SECOND CIRCUIT ISSUES SIGNIFICANT DECISION RESTRICTING SUBJECT MATTER JURISDICTION OVER "FOREIGN-CUBED" SECURITIES CLASS ACTION

Last week the Second Circuit, in *In re National Australia Bank Securities Litigation*, issued a significant decision restricting the subject matter jurisdiction of U.S. courts over so-called "foreign-cubed" securities class actions. "Foreign-cubed" refers to securities actions brought in U.S. courts against foreign issuers, on behalf of a class of foreign investors that purchased securities on foreign securities exchanges. Rejecting requests to adopt a rigid "bright-line" jurisdictional rule barring all foreign-cubed actions, as well as a more liberal jurisdictional standard proposed by the Securities & Exchange Commission (the "SEC") in an amicus brief, the Court concluded that the "usual rules" for determining the extraterritorial reach of Section 10(b) were appropriate for foreign-cubed securities class actions. Following the parameters of its well-settled "conduct test" and relying primarily on (1) the fact that 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 Second Circuit concluded that the U.S. courts did not have subject matter jurisdiction over the foreign investors' claims.

Legal Standard

The Second Circuit has "consistently looked at two factors to determine whether it had jurisdiction over securities claims asserted by foreign investors: (1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had substantial effect in the United States or upon United States citizens." *S.E.C. v. Berger*, 322 F.3d 187, 192 (2d Cir. 2003) (citations omitted). These factors are known, respectively, as the "conduct test" and the "effects test." *Berger*, 322 F.3d at 193. In securities class actions, claims brought by domestic shareholders who purchased shares of foreign corporations generally satisfy the effects test. Subject matter jurisdiction over the claims of foreign shareholders who purchased shares on a foreign stock exchange generally turns on the extent of defendants' conduct within the United States.

As a general guideline, the Second Circuit has found that the conduct test is met when "(1) the defendant's activities in the United States were *more than 'merely preparatory'* to a securities fraud conducted elsewhere and (2) the activities or culpable failures to act within the United States '*directly caused' the claimed losses.*" *Berger*, 322 F.3d at 193 (citations omitted) (emphasis added). Although the Second Circuit has held that jurisdiction exists under the conduct test only if substantial acts in furtherance of the fraud were committed within the United States, jurisdiction ordinarily does not exist where the "bulk of the activity was performed in foreign countries." *IIT v. Vencap*, 519 F.2d 1001, 1018 (2d Cir. 1975). To support a finding of subject matter jurisdiction, foreign investors usually are required to demonstrate conduct in the United States of sufficient centrality to the claim of fraud to warrant an exercise of such jurisdiction.

Factual Background and the District Court's Decision

Plaintiffs brought an action alleging that National Australia Bank ("NAB"), one of Australia's largest financial institutions, made a number of false statements relating to one of its former U.S. subsidiaries, HomeSide Lending, Inc. ("Homeside"), which was based in Jacksonville, Florida. In particular, the complaint asserted that Homeside falsely increased the value of one of its assets — mortgage servicing rights ("MSRs") — in Florida and then sent this falsified data to NAB in Australia. NAB personnel in Australia then disseminated the false and misleading data via public filings and statements. Plaintiffs claimed that these material misrepresentations and omissions directly or proximately caused their loss by inflating the price of NAB's securities. NAB's nearly one-and-a-half billion ordinary shares were not traded on any U.S.-based stock exchange, and only 1.1% of NAB's shares were traded in the United States during the period at issue in the form of American Depositary Receipts ("ADRs"). The Lead Plaintiffs were Australians who purchased shares of NAB on an Australian exchange. And finally, each of the alleged misstatements about the value of Homeside's MSRs and Homeside's financial performance was allegedly prepared and issued in Australia by NAB.

