Morrison v. National Australia Bank: Supreme Court Limits Reach of U.S. Securities Law in "Foreign-Cubed" Cases, Overruling Nearly Half a Century of Lower Court Precedent Based on Long-Standing Presumption that U.S. Laws Do Not Apply Abroad Absent Express Congressional Intent

After years of declining to review the issue of whether U.S. securities law applied extraterritorially to so-called "foreign cubed" securities litigation - involving claims of foreign investors against foreign securities issuers to recover losses arising from purchases made on foreign securities exchanges - the Supreme Court squarely addressed that issue on June 24, 2010 in *Morrison v. National Australia Bank*.[1] The Court overruled nearly half a century of lower court precedent that had allowed the application of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") to foreign based securities transactions in which domestic conduct or effects was alleged. In a majority opinion authored by Justice Antonin Scalia, the Court rejected the "conduct" or "effects" tests employed by the lower courts in determining whether U.S. securities law applied.[2] Justice Scalia admonished the lower courts for creating, out of whole cloth, the authority to decide such foreign cases and ignoring the long-standing presumption that U.S. laws do not apply extraterritorially absent explicit Congressional authorization. Applying the presumption to the statutory language of Section 10(b), the Court found "nothing to suggest it applies abroad" and therefore adopted a bright-line rule that "[o]nly transactions in securities listed on domestic exchanges, and domestic transactions in other securities are covered by [Section 10(b)]."[3]

I. Background

While it is clear that allegedly fraudulent securities transactions occurring wholly outside of the United States do not fall under the 1934 Act, the statute is silent on whether its anti-fraud provision, Section 10(b), applies to securities transactions that, though primarily foreign, involve some domestic conduct or some domestic effect or impact. In the absence of clear Congressional intent, the Second Circuit, beginning in 1968, interpreted Congressional silence on the extraterritorial scope of the 1934 Act to permit the court to determine whether it thought Congress would want to apply the Act even in "predominantly foreign" securities transactions. Specifically, the Second Circuit held, in separate opinions, that the application of Section 10(b) could be premised upon (1) some effect on the United States securities markets or investors, (2) significant conduct in the United States or (3) some combination of the two.[4] In its jurisprudence the Second Circuit readily admitted that there was neither a textual nor extra-textual basis for these tests, stating that "if we were asked to point to language in the statutes, or even in the legislative history, that compelled these conclusions, we would be unable to respond."[5]

Even though other Circuits found the Second Circuit's "conduct" and "effects" tests vague and difficult to apply, a majority of Circuits adopted similar policy-based balancing tests for determining when the 1934 Act applied extraterritorially. Some Circuits, while doubting the wisdom of the tests in light of the traditional

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1 No. 08-1191 (U.S. June 24, 2010).

2 *Id.* at 8 (citing *Schoenbaum v. Firstbrook*, 205 F.2d 215, 206 (2d Cir. 1968); *Leasco Data Processing Equip. Corp.* v. *Maxwell*, 468 F.2d 1362 (2d Cir. 1972); *SEC v. Berger*, 322 F. 3d 187, 192-193 (2d Cir. 2003)).

3 *Id*. at 3.

4 *Id*. at 8 (citing *Itoba Ltd. v. Lep Group PLC*, 54 F. 3d 118, 122 (2d Cir. 1995).

5 *Id.* (citing *Bersch*, 519 F.2d at 993).

presumption against applying United States law extraterritorially in the absence of explicit Congressional intent, followed the Second Circuit in light of its "preeminence in the field of securities law."[6]

