DIRECTORS' AND OFFICERS' LIABILITY

FOREIGN INVESTORS AND SECURITIES CLASS ACTIONS

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The globalization of financial markets and increased cross-border investment has resulted in foreign investors, both individual and institutional, that purchased securities of a foreign issuer on a foreign securities exchange increasingly seeking to assert federal securities law claims in United States courts. The U.S. forum is attractive to these "foreign cubed" and other overseas investors because of, among other things, the potential availability of certification of a class of investors, contingency fee arrangements and broad discovery generally unavailable outside the United States. The inclusion of claims of foreign cubed investors in securities litigation brings into sharp relief the ongoing debate about the extent to which U.S. securities laws should reach alleged frauds perpetrated abroad and which damaged overseas investors. Judge Friendly memorably cautioned that when a federal securities fraud class action is brought on behalf of both domestic and foreign class members, "a very small tail may be wagging an elephant."[1] For a foreign issuer weighing whether to list perhaps one or two percent of its shares on a U.S. exchange through American Depositary Receipts, the prospect of certification in federal court of a multi-national class of shareholders, all but only one or two percent of whom purchased their shares on a foreign exchange, may present an unacceptable risk that tips its decision against a U.S. listing. That two of the largest securities class action settlements in recent years, each more than $1 billion, involved foreign companies on behalf of classes that included foreign investors (Nortel Networks and Royal Ahold) illustrates the financial exposure such cases may present. This column reviews recent case law addressing the three litigation events in which challenges to the participation of foreign investors, particularly foreign cubed investors, frequently are asserted: (i) challenges to a U.S. court's subject matter jurisdiction over the claims of foreign cubed investors; (ii) appointment of the lead plaintiff; and (iii) the motion for class certification.

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Jurisdictional Issues

The Supreme Court recently reaffirmed the "presumption that United States law governs domestically but does not rule the world."[2] That is, principles of restraint and comity to other nations, together with the desire to attract foreign companies to the U.S. public capital markets, counsel enforcement of appropriate limits on the extraterritorial application of the federal securities laws.

Although the securities laws are largely silent concerning their extraterritorial reach, courts have sought to define the circumstances in which they have subject matter jurisdiction over alleged violations of the federal securities law where a substantial amount of the relevant events and transactions occurred outside the United States. The Second Circuit has developed a conduct and effects test to address the application of the anti-fraud provisions of the federal securities laws, particularly Section 10(b) of the Securities Exchange Act, to foreign transactions and conduct. To determine whether Congress intended to apply a federal securities law provision to predominantly foreign transactions, the conduct and effects test asks: "(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."[3] Because Congress does not want the U.S. to be used as a base for securities fraud, the conduct test seeks to determine when U.S. law should step in to remedy an alleged exportation of fraud from the U.S.[4] It supports the exercise jurisdiction if a defendant's conduct in the United States was more than "merely preparatory" to the fraud, and culpable acts or omissions within the United States directly caused losses to foreign investors abroad. Courts applying the conduct test usually focus on the location from which allegedly false statements were prepared and issued, and the circumstances of statements' dissemination.[5]

The requirement under the "effects" test that the fraud's effect in the United States be substantial means that predominantly foreign-based fraud having only tangential impact in the U.S. market, such as by affecting general investor confidence, will not support extraterritorial application of the securities laws. The conduct and effects tests may be considered collectively in determining jurisdiction. If the claims alleged meet neither test, the court will presume that Congress would not "have wished the precious resources of United States courts . . . to be devoted to them rather than leave the problem to foreign countries."[6] Generally, the degree of conduct or effect in the U.S. needed to invoke federal jurisdiction over an alleged violation of a registration provision of the securities must be greater than that which would trigger U.S. jurisdiction over a claim of fraud.[7]

Under these standards, it is now established that federal subject matter jurisdiction may extend in certain circumstances to claims involving alleged transnational securities frauds. In the Second Circuit's seminal Bersch v. Drexel Firestone, Inc.[8], the court enunciated the limitation that "the anti-fraud provisions of the federal securities laws . . . [d]o not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses."

