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Jurisdiction Over Fraud Claims Of Foreign Investors

Recent decisions reflect a shift in thinking by the federal courts.

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OVER THE PAST YEAR, we have seen an increasing number of federal district courts, especially in the U.S. Court of Appeals for the Second Circuit, repeatedly dismissing, for lack of subject matter jurisdiction, fraud claims brought by the so-called "f-cubed class," that is, foreign purchasers who acquired the securities of a foreign issuer on a foreign exchange.

Viewed collectively, these cases suggest a shift in thinking by the federal courts. Previously, federal courts had been more willing to exert subject matter jurisdiction over cases involving such foreign purchasers. See, e.g., *Bersch v. Drexel Firestone Inc.*, 519 F.2d 974, 985 (2d Cir. 1975); *SEC v. Kasser*, 548 F.2d 109, 116 (3d Cir. 1977). The recent decisions, which we discuss below, suggest that the federal courts may be increasingly wary of adjudicating claims relating to predominantly foreign securities transactions, even where some activities relating to the alleged fraud occur in the United States.

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Background

The Securities Exchange Act of 1934 is silent as to its extraterritorial reach. 15 USC §78a et seq. ("the '34 Act"); *SEC v. Berger*, 322 F.3d 187, 192 (2d Cir. 2003). As a result, it has been left to the federal courts to determine the extent to which foreign plaintiffs who purchased securities on foreign exchanges may prosecute their fraud claims in the U.S. courts. As Judge Henry J. Friendly wrote in the seminal case of *Bersch v. Drexel Firestone Inc.*, when faced with such predominantly foreign transactions, courts must "determine whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to them rather than leave the problem to foreign countries." 519 F.2d at 985.

In explaining the court's decision to allow extraterritorial application of the federal securities laws, Judge Friendly reasoned that the United States should not allow itself to become a "base for manufacturing fraudulent securities devices...even when these are peddled only to foreigners." Id. at 1017.

Following *Bersch*, the courts developed two tests for determining whether subject matter jurisdiction would exist over foreign plaintiffs' fraud claims.

- First, the court must determine whether the wrongful conduct had a substantial effect on investors or markets in the United States, referred to as the "effects" test.
- Second, the court must evaluate whether substantial wrongful conduct occurred in the United States, referred to as the "conduct" test. Under the "conduct" test, the plaintiff must first establish that the defendant's activities in the United States were more than merely preparatory to a securities fraud conducted elsewhere. The plaintiff must also establish that the culpable activities or failure to act within the United States were the direct cause of the claimed losses. *Itoba Ltd. v. LEP Group Plc*, 54 F.3d 118, 122 (2d Cir. 1995).

As a practical matter, the "conduct" test tends to be outcome-determinative, since courts rarely find that the foreign transactions at issue in these cases had a substantial effect in the United States.

Applying this test, courts have often found subject matter jurisdiction over the "f-cubed" plaintiffs' case. For instance, in *In re Vivendi Universal, S.A., Securities Litigation*, 381 F.Supp.2d 158 (SDNY 2003), rec'n denied in 2004 WL 2375830 (SDNY Oct. 22, 2004) (Holwell, J.), Judge Harold Baer Jr. denied defendants' motion to dismiss claims by European investors in Vivendi, a French company alleged to have misrepresented its financial condition. Notwithstanding that the alleged false statements were created and disseminated in France, Judge Baer found that there existed substantial U.S. conduct—specifically, the presence of Vivendi's executives here in the United States. See id. at 169-70. See also *In re Nortel Networks Corp. Sec. Litig.*, No. 01 Civ. 1855, 2003 WL 22077464 (SDNY Sept. 8, 2003); *In re Gaming Lottery Sec. Litig.*, 58 F.Supp.2d 62 (SDNY 1999).

Over the past year, however, four district court judges in the Southern District of New York have applied this test to fraud claims brought under the '34 Act to conclude that subject matter jurisdiction did not extend to the foreign plaintiffs. Three of these cases addressed fraud claims against issuers; the fourth addressed fraud claims against banks and auditors alleged to have participated in an issuer's fraud. While too early to say, these recent decisions may represent a more stringent approach by the lower courts in applying the "conduct" test, even when there is conduct taking place in the United States. We briefly discuss each decision below.

