ALERT MEMORANDUM

Ninth Circuit Addresses Requirements for Pleading Section 10(b) Claims Concerning Unsponsored ADRs and Rejects Second Circuit's *Parkcentral* Decision

July 26, 2018

On July 17, 2018 the Ninth Circuit, in *Stoyas v. Toshiba Corporation*,[1] held that the Supreme Court's ruling in *Morrison v. National Australia Bank Ltd.*[2] did not preclude the assertion of claims under the U.S. federal securities laws against foreign issuers with respect to domestic transactions in unsponsored American Depository Receipts ("ADRs"). The court, however, further held that even though a domestic transaction in unsponsored ADRs is necessary for the federal securities law to apply under *Morrison*, it is not sufficient under the Exchange Act. In order to state a claim against a foreign issuer, a plaintiff must also allege sufficient facts to demonstrate that the defendant's actions were committed "in connection with" the domestic transaction at issue. In short, the plaintiff must allege facts showing that the foreign issuer committed the fraud to induce the domestic transaction. In issuing this decision, the Ninth Circuit explicitly parted ways with the Second Circuit's decision in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings*,[3] which held that a domestic transaction may not satisfy *Morrison* if the nature of the transaction and allegations of fraud were predominantly foreign. The Ninth Circuit's decision has important consequences for determining the extraterritorial scope of the federal securities laws, particularly with respect to unsponsored ADRs and other transactions in which the named foreign entity may not have been involved.

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[1] No. 16-56058, --- F.3d ---, 2018 WL 3431764 (9th Cir. July 17, 2018).
[2] 561 U.S. 247 (2010).
[3] 763 F.3d 198 (2d. Cir. 2014).

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Background

In June 2015, a securities fraud class-action lawsuit was filed against the Toshiba Corporation ("Toshiba") in the Central District of California in the midst of ongoing internal investigations ordered by the Japanese government into the company's accounting practices.[4]

The operative complaint (the "FAC"), which named three plaintiffs ("Funds"), alleged that Toshiba violated §§ 10(b) and 20(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Japan's Financial Instruments & Exchange Act. The FAC defined the putative class as all citizens and residents of the United States who acquired either Toshiba ADRs or common stock between May 8, 2012 and November 12, 2015 (the proposed class period).[5] The ADRs owned by the putative class were unsponsored, meaning the depository institutions that issued the ADRs in the U.S. did so without Toshiba's formal participation or involvement.

Toshiba moved to dismiss the Exchange Act claims under the Supreme Court decision *Morrison v. National Australia Bank Ltd.*[6] It argued that the Funds failed to state a claim because they did not allege that they purchased a Toshiba security on a U.S. exchange or that Toshiba was involved in any domestic transaction. Toshiba argued that it was not involved in any domestic transaction because, since the ADRs were unsponsored, it was the depository banks that were involved in the domestic transactions at issue, and not Toshiba itself.

The district court agreed with Toshiba's *Morrison* arguments and dismissed the FAC with prejudice.[7] In its holding, the district court determined that while the transactions were domestic on their face, they did not satisfy the second prong of the *Morrison* transactional test because the Funds failed to allege that Toshiba was involved in the transactions in any way.[8] The court reasoned that while the *Morrison* court did not directly address the question whether a defendant needs to be involved in a domestic transaction, the spirit and rule of *Morrison* would be undermined if a foreign company that did not list its securities on U.S. exchanges (but whose shares are purchased by depository banks for the purpose of being sold as ADRs in the U.S.) could be held liable under Section 10(b). The court concluded that to do so "would create essentially limitless reach of § 10(b) claims because even if the foreign defendant attempted to keep its securities from being sold in the United States, the independent actions of depository banks selling on OTC markets could create liability."[9] The Funds timely appealed the district court's decision.

The Ninth Circuit Decision

In a decision issued on July 17, the Ninth Circuit reversed the district court's order.[10] It held that while the transactions did not involve a security listed on a domestic exchange,[11] they were domestic transactions in "other securities" and therefore subject to federal securities laws. The Ninth Circuit further ruled that the fact the securities were unsponsored ADRs did not impact the *Morrison* analysis, but required plaintiffs to allege sufficient facts to plead that any fraud committed by Toshiba was perpetrated for the purpose of inducing the purchase of the unsponsored ADRs at

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[4] *Stoyas v. Toshiba Corp*, 191 F. Supp. 3d 1080, 1085 (C. D. Cal, May 20, 2016).
[5] *Id*. at 1084-85.
[6] 561 U.S. 247 (2010).
[7] *Stoyas*, 191 F. Supp. 3d at 1096. The court also dismissed the Funds' Japanese law claims under principles of comity and *forum non conveniens*. *Id*. at 1099-1100.

