Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Effects Of 2nd Circ. Stance On 'F-Cubed' Securities

Law360, New York (November 20, 2008) -- The United States Court of Appeals for the Second Circuit, in Kennedy v. National Australia Bank Ltd., No. 07-0583 (Oct. 23, 2008), recently "revisit[ed] the vexing question of the extraterritorial application" of the United States securities laws.

Despite overtures from a number of amici seeking a more definitive ruling, the Second Circuit, in a matter of first impression, declined to adopt a bright-line test that would have barred all so-called "Foreign-Cubed" (or "F-Cubed") securities cases from being brought in U.S. courts ("F-Cubed" being shorthand for actions brought pursuant to the U.S. securities laws commenced by (1) foreign plaintiffs against (2) foreign issuers of securities based on (3) foreign transactions).

The Court of Appeals nonetheless affirmed the district court's dismissal of the proceeding, concluding that the action, which was commenced by foreign purchasers of the stock of a foreign issuer, National Australia Bank ("NAB"), through transactions on a foreign exchange in reliance on false financial statements issued in Australia, lacked subject matter jurisdiction in U.S. Courts, even though the Bank's false statements were deceptive as a result of the inclusion of false financial data relating to a U.S. subsidiary.

In doing so, the Court reaffirmed the application of the "conduct" and "effects" for determining the extraterritorial reach of Section 10(b) of the Securities Exchange Act of 1934 enunciated in Psimenos v. E.F. Hutton & Co., 722 F.2d 1041, 1045 (2d Cir. 1983), and made clear that the inquiry requires a case by case assessment of (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.

The Court's application of the "conduct and effects" test to the facts in NAB demonstrate, however, that, although the Second Circuit rejected a bright-line prohibition of F-Cubed suits, such cases must be carefully scrutinized and only cases with a strong nexus to the United States allowed to proceed.

Court Reaffirms 'Conduct Test' And 'Effects Test'

As an initial matter, the Court reiterated its view that "it is consistent with the statutory scheme [of Section 10(b) of the Securities Act of 1934] to infer than Congress would have wanted 'to redress harms perpetrated abroad which have a substantial impact on investors or markets within the United States."

"[L]eery of rigid bright-line rules," the Court concluded that "adopting a bar of all "F-cubed" cases could make the U.S. be seen as a "safe haven for securities cheaters" and would "conflict with the goal of preventing the export of fraud from America."

Nonetheless, the Court pointedly noted: "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."

To strike an appropriate balance, the Court of Appeals therefore reaffirmed the "conduct test" and the "effects test" for determining the extraterritorial reach of Section 10(b), directing lower courts to "look to whether the harm was perpetrated here or abroad and whether it affected domestic markets and investors."

Noting some confusion with its prior precedents, the Second Circuit, citing Alfadda v. Fenn, 935 F.2d 475, 478 (2d Cir. 1991), reiterated that the "conduct test" requires that the defendant's conduct in the U.S. be "more than merely preparatory to the fraud" and that acts or culpable failures to act within the U.S. "directly cause losses to foreign investors abroad."

The Court acknowledged that "[d]etermining what is central or at the heart of a fraudulent scheme versus what is 'merely preparatory' or ancillary can be an involved undertaking."

In the case before it, it was alleged that the primary cause of the financial statement fraud was the inclusion of false asset values for mortgage servicing rights results by the bank's U.S. subsidiary, HomeSide Lending Inc., a mortgage service provider headquartered in Florida.

In concluding that subject matter jurisdiction did not exist, the Court rejected the plaintiffs' effort to focus the Court's attention on the essential first step in the fraud – the exaggerated asset valuations by the Florida subsidiary – and instead looked to the "place of compilation" and place of dissemination (Australia) holding that the "actions taken and the actions not taken by [the bank] in Australia were, in our view, significantly more central to the fraud and more directly responsible for the harm to investors than the manipulation of the numbers in Florida."

This conclusion, coupled with the absence of any basis for application of the "effects" test on American investors and the "lengthy chain of causation" between the Florida

fraud and the information provided by the bank to investors, led to the Court's determination that subject matter jurisdiction was lacking.

A Potentially High Bar For F-Cubed Actions To Remain In U.S. Courts

Given the preliminary but key role the NAB Florida subsidiary played in the alleged fraud, the Second Circuit's rejection of subject matter jurisdiction in National Australia Bank would appear to set a high bar for F-Cubed actions to remain in U.S. courts.

The Second Circuit's refusal to adopt a bright-line test barring F-Cubed securities cases, however, could encourage the bringing of such actions notwithstanding the fact that its rigorous application of the "conduct" and "effects" tests will likely cause many, if not most, to fail.

Given the limited options for collective shareholder actions in other countries, this is a risk that disappointed investors and aggressive plaintiffs' counsel may be willing to take in order to exploit the narrow jurisdictional window NAB has arguably opened.

Indeed, with increasing globalization of major companies and of the securities markets themselves, it is possible that the number of cases over which U.S. courts accept jurisdiction will increase, perhaps substantially, and that, given the uncertainty of the law in other circuits, many of such cases will be brought in the Second Circuit.

And while opposition to F-Cubed cases may shift focus to legislative relief, the crowded legislative docket in the next Congress with a new administration may make it difficult to attract interest in the issue. The plaintiffs may seek Supreme Court review of the Second Circuit's decision, which may provide another forum for this important jurisdictional controversy.

--By William K. "Ned" Dodds and David S. Hoffner, Dechert LLP

Ned Dodds and David Hoffner are both partners with Dechert in the firm's New York office.