CaseNote
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The Long Arm of the US law

For some time, there has been concern over the long arm of the US law and the attempts of US regulators and US Courts to impose US law on foreign companies and their directors.

A recent development has been the emergence of "foreign-cubed" (or F-cubed) lawsuits. These securities class actions involve allegations by non-US shareholders against non-US issuers with respect to breaches of US securities laws arising from securities fraud in a foreign jurisdiction.

Because the company or its directors have some connection with the United States, plaintiff shareholders attempt to bring proceedings in the US Courts, which are clearly more favourable for plaintiff shareholders than the foreign jurisdiction.

This development has placed foreign companies and directors in a difficult position of having to defend US proceedings and deal with US legal principles, such as the "fraud on the market theory", which has not been adopted in jurisdictions outside of the US.

The US Supreme Court recently heard oral argument in the case of ***Morrison v National Australia Bank***. This case involves plaintiff shareholders of NAB who purchased shares in National Australia Bank (**NAB**) in Australia. In summary, the plaintiff shareholders allege that NAB's wholly owned US subsidiary, HomeSide Lending Inc., (**HomeSide**) had overstated the present value of fees it would generate from the servicing of the mortgages. HomeSide's overstated financials were incorporated into the public financials of NAB in Australia. In 2001 NAB disclosed that the value of HomeSide's servicing rights and goodwill had been overstated and announced write-downs of approximately $2.2 billion. Following the announcement of the write-downs, NAB's share price fell.

The Proceedings

District Court

The plaintiff shareholders brought proceedings out of the Southern District of New York, alleging securities fraud against NAB and HomeSide and four of its directors under Section 10(b) of the *Securities Exchange Act of 1934*. NAB and other defendants filed dismissal proceedings, arguing that the *Securities Exchange Act* and other US law did not apply, as the transaction occurred mainly in Australia with little or no impact in the US. The US District Court ruled that the knowledge of HomeSide and its directors of the financial inaccuracies was only a link in the chain of causation. The court held that because NAB had made the financial announcements in Australia, the plaintiff shareholders had failed to satisfy the relevant tests for subject matter jurisdiction.

Second Circuit Court of Appeals

On appeal, the plaintiff shareholders and various amici parties, including the Securities Exchange Commission (**SEC**) and industry organisations, argued that the "bright line test" applied, namely that the *Securities Exchange Act* laws will apply to transnational (extra-territorial) frauds that result in losses which are exclusively or principally outside the US, if the conduct in the US is material to the fraud's success and forms a substantial component of the fraudulent scheme.

The Second Circuit rejected the plaintiffs' argument and applied the traditional and standard rule. The court held that" *We look to whether the harm was perpetrated here or abroad and whether it affected domestic markets and investors. This binary inquiry calls for the application of the 'conduct test' and the 'effects test'. We ask : (1) whether the wrongful conduct occurred in the United States and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens. Where appropriate, the two parts of the test are applied together because an admixture or combination of the two often give a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American Court."* The Second Circuit recognised the need to avoid aggressive application of US securities law and commented that *"We are an American Court, not the World's Court and we cannot and should not expend our resources resolving cases that do not affect Americans or involve fraud emanating from America."*

The Second Circuit Court dismissed the appeal on the following grounds:

- section 10(b) of the *Securities Exchange Act* is silent as to its extraterritorial application
- HomeSide's conduct of the preparation of false data fell within the activity of aiding and abetting which was not sufficient to trigger liability under section 10(b) of the *Securities Exchange Act*, and
- there was clearly an absence of evidence that US investors and the US financial market was impacted by the fraud.

Appeal to Supreme Court

The Plaintiffs filed a writ of certiorari which was granted, allowing the Appeal to the US Supreme Court to proceed.

Oral argument was recently heard before the US Supreme Court.

The plaintiff shareholders argued that a federal violation occurs whenever a fraud is committed in connection with the purchase or sale of any security as long as one of any three conditions are met:

- using an instrument of commerce
- the US mail, or
- any national securities market.

It was argued that, as NAB had engaged in fraud through interstate commerce in the US, and through the use of US Mail, one of the elements had been satisfied and therefore Section 10(b) of the

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Securities Exchange Act would apply. It was further argued that the lower courts could not disclaim the subject matter jurisdiction given to them by Congress.

NAB's arguments in response were:

- allowing this lawsuit to proceed would unleash claims by hundreds of thousands of investors who have no connection to the US or the US securities market
- US Federal Courts had been disregarding the principle that US law does not reach beyond US shores, unless Congress explicity says it does, and
- extending the law overseas would intrude on sovereign authority of other nations.

The US Solicitor General, appearing as amicus curiae in a brief with the SEC, argued that the question was not one of jurisdiction or reach of the *Securities Exchange Act* as US courts do have jurisdiction over conduct regulated by that statute.However, in the present circumstances, the Second Circuit was correct in finding that the link between the US component of the conduct and the injury or loss suffered was insufficient to support rights to bring a private suit.

During the oral argument, a number of the Justices expressed concerns as follows:

- whether the US was the appropriate forum for Australian shareholders who purchased shares of an Australian domiciled company sold on the Australian Stock Exchange
- whether it would be appropriate for US securities law to apply in circumstances where a foreign country's laws are regulated and may be in conflict or incompatible with US law, and
- whether the *Securities Exchange Act*'s private right action applies to the securities of foreign companies purchased by foreign investors.

Importance

Given the significant implications and vested interests at stake, many interested parties await the outcome of these proceedings, including foreign institutional investors with trillions of dollars in funds under management (supporting the plaintiff shareholders) and foreign governments (supporting NAB).

If the US Supreme Court upholds the decision of the circuit court affirming the dismissal of the securities fraud complaint for lack of jurisdiction, it could have a very significant impact on foreign companies and directors who are concerned to understand the nature and extent of their potential exposure with respect to US securities class actions and the implications this has upon their operations.

The US Supreme Court ruling is expected by late June or early July.

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