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THE LATEST IN THE TOSHIBA SECURITIES LITIGATION: PERILS FOR FOREIGN ISSUERS

Following a remand from the Ninth Circuit, a federal district court in California denied a motion to dismiss a federal securities law class action against Toshiba Corp. by plaintiffs who alleged that they purchased unsponsored ADRs in domestic transactions. The court also refused to dismiss plaintiffs' Japanese law claim concerning the company's underlying common stock on the Japanese stock exchanges. The authors discuss the case, its risks for foreign issuers, and its tension with the Supreme Court's Morrison decision.

By Roger Cooper, Jared Gerber, and Les Silverman *

On January 28, 2020, following remand from the Ninth Circuit, the district court in *Stoyas v. Toshiba Corp.* denied a motion to dismiss a complaint asserting claims under the U.S. Securities Exchange Act of 1934 and Japanese law against a foreign issuer on behalf of investors in unsponsored American Depositary Receipts ("ADRs"), so-called "F-shares," and common stock traded only on Japanese stock exchanges. In reaching that decision, the district court held that the plaintiffs adequately alleged they purchased the unsponsored ADRs in domestic transactions, as well as that the foreign issuer was sufficiently involved in the sale of those securities to satisfy the "in connection with" element of the federal securities laws. Having declined to dismiss the plaintiffs' U.S. law claims, the district court further determined that principles of comity and *forum non conveniens* did not compel the dismissal of the plaintiffs' Japanese law claim concerning the company's underlying common stock on the Japanese stock exchanges.

The decision, if broadly followed by other courts, would threaten foreign issuers with potentially expansive securities liability in U.S. courts, even where those issuers had little involvement with the issuance of securities in the United States and even with respect to shares listed only on foreign exchanges, notwithstanding the Supreme Court's attempt to limit such liability in *Morrison v. National Australia Bank Ltd.*

BACKGROUND

In June 2015, three named plaintiffs filed a securities fraud class-action lawsuit against Toshiba Corporation in the Central District of California.[1] The action was filed amid ongoing internal investigations ordered by the Japanese government "that revealed widespread,

[1] *Stoyas v. Toshiba Corp.*, 191 F. Supp. 3d 1080 (C. D. Cal. 2016).

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deliberately fraudulent accounting practices" at the company.[2]

The First Amended Complaint (the "FAC") alleged that Toshiba violated §§ 10(b) and 20(a) of the Exchange Act and Japan's Financial Instruments & Exchange Act ("JFIEA"). The FAC identified the proposed class as all persons who acquired unsponsored Toshiba ADRs on the U.S. OTC Market and all U.S. citizens and residents who acquired common stock during the proposed class period.[3] In particular, the Toshiba common stock at issue was publicly traded on the Tokyo and Nagoya stock exchanges and the ADRs on the Over-the-Counter ("OTC") Market in the United States. Plaintiffs alleged that Toshiba deliberately employed improper accounting methods to overstate its pre-tax profits and conceal impairment losses by billions of dollars for over six years.[4] The FAC further alleged the internal investigation's revelations precipitated a decline of over 40% in the price of Toshiba securities, "resulting in a loss of . . . hundreds of millions of dollars in damages to U.S. investors in Toshiba securities."[5]

Toshiba moved to dismiss the FAC for failure to state a claim in light of the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*,[6] which limited the federal securities laws to claims concerning transactions on a domestic exchange and other domestic transactions. Toshiba argued that plaintiffs did not allege they had purchased a Toshiba security on a domestic exchange or that Toshiba was involved in any domestic transaction.[7] Toshiba contended that by virtue of the ADRs being unsponsored, the depositary banks were the only parties that participated in the domestic transactions — not Toshiba.[8] The district court accepted Toshiba's *Morrison* arguments, granting its motion to dismiss the FAC with prejudice.[9] The court reasoned that although *Morrison* did not directly determine whether a "defendant security issuer can be liable for fraud even if the issuer did not sell its securities to the plaintiff" under Section 10(b), the undergirding policy rationale of *Morrison* counseled against such a finding.[10] The court held that to find otherwise "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 depositary banks selling on OTC markets could create liability."[11] The court also accepted Toshiba's further argument that the principles of comity and *forum non conveniens* compelled the dismissal of the plaintiffs' JFIEA claim.[12]

Plaintiffs appealed to the Ninth Circuit, which held that the district court misapplied *Morrison*.[13] Although adopting the Second Circuit's "irrevocable liability" test,[14] which defines a "domestic transaction" as occurring when irrevocable liability for a transaction in securities is incurred in the United States or title is transferred in the United States, the Ninth Circuit explicitly rejected the Second Circuit's decision in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*,[15] which held that a domestic transaction is necessary, but not sufficient, for the Exchange Act to apply. The Ninth Circuit instead determined that the presence of a domestic transaction is sufficient to satisfy *Morrison*, and that the question of whether a foreign party was adequately involved in the transaction for liability to apply should be decided under the separate

[2] *Stoyas v. Toshiba Corp.*, 896 F.3d 933, 937 n.1 (9th Cir. 2018).