[8] *Id*. at 1094.
[9] *Id*. at 1094-95.
[10] The Ninth Circuit declined to opine on whether the district court's dismissal of the Japanese law claims concerning Toshiba's common shares was appropriate given the dismissal was predicated on the dismissal of the Exchange Act claims.
[11] The parties advanced arguments as to whether there is a difference between securities listed on a "national securities exchange," which is the language used in Section 10(b), 15 U.S.C. § 78j(b), and those listed on "domestic exchanges", which is the terminology used by the *Morrison* Court in setting forth the transactional test. 561 U.S. at 267. The court declined to resolve the question because of its holding that the OTC market in which the Toshiba ADRs trade is not an exchange under the Exchange Act. *Stoyas*, 2018 WL 3431764 at *9.

issue. The Ninth Circuit remanded to the district court to grant the Funds an opportunity to amend their complaint pursuant to its ruling.

In reaching these decisions, the Ninth Circuit first discussed at length, and ultimately adopted, the Second Circuit's *Absolute Activist* irrevocable liability test[12] to determine that the Funds' purchases of Toshiba ADRs were domestic transactions.[13] The court held that the FAC alleged that the Funds purchased the ADRs in the U.S., and even though the FAC lacked specific allegations as to where the Funds incurred irrevocable liability, an amended complaint could likely overcome this deficiency.[14]

Toshiba did not challenge that the transactions were domestic on their face, but, instead, relied on the Second Circuit's decision in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings*[15] to argue that a domestic transaction was necessary but not sufficient to conclude that the transactions were within the scope of the federal securities laws under *Morrison*. Toshiba posited that the Funds' inability to allege any connection between Toshiba and the ADR transactions put the transactions outside Section 10(b)'s reach.[16]

The Ninth Circuit rejected the *Parkcentral* test, holding that it was "contrary to Section 10(b) and *Morrison* itself."[17] The court characterized the *Parkcentral* test as an "open-ended, under-defined multi-factor test," which is the very type of analysis that *Morrison* sought to correct with a "clear, administrable" rule.[18] Consequently, the court found Toshiba's arguments and the district court's reasoning unavailing, explicitly stating that the involvement, or lack thereof, of a foreign entity in a transaction is irrelevant to the analysis whether a transaction is domestic and therefore under the ambit of the Exchange Act pursuant to *Morrison*.[19] The court noted that under its interpretation of *Morrison*, there very possibly could be cases where the Exchange Act would be applied to "claims of manipulation of share value from afar."[20]

The Ninth Circuit, however, further held that while a domestic transaction is necessary, it is not sufficient to state an Exchange Act claim. The court noted the Ninth Circuit's long held precedent that Section 10(b)'s prohibition "'to use or employ, *in connection with* the purchase or sale' of a security 'any manipulative or deceptive device or contrivance'" requires that a plaintiff must allege that the fraud was committed to induce the purchase at issue.[21]

The Ninth Circuit ruled that the FAC failed to allege sufficient facts to satisfy this "in connection with" requirement. The court noted several deficiencies in the FAC, including, *inter alia*, that the FAC: (1) omits basic facts about the Toshiba ADRs, including their contractual terms, whether they are sponsored, the depository banks that offer the ADRs, the ADRs trading volume, the OTC market on which the ADRs are listed, and details about the Funds purchase of the ADRs; (2) erroneously conflates the ADRs and common stock in several allegations; and (3) most importantly, omits the Funds' allegations made before the district court and on appeal that Toshiba was likely involved in the establishment of the ADRs despite the

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[12] *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 68 (2d. Cir. 2012) (holding that "the point of irrevocable liability can be used to determine the locus of a securities purchase or sale. Thus, in order to adequately allege the existence of a domestic transaction, it is sufficient for a plaintiff to allege facts leading to the plausible inference that the parties incurred irrevocable liability within the United States: that is, that the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security.")

[13] *Stoyas* at *12.

[14] *Id.*

[15] 763 F.3d 198 (2d. Cir. 2014).

[16] *Stoyas* at *12.