This standard recently has proved an impediment to inclusion of foreign cubed plaintiffs in securities classes. In securities law parlance, a foreign cubed plaintiff is a foreign investor that purchased securities of a foreign company on a foreign securities exchange. Because "the effects test concerns the impact of overseas activity on U.S. investors and securities traded on U.S. securities exchanges,"[9] it is hard envisage circumstances where the effects test would support the exercise of jurisdiction over foreign cubed plaintiffs. Thus, foreign plaintiffs who purchased securities abroad may not establish jurisdiction by "bootstrap[ping] their losses to . . . independent American losses."[10]

In re Nat'l Austl. Bank Sec. Litig.[11], currently on appeal in the Second Circuit, nicely presents the jurisdictional issues relating to foreign cubed investors. There, the lead foreign plaintiffs -- Australians who purchased, on an Australian exchange, shares of National Australia Bank ("NAB"), an Australian corporation listed on the Australian Securities Exchange -- filed a putative securities fraud class action on behalf of U.S. and foreign shareholders. While ADRs representing shares of NAB traded in the United States during the proposed class period, they represented only 1.1% of NAB's nearly one-and-a-half billion shares. Although the alleged misrepresentations were made in Australia to Australian investors in filings made under Australian securities laws, the asserted jurisdictional hook was that NAB's American subsidiary reported fraudulent financials to NAB, which related to alleged accounting fraud that occurred at the American subsidiary, and which NAB subsequently reported in disclosures prepared and filed in Australia. The district court held that it lacked subject matter jurisdiction over the claims of the foreign plaintiffs, reasoning that "a case in which the alleged fraud was committed by foreign defendants on foreign individuals in a foreign country is not what the securities laws of this country were designed to remedy." The court found persuasive that the securities at issue were "predominantly foreign securities traded on foreign exchanges" and that even though some of the alleged conduct occurred in the United States, "a significant, if not predominant, amount of the material conduct ... occurred a half-world away." Even the conduct of the subsidiary that occurred in the U.S., the court reasoned, was "not in itself securities fraud. It amounts to, at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad." Thus as another court observed, "[s]imply making fraudulent statements about what is happening in the United States does not make those statements 'United States conduct' for purposes of the conduct test."[12]

Similarly, in In re Rhodia S.A. Sec. Litig.,[13] a New York district court last year dismissed for lack of subject matter jurisdiction a putative securities fraud class action brought against a French chemicals company by two foreign investment funds on behalf of all purchasers of Rhodia's ordinary shares, which traded on the Euronext Paris, and its American Depositary Shares. ADSs traded on the New York Stock Exchange represented less than two percent of Rhodia's outstanding stock during the three-year proposed class period. Plaintiffs alleged that Rhodia artificially inflated the value of its stock on foreign exchanges through a series of false and misleading statements about the company's financial results created and planned overseas, but made in press releases and quarterly and annual SEC filings. Defendants did not challenge jurisdiction over transactions in Rhodia's common stock by U.S. residents or transactions in Rhodia's ADSs on U.S. securities markets. Plaintiffs argued that the conduct test

was met for the securities claims of foreign investors through the allegations regarding assignment to Rhodia of environmental liabilities from a plant owned by Rhodia in Montana, and Rhodia's overstatement of financial projections for ChiRex, an American subsidiary of Rhodia.

The court held that plaintiffs failed to establish the first step under the conduct test -- that the acts in the U.S. "were more than merely preparatory acts of a securities fraud conducted elsewhere." The activities undertaken in the U.S. were "the object of the misrepresentations allegedly made by Rhodia, but were not themselves securities fraud." The alleged fraud – the making of material misstatements concerning environmental liabilities and ChiRex's true financial status which induced investors to purchase artificially inflated securities – occurred overseas. Moreover, the court concluded, plaintiffs' allegations failed to satisfy the second element of the conduct test because they did not allege that the alleged misrepresentations concerning U.S. environmental liabilities and ChiRex's true financial status, which were only a small part of a larger, multi-faceted cross-border fraud alleged in the complaint, directly caused their loss. The court also rejected the notion that alleged false statements contained in a foreign issuer's SEC filings automatically satisfied the conduct test. The proper inquiry evaluates where "SEC reports were conceived, engineered, and published" and whether foreign investors can credibly allege that they relied upon these U.S. filings when they purchased stock in a foreign corporation, and in Rhodia these considerations did not support subject matter jurisdiction over foreign plaintiffs.

