Client Alert.

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United States Supreme Court Hears Oral Argument on the "Extraterritorial" Application of the Securities Exchange Act

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Today the United States Supreme Court heard oral argument on the question of whether "Foreign-Cubed" securities class actions — private actions brought on behalf of *foreign* purchasers of the securities of *foreign* companies on *foreign* exchanges — may be litigated in United States courts.

The "extraterritorial" reach of the federal securities laws is the central focus of *Morrison v. National Australia Bank*, No. 08-1191. *Morrison* is the third in a series of fairly recent Supreme Court cases reviewing the extraterritorial application of federal statutes, following the Court's consideration of the reach of antitrust law in *F. Hoffmann-LaRoche Ltd. v. Empagran S.A.*, 542 U.S. 155 (2004), and patent law in *Microsoft v. AT&T Corp.*, 550 U.S. 437 (2007). In *Empagran* (a unanimous decision) and *Microsoft* (an 8-to-1 decision), the Court concluded that the extraterritorial scope of the federal antitrust and patent statutes was a matter for Congress to decide. In the face of statutes that were ambiguous or silent on the issue, the Court applied a "presumption that United States law governs domestically but does not rule the world."

THE LONG-STANDING "CONDUCT" TEST.

The lower federal courts have long acknowledged that Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") "is silent as to its extraterritorial application." Rather than limit the scope of the statute to the United States, courts, starting with the Second Circuit in 1975, have instead applied their "best judgment as to what Congress would have wished if these problems had occurred to it," and surmised that Congress did not intend "to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners."

The result was a "conduct" test for extraterritoriality, under which a Foreign-Cubed purchaser has a right of action where the foreign issuer's "acts (or culpable failures to act) within the United States directly caused [his] losses." In creating this test, the Second Circuit "freely acknowledge[d] 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." *See IIT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir. 1975); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir. 1975).

MORRISON V. NATIONAL AUSTRALIA BANK.

Morrison was the first opportunity for the Second Circuit to consider the "conduct" test as applied to Foreign-Cubed plaintiffs after *Empagran* and *Microsoft*. The court of appeals again recognized that the Exchange Act is silent on its extraterritoriality, but the court declined to apply the presumption against extraterritoriality. Instead, the Second Circuit again applied the "conduct" test, returning "to the underlying purpose of the anti-fraud provisions as a guide to discern whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to [the claims of Foreign-Cubed plaintiffs]." The court concluded that the Foreign-Cubed plaintiffs had failed the

"conduct" test due to the "lengthy chain of causation between the American contribution to the [alleged] misstatements and the harm to investors."

The Foreign-Cubed plaintiffs filed a petition for a writ of certiorari, which the Supreme Court granted after first requesting the views of the Solicitor General of the United States.

Respondents (the defendants in *Morrison*) and 15 amici[1] (including various foreign governments) have argued that the Supreme Court should affirm the Second Circuit's ruling — not on the basis of the Second Circuit's reasoning, but because Section 10(b) of the Exchange Act does not apply to Foreign-Cubed transactions at all.

Respondents and their amici have argued that such a result would accord with the Court's presumption against extraterritoriality in *Empagran* and *Microsoft*, and it would be consistent with the Court's decision in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), in which the Court held that the private right of action under Section 10(b) should not be expanded judicially beyond its present boundaries. Indeed, in *Stoneridge*, the Supreme Court expressed concern that, with any further expansion of Section 10(b)'s private right of action, "[o]verseas firms with no other exposure to our securities laws could be deterred from doing business here." Given possible consequences of this nature, the Court held, "[t]he decision to extend the cause of action is for Congress, not for us."

The United States also filed an amicus brief in the *Morrison* case. The government argued that the United States Securities and Exchange Commission ("SEC") properly may enforce the federal securities laws extraterritorially against foreign issuers, even where their securities were offered only on foreign exchanges. While the government argued that it could enforce Section 10(b) under those circumstances so long as material, significant conduct occurred in the United States, it contended that Foreign-Cubed purchasers could not bring private actions to do so unless that conduct "directly caused" their claimed losses.

If the Supreme Court holds in *Morrison* that Foreign-Cubed plaintiffs have no private cause of action under the Exchange Act, one of the most troubling aspects of the "conduct" test would be eliminated — Foreign-Cubed class actions. Even the Second Circuit in 1975 recognized that its "conduct" test did not really translate to the class action context. How can thousands of Foreign-Cubed investors purchasing on a foreign exchange establish that United States conduct "directly caused" their losses? How can courts issue effective class notice, where the vast majority of absent class members reside in countries requiring actual notice? Would the courts of the foreign issuers' home countries, which often reject the concept of an "opt-out" class, recognize a U.S. judgment as binding against absent plaintiffs? And, if not, if the foreign issuer prevails in the suit, is it getting the benefit of the class action mechanism? Due to these and similar concerns, few "Foreign-Cubed" class actions make it past the certification stage, but the high cost of litigating these actions to that point represents an *in terrorem* increment of the action's settlement value.

ORAL ARGUMENT HIGHLIGHTS.

While the outcome of a case cannot be predicted with any degree of certainty based upon the oral argument, the questions posed to counsel can shed light on where the Court — or at least particular Justices — may be heading. At the outset, a number of Justices expressed significant skepticism as to whether the Exchange Act's private right of action applies to the securities of foreign companies purchased by foreign investors on foreign exchanges — a potentially strong indication that the Supreme Court may invalidate the "conduct" test adopted by the Second Circuit and other courts of

[1] Morrison & Foerster LLP represents one of these *amici* and filed a brief on its behalf.

appeals, in favor of a bright-line rule that would preclude Foreign-Cubed cases.

Another theme that developed at oral argument was whether the United States possessed an interest in Foreign-Cubed transactions, particularly where other nations have adopted their own means to regulate their securities markets. For example, Justice Ginsburg noted that this case "has 'Australia' written all over it" and questioned counsel for the plaintiffs whether — in a case involving Australian purchasers of the securities of an Australian company purchased and sold on an Australian exchange — "the most appropriate choice of law [is] that of Australia, not the United States." Likewise, Justice Alito asked why, if Australia has determined that Foreign-Cubed plaintiffs have no remedy, the United States would have an interest in whether any securities fraud occurred.

Justices also questioned whether it would be appropriate to apply United States securities fraud law in circumstances where application of United States law would directly conflict with, or at a minimum be incompatible with, the laws of other nations. Justice Breyer drew attention to the amicus briefs filed by foreign governments urging against the extraterritorial application of the Exchange Act. Justice Scalia drew attention to the fact that Australia and other nations want actions involving statements made by companies organized under their laws, in connection with transactions in securities traded on the exchanges of their countries, to be decided by their courts, rather than United States courts. And Justice Kennedy drew attention to the burdensome levels of discovery that Foreign-Cubed cases may raise that otherwise might not occur in actions brought in foreign courts.

The Court's questions were no more friendly to the government's middle-ground approach — that the conduct at issue in *Morrison* would constitute a violation of the securities laws that only the SEC could enforce. The Chief Justice and Justice Scalia questioned whether the government's test — which employed broad phrases such as "significant" and "directly caused" and required an examination of the totality of the circumstances — could be applied meaningfully.

While the tenor of the argument was generally not favorable to the Foreign-Cubed plaintiffs, there were some concerns raised about the possibility of the United States becoming a base of operations for extraterritorial fraudulent conduct.

CONCLUSION.

Although the lower courts have been grappling with this issue for 35 years, this is the first time it is being addressed by the Supreme Court. And none too soon — the highly fact-based "conduct" test makes it nearly impossible for foreign companies to predict what litigation risks may accompany various levels of association with the United States. Foreign companies have already begun withdrawing from United States capital markets, and are threatening to retreat from doing business in the United States, due to the unpredictable risk of being subjected to a United States securities class action brought on behalf of a foreign issuer's *foreign* investors who purchased their securities on a *foreign* exchange.

Most countries do not enforce their securities laws with private class actions, driven aggressively by plaintiffs' attorneys who are not subject to any "loser pays" requirement. The United States also provides an underlying discovery framework that is exponentially more costly and burdensome than exists elsewhere in the world. To make basic business decisions, foreign companies need to be able to assess their exposure to the risk of a U.S. securities class action. Foreign companies are likely focused on this risk exposure today more than ever, weeks after a multi-billion-dollar jury verdict was handed down in *In re Vivendi Universal S.A. Securities Litigation*, a class action brought in the Southern District of New York on behalf of French purchasers of Vivendi S.A. securities on the Paris Stock Exchange.

While the oral argument provides a good indication that certain Justices are skeptical of private securities fraud actions

involving Foreign-Cubed plaintiffs, the outcome of the case will not be known until the Supreme Court issues its decision, which is expected before the end of June 2010. Because Justice Sotomayor has recused herself from the case, there is a remote possibility that the Court will be evenly divided 4-to-4, which would leave the Second Circuit ruling intact without a precedential decision from the Supreme Court.

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