New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
Web address: http://www.nylj.com

An incisivemedia publication
VOLUME 240—NO. 17
WEDNESDAY, NOVEMBER 26, 2008

SECOND CIRCUIT REVIEW

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'Foreign-Cubed' Securities Class-Action Plaintiffs

In this month's column, we discuss *Morrison v. National Australia Bank Ltd.*,[1] in which the U.S. Court of Appeals for the Second Circuit confronted the question of federal courts' subject matter jurisdiction over suits between foreign parties concerning alleged securities fraud violations.[2]

Although the court had previously addressed the "vexing question of the extraterritorial application of the securities laws,"[3] *Morrison* marked the first time the court addressed a securities fraud claim arising from what commentators have termed a "foreign-cubed" transaction—that is, a securities transaction involving the sale of (1) a foreign corporation's securities, (2) on a foreign exchange, (3) to a foreign investor.[4]

In its decision, written by Judge Barrington D. Parker and joined by Judges Jon O. Newman and Guido Calabresi, the court affirmed the district court's dismissal for lack of subject matter jurisdiction. In doing so, however, the court declined to set a bright-line rule barring foreign-cubed suits that did not involve harm to American investors, observing that such a rule would "conflict with the goal of preventing the export of fraud from America."

The Court instead concluded that a foreign plaintiff could, at least in theory, satisfy subject matter jurisdiction by relying upon allegations of domestic fraudulent conduct without also showing any domestic harm.[5] Nevertheless, the court concluded that plaintiffs here could not demonstrate, as they must, that the alleged misconduct within the United States was "more than merely preparatory to a fraud" and that the culpable acts within the United States "directly caused losses to investors abroad."[6] The alleged domestic conduct—the domestic subsidiary's falsification of data reported to the foreign parent company—was not at the heart of the fraud and was too causally removed from the actual fraudulent conduct, which in the court's view consisted of the foreign parent's dissemination of misleading financial statements.

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Background and Procedural History

National Australia Bank (NAB) is headquartered in Australia and incorporated under Australian law. Its ordinary shares trade on several foreign stock exchanges, and its American Depository Receipts (ADRs) trade on the New York Stock Exchange. HomeSide Lendings Inc. (HomeSide) is a wholly owned subsidiary of NAB, headquartered in Florida. In 2001, NAB announced the need for a write-down due to the correction of improper accounting by HomeSide. HomeSide had used incorrect valuation models in calculating the value of certain assets, and NAB had incorporated those incorrect calculations into its public filings, resulting in an overstatement of asset value for the subsidiary and the parent.

Following the announcement, NAB's ordinary shares and ADRs fell 5 percent. Later that same year, NAB announced the need for a second write-down in connection with the accounting errors, resulting in an additional decline of 11.5 percent in its ordinary shares and 13 percent in its ADRs.

Four NAB shareholders brought suit in the U.S. District Court for the Southern District of New York against NAB, HomeSide, and various officers and directors, alleging violations of §§10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. Plaintiffs alleged that HomeSide had knowingly used unrealistic valuation assumptions to generate falsified data, and then passed this false data from the subsidiary's Florida headquarters to the parent's headquarters in Australia. From Australia, NAB then allegedly disseminated the false data to the public.

Three of the four plaintiffs were foreign investors who purported to represent a class of non-American purchasers of NAB securities; the fourth plaintiff was a domestic investor who purported to represent a class of American purchasers of NAB ADRs. Defendants moved to dismiss the foreign investors' claims for lack of subject matter jurisdiction and moved to dismiss the domestic investor's claims for failure to state a claim.[7]

District Judge Barbara S. Jones of the Southern District of New York granted defendants' motion to dismiss as to both sets of claims. In evaluating its subject matter jurisdiction over the foreign plaintiffs' claims, the district court applied existing Second Circuit precedent requiring courts to consider the location of the alleged fraudulent conduct (the "conduct test") and the location of the alleged harm (the "effects test"). Although characterizing the case as a "close call," the district court ultimately concluded that jurisdiction was lacking, emphasizing that the only alleged conduct within the United States—HomeSide's allegedly knowing manipulation of data—was "not in itself securities fraud," but at most a link in a chain of events that led to NAB preparing and filing false financial statements from Australia.[8] As to the effects test, the district court noted that plaintiffs had not demonstrated damage to any U.S. citizen, including even the lead domestic plaintiff.[9] In light of the domestic plaintiff's failure to assert any damages, the district court also granted defendants' motion to dismiss the domestic plaintiff's claims.[10]

Plaintiffs appealed the district court's dismissal of the foreign plaintiffs; they did not challenge the dismissal of the domestic plaintiff.[11]

The Second Circuit Decision

• ***Foreign-cubed actions alleging domestic fraudulent conduct but no domestic effect are not categorically barred.***

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On appeal, the court began by summarizing the "conduct test" and "effects test" that the Second Circuit traditionally applies in evaluating the extraterritorial application of U.S. laws governing securities fraud. These two tests, which are often applied together, ask "(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens." Here, the court noted, plaintiffs rely solely upon allegations of wrongful conduct within the United States and do not advance any argument under the effects test.[12]

The court rejected defendants' and amici's suggestion for a bright-line rule barring any foreign-cubed securities action where no harm was alleged as to any U.S. shareholder and where jurisdiction was based solely on alleged domestic conduct. The court was not concerned that opening American courts to foreign investors' fraud claims would interfere with foreign jurisdictions' enforcement of their own regulations and policy choices. The court reasoned that "anti-fraud enforcement objectives are broadly similar[,] as governments and other regulators are generally in agreement that fraud should be discouraged." The court also observed that defendants' proposed bar would interfere with the goals of "preventing the export of fraud from America."

