Legal Backgrounder

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NATIONAL AUSTRALIA BANK AND THE THREAT OF GLOBAL CLASS ACTION SECURITIES SUITS

by

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The golden age of domestic securities class action litigation has seemingly passed. Last year plaintiffs' filings were down almost 40 percent, dropping to the lowest level in more than a decade.[1] To fill this void, innovative trial lawyers are increasingly looking abroad for a new pool of plaintiffs to feed massive class actions in U.S. courts. This LEGAL BACKGROUNDER analyzes one such example, *In re National Australia Bank Securities Litigation*,[2] a pending U.S. Court of Appeals for the Second Circuit case that illustrates the so-called "f-cubed" problem – *i.e.*, class action lawsuits filed in U.S. courts by foreign plaintiffs suing foreign defendants with claims arising out of predominantly (if not entirely) foreign conduct.[3] We also discuss the policy consequences arising from U.S. judicial facilitation of extraterritorial securities class actions.

An Ambitious Beginning. On August 29, 2003, the U.S. District Court for the Southern District of New York received a peculiar complaint: Australian shareholders of an Australian bank alleged that misrepresentations in Australian securities filings had caused a stock drop on the Australian Stock Exchange. The immense class includes "everyone in the entire world who purchased the common stock of the National Australia Bank, one of the world's largest banks, over a period of almost two and one-half years."[4] But why were the plaintiffs allowed access to U.S. courts? To justify extraterritorial application of U.S. securities law, plaintiffs claimed that internal activities of one of the bank's privately-held U.S. subsidiaries rendered the bank vulnerable to U.S. jurisdiction.

The Facts. National Australia Bank Ltd. ("NAB") is the largest financial institution in Australia. NAB is headquartered in Melbourne, Australia, and organized under Australian law. Shares of NAB trade primarily on the Australian Stock Exchange ("ASX"), and more than 98 percent of ordinary shares are held by people with addresses in Australia.[5] Of the 284,518 ordinary shareholders worldwide, "only 399—roughly *fourteen hundredths of one percent (0.14%)*—were listed as having United States addresses. This represents less than

[1] Andrew Longstreth, *Starving for (Class) Action*, AMERICAN LAWYER, Vol. 29, No. 8, Aug. 2007, at 13.
[2] 2006 U.S. Dist. Lexis 94162 (S.D.N.Y. Oct. 25, 2006), *appeal docketed*, No. 07-0583 (2d Cir. Feb. 16, 2007).
[3] *See generally*, Andrew Longstreth, *Coming to America*, AMERICAN LAWYER, Nov. 2006.
[4] Brief of Defendants-Appellees at 1, *In re National Australia Bank Securities Litigation*, No. 07-0583 (2d Cir. July 2, 2007).
[5] *Id.* at 5.

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three hundredths of one percent (0.03%) of the outstanding ordinary shares."[6] Also, 200 U.S. residents owned NAB American Depositary Receipts ("ADRs"), this represents a scant 1.1 percent of NAB's ordinary shares.[7]

NAB's troubles began with the 1997 purchase of HomeSide, a privately-owned mortgage servicing company headquartered in Florida. NAB hoped to capture part of the burgeoning U.S. mortgage market and expand mortgage servicing in Australia and the United Kingdom.[8] Soon after the acquisition, U.S. interest rates plummeted to a 40-year low.[9] The subsequent wave of refinancing devastated many mortgage brokers, and NAB soon discovered that HomeSide's earnings estimates were off – way off. In July 2001, NAB announced a $450 million writedown based on the deteriorating U.S. financial market.[10] In September 2001, NAB announced an additional $755 million writedown due to an "incorrect interest rate assumption" in the company's internal model.[11] NAB eventually announced a further $590 million writedown due to loss of goodwill.[12] This wave of corrections led NAB stock on the ASX to fall $4.30 AUS (12.95%), and U.S. ADRs dropped $10.24 US (11.58%).[13]