II. Facts of the Case

In February of 1998, National Australia Bank ("National"), at the time Australia's largest bank, bought HomeSide Lending ("HomeSide"), a mortgage servicing company headquartered in Florida. HomeSide functioned as a subsidiary of National and generated income from collecting mortgage payments for which it was paid an administrative fee. The value of such so-called "mortgage-servicing rights" depends on the likelihood that the mortgage to which it applies will be fully repaid before it is due, where the higher the likelihood the lower the value. During the period from 1998 until 2001, HomeSide reported and other public documents announced the success of HomeSide's business due in large part to the high value of the company's mortgage-service rights. However, twice in 2001 National announced that it was writing down the value of HomeSide's assets in light of an alleged failure to anticipate the lowering of prevailing interest rates and other errors in HomeSide's valuation models.[7]

The lawsuit arose out of the purchase of National's Ordinary Shares (common stock) by Australian citizens in 2000 and 2001 prior to the write-downs. The Australian stockholders brought a class action in the Southern District of New York against National, HomeSide, and certain of their executives for alleged violations of Sections 10(b) and 20(a) of the 1934 Act and SEC Rule 10b-5[8] arising out of alleged fraudulent misrepresentations made by Respondents. Most notably, for the purpose of the present case, Ordinary Shares of National were sold on the Australian Stock Exchange Limited and on other foreign securities exchanges, *but not on any exchange in the United States*. Further, while the class initially included American shareholders, by the time it reached the Court petitioners were all foreign citizens of Australia. Thus, this case fell within the category of "f-cubed" litigation because it involved foreign stockholders, foreign issuers and claims to recover losses from purchases of foreign securities.

Respondents moved to dismiss the complaint for lack of subject-matter jurisdiction under F.R.C.P. 12(b)(1) and for failure to state a claim under F.R.C.P. 12(b)(6). The District Court granted the motion on the grounds of lack of subject matter jurisdiction, holding that the links to the United States were "at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad." The Second Circuit affirmed on similar grounds and the Supreme Court granted certiorari.[9]

III. The Supreme Court's Decision

In a unanimous decision authored by Justice Scalia, the Supreme Court held that the private right of action under the antifraud provisions of Section 10(b) of the 1934 Act only applies "in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."[10] The Court rejected the "conduct test" and "effects tests" of the Second Circuit in favor of a

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6 *Id.* at 11 (citing *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 32 (D.C. Cir. 1987) (criticizing the "conduct" and "effects" test and the rationale underlying it).

7 *Id*. at 1-2.

8 *Id.* at 3 (citing 48 Stat. 8911, 15 U.S.C. §§ 78j(b) and 78t(a); 17 CFR §240.10b-5 (2009)).

9 *Id*. at 4 (citing *In re National Australia Bank Sec. Litig*., 547 F.3d 167, 175-176 (2d Cir. 2008); No. 08-1191, 130 S.Ct. 783 (2009)).

10 *Id.* at 24.

bright line "transactional test." This test hinges on whether the security at issue is traded on an American stock exchange, or, if not, whether the sale or purchase of the security occurred within the United States.[11] In rejecting decades of Circuit Court jurisprudence, the Court pointed to the fact that as they developed, these tests were not easy to administer and inconsistent results were produced as a result. "There is no more damning indictment of the "conduct" and "effects" tests than the Second Circuit's own declaration that 'the presence or absence of any single factor which was considered significant in other cases . . . is not necessarily dispositive in future cases."[12] The Court pointed out that there is no reason to think that the longstanding presumption that without specific Congressional intent U.S. laws are only applicable within the territorial jurisdiction of the United States would not apply equally to Section 10(b). The Court found no Congressional intent in Section 10(b) to have its provisions apply outside the United States and held that where a statute gives no clear indication of an extraterritorial application, none exists. The Court reasoned that "probability of incompatibility with other countries' laws is so obvious that if Congress intended such foreign application 'it would have addressed the subject of conflicts with foreign laws and procedures.'"[13] Furthermore since Rule 10b-5 was promulgated under Section 10(b), "it does not extend beyond conduct encompassed by Section 10(b)'s prohibition," and has no extraterritorial application.[14]