Cases Finding No Jurisdiction

In *In re Rhodia S.A. Securities Litigation*, 531 F.Supp.2d 527 (SDNY 2007), in which the defendants were represented by the authors' firm, Judge Deborah A. Batts dismissed the claims of foreign investors against Rhodia, a French chemicals company. Addressing the effects test first, the court concluded that it cannot be satisfied by plaintiffs who are foreign investors purchasing shares in a foreign corporation on a foreign exchange.

Turning to the conduct test, Judge Batts then considered plaintiffs' argument that jurisdiction was proper because the alleged fraudulent statements themselves concerned Rhodia's U.S.-based business, namely, the extent of Rhodia's environmental liabilities from a Montana plant site and the overstatement of projections by Rhodia's U.S. subsidiary. Id. at 538. Judge Batts, however, found that sufficient conduct did not exist simply because the "object of the misrepresentations" was located in the United States. Id. at 539.

In determining the insufficiency of the U.S.-based activity, Judge Batts placed particular emphasis on several points. First, the alleged misrepresentations had been generated abroad by foreign employees. Second, the misstatements about the U.S. environmental liabilities and projections were only part of an international fraud. Judge Batts thus concluded that, at most, the U.S.-based conduct was "merely a link in the chain of the overall scheme, which was perpetrated abroad." Id. at 540. She further determined that, given the international reach of the fraudulent scheme, the foreign plaintiffs' losses had not been directly caused by the U.S.-based conduct. Id.

Judge Denise L. Cote applied similar reasoning in excluding foreign plaintiffs from the class certified in *In re SCOR Holding (Switzerland) AG Litigation*, 537 F.Supp.2d 556 (SDNY 2008). In that case, plaintiffs alleged that Converium, a multinational reinsurer organized under Swiss law, misrepresented its financial information by failing to disclose a shortfall in its loss reserves. As in *Rhodia*, the plaintiffs argued that the fraud concerned misstated financial information for U.S. assets. Plaintiffs also pointed to numerous instances of U.S.-based conduct, including the participation of American executives; policy-making activities; board meetings at which financial information reporting was discussed; and the making of false statements in SEC filings and on calls with Wall Street analysts.

Judge Cote held that the plaintiffs had not satisfied their burden of establishing either sufficient U.S. conduct or losses resulting from U.S. conduct. Like Judge Batts in *Rhodia*, Judge Cote emphasized that the vast bulk of the fraudulent statements were issued abroad and that the fraudulent scheme was "masterminded" by foreign decision-makers. Id. at 564-68.

Judge Cote also found that the foreign plaintiffs had failed to show a direct causal relationship between the U.S. conduct, such as the allegedly false SEC filings, and their losses. Id. at 569. To that end, Judge Cote held that, because the U.S. conduct, "considered collectively, is far outweighed by the relevant foreign conduct, …the causal connection between the U.S. conduct and the Foreign Plaintiffs' alleged losses is simply too attenuated to be accurately described as 'direct.'" Id. at 569.[1]

This causation requirement was strictly applied by Judge Thomas P. Griesa in the most recent of these cases, *In re Astrazenica Securities Litigation*, No. 05 Civ. 2688, 2008 WL 2332325 (SDNY June 3, 2008). In that case, plaintiffs brought fraud claims on behalf of a putative class consisting of the 10 percent of investors who purchased Astrazenica securities on the New York Stock Exchange, as well as the 90 percent who purchased on the Stockholm and London Exchanges. Plaintiffs argued that the court had jurisdiction over the foreign purchasers as a result of substantial U.S.-based conduct, including that numerous alleged misstatements were made in the United States, and plaintiffs' fraud claim centered around whether the U.S. Food and Drug Administration (FDA) would approve Exanta (a drug manufactured by Astrazenica).

