Morrison v National Australia Bank Ltd 561 US (2010)

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Abstract

The United States (US) Supreme Court recently overturned more than 40 years of US Federal Court of Appeal jurisprudence in holding that US anti-fraud provisions do not apply to securities listed on a non-US stock exchange, even if the alleged fraud occurs or has an effect within the US or on US citizens. In determining whether US anti-fraud provisions apply to securities fraud, US courts traditionally applied the 'conduct and effect' test. This test required courts to firstly decide whether the alleged fraudulent conduct had occurred in the US, and secondly, whether it had a substantial effect in the US or upon US citizens.[1] However, in *Morrison v National Australia Bank Ltd*, the Supreme Court adopted a new 'transactional' test. Under this test, the Court held that US anti-fraud provisions will only apply to:

1. transactions in securities that either occur in the US; or
2. transactions in securities that are listed on a US stock exchange.

I The facts

In February 1998, National Australia Bank Limited (NAB) bought HomeSide Lending Inc (HomeSide), an American mortgage servicing company based in Florida. Over the following three years, NAB's financial reports included figures that outlined the success of HomeSide's business. However, in July 2001, NAB announced that it would be writing down the value of HomeSide's assets by US$450 million and then again by a further US$1.75 billion in September 2001. As a result, the value of NAB shares listed on the Australian Stock Exchange (ASX) fell sharply.

The plaintiffs in the case were Australian residents who had purchased shares in NAB on the ASX. They alleged that HomeSide had manipulated financial models so as to artificially inflate the value of the company and that NAB was aware of this deception by July 2000, but did nothing about it. The plaintiffs brought an action against NAB in the Southern District Court of New York, alleging violations of section 10(b) of the *Securities Exchange Act 1934* ('*Exchange Act*'), which stipulates:

> It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange [...]
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange [...] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

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1 *Securities and Exchange Commission v Berger*, 322 F 3d 187, 192–3 (2nd Cir, 2003).

> prescribe as necessary or appropriate in the public interest or for the protection of investors.[2]

Despite NAB being a Melbourne-based bank incorporated in Australia and listed on the ASX, the plaintiffs chose to bring the action in US courts. These factual scenarios have been referred to in the US as 'foreign-cubed' securities actions in that they involve a foreign (or non-US) plaintiff suing a foreign issuer in respect of shares listed on a foreign exchange.[3]

At first instance, the Southern District Court of New York applied the 'conduct and effect' test. It found that the alleged fraud had insufficient connection with the US and that, as such, the Court lacked subject-matter jurisdiction to hear the case. On appeal to the Second Circuit, the Court affirmed the 'conduct and effect' test and once again dismissed the plaintiffs' appeal for lack of subject-matter jurisdiction.

II The US Supreme Court's decision

Justice Scalia delivered the opinion of the majority of the US Supreme Court.[4] It found that the Court of Appeal had erred in determining the case on the basis of the conduct and effect test, instead stating that the central issue to be determined was whether the US Congress had ever intended section 10(b) of the *Exchange Act* to apply extra-territorially or only to securities within the US. The wording of section 10(b) is silent as to the question of its geographical application. Employing a literal approach to statutory interpretation, Justice Scalia emphasised that the role of judges is to give a statute the effect that its language suggests and found that, 'when a statute gives no clear indication of an extraterritorial application, it has none'.[5]

Accordingly, and in order to provide added clarity to the application of section 10(b), the Supreme Court generated a new 'transactional' test, which limited the application of section 10(b) to cases where the purchase or sale of security is made in the US, or involves a security listed on a US stock exchange.

Concurring judgment

Justice Stevens, who was joined by Justice Ginsburg, delivered a concurring judgment in which he agreed with the result of the Court's opinion, but strongly disagreed with the Court's reasoning.

Unlike the majority of the Court, Justice Stevens endorsed the Court of Appeal's use of the 'conduct and effect' test as the appropriate test. In his view, the fraudulent conduct complained of in the case had occurred in Australia and the effect of the fraudulent conduct was on Australian investors based in Australia. On that basis, US courts had no business accepting jurisdiction over the matter. In Justice Stevens' own words, 'this case has Australia written all over it'.[6]

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2 *Securities and Exchange Act*, 15 USC §§ 78j(b) (1934).

3 *Morrison v National Australia Bank Ltd* 561 US (2010) fn 11 (Stevens J).

