ARNOLD & PORTER LLP

ADVISORY

April 2010

SUPREME COURT TO CONSIDER WHETHER "FOREIGN-CUBED" SECURITIES FRAUD CASES MAY BE HEARD IN US COURTS

On March 29, 2010, the Supreme Court of the United States heard oral arguments in the case of *Morrison* v. *National Australia Bank*, No. 08-1191. The *Morrison* case, which has been the subject of previous advisories by Arnold & Porter LLP,[1] involves a so-called "foreign-cubed" securities fraud suit—a litigation where (1) a foreign plaintiff; (2) is suing a foreign issuer in a US court for violations of US securities laws; (3) based on securities purchases in a foreign country. The Supreme Court accepted *certiorari* to consider whether Section 10(b) of the Securities and Exchange Act of 1934 (the Exchange Act), which is the primary antifraud provision of the US securities laws, extends to transnational securities fraud, as well as to resolve a conflict among various courts of appeal on the proper test to determine whether US federal courts have subject matter jurisdiction to hear such suits.

During oral argument, a clear majority of Supreme Court Justices asked questions suggesting a view that US courts should not hear a "foreign-cubed" securities fraud suit. Several Justices asked questions, however, that suggested that it would not be appropriate to adopt a bright-line rule that would prohibit any suit in US courts based on purchases or sales of securities that occur outside of the United States.

As the securities markets have become more global in nature, foreign-cubed securities suits have become more common. The Supreme Court's decision, which is expected in the next three months, will hopefully provide useful guidance for determining when such suits may be heard in US courts.

BACKGROUND AND PROCEEDINGS BELOW

In *Morrison*, three Australian investors alleged that the defendants, an Australian bank, its wholly-owned US-based subsidiary and individual officers of the two companies, engaged in transnational securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The plaintiffs alleged

1 Arnold & Porter LLP Advisories "US Supreme Court Grants Certiorari to Review Foreign-Cubed Securities Transaction Case Despite Solicitor General's Opposing View," *available at:* http://www.arnoldporter.com/public_document.cfm?id=14963&key=23D3; "The Eleventh Circuit Finds Subject Matter Jurisdiction in 'Foreign-Cubed' Securities Lawsuit," *available at:* http://www.arnoldporter.com/public_document.cfm?id=14678&key=24I2; and "Second Circuit Rejects Bar On 'Foreign-Cubed' Securities Lawsuits," *available at:* http://www.arnoldporter.com/public_document.cfm?id=13644&key=26E0.

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

London
+44 (0)20 7786 6100

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

that they were harmed after the US subsidiary provided false accounting figures to the Australian bank and the Australian bank incorporated that false information into its financial reports and other public statements. The plaintiffs, who purchased stock in the Australian bank on Australian stock exchanges, alleged that their stock purchases were at prices that were inflated by the misstatements, causing the price of the plaintiffs' stock to fall when the misstatements were exposed.

In proceedings below, the defendants successfully argued that the suit should be dismissed because there was no subject matter jurisdiction over the suit, and further argued that there should be a bright-line rule that US courts should have no jurisdiction to hear "foreign-cubed" cases.

In the decision below, the Second Circuit Court of Appeals affirmed the dismissal of the plaintiffs' suit for lack of subject matter jurisdiction after examining the facts under its long-standing "conduct and effects test"—namely whether the wrongful conduct that occurred in the United States was "more than merely preparatory to the fraud" and whether "the wrongful conduct had a substantial effect in the United States or upon United States citizens."[2] Other appellate courts have applied less stringent tests, examining whether "at least some activity designed to further a fraudulent scheme occurs within [the United States]" or whether the US conduct "was significant with respect to [the] accomplishment" of a fraudulent scheme.[3] In contrast, the DC Circuit requires that the US conduct constitute "all the elements of a defendant's conduct necessary to establish a violation of Section 10(b)."[4]

Reasoning that the actions by the Australian bank were significantly more central to the fraud, and more directly responsible for the harm to investors than any manipulation of financial results by the US subsidiary in the United States, the Second Circuit concluded that the "heart of the fraud" lay outside of the United States. The Second Circuit also noted the lack of any allegations that the alleged fraud affected US investors or US capital markets. However, the Second Circuit declined to adopt a bright-line rule to bar "foreign-cubed" cases, instead holding that the decision as to whether subject matter jurisdiction exists should be made on case-by-case basis.