The court concluded that plaintiffs had, indeed, alleged that the U.S. conduct was "more than merely preparatory to the alleged fraud." Id. at *11. The court found, however, that the plaintiffs had not sufficiently alleged facts showing that the U.S. conduct directly caused plaintiffs' losses under the second prong of the conduct test. Finding that the fraudulent conduct took place both in the United States and abroad, the court held that plaintiffs were required to allege that the foreign purchasers relied on the U.S.-based conduct when deciding to acquire the stock. Id. at *11-12. The court further declined to presume the foreign plaintiffs' reliance under a "global fraud-on-the-market presumption," despite the fact that the price of Astrazenica stock on foreign markets tended to move in tandem with the U.S. market. Id.

A plaintiff seeking to represent a global class must do more than merely identify a U.S. presence by the company; instead, he must identify specific activities conducted by persons involved in the fraudulent scheme that were both central to the scheme and direct causes of the foreign plaintiffs' losses.

Finally, Judge Lewis A. Kaplan had occasion to apply this jurisdictional test to fraud claims asserted against auditors and bankers in *In re Parmalat Securities Litigation*, 497 F.Supp.2d 526 (SDNY 2007). Addressing first the claims against Parmalat's auditors, Judge Kaplan noted that it was undisputed that the audit work alleged to constitute the fraud was performed exclusively in Italy by Italian affiliates of the auditor defendants. Id. at 533. Finding that the only U.S.-based conduct by the auditors was the formation of "the relationships of agency and control" that gave rise to the control person and vicarious liability claims against them, Judge Kaplan dismissed the claims, concluding that such conduct was "not part of the alleged fraud and did not directly cause plaintiffs' alleged injuries." Id. at 533.

Judge Kaplan then addressed in turn each of the three types of fraudulent transactions that the bank defendants were alleged to have engineered.

- First, Judge Kaplan held that the solicitation of American investors in a private placement, including through U.S. "road shows," occurred subsequent to the structuring of the fraudulent arrangement, and thus neither completed the fraud nor caused plaintiffs' losses. Id. at 535-36.
- Next, addressing a bank loan that was used to fund a fraudulent insurance scheme, Judge Kaplan held that the payment of insurance premiums out of a U.S. bank account was merely peripheral to the fraud. Id. at 536-37.
- Finally, Judge Kaplan held that the court did not have jurisdiction over claims relating to the alleged securitization in Italy of worthless receivables. Notwithstanding his finding of "regular U.S. conduct in a variety of areas," including the bank's U.S.-based conduct relating to the funding and administration of the securitization program, as well as the existence of a parallel (but not allegedly fraudulent) securitization program in the United States, Judge Kaplan concluded that none of the U.S. activities were "essential to the completion of the fraud" Id. at 539.

In making these findings, Judge Kaplan gave great weight to the fact that the U.S. bank personnel assisting with these three transactions were not alleged to have known of the fraud.

Conclusion

As illustrated above, the resolution of a jurisdictional challenge to foreign plaintiffs' fraud claims requires the application of a straightforward legal test to what may be a complicated set of factual allegations unique to the pleaded fraud. Key factual considerations tend to include the geographic origin of the alleged misstatements, the location of key decision-makers, and the extent to which the U.S. conduct is deemed central to allegations of an international fraudulent scheme.

Under the reasoning applied in the recent decisions, foreign companies faced with fraud claims appear to be able to mount strong jurisdictional defenses against foreign plaintiffs who have purchased their shares on foreign exchanges notwithstanding their conduct of substantial business activities in the United States.

A plaintiff seeking to represent a global class must do more than merely identify a U.S. presence by the company; instead, he must identify specific activities conducted by persons involved in the fraudulent scheme that were both central to the scheme and direct causes of the foreign plaintiffs' losses. The reasoning in this recent line of cases thus certainly represents a new, and substantial, roadblock for plaintiffs seeking to bring claims on behalf of a worldwide class of investors. Whether other courts will follow, of course, remains to be seen.

1. On March 20, 2008, plaintiffs moved for reconsideration of Judge Cote's class certification order on the basis that newly obtained discovery revealed additional U.S.-based conduct. The case subsequently was stayed, and the reconsideration motion has not yet been fully briefed.