Defendants moved to dismiss the complaint on several grounds, including under Fed. R. Civ. P. 12(b)(1), arguing that the district court could not exercise subject matter jurisdiction over plaintiffs' claims. The district court dismissed the foreign plaintiffs' claims for lack of subject matter jurisdiction, holding that they had failed to meet "their burden of demonstrating that Congress intended to extend the reach of its laws to the predominantly foreign securities transactions at issue here."

The Second Circuit's Decision

The Second Circuit affirmed the district court's subject matter jurisdiction ruling. The Court found that despite the unusual fact pattern surrounding foreign-cubed securities class actions, "the usual rules still apply," and declined "to place any special limits beyond the 'conduct test' on 'foreign-cubed' securities fraud actions." Conceding that "what is central or at the heart of a fraudulent scheme versus what is 'merely preparatory' or ancillary can be an involved undertaking," the Court noted that the well-settled "conduct test" still worked best in these situations and that the Court was "leery of rigid bright-line rules because [it] cannot anticipate all the circumstances in which the ingenuity of those inclined to violate the securities laws should result in their being subject to American jurisdiction."[1]

[1] The Second Circuit also rejected (without express acknowledgement) the SEC's proposed jurisdictional test that would have broadened the extraterritorial reach of Section 10(b) for foreign-cubed securities class actions. The SEC's standard would have extended Section 10(b) "to transnational frauds that result exclusively or principally in overseas losses if the conduct in the United States is material to the fraud's success and forms a substantial component of the fraudulent scheme."

The Second Circuit then applied the conduct test to the underlying facts to determine "what conduct comprise[d] the heart of the alleged fraud." The Court made three principal findings in support of its holding that it did not have subject matter jurisdiction under the "conduct test":

- First, NAB's actions in Australia were, "significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of the numbers in Florida." To reach that finding, the Court noted that NAB, not Homeside, is the publicly traded company, and its executives have the "primary responsibility for the corporation's public filings, for its relations with investors, and for its statements to the outside world" and "[w]hen a statement or public filing fails to meet these standards, the responsibility, as a practical matter, lies in Australia, not Florida."

- Second, there was a "striking absence" of any allegation that the alleged fraud affected American investors or America's capital markets. The foreign investors failed to contend that what allegedly happened "had any meaningful effect on America's investors or its capital markets."

- Third, there existed a "lengthy chain of causation between the American contribution to the misstatements and the harm to investors." The Court reasoned that if NAB's corporate headquarters had monitored the accuracy of Homeside's numbers before transmitting them to investors, the inflated numbers would not have been reported. Citing the Supreme Court's recent decision in *Stoneridge*, the Court found that if NAB had corrected the irregularities, investors would not have been aware of them, "much less suffer[ed] harm as a result."

According to the Second Circuit, this particular mix of factors "add[ed] up to a determination" that it lacked subject matter jurisdiction.

Ramifications of the Second Circuit's Decision

The Second Circuit's decision will likely have important ramifications. Although the Court did not change the conduct test that has been applied in the Second Circuit for more than three decades and refused to adopt a bright-line test that would act as a bar to all future foreign-cubed securities class actions, *In re National Australia Bank Securities Litigation* can be used as an important precedent by foreign issuers seeking to dismiss securities class actions brought by foreign investors in U.S. courts. The Court 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." Moreover, even foreign issuers that have significant operations in the U.S. will be able to persuasively contend that fraudulent conduct taking place in those operations does not provide a basis for subject matter jurisdiction as long as

the company's public disclosures were prepared and issued abroad. As the Second Circuit warned, however, U.S. courts may have subject matter jurisdiction "in a case where the American subsidiary of a foreign corporation issues fraudulent statements or pronouncements from the United States impacting the value of securities trading on foreign exchanges."

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If you have any questions concerning the foregoing or would like additional information, please contact Stephen W. Greiner (212-728-8224, sgreiner@willkie.com), Todd G. Cosenza (212-728-8677, tcosenza@willkie.com), or the attorney with whom you regularly work.

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