The court suggested that a strong case for jurisdiction would exist, but would be foreclosed by defendants' position, where an American subsidiary of a foreign corporation manipulated foreign securities markets by issuing fraudulent statements from American soil. Finally, the court expressed its hesitation to adopt a bright-line rule "because we cannot anticipate all of the circumstances in which the ingenuity of those inclined to violate the securities laws should result in their being subject to American jurisdiction." The court concluded that the "conduct test" alone was an adequate tool for evaluating subject matter jurisdiction in foreign-cubed cases, and that such a test balanced the competing interests of deterring fraud and conserving judicial resources.[13]

• Focus is on the conduct at the "heart of the alleged fraud."

The court then analyzed plaintiffs' arguments that defendants' domestic misconduct alone supported subject matter jurisdiction. The court essentially adopted the reasoning of the district court, and rejected plaintiffs' arguments.

The court reviewed prior cases applying the "conduct test" in foreign plaintiffs' securities fraud actions, and observed that the test required the court to "identify which action or actions constituted the fraud and directly caused harm," and then "determine if that act or those actions emanated from the United States." Putting it another way, the court viewed its main task as evaluating "what conduct comprise[d] the heart of the alleged fraud."

The court concluded that NAB's actions and omissions in Australia, in the form of preparing public filings, were "significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of numbers in Florida." In reaching this conclusion, the court focused on three factors:

- First, it noted that NAB, and not its Florida subsidiary, was the publicly traded company with a responsibility to oversee operations and report to the financial community, and that NAB was the entity that in fact issued the false statements that allegedly violated Rule 10b-5(b).[14]
- Second, despite rejecting the argument that domestic harm was an essential element of subject matter jurisdiction in securities fraud claims, the court stated that the absence of any alleged effects upon Americans here weighed as a "significant factor" against the court's exercise of jurisdiction.[15]
- Third, the court stressed that although "HomeSide may have been the original source of the problematic numbers, those numbers had to pass through a number of checkpoints manned by NAB's Australian personnel before reaching investors." Finding support in the reasoning of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*,[16] in which the U.S. Supreme Court held that investors could not demonstrate reliance upon deceptive acts not communicated to the public because such actions were too remote in the causal chain, the court in *Morrison* concluded that the lengthy causal chain between the manufacture of faulty data and its ultimate dissemination to the market militated against finding that HomeSide's U.S.-based actions lay at the heart of plaintiff's fraud claim.[17]

'Morrison' was the first time the court addressed a securities fraud claim arising from…a "foreign-cubed" transaction, i.e., a transaction involving the sale of (1) a foreign corporation's securities, (2) on a foreign exchange, (3) to a foreign investor.

• Open questions.

Because the court's decision turned on the particular facts presented, the opinion leaves several questions open. In light of plaintiffs' failure to satisfy either the conduct test or the effects test, the decision does not address how to balance the two. Although the court rejects defendants' suggestion that the absence of domestic harm should operate as an automatic jurisdictional bar, the court makes clear that the presence or absence of domestic harm still plays an important role in its overall analysis and weighing of factors. It remains to be seen, in a case with more straightforward allegations of domestic misconduct, whether the court will still take into account the absence of domestic harm and, if so, how heavily the court will weigh this factor. The decision also leaves open questions regarding the manner in which a foreign-cubed plaintiff may demonstrate harm within the United States, including whether a fraud-on-the-market theory may ever be invoked.

Conclusion

Although the Second Circuit in *Morrison* did not impose a bright-line rule barring securities fraud claims based on foreign-cubed transactions, the decision significantly limits the threat of such claims: first, by requiring district judges to ensure that domestic conduct lies at the heart of the fraud alleged, and, second, by suggesting that the absence of harm to American shareholders or the American market is a factor that will weigh heavily in the court's jurisdictional analysis.

1. Docket No. 07-0583-cv, 2008 WL 4660742 (2d Cir. Oct. 23, 2008).
2. 15 U.S.C. §§78j(b) and 78t(a); 17 C.F.R. §240.10b-5.
3. *Morrison*, 2008 WL 4660742 at *1.
4. Id. at *4.
5. Id. at *5-6.
6. Id. at *3.
7. Id. at *1-*2.
8. *In re National Australia Bank Securities Litigation*, Docket No. 03-cv-6537, 2006 WL 3844465, at *8 (S.D.N.Y. Oct. 25, 2006).
9. Id. at *4.
10. Id. at *8-9.
11. *Morrison*, 2008 WL 4660742, at *2.
12. Id. at *2-3.
13. Id. at *5-7.
14. Id. at *5, *7.
15. Id. at *8.
16. 128 S. Ct. 761, 769 (2008).
17. *Morrison*, 2008 WL 4660742, at *8.