have targeted companies that are not listed in the United States, but that have other U.S. contacts.

At the same time, both the District Court and the Second Circuit Court of Appeals made clear that the jurisdiction determination under the "conducts" test is highly fact specific. It is possible that a slight change in the factual situation could lead to a different result. Plaintiffs may tailor their factual allegations in the future to avoid dismissal under the *National Australia Bank* precedent.

To minimize the risk of a U.S. court finding that it has jurisdiction over a "foreign-cubed" class action lawsuit, foreign companies should consider taking some or all of the following steps (in addition to monitoring their accounting and disclosure procedures to reduce the risk of material misstatements):

- Ensuring that all public communications for non-U.S. investors are prepared and distributed outside the United States, even when they contain information relating to United States operations.

- Establishing and maintaining procedures to ensure that information is communicated outside the United States prior to or simultaneously with its communication in the United States (so that non-U.S. investors cannot claim to rely on information that is communicated in the United States but is not available overseas).

- Prohibiting U.S. employees from communicating financial and business information regarding the group, except as expressly authorized by the head office (for example, U.S. investor relations employees would ordinarily be authorized to communicate, but generally only with U.S. investors, and always information that is previously or simultaneously communicated outside the United States).

* * *

The Second Circuit stated in the *National Australia Bank* opinion that it is "an American court, not the world's court, and [it] cannot and should not expend [its] resources resolving cases that do not affect Americans or involve fraud emanating from America." Whether courts in the future take the same approach in similar cases remains to be seen. Companies can increase their chances of benefiting from the *National Australia Bank* case by reviewing and, if necessary, modifying their internal procedures for communicating with non-U.S. investors, as described above.

Cleary Gottlieb Steen & Hamilton LLP represented the Securities Industry and Futures Market Association, the U.S. Chamber of Commerce, the U.S. Council for International Business, and the Association Française des Enterprises Privées, which were *amici curiae* in the *National Australia Bank* appeal.

For further information about the *Morrison* decision or any of the issues discussed above, please feel free to contact any of your regular contacts at the firm, or any of our partners and counsel listed under "Securities and Capital Markets" in the Our Practice section of our web site (http://www.clearygottlieb.com).

CLEARY GOTTLIEB STEEN & HAMILTON LLP

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax