Morrison v. National Australia Bank: The Supreme Court Addresses The Extraterritorial Application Of U.S. Securities Laws

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In *Morrison v. National Australia Bank*, No. 08-1191 (June 24, 2010), the Supreme Court clarified and significantly limited the extraterritorial application of Section 10(b) of the Securities Exchange Act of 1934 – the primary antifraud provision of the U.S. securities laws. Under the Court's new bright-line "transactional test," Section 10(b) applies *only* in connection with the purchase or sale of a security listed on a United States stock exchange or the purchase or the sale of any other security in the United States. This decision will have significant ramifications for foreign issuers with U.S. operations. Beyond providing more predictability, the new transactional test significantly limits the scope of foreign companies' potential liability under the U.S. securities laws. Simply put, investors can no longer invoke Section 10(b) or Rule 10b-5 to sue in U.S. courts for misconduct in connection with securities purchased abroad. As a result, the decision effectively marks the end of the era of high-profile "foreign-cubed" securities class actions brought in U.S. courts against *foreign* issuers on behalf of a class of *foreign* investors who purchased securities on *foreign* securities exchanges.

Factual Background And The Second Circuit's Decision

In August 2003, investors brought a purported securities class action in the Southern District of New York, alleging, among other things, that National Australia Bank (NAB), an Australian company, violated Section 10(b) by making a number of false public disclosures relating to one of its former U.S. subsidiaries, HomeSide Lending, Inc. (HomeSide). HomeSide allegedly overvalued one of its assets – mortgage servicing rights (MSRs) – in Florida and sent this falsified data to NAB in Australia. According to plaintiffs, NAB personnel in Australia then disseminated the false and misleading data via public filings in Australia. Because it had issued American Depositary Receipts (ADRs), NAB also included many of those same Australian filings in submissions to the SEC in the United States. Plaintiffs claimed that these material misrepresentations and omissions directly or proximately caused their loss by inflating the price of NAB's securities. Each of the alleged misleading disclosures was prepared and initially issued in Australia by NAB. NAB's nearly 1.5 billion ordinary shares were not traded on any U.S. stock exchange, and only 1.1 percent of NAB's shares – in the form of ADRs – were traded in the U.S. during the period at issue. The lead plaintiffs were Australians who purchased shares of NAB on an Australian exchange.

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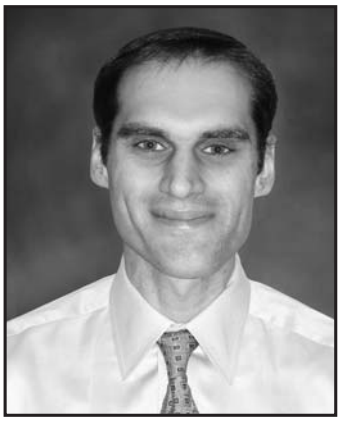

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The Second Circuit (as well as other circuit courts) had historically viewed the extraterritorial application of Section 10(b) as raising a question of subject matter jurisdiction. Even though its statutory text was silent, courts generally found that Section 10(b) could be applied extraterritorially where either the *conduct test* (whether the wrongful conduct occurred in the United States) or the *effects test* (whether the wrongful conduct had substantial effects in the United States, or upon U.S. citizens) was satisfied.

Applying the conduct and effects tests in the *National Australia Bank* case, the district court granted defendants' motion to dismiss for lack of subject matter jurisdiction. The Second Circuit affirmed. Despite the substantially foreign-based fact pattern involved in *National Australia Bank,* the Second Circuit said "the usual rules still apply," and declined "to place any special limits beyond the '*conduct test*'" on foreign-cubed securities class actions. The Second Circuit made three principal findings in support of its affirmance of the district court's decision: (1) the alleged fraudulent disclosures were issued in Australia; (2) the "absence of any allegation that the alleged fraud affected American investors or America's capital markets"; and (3) the "lengthy chain of causation between the American contribution to the misstatements and the harm to investors." The court also noted that it is "an American court, not the world's court," and that it "cannot and should not expend [its] resources resolving cases that do not affect Americans or involve fraud emanating from America." Following the Second Circuit's ruling, the Supreme Court granted plaintiffs' petition for a writ of certiorari.

The Supreme Court's Decision

The Court first addressed whether the Second Circuit was correct in ruling that the extraterritorial application of Section 10(b) raised a question of subject matter jurisdiction (*i.e.*, "a tribunal's power to hear a case"). According to the Court, the Second Circuit (and other courts) had viewed the issue from the wrong perspective. The extraterritorial application of a U.S. statute, including Section 10(b), goes to the "merits" of plaintiffs' claim for relief – whether the statute "prohibits" the conduct about which plaintiffs complain – *not* to subject matter jurisdiction.[1]

In light of the Exchange Act's silence as to the extraterritorial application of Section 10(b), the Court then concluded that the presumption against extraterritoriality applied. According to the Court, "[w]hen a statute gives no clear indication of an extraterritorial application, it has none." The Court observed that the traditional *conduct* and *effects* tests lacked a "textual basis" and that it was not the judiciary's function to extend Section 10(b) beyond the words of the statute for "admirable purposes it might be used to achieve." The Court further commented that "the unpredictable and inconsistent application" of the traditional conduct and effects tests was the unfortunate result "of judicial-speculation-made-law – divining what Congress would have wanted if it had thought of the situation before the court." The application of the presumption against extraterritoriality avoids such inconsistencies. Rejecting investors' argument that Section 10(b) should apply in the *National Australia Bank* case because the deceptive conduct emanated from Florida, the Court stated that "[t]he presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever some domestic activity is involved in the case." According to the Court, the "focus of the Exchange Act is *not* upon the place where the deception originated, but upon purchases and sales of securities in the United States." Moreover, the Court noted that Section 10(b) does not punish all deceptive conduct, "but *only* deceptive conduct 'in connection with the purchase or sale of any security registered on a national exchange or any security not so registered.'"

Considering the statute's text and the presumption against extraterritoriality, the Court adopted a bright-line "transactional test." It held that Section 10(b) reaches a manipulative or deceptive device or contrivance *only* when "the purchase or sale is made in the United States, or involves a security listed on a domestic exchange." In reaching this conclusion, the Court found that the "adoption of [this] clear test" also addressed the concerns expressed by several foreign governments (including Australia, Britain, and France) that the application of the conduct and effects tests by U.S. courts to permit Section 10(b) claims against foreign issuers selling securities on foreign exchanges "infringed upon" their sovereign authority to regulate securities transactions. Rejecting an argument put forth by petitioners and the U.S. government that some formulation of the traditional conduct test should be retained to "prevent[] the United States from becoming a 'Barbary Coast' for malefactors perpetrating frauds in foreign markets," the Court observed that "one should also be repulsed by [the] adverse consequences" of the conduct test, specifically, that the United States "has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."

As applied to the facts in *National Australia Bank*, the transactional test resulted in the dismissal of the case for failure to state a claim. The NAB shares at issue were traded exclusively on foreign exchanges, and none of the relevant purchases or sales occurred in the United States.

Ramifications

Morrison v. National Australia Bank is an important precedent limiting securities class actions brought in U.S. courts against foreign issuers. Like several other Supreme Court decisions over the past several years (including *Stoneridge*, *Tellabs*, and *Dura*), this case continues the Court's narrowing of the private right of action under Section 10(b). For foreign issuers, the transactional test provides needed clarity and avoids the "interference with foreign securities regulation that the application of Section 10(b) abroad would [otherwise] produce." While the decision leaves open the prospect of Section 10(b) liability to investors who purchased shares in the United States or on a U.S.-based stock exchange (such as in the case of ADRs), it eliminates claims in connection with securities purchased abroad. Further, the Court's broad invocation of the presumption against extraterritoriality may impact the scope of other U.S. statutes (including the Racketeer Influenced and Corrupt Organizations Act) that are arguably silent on their extraterritorial application.

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[1] *The Court chose not to send the case back to the Second Circuit on this basis because "a remand would only require a new Rule 12(b)(6)" motion for failure to state a claim that would result in the same "conclusion [reached] under Rule 12(b)(1)."*

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