4 Ibid. The majority judgment comprised Scalia J, Roberts CJ, Kennedy, Thomas and Alito JJ. Breyer J concurred in the judgment. Stevens J and Ginsburg J filed an opinion concurring in the judgment, but for different reasons. Sotomayor J, took no part in the consideration or decision of the case.

5 Ibid 6 (Scalia J).

6 Ibid 13.

Justice Stevens strongly disagreed with the majority's sole focus on the wording of section 10(b) of the *Exchange Act*. He stated:

> If one confines one's gaze to the statutory text, the Court's conclusion is a plausible one ... [However] I take issue with the Court for beginning *and ending* its inquiry with the statutory text, when the text does not speak with geographic precision, and for dismissing the long pedigree of, and the persuasive account of congressional intent embodied in, the Second Court's rule.[7]

In contrast to Justice Scalia's opinion, Justice Stevens endorsed the role of judges in giving concrete meaning to the general commands of Congress, stating that in respect of section 10(b), 'Congress invited an expansive role for judicial elaboration when it crafted such an open-ended statute in 1934'.[8]

While Justice Stevens conceded that the 'transactional test' provided improved clarity as to how US courts should apply section 10(b) of the *Exchange Act*, he also warned that, 'like all bright-line rules it also has drawbacks'.[9] In particular, and as will be discussed further below, Justice Stevens pointed to the fact that the new test significantly limited anti-fraud protections in the US, stating that it had the potential to leave American investors without recourse to US courts.

III Effects of the decision

The 'transactional test' set out by the Court in *Morrison* has significant ramifications for US investors as they are no longer afforded the protection of the anti-fraud provisions if they buy shares in a non-US listed company in an overseas transaction. Imagine, for example, a situation where a US investor has purchased shares in a company listed on an overseas exchange, and American executives derive and execute a fraudulent scheme in the US.[10] Under the new test, this investor would be barred from bringing an action under s 10(b), which is perhaps one of the more counterintuitive results of the decision.

The decision does, however, leave some key areas of uncertainty. Primarily, it remains unclear as to when a transaction will be found to have *taken place* in the US. This question is significant because a company may do all of the marketing or spruiking of an investment in the US and then facilitate the transaction to occur through an off-shore entity. The interpretation of where the transaction takes place will be critical in these situations, and is now left for determination before the lower courts.

Morrison raises the possibility of foreign financial institutions structuring investment transactions so as to limit the circumstances in which they can be exposed to the US's rigorous class action regime. By way of example, a company selling non-US listed securities to either US or non-US parties may insist that these transactions take place off-shore, or through foreign related companies.

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7 Ibid 1, 11 (emphasis in original).

8 Ibid 4.

9 Ibid 12.

10 Ibid 13. Justice Stevens postulates a similar scenario in his judgment and remarks that the potential for American investors to be left without anti-fraud protection should have given the Court pause for thought in coming to its decision.

From the perspective of an Australian or any other foreign investor hoping to invest in non-listed US enterprise or affiliate companies, the decision provides a strong incentive to scrutinise the relevant transaction and the legal framework that governs it, as to whether it is covered by the US anti-fraud legislation or another foreign regime. The limitation of s 10(1)(b) to domestic transactions means that protections and remedies afforded by another jurisdiction take on increased importance.

An interesting comparison can be drawn with the extraterritoriality of Australian law dealing with market manipulation or making materially false or misleading statements that are likely to impact the prices on the financial market.[11] As a general rule, this law applies to conduct, meaning acts *or* omissions regardless of where they occur, but requires the conduct to have an effect on the financial market in Australia.[12] The provision relating to false or misleading information is limited in territoriality only to the extent that the person affected by the conduct is in Australia.[13] The offending conduct can occur outside the jurisdiction, and the investment could be shares in a foreign incorporated body.[14]

IV Why not sue in Australia?

The rationale behind the Australian plaintiffs' decision to sue in the US, instead of domestically, was not addressed in the Supreme Court or either of the lower court decisions. One can only speculate that the plaintiffs perceived certain advantages in having the case heard in the US, which may include: the availability of punitive damages; the right to trial by jury; or the ordinary position of the US courts to order that each party bears its own costs, which differs to the Australian default position that costs follow the event.