Lead Plaintiff Issues

In addition to seeking to be included in shareholder classes, foreign investors are increasingly seeking to be appointed lead plaintiffs and thereafter class representatives. The Private Securities Litigation Reform Act sets forth the procedure governing the appointment of a lead plaintiff in putative securities class actions. The lead plaintiff should be the plaintiff "most capable of adequately representing the interests of class members,"[14] and ordinarily is the investor who, among other things, has the largest financial interest in the relief sought. There is no per se bar to lead plaintiff appointment of a foreign investor that either purchased shares of a U.S issuer on a U.S. exchange, or purchased a foreign issuer's ADRs traded on a domestic exchange, because in both circumstances the foreign investor alleges that a fraud has affected a U.S. securities exchange.

The presumption that the investor with the largest financial interest should be lead plaintiff may be rebutted if it may be subject to a unique defense. Courts have refused to appoint foreign investors as lead plaintiff where (i) a credible showing is made (usually through expert affidavit) that a strong possibility exists that the courts of the proposed foreign lead plaintiff will not grant preclusive effect to any judgment entered in the securities class action, potentially allow foreign class members to file duplicative suits against the defendant in foreign courts; or (ii) particularly as to proposed foreign cubed lead plaintiffs, a serious question exists about the court's subject matter jurisdiction. A substantial body of law has recently grown around whether foreign cubed investors may properly be appointed lead plaintiff. Citing the

preclusion concern, a New York district court last year in Borochoff v. Glaxosmithkline, PLC,[15] declined to permit a group of German investors who purchased the issuer's securities on foreign exchanges to serve as lead plaintiff, even though they had the largest financial interest in the relief sought. In In re Royal Ahold N.V. Sec. & ERISA Litig.[16], the court denied lead plaintiff status to a foreign cubed investor, citing both the concern that the foreign investor would need to devote substantial attention to fending off the unique defense of lack of subject matter jurisdiction, and uncertainty about whether foreign courts would recognize any judgment entered in the action. It bears emphasis that the failure of the party opposing a foreign investor's appointment as lead plaintiff to substantiate the assertion that a strong possibility exists that the courts of the foreign investor will not recognize the U.S. judgment may warrant denial of the challenge on the non-recognition or enforceability basis.[17]

Other courts have concluded that foreign cubed status is not always an insuperable hurdle to lead plaintiff status. In January 2008, the court in Corwin v. Seizinger[18] appointed Axxion, a Luxembourg-based investment company, as lead plaintiff in a securities action against GPC Biotech AG, a biotechnology company based in Germany whose stock trades on NASDAQ. The statutory presumption that this foreign investor with the largest financial interest was the most adequate plaintiff was not overcome, the court concluded, because even though it purchased securities of a foreign company on a German exchange, the plaintiff was a sophisticated institutional investor and any asserted "subject matter jurisdiction defense . . . would not be 'unique' to Axxion, as it appears that many (if not most) of the class members would be foreign investors."

Class Certification Issues

The inclusion of foreign investors in a proposed multi-national class may raise additional concerns at the crucial class certification stage, concerns amplified by the presence of foreign cubed investors. On class certification, defendants have raised (i) challenges to the court's subject matter jurisdiction over the claims of foreign members of a proposed securities class, and (ii) the risk of non-recognition or enforceability of a U.S. judgment in foreign courts, and related difficulties in providing notice of pendency under Fed. R. Civ. P. 23(c)(2)(B), usually to bolster an argument a class action is not a superior method for adjudicating the claims of foreign purchasers of the issuer's shares. In Judge Friendly's seminal Bersch v. Drexel Firestone, Inc.[19], the Second Circuit held that all foreign shareholders must be excluded from a Rule 23(b)(3) opt-out class because, among other reasons, it was a "near certainty" that the relevant foreign court would not recognize any eventual judgment in the U.S. action. Unfortunately, as Judge Holwell noted last year in In re Vivendi Universal S.A. Sec. Litig.,[20] the leading recent case on these issues, post-Bersch, courts in New York "and elsewhere have considered, in a somewhat haphazard way, the risk of non-recognition by a foreign court as a factor relevant to whether . . . class treatment of foreign purchasers' claims is a superior method of adjudication."