[17] *Id* at *13. The court also distinguished *Parkcentral* on several factual bases, including, *inter alia*, (1) *Parkcentral* did not involve ADRs but securities-based swap agreements referencing foreign securities issued by Volkswagen; and (2) these agreements were not traded on Securities and Exchange commission-regulated platforms, systems or exchanges. *Id.* at *12.

[18] *Id*. at *13 (internal quotations omitted).

[19] *Id*. at *12.

[20] *Id*. at *13.

[21] *Id.* at *13 (citing cases) (emphasis in original) (internal quotations omitted).

ADRs being unsponsored, because depository banks issuing unsponsored ADRs "typically"[22] send a letter to foreign issuers requesting non-objection to the establishment of unsponsored ADR programs.

Given the deficiencies identified in the FAC, the court reversed and remanded the case to the district court to provide the Funds an opportunity to amend the FAC.[23] In doing so, the court explicitly noted that the Funds' arguments, made subsequent to the filing of the FAC, that Toshiba enabled depository institutions to issue unsponsored Toshiba ADRs by posting on its website its annual report and certain other documents in English in satisfaction of the requirements of 17 C.F.R. § 240.12g3-2(b) could not, without additional facts, establish a valid claim that Toshiba's fraud was meant to induce the Funds' purchase of the ADRs.[24]

Implications

There are several key takeaways from the Ninth Circuit's decision. *First*, in rejecting *Parkcentral*, the Ninth Circuit has adopted a test that is in some ways narrower than the Second Circuit's, and that therefore may make it harder for foreign defendants to argue that domestic transactions in their securities do not satisfy *Morrison*. By looking solely to whether the transaction was domestic and if the alleged fraud was committed to induce the domestic transactions, *Stoyas* exposes foreign defendants to liability they might be able to avoid under *Parkcentral*, particularly in cases where the entirety of the alleged fraud occurs abroad.[25] Moreover, by focusing on whether the defendants' actions induced the domestic transaction, the *Stoyas* test would appear to be limited to transactions in which the foreign issuer may not have been involved (such as unsponsored ADRs and swaps), whereas the Second Circuit's *Parkcentral* test on its face appears to apply to other securities, including sponsored ADRs and notes. On the other hand, with respect to transactions like unsponsored ADRs and swaps that may not involve a foreign issuer, the *Stoyas* test may frequently lead to the same result as *Parkcentral*.

Second, although *Stoyas* rejected the Second Circuit's *Parkcentral* test, it adopted the Second Circuit's test for determining when transactions in securities not traded on an exchange constitute domestic transactions, considering the location(s) of irrevocable liability and title transfer as set forth in *Absolute Activist*. This ruling further solidifies those considerations as the appropriate test for determining whether a securities transaction is domestic for purposes of the *Morrison* analysis.

Third, the Ninth Circuit's decision provides important guidance on what actions by a foreign issuer may satisfy *Stoyas*' "in connection with" requirement for unsponsored ADRs. In particular, the court clarified that merely complying with Rule 12g3-2(b)'s requirements for posting certain documents on a website in English could not, without additional facts, establish a valid claim against the foreign issuer. However, the court left open the question whether additional actions might suffice to demonstrate a foreign issuer's requisite connection to the transaction. Foreign issuers may wish to keep this in mind in deciding whether to respond to letters seeking non-objection to issuing unsponsored ADRs.

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[22] The Funds relied, in part, on comments provided to the SEC (stating "in practice, depositary banks *typically* obtain the issuer's consent before establishing an unsponsored ADR facility") 2008 SEC ADR Rulemaking Fed. Reg. 52,762 n.113 (emphasis added).

[23] *Stoyas* at *14.

[24] *Id*. at *14 n. 24.

[25] Importantly, the *Parkcentral* court looked not only to the nature of the transaction but also to the alleged fraud to rule that the plaintiff's claims could not survive *Morrison*. *Parkcentral*, 763 F.3d at 216 (holding that the alleged fraud was "primarily in Germany with respect to stock in a German company traded only in exchanges in Europe" and has "been the subject of investigation by PCGerman regulatory authorities and adjudication in German courts. Although we recognize that the plaintiffs allege that the false statements may have been intended to deceive investors worldwide, we think that *the relevant action in the case are so predominately German* as to compel the conclusion that the complaints fail to invoke § 10(b) in a manner consistent with the presumption against extraterritoriality") (emphasis added).