Once the Court determined that Section 10(b) and Rule 10b-5 do not have extraterritorial application, it turned to the facts of the case. Petitioners' contended that even if Section 10(b) did not have extraterritorial application, the alleged deceptive conduct occurred in Florida and thus only domestic application of Section 10(b) was sought. However, the Court held that the 1934 Act's focus is not on the place where the deception occurred but rather on purchases and sales of securities within the United States. The Court did not even feel the need to consider the fact that the deceptive conduct occurred on U.S. soil as "it is a rare case of prohibited extraterritorial application that lacks all contact with the territory of the United States."[15] Section 10(b) applies only to transactions in securities that are listed on exchanges in the United States or domestic transactions in other securities, neither of which took place here. The Court referenced the 1934 Act's prologue in pointing out the primacy of the domestic exchange over the location of the deceptive conduct.[16]

IV. Justice Stevens' Opinion Concurring in the Judgment

Justice Stevens wrote a concurring opinion in which he was joined by Justice Ginsburg. Justice Stevens agreed that the petitioners failed to state a claim, but differed in his reasoning from that of the majority opinion. Justice Stevens wrote that although the Court's adoption of the "transactional test" for defining the reach of Section 10(b) is plausible, the Court's textual analysis is not compelling enough to abandon decades of Federal court doctrine in assessing these types of cases.[17] Justice Stevens held that the text and history of Section 10(b) are quite opaque on the question of transnational securities fraud and that the entire history of those types of cases was crafted by Federal judges. He criticized that Court's holding that the application of judge made rules is misplaced. If Congress did not wish for judges to elaborate on Section 10(b) then they would not have crafted

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11 *Id*. at 21.

12 *Id*. at 9 (quoting *IIT v. Cornfield*, 619 F.2d 909, 918 (2d Cir. 1980).

13 *Id.* at 20 (citing *E.E.O.C. v. Arabian American Oil Co.*, 499 U.S. 244, 256 (1991).

14 *Id. at 2.* (citing *United States* v. *O'Hagan*, 521 U. S. 642, 651 (1997).

15 *Id*. at 17.

16 *Id*. at 18.

17 No. 08-1191 at 1 (U.S. June 24, 2010) (Stevens, J., concurring).

such an open ended statute. Furthermore, according to Justice Stevens, both Congress and the SEC affirmed the judicial interpretation of the statute by leaving the statute intact through all the years following its passage.[18]

Secondly, Justice Stevens felt, unlike the majority, that the presumption against extraterritorial application of a statute without contrary intent was not a clear rule. He wrote that the presumption "can be useful as a theory of congressional purpose, a tool for managing international conflict, a background norm, a tiebreaker. It does not relieve courts of their duty to give statutes the most faithful reading possible."[19] This approach, according to Stevens, is consistent with the Second Circuit's "conduct" and "effects" test. "While Section 10(b) may not give any "clear indication" on its face as to how it should apply to transnational securities frauds, it does give strong clues that it should cover at least some of them[20] . . . the Second Circuit has done the best job of discerning what sorts of transnational frauds Congress meant in 1934—and still means today—to regulate." [21] Justice Stevens felt that the Second Circuit's "conduct test" and "effects test" should remain as the governing barometer for transnational securities fraud situations.

V. Significance of the Decision

The bright line rule adopted by the Court will likely provide substantial guidance to foreign issuers and investors, and securities counsel. It might also cause some companies without need for access to U.S. capital markets to reconsider listing their securities on the New York Stock Exchange, NASDAQ or any other United States stock exchanges.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Michael Rosenberg at 212.701.3654 or mrosenberg@cahill.com.

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18 *Id*. at 4.

19 *Id*. at 7.

20 *See Id*. at 9 fn 9. (By its terms, §10(b) regulates "interstate commerce," 15 U. S. C. §78j, which the Exchange Act defines to include "trade, commerce, transportation, or communication . . . between any foreign country and any State, or between any State and any place or ship outside thereof." §78c(a)(17).) Thus there is a basis in the statute that foreign situations were considered in the statutes construction.

21 *Id.* at 11.