Had the claimants sought to sue NAB in Australia, there is nothing in the facts to suggest that an Australian court would deny jurisdiction on the basis that Australia was an inappropriate forum to hear the dispute.[15] NAB is an Australian company subject to regulation by the Australian Securities and Investment Commission (ASIC) and the conduct complained of in this case would have invoked civil liability under both the *Corporations Act 2001* (Cth) and the *Australian Securities Investment Commission Act 2001* (Cth),[16] and thus the matter falls easily within the scope of the Australian courts. Australia is also developing as a sophisticated jurisdiction following the implementation in 1992 of the class action procedure found in part IVA of the *Federal Court of Australia Act 1976* (Cth). This procedure has been employed in cases such as *King v GIO*,[17] and the shareholders class action against the Australian Wheat Board, which concluded in a court-approved settlement of US$39.5 million on 27 April 2010.[18]

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11 See *Corporations Act 2001* (Cth) pt 7.10.

12 Ibid s 1041B, 1041C, 1041D, 1041E.

13 Ibid s 1041E.

14 Ibid s 9. The definition of 'Financial Product' includes buying shares in a body; the definition of 'Body' includes a body corporate, an expression which by extension includes a foreign incorporated company.

15 *Voth v Manildra Flour Mills Pty Ltd* (1990) 171 CLR 538.

16 *Corporations Act 2001* (Cth) s1041I, 1041E, 1041F, 1041G or 1041H; *Australian Securities and Investment Commission Act 2001* (Cth) s 12GF, 12CA, 12DA, 12DB.

17 *King v GIO Australia Holdings Ltd* [2001] FCA 270.

18 *Watson v AWB Limited* [2007] FCA 1367. See AAP, 'Federal Court approves settlement of AWB class action', *news.com.au* (online), 27 April 2010 <http://www.news.com.au/business/breaking-news/federal-court-approves-settlement-of-awb-class-action/story-e6frfkur-1225858889534>.

V Will the decision in Morrison last?

It is possible that any effect of this decision may be short-lived. Congress immediately stepped in and passed the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.[19] The Act affirms that US Federal Courts retain jurisdiction in respect of actions brought by the Securities Exchange Commission (SEC) or US Department of Justice for securities fraud where the offending conduct occurs within the US or has a *'foreseeable* substantial effect' within the US even if that conduct involves foreign investors.[20] In this regard, the legislation has effectively reinstated the old 'conduct and effect' but only in respect of the SEC or the Department of Justice.

In addition, Congress has required that the SEC undertake a study to determine the extent to which private rights of action under the anti-fraud provisions of the SEC should extend to cover conduct occurring within the US, regardless of where the securities transaction occurs or the nationality of the investors involved.[21]

It is possible that, in this report, the SEC may pay heed to some of the issues raised by a number of *amici* in their briefs to the court in *Morrison*. The Government of the Commonwealth of Australia submitted an *amicus curiae* brief against the proposition that the US should assert jurisdiction over foreign cubed securities. Their criticisms centred around the right of Australia to regulate its own securities market in a way that reflects the public policy choices made by the Australian Government.[22] It is a matter of international comity that there is acceptance that various sovereigns may differ in their regulation of securities. In this case, NAB is a company that is regulated by the ASIC, a body with broad and comprehensive powers of oversight, investigation and enforcement.[23] Further, ASIC participates in the international regulation of securities markets and engages in a specific mutual recognition arrangement with the SEC.[24]

If the *Exchange Act* is amended so as to inappropriately broaden the reach of the US courts, there is a risk that the US will be seen to impose itself as an international court, which could be contrary to principles of international comity.[25] This decision raises the issue of striking the appropriate balance between states being able to provide adequate protection for their own citizens, while still respecting the jurisdiction of other sovereign states.

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19 *Dodd-Frank Wall Street Reform and Consumer Protection Act*, HR 4173, 111th Congress (2010).

20 Ibid s 929P(b) (emphasis added).

21 Ibid s 929Y.

22 See amicus curiae brief of the Government of the Commonwealth of Australia in support of the Defendants-Appellees: *Morrison v National Australia Bank Ltd* 561 US (2010), 5.

23 Power to obtain civil remedies in Court : *Corporations Act 2001* (Cth) ss 1043L(6), 1325; imposition of conditions on securities licences, and orders restricting offers of financial products: *Corporations Act 2001* (Cth) ss 739, 749D, 914A, 1020E.

24 See amicus curiae brief of the Government of the Commonwealth of Australia in support of the Defendants-Appellees: *Morrison v National Australia Bank Ltd* 561 US (2010), 10, 13.

25 This sentiment was affirmed in the US decision of *Sosa v Alvarez-Machain* 542 US 727 (2004) and by the Australian High Court in *Kartinyeri v The Commonwealth* (1998) 195 CLR 337 (referred to in brief of the Government of the Commonwealth of Australia as *amicus curiae* in support of the Defendants-Appellees).