The District Court Decision. Australian stockholders and a single named American ADR holder filed a class action in the Southern District of New York, alleging that NAB, HomeSide, and certain executives had violated Section 10(b) of the Securities and Exchange Act of 1934 by misrepresenting material financial information. Although the alleged misrepresentations were made in Australia to Australian investors through disclosures made in accordance with Australian securities law, plaintiffs claimed that the U.S. court had jurisdiction because "the day-to-day misconduct that rendered the defendants' public statements false and misleading took place on American soil."[14] However, the U.S. District Court disagreed. On October 25, 2006, the court dismissed the foreign plaintiffs' case for lack of jurisdiction, and discarded the lone named domestic plaintiff for failure to allege an injury.[15] Plaintiffs' appeal is now pending in the Second Circuit.

Considerations for Second Circuit Review. When considering the extraterritorial reach of the Securities and Exchange Act, the Second Circuit asks "whether Congress would have wanted the precious resources of the United States . . . to be devoted to them rather than leave the problem to foreign countries."[16] In this case, both the presumption against extraterritoriality and the Second Circuit's tests require dismissal.

The Presumption Against Extraterritoriality. A fundamental principle of American jurisprudence is "that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States."[17] Congress generally does not intend its legislation to bind every person and corporation worldwide, and as such, courts presume that congressional silence limits the scope of legislation to domestic application. During the passage of the Securities and Exchange Act, Congress was, at best, silent. There was no contrary intent to disturb the normal presumption against extraterritoriality.[18] In fact, there is some evidence that "Congress specifically considered and *rejected* application of Section 10(b) to non-U.S. investors."[19] Congress never intended Section 10(b) to enable foreign plaintiffs to commandeer the U.S. courts.

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[6] *Id.* at 5-6 (emphasis in original).

[7] *Id.*

[8] *See* HomeSide Lending Corporation (Oct. 11, 2000), *at* http://www.nabgroup.com/vgnmedia/downld/2000-10-11-homeSideLending.pdf.

[9] Brief of Defendants-Appellees at 12, *In re National Australia Bank Securities Litigation*, No. 07-0583 (2d Cir. July 2, 2007).

[10] NATIONAL AUSTRALIA BANK GROUP, Homeside International Inc – Restatement, *at* http://www.nabgroup.com/0,35073,00.html (last visited Aug. 2, 2007).

[11] *Id.*

[12] *Id.*

[13] Brief of Plaintiff-Appellant at 16, *In re National Australia Bank Securities Litigation*, No. 07-0583 (2d Cir. May 2, 2007).

[14] *Id.* at 28.

[15] *National Australia Bank*, 2006 U.S. Dist. Lexis 94162, at 20.

[16] *Id.* at 7.

[17] *Foley Bros., Inc. v. Filardo*, 336 U.S. 281, 285 (1949); *see also EEOC v. Arabian American Oil Company*, 499 U.S. 244, 248 (1991) (noting that "We assume that Congress legislates against the backdrop of the presumption against extraterritoriality. Therefore, unless there is the affirmative intention of the Congress clearly expressed, we must presume it is primarily concerned with domestic conditions.") (internal quotations and citations omitted).

[18] *National Australia Bank*, 2006 U.S. Dist. Lexis 94162, at 6.

[19] Brief for the Washington Legal Foundation as *Amicus Curiae* Supporting Defendants-Appellees and Affirmance at 18, *In re*

The Second Circuit Tests. To cope with 10(b)'s lack of legislative history, the Second Circuit has developed two statute-specific tests: the "effects" test and the "conducts" test. If plaintiffs can satisfy either test, extraterritorial jurisdiction may exist.

