SECOND CIRCUIT APPELLATE COURT LIMITS U.S. SECURITIES LITIGATION AGAINST AUSTRALIAN COMPANIES BY AUSTRALIAN PLAINTIFFS

Introduction

In *Morrison v. National Australia Bank* No. 07-0853-cv, 2008 WL 4660742 (2d Cir. Oct. 23, 2008) (*"NAB"*), the United States Court of Appeals for the Second Circuit, which sits in New York City, limited the ability of U.S. courts to hear claims in U.S. courts based on alleged breaches of U.S. securities laws on behalf of Australian investors who purchased shares on the ASX (so-called "foreign-cubed claims"). Eschewing a "bright-line rule" precluding the exercise of subject matter jurisdiction over such claims, the Second Circuit held that, in general, a U.S. court does not have subject matter jurisdiction over foreign-cubed claims when the acts that constituted the alleged fraud and directly caused the alleged harm emanated from outside the United States. Under this approach, the court concluded, subject matter jurisdiction does not exist over a foreign-cubed claim when the Australian company's executives: (a) made decisions concerning the content of alleged misstatements to investors from Australia and (b) issued those statements from Australia.

The decision represents a significant narrowing of the availability of class actions against Australian companies for alleged breaches of U.S. securities laws.

Paradoxically, however, the decision may prove a stimulus for the commencement of class actions before Australian courts under Australian rules governing representative proceedings for breach of similar anti-fraud Australian securities laws. As such, the decision may constitute an additional contextual consideration adding to the momentum of securities class actions in Australia at a time when United States courts and regulators are winding back the availability of securities class actions.

Background

One distinctive feature of U.S. securities regulation is that the potential for large securities law civil suits in the United States is appreciably higher than in other jurisdictions. As a general matter, the heightened liability risk in the

United States is not so much a product of more investor friendly securities laws (or “law on the books” in the words of Professor John Coffee of Columbia University), but differences of legal culture and methods of enforcement of securities laws. It is well known that the United States is a litigious culture and this extends to securities laws. This litigious culture is fed by the widespread historical use of class actions as a form of private enforcement of securities laws and the generally more permissive and flexible laws providing for the use of such class actions, the costs system (i.e., costs do not follow the event as in Australia), the availability of contingency fees, and the size and coordination of the securities litigation bar. Class actions in the United States are also facilitated by the fraud on the market doctrine, which has hitherto not been embraced by Australian courts. Under this theory, plaintiffs are entitled to a rebuttable presumption that class members had relied on the integrity of the trading market in deciding to sell their shares and are not required to prove direct reliance in order to establish causation.

The principal legal source of civil liability for misleading statements conveyed to investors under U.S. securities laws is Rule 10b-5 promulgated under the Securities and Exchange Act of 1934. Most relevantly, Rule 10b-5 proscribes making any untrue statements of material fact or failing to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. Its legal contours are thus, speaking generally, analogous to s 52 of the *Trade Practices Act 1974* (Cth) for misleading and deceptive conduct and analogous provisions in ss 670 and 728 of the *Corporations Act 2001* (Cth). Apart from the private enforcement through class actions, another distinctive feature of Rule 10b-5 is its extraterritorial reach. A number of decisions prior to NAB had established subject matter jurisdiction for Rule 10b-5 claims concerning non-U.S. companies where it could be established that the conduct in the United States was more than merely preparatory and had some discernible effect in the United States.

Distinguished U.S. securities regulation academic, Professor John Coffee, in a recent paper, has been highly critical of the extra-territorial operation of Rule 10b-5 so as to extend its reach to a predominantly extraterritorial class of foreign investors. He has cogently argued (Coffee, “The Law and the Market:

The Impact of Enforcement (2007)) that the availability of securities class actions should be restricted to U.S. nationals and foreign residents because allowing foreign non-resident investors to be included within a class not only forces U.S. courts to serve as “policemen to the world”, but also discourages foreign companies form cross-listing. The influential Committee on Capital Markets Regulation has also criticized the availability and proliferation of class actions against foreign issuers in respect of largely extra-territorial conduct. They contend it has had a corrosive impact on the competitiveness of U.S. capital markets because the spectre of becoming embroiled in a U.S. class action discourages foreign companies from raising capital in the United States.

It is against this background that the Second Circuit rendered its decision in *NAB*.

Facts

In *NAB*, U.S. plaintiffs who purchased National Australia Bank (”NAB”) American Depository Receipts on the New York Stock Exchange and Australian plaintiffs who purchased NAB ordinary shares on the ASX brought a securities fraud class action based on Rule 10b-5 against NAB in the Southern District of New York. To connect the alleged fraud to the United States, and thus to provide a basis for the U.S. court to exercise jurisdiction over their foreign-cubed claims, the Australian plaintiffs alleged that employees of HomeSide, NAB’s U.S. mortgage service provider subsidiary, knowingly created models that falsely inflated the value of its Mortgage Servicing Rights (“MSRs”). HomeSide employees then allegedly transmitted these inflated values to NAB executives in Australia, who allegedly participated in the fraud by including that information in NAB’s ASX financial disclosures. When the inflated MSR values became apparent, NAB took large write-downs, allegedly causing a decline in NAB’s share price.

The district court dismissed the Australian plaintiffs’ claims for lack of subject matter jurisdiction, holding that because the claims concerned alleged public misstatements, the “heart” of the alleged fraud had occurred in Australia, where NAB executives determined the content of, and issued NAB’s public disclosures. The underlying conduct by HomeSide employees, while part of

the chain of events that ultimately caused the alleged losses, was insufficient to establish the right of the Australian plaintiffs to bring suit in the United States. This conduct, at most, amounted to a link in the chain of a scheme that culminated at NAB's nerve centre of operations in Melbourne.

The Second Circuit Decision

The Second Circuit affirmed the decision of the District Court and reaffirmed that a U.S. court generally has jurisdiction to hear foreign-cubed claims only if activities in the United States "were more than merely preparatory to a fraud and culpable acts or omissions occurring here directly caused losses to investor abroad". The court said this determination is not mechanical but contextual and fact-intensive, and ultimately "depends on what and how much was done in the United States and on what and how much was done abroad."

The Second Circuit emphasized that because the U.S. securities laws focus on disclosures, a U.S. court should not exercise jurisdiction where primary responsibility for the content of the disclosures and the issuance of the disclosures occurred abroad. Accordingly, the Second Circuit rejected the proposition that a U.S. court can exercise jurisdiction over foreign-cubed claims solely because certain conduct contributing to the creation of the alleged misstatements occurred in the United States. At the same time, the Second Circuit was not persuaded that the bringing of such claims would bring U.S. securities laws into conflict with those of other jurisdictions, since the anti-fraud rules and enforcement objectives of other countries were broadly similar. A bright-line rule, therefore, precluding foreign-cubed claims was not warranted. Conscious, however, that it is not a world court charged with policing securities fraud globally, the Second Circuit concluded that its existing doctrinal framework, which focuses on the locus of the conduct said to comprise the heart of the alleged fraud, appropriately balanced the competing policy goals of avoiding conflict with foreign securities laws, on the one hand, and preventing the export of fraud from the United States on the other hand.

As applied to the facts of NAB, the Second Circuit held that (1) because the U.S. plaintiffs had not appealed the district court's dismissal of their claims, there were no allegations of any effect on U.S. investors or U.S. markets, (2)

none of the alleged misstatements were made from the United States but from NAB's headquarters in Melbourne, which took primary responsibility for NAB's public filings and its communications with investors and the outside world, and (3) the lengthy chain of causation between Homeside's actions and the statements that reached investors, amounted to a conclusion that the total "mix of factors" meant that that US courts lacked subject matter jurisdiction.

It is unclear whether the appellants will seek certiorari to appeal to the US Supreme Court.

Implications for Australian Companies and Class Actions

The *NAB* decision has several implications for Australian companies whose securities trade in the United States or that conduct extensive business in the United States. First, *NAB* should limit the exposure of Australian companies to foreign-cubed claims in United States courts, especially those arising out of the current credit crisis and collapse in the share price of most Australian public companies. Second, *NAB* suggests that Australian companies can reduce the risk of foreign-cubed claims by taking steps to ensure that the decisions about the content of their disclosures, as well as the issuance of those disclosures, occur outside the United States. Third, *NAB* suggests that Australian companies could improve the strength of their jurisdiction defenses against foreign-cubed claims by limiting public disclosures made by high-ranking company officials within the United States thereby limiting unnecessary links between their public disclosures and the United States.

Finally, *NAB* may have the consequence of simply diverting class action claims by Australian plaintiffs against Australian companies that otherwise might have been pursued in the US—because of the favourable legal environment for shareholder class actions in the United States—to class actions pursued before Australian courts (or proceedings brought by ASIC on behalf of shareholders). This seems likely given the more favourable legal environment for class actions in Australia in recent years. At a time when the US is winding back on the availability of securities class actions, through a combination of a series of recent narrowing Supreme Court decisions and Congressional restrictions, in recognition of the damaging impact of class actions on the competitiveness of the US capital markets and the health of the

national economy, the emergence of litigation funders (bolstered by the High Court's decision in *Fostif*), publicly-listed law firms and the liberalisation of the rules governing representative proceedings has seen Australia move in the opposite direction toward an environment more conducive to the bringing of large shareholder class actions.

The *NAB* decision is illustrative of the inherently cross-jurisdictional operation of securities laws in a world of interdependent global capital markets and how decisions of courts and regulators in one jurisdiction, especially United States decisions, often have a reverberating effect in other jurisdictions. As the current financial crisis highlights, the trans-national operation of securities laws presents challenging issues for domestic securities regulators and ASIC and the ASX will surely follow with interest any appeal to the U.S. Supreme Court because of the impact it may have on the domestic incidence of class actions in Australia for breach of its own securities laws.