In Vivendi, plaintiffs alleging securities fraud against a French corporation sought certification of a class consisting of purchasers of Vivendi's ordinary shares on foreign exchanges and ADSs traded on the NYSE. Approximately 25% of Vivendi's one billion outstanding shares during the class period were held by U.S. citizens, with most of the remainder held by shareholders throughout Europe. Citing extensive case law establishing that concerns about the preclusive effect of a U.S. judgment abroad are properly considered in evaluating whether class certification is superior to other methods of adjudication, Judge Holwell considered whether all foreign members of the putative class must be excluded. After reviewing extensive expert submissions addressing whether the relevant foreign courts would grant preclusive effect to a judgment entered in a U.S. class action, the court certified a class that included investors from several European countries who bought stock on foreign exchanges because their countries were "more likely than not" to grant preclusive effect to a judgment in a securities fraud class action against a French corporation. The likelihood of non-recognition in German and Austrian courts, however, defeated the superiority of adjudicating the claims of investors from those two countries in the class, and resulted in their exclusion. Last month, in In re SCOR Holding AG Litig.[21], Judge Cote excluded from the class and dismissed the securities fraud claims of foreign investors who purchased the shares of a Swiss corporation on the SWX Swiss Exchange, but certified a class consisting of U.S. residents who purchased the issuer's ADSs on the NYSE or its shares on the SWX. Because approximately 10% of the issuer's shares traded on the NYSE in the form of ADSs during the class period, the court concluded that the alleged fraud, even if it occurred entirely outside the United States for conduct test purposes, would have had a substantial effect on U.S. citizens. The court reaffirmed however, that foreign investors may not sue in the U.S. simply by alleging that false statements were made in SEC filings. Similarly, in In re DaimlerChrysler AG Sec. Litig.[22] Delaware federal court certified a securities class but excluded foreign investors based on "a significant likelihood" that foreign courts will not recognize and enforce a United States judgment," and citing concerns regarding "issues of class management and damages suffered by purchasers on foreign exchanges," even though a substantial portion of the alleged fraud regarding the merger of U.S. and German companies occurred in the U.S.

In contrast, a Pennsylvania district court last year in Marsden v. Select Medical Corp.[23], refused to exclude Austrian investors from the class certified, reasoning that unlike Vivendi, the defendants made no showing concerning whether an Austrian court would grant preclusive effect to any eventual judgment, and that the alleged misrepresentations were made in the U.S. by an American company whose shares traded on an American stock exchange, so that the case was not one of "borderline subject matter jurisdiction." The court in In re Nortel Networks Corp. Sec. Litig.[24] made no attempt to predict the likely preclusive effect of its judgment abroad, and refused to exclude from the class certified against a Canadian company foreign investors who purchased on the Toronto Stock Exchange, citing substantial activities in the United States that were alleged to be more than merely preparatory to the fraud and thus favored a finding of subject matter jurisdiction.

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

[2] *Microsoft, Inc. v. AT&T*, 127 S. Ct. 1746, 1758 (2007).

[3] *S.E.C. v. Berger*, 322 F.3d 187, 192 (2d Cir. 2003).

[4] *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1045 (2d Cir. 1983) (quoting *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir.1975)).

[5] *See, e.g.*, *In re Bayer AG Sec. Litig.*, 423 F. Supp.2d 105, 111 (S.D.N.Y. 2005).

[6] *Bersch*, 519 F.2d at 985.

[7] *Eur. & Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118, 125-26 (2d Cir. 1998).

[8] 519 F.2d 974, 993 (2d Cir. 1975).

[9] *Eur. & Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118, 128 (2d Cir. 1998).

[10] *Tri-Star Farms Ltd. v. Marconi, PLC*, 225 F. Supp. 2d 567, 573 n.7 (W.D. Pa. 2002).

[11] 2006 WL 3844465 (S.D.N.Y. Oct. 25, 2006).

[12] *Marconi*, 225 F. Supp. 2d at 578.

[13] 531 F. Supp.2d 527 (S.D.N.Y. 2007).

[14] 15 U.S.C. § 78u-4(a)(3)(B)(i).

[15] 246 F.R.D. 201 (S.D.N.Y. 2007).

[16] 219 F.R.D. 343 (D. Md. 2003).

[17] *See Mohanty v. BigBand Networks, Inc.*, 2008 WL 426250 (N.D. Cal. Feb. 14, 2008).

[18] 2008 WL 123846 (S.D.N.Y. 2008).

[19] 519 F.2d 974 (2d Cir. 1975).

[20] 242 F.R.D. 76 (S.D.N.Y. 2007).

[21] 2008 WL 608606 (S.D.N.Y. March 6, 2008).

[22] 216 F.R.D. 291 (D. Del. 2003).

[23] 246 F.R.D. 480 (E.D. Pa. 2007).

[24] 2003 WL 22077464 (S.D.N.Y. Sept. 8, 2003).