The Effects Test. Under the "effects" test, a defendant's alleged conduct must "caus[e] a 'substantial effect' on United States investors or markets."[20] The *National Australia Bank* plaintiffs did not even attempt to make this claim. The district court was unable to find any evidence that the single named domestic ADR holder had suffered any damages as a result of the alleged misrepresentations. More importantly, even if U.S. residents *had* suffered sufficient injuries, this would not help the foreign plaintiffs. The Second Circuit has explained that the effects test is designed to protect "purchasers or sellers of those securities in whom the United States has an interest, not where acts simply have an adverse affect on the American economy or American investors generally."[21] This means foreign plaintiffs "may not establish jurisdiction by 'bootstrap[ping] their losses to . . . independent American losses.'"[22] The effects test is designed to capture cases that substantially affect U.S. interests, but masquerade as foreign disputes. The case of Australian plaintiffs allegedly defrauded by an Australian corporation in Australia surely does not qualify. *National Australia Bank* at best has "a very small [domestic] tail . . . wagging an elephant" of a foreign dispute.[23]

The Conducts Test. The "conducts" test requires a substantial connection between the conduct at issue and the United States. Alleged conduct in the United States must be "more than 'merely preparatory' to the fraud," and U.S. actions must "*directly* cause" foreign losses.[24] However, as the District Court noted, "HomeSide's alleged conduct – however it may be classified – is not in itself securities fraud. It amounts to, at most, a link in the chain of an alleged overall securities fraud that culminated abroad."[25] This chain is lengthy, and includes: HomeSide's transmittal of its financial estimates to NAB headquarters (in Australia); NAB's incorporation of these estimates into its financial projections (in Australia); NAB's public filing, which included these financial projections (in Australia); and plaintiffs' alleged detrimental reliance on this filing (in Australia).[26] This series of actions did not become securities fraud until the end of the chain was reached; "[t]he fraud, if there was one, was committed by placing the allegedly false and misleading prospectus in the purchasers' hands."[27] As the Second Circuit wrote in the seminal extraterritoriality case, *Bersch v. Drexel Firestone, Inc.*, "[a]t most the acts in the United States helped to make the gun whence the bullet was fired from places abroad."[28] This is insufficient to establish jurisdiction.

A Disturbing Trend. By itself, *National Australia Bank* is alarming enough. This case, however, is far from an anomaly. Foreign plaintiffs are becoming more aggressive in filing "f-cubed" class actions in U.S. courts.[29] A number of features of the U.S. civil litigation system encourage this phenomenon. First, permissive U.S. discovery rules present public relations challenges for companies (particularly publicly traded companies) and create settlement pressure. Second, securities class action proceedings are not generally permitted in foreign jurisdictions, making U.S. courts a magnet for such litigation.[30] Third, juries, which are rarely used in civil trials

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National Australia Bank Securities Litigation, No. 07-0583 (2d Cir. July 12, 2007) (emphasis added) (citing Margaret V. Sachs, *The International Reach of Rule 10(b): The Myth of Congressional Silence*, 28 COL. J. TRANSNAT'L L. 677 (1990)).

[20] *National Australia*, 2006 U.S. Dist. Lexis 94162, at 8 (citing *Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir. 1991)).

[21] *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 989 (2d Cir. 1975).

[22] Brief of Defendants-Appellees at 28, *In re National Australia Bank Securities Litigation*, No. 07-0583 (2d Cir. July 2, 2007) (citing *Tri-Star Farms Ltd. v. Marconi, PLC*, 225 F. Supp. 2d 567, 573 n.7 (W.D. Pa. 2002)).

[23] *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1018 n.31 (2d Cir. 1975).

[24] *National Australia Bank*, 2006 U.S. Dist. Lexis 94162, at 8.

[25] *Id.* at 19.

[26] *See* Brief of Defendants-Appellees at 32, *In re National Australia Bank Securities Litigation*, No. 07-0583 (2d Cir. July 2, 2007).

[27] *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 987 (2d Cir. 1975).

[28] *Id.*

[29] John C. Coffee, Jr., *Foreign Issuers Fear Global Class Actions*, THE NATIONAL LAW JOURNAL, June 14, 2007 [hereinafter *Coffee*]. Professor Coffee notes recent "f-cubed" cases such as *In re Vivendi Universal S.A. Sec. Litig.*, 241 F.R.D. 213 (S.D.N.Y. 2007); *Royal Dutch/Shell Transp. Sec. Litig.*, 380 F. Supp. 2d 509 (D.N.J. 2005); and *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334 (D. Md. 2004).

[30] *Id.* Professor Coffee notes the possible exceptions of Canada and Australia.

outside of the United States, invite the potential for obscenely large verdicts directed at foreign corporations. Finally, defendants often feel pressured to settle in order to avoid costly and protracted litigation. Plaintiffs, by contrast, encounter no such obstacles, as they are generally represented on a contingency fee basis.

In short, the leverage provided to plaintiffs in the U.S. civil litigation system creates enormous incentives for foreign plaintiffs to file "f-cubed" cases in U.S. courts. To date, this trend has yielded significant results. Both Nortel Networks and Royal Ahold have recently settled "f-cubed" class actions for over $1 billion, and Royal Dutch Shell agreed to pay more than $400 million to avoid litigation in the United States.[31]

The Importance of International Comity. All nations – except for rogue nations – are entitled to a certain degree of deference and respect. The *National Australia Bank* plaintiffs do not argue that they are inadequately protected by Australian law, but that is the clear implication of their claim. Surely the United States would not want Australian courts to judge the adequacy of securities disclosures made by U.S. companies to U.S. citizens in the United States. If U.S. courts take an activist jurisdictional approach to "f-cubed" cases, then they effectively invite foreign courts to engage in judicial imperialism *vis-à-vis* U.S. citizens and U.S. corporations.

Moreover, the threats posed by U.S. litigation go far beyond damage to individual foreign corporations. A single U.S. jury verdict could drastically harm a host of foreign constituencies including foreign investors, foreign creditors, foreign laborers, and even foreign governments.[32] As a practical matter, entire communities abroad could be economically devastated by the ripple effects of a single U.S. jury verdict. The regulatory bodies and civil justice systems of foreign nations are better situated to regulate their own corporations and weigh the consequences of judicial remedies for their domestic shareholders and stakeholders.

Discouraging Investment and Mergers. If foreign corporations can be forced into U.S. courts for costly and protracted class actions based on the actions of privately-held subsidiaries, we can expect a chilling effect on foreign investment in the United States. Any companies considering U.S. investments will be encouraged to take a hard look at alternative markets, and those brave enough to make the attempt will face substantially increased uncertainty. As Professor John Coffee has explained, a foreign issuer is not principally concerned with the Sarbanes-Oxley Act or regulatory oversight, but instead fears exposure to "potentially bankrupting securities liabilities if its stock price were to decline sharply. This liability would not be owed simply to U.S. investors, but, more importantly, to a much larger worldwide class of foreign shareholders who acquired their shares outside the United States."[33] Foreign investors should be *encouraged* to enter the U.S. market, not be forced away by fear that any misstep anywhere in the world would result in expensive litigation in U.S. courts.[34]

Conclusion. The Second Circuit's decision in *In re National Australia Bank* has the potential to fundamentally reshape the way in which we approach the extraterritorial application of U.S. securities law. As a legal matter, the plaintiffs' claims should be dismissed for lack of jurisdiction. Plaintiffs' claims fail to pass both the effects and the conduct test. Moreover, there is no legislative history from the passage of the Securities and Exchange Act to justify overriding the presumption against extraterritoriality.

From a public policy perspective, prudence cautions judicial restraint. Reversing the district court decision has the potential to open the floodgates to scores of wholly-foreign disputes. Such an exercise in judicial activism would threaten international comity and discourage foreign investors from entering the U.S. market. For all of the above reasons, the judgment of the district court should be affirmed.

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[31] *Id.*

[32] *Id.*

[33] Coffee, *supra* note 32.

[34] Foreign investment plays a vital role in the U.S. economy, consider that U.S. subsidiaries of foreign companies: (1) Employ more than 5.1 million workers (33 percent in the manufacturing sector); (2) Provide an average annual compensation of $63,428; (3) Account for 5.7 percent of U.S. economic output; (4) Export $153.9 billion worth of goods, or 19 percent of all U.S. exports in goods; and (5) Spend nearly $30 billion on research and development, or roughly 13 percent of total U.S. R&D. *See* http://www.treasury.gov/press/releases/hp395.htm.