SUMMARY OF ARGUMENT

At oral argument, the parties' arguments focused on four key issues.

1. Does Section 10(b) Cover Foreign-Cubed Suits?

The parties disagreed on whether Section 10(b) covers transnational securities fraud and whether the statute should extend to cover "foreign-cubed" suits. In their briefs, plaintiffs argued that Section 10(b) does not on its face limit its reach to domestic fraud, and pointed to various provisions of the Exchange Act that suggest Congress intended to cover foreign conduct. For example, plaintiffs cited to the preamble of the Exchange Act, which says that the Exchange Act is designed "[t]o provide for the regulation of securities exchanges…operating in interstate and *foreign commerce* and through the mails…." In response, the defendants noted that Section 10(b) is silent on the issue of its extraterritorial application, and that in interpreting the statute, there is a presumption against extraterritoriality. The Defendants also argued that it should be left to Congress to decide whether Section 10(b) should have extraterritorial reach.

During oral argument, several Justices asked questions suggesting that they did not think Section 10(b) should extend to the Morrison suit. For example, Justice Ginsburg commented that the suit involved "Australian plaintiffs, Australian defendant, shares purchased in Australia…it has 'Australia' written all over it." Similarly, Justice Scalia questioned why the plaintiffs were "dragging the American courts into" addressing "a misrepresentation, if there was one…made in Australia to Australian purchasers."

2 *Morrison* v. *National Australia Bank Ltd.,* 547 F.3d 167 (2d Cir. 2008).

3 *See, e.g., S.E.C.* v. *Kasser,* 548 F.2d 109 (3d Cir. 1977); *Continental Grain (Austl.) Pty. Ltd.* v. *Pacific Oilseeds, Inc.,* 592 F.2d 409 (8th Cir. 1979); *Grunenthal GmbH* v. *Hotz,* 712 F.2d 421, 425 (9th Cir. 1983).

4 *Zoelsch* v. *Arthur Andersen & Co.,* 824 F.2d 27 (D.C. Cir. 1987).

2. Was Dismissal Below Proper on Jurisdictional Grounds? The parties disputed whether the decision below was properly grounded as a question of whether federal courts should have subject matter jurisdiction over "foreign-cubed" suits or whether the reach of Section 10(b) should extend to "foreign-cubed" suits. The plaintiffs argued in their briefs that the Second Circuit improperly framed the issue as one of "subject matter jurisdiction," noting that there had been several recent Supreme Court cases that had emphasized that subject matter jurisdiction is a matter of statutory construction and should not turn on the proof offered in a particular case, and requesting the Supreme Court to summarily remand the decision.[5] Both Justices Ginsburg and Scalia (who were the only Justices to inquire about this argument) expressed skepticism that the decision below should be reversed on this ground.

3. Would Extraterritorial Application of Section 10(b) Interfere With Foreign Nation's Enforcement of Their Securities Laws? There was extensive argument about whether the extraterritorial application of Section 10(b) would offend principles of foreign relations. The plaintiffs argued in their briefs that the Second Circuit properly concluded that Section 10(b) extended to a "foreign-cubed" case would not offend foreign relations because the potential for conflict is minimal because governments of most nations are generally in agreement that fraud should be discouraged. The defendants responded that allowing private shareholders to litigate under Section 10(b) based on foreign sales or puchases of securities would constitute an unreasonable interference with the sovereign authority of other nations, and that construing Section 10(b) to apply extraterritorially would violate a canon of construction which requires that an act of Congress ought never be construed to violate the law of nations if any other possible construction exists. During argument, Justice Breyer noted that *amicus* briefs filed by Australia, the United Kingdom, and France had all argued that there were "a number of conflicts…that will interfere with their efforts to regulate their own securities markets." Justice Scalia similarly noted that Australia's brief, in essence said "we should be able to decide… and we don't want it decided by a foreign court." Justice Kennedy similarly expressed concern that "the burden of discovery…would be an offense" to foreign nations.