[3] FAC at 1, *Stoyas v. Toshiba Corp.*, No. 15-cv-04194-DDP(JCx) (C.D. Cal. Dec. 17, 2015), ECF No. 34.

[4] *Id.*

[5] *Id.* at 3-4.

[6] 561 U.S. 247 (2010).

[7] *Stoyas*, 191 F. Supp. 3d at 1087.

[8] *Id.* at 1091.

[9] *Id.* at 1100. The court held the defendant "neither list[ed] its securities on a domestic exchange nor was involved in the transaction of AD[R]s in this country." *Id.* at 1095.

[10] *Id*. at 1094.

[11] *Id*. at 1094-095.

[12] *Id*. at 1099-1100.

[13] *Stoyas*, 896 F.3d at 952.

[14] *Id.* at 948 (citing *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012)).

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

requirement that the fraud occur "in connection with" the sale of securities at issue.[16]

Under these tests, the Ninth Circuit determined that the FAC insufficiently alleged a domestic ADR transaction or Toshiba's participation in the issuance of ADRs in the United States.[17] Because the district court predicated its dismissal of plaintiffs' JFIEA claim on the dismissal of the Exchange Act claims, the Ninth Circuit declined to determine the appropriateness of the JFIEA claim in the first instance.[18] Nevertheless, because the FAC's shortcomings were curable, the Ninth Circuit reversed the district court's decision and remanded to allow plaintiffs leave to amend.[19]

After the Supreme Court denied defendant's certiorari petition, the plaintiffs filed a Second Amended Complaint ("SAC").[20] In addition to providing allegations concerning Toshiba's purported actions and inactions with respect to the trading of the ADRs in the United States, the SAC further specified that the proposed class included all persons who acquired Toshiba common stock sold as F-shares on the U.S. OTC Market,[21] although no named plaintiff had purchased any F-shares, as well as all U.S. citizens and residents who acquired Toshiba common stock on the Tokyo and Nagoya stock exchanges during the proposed class period.[22] Toshiba subsequently moved to dismiss the SAC for failure to state a claim.

THE CALIFORNIA DISTRICT COURT'S DECISION ON REMAND

The district court denied Toshiba's motion to dismiss the SAC in its entirety. With respect to Toshiba's unsponsored ADRs, the district court held the plaintiffs satisfied both issues raised by the Ninth Circuit, sufficiently alleging facts that (1) the parties incurred irrevocable liability in a domestic transaction and (2) Toshiba was involved in the issuance of the ADRs. Although the district court did not specifically address the claims asserted on behalf of investors in Toshiba's F-shares, it did not appear to dismiss these claims. The district court also declined to dismiss the plaintiffs' JFIEA claim concerning Toshiba's common stock traded on the Tokyo and Nagoya exchanges.

In particular, the district court first concluded that the plaintiffs sufficiently pleaded that irrevocable liability was incurred in the United States with respect to their transactions in the unsponsored ADRs, as required to allege a domestic transaction, by alleging that "[t]he placement of the buy order, the payment of the purchase price, [and] transfer of the title to the securities . . . took place within the territorial jurisdiction of the United States"; the plaintiffs' "purchase was directed by its outside investment manager . . . located in New York"; that the manager "placed the buy order through a broker . . . located in New York"; "the broker purchased the [securities] on the OTC Market using the OTC Link trading platform, both of which are based in New York"; "the purchase order and trade confirmation were routed through OTC Link's servers"; "the depositary bank issued the ADRs from the bank's office in New York, [the plaintiffs] made payment from a New York based bank, and a transfer of title was recorded . . . in New York."[23] The court further rejected Toshiba's contention that it should draw the inference that transactions in Toshiba's unsponsored ADRs were not "domestic" because those shares were first purchased by a depositary institution in a foreign transaction and