4. What Test Should the Supreme Court Adopt? There was disagreement about whether the Supreme Court should adopt a bright-line test that would limit Section 10(b), as defendants requested, to "securities purchased and sold in the United States." Several Justices asked questions suggesting they thought such a rule was too exclusionary. For example, Justice Stevens inquired whether such a rule would bar suits by "a group of Americans…who purchased their stock over the Australian exchange," and Justice Breyer asked whether Section 10(b) should not extend where all the fraudulent conduct occurred in the United States except the purchase of the security. The Solicitor General, appearing as *amici*, similarly expressed a concern that "there is a danger in bright line rules for fraud prohibitions because they can provide a road map for evasion of the statute."

As an alternative, the Solicitor General urged the Court to adopt a rule that "a transnational securities fraud violates Section 10(b) if significant conduct material to the fraud's success occurs in the United States," and that in order to bring a private lawsuit, a plaintiff "should be required to prove that his injury was a direct result of the component that occurred in the United States." The Solicitor General argued that a two-part test was appropriate because it was important that the authority of the Securities and Exchange Commission not be limited when misconduct occurs on US soil, but that a "direct-injury" requirement on private shareholder suits would reduce the potential for conflicts with foreign nations. Chief Justice Roberts questioned whether the government's proposed test had too many "moving parts" and whether "the complication [would] defeat the whole purpose," and Justice Scalia similarly noted that "a totality of the circumstances

5 *See Reed Elsevier* v. *Muchnick,* 130 S.Ct. 1237 (2010); *Union Pacific Railroad Co.* v. *Brotherhood of Locomotive Engineers & Trainmen General Committee of Adjustment, Central Region,* 130 S. Ct. 584 (2009); *Arbaugh* v. *Y&H Corp.,* 546 U.S. 500 (2006).

test…doesn't seem…[to be] an appropriate test for a jurisdictional question." Justice Breyer also inquired about the "feasibility" of the proposed test, and Justice Ginsburg questioned whether it was appropriate "to make a distinction between what the US Securities and Exchange Commission can sue for and what a private party can sue for."

POTENTIAL SIGNIFICANCE OF DECISION

Although it is unclear how the Supreme Court will rule in the *Morrison* case, it is clear that, whatever its decision, the ruling will have a far-reaching impact on the global securities markets and could determine whether foreign-cubed securities cases will be continue to be heard in the United States. In the last several months there have been noteworthy decisions in two other foreign-cubed cases, in addition to *Morrison*. Both of these cases found that subject matter jurisdiction existed for the transactions at issue. In August 2009, the US Court of Appeals for the Eleventh Circuit found in *In Re: CP Ships Ltd. Securities Litigation* that the district court properly exercised subject matter jurisdiction over securities fraud claims brought by foreign investors against a Canadian company that was headquartered in England.[6] Similarly, in January 2010, in *In re: Vivendi Universal SA Securities Litigation*, a federal jury in New York found that that Vivendi, a French-based media conglomerate was liable for 57 misstatements to the public about the foreign company's finances following the district court's denial of a motion to dismiss on the grounds that the foreign investors were permitted to bring forth their securities fraud claims in a US court based on allegations that the foreign company made false and misleading statements abroad that covered up company liquidity troubles.

In addition to litigation, there have been recent efforts in Congress to clarify the issue of jurisdiction relating to foreign-cubed securities transactions. Most notably, the "Wall Street Reform and Consumer Protection Act of 2009" passed by the House of Representatives on December 11, 2009 contains a provision (Section 7216) to amend the securities laws to clarify that federal courts would have jurisdiction over securities cases that involve "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States."

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

Scott B. Schreiber, Co-Chair
Securities Enforcement and Litigation Practice
+1 202.942.5672
Scott.Schreiber@aporter.com

Michael D. Trager, Co-Chair
Securities Enforcement and Litigation Practice
+1 202.942.6976
Michael.Trager@aporter.com

Stewart D. Aaron
+1 212.715.1114
Stewart.Aaron@aporter.com

John A. Freedman
+1 202.942.5316
John.Freedman@aporter.com

Lauren R. Bittman
+1 212.715.1199
Lauren.Bittman@aporter.com

6 *In Re: CP Ships Ltd. Securities Litigation,* 578 F.3d 1306 (11th Cir. 2009). *See also* Arnold & Porter advisory "The Eleventh Circuit Finds Subject Matter Jurisdiction in 'Foreign-Cubed' Securities Lawsuit," *available at:* http://www.arnoldporter.com/public_document.cfm?id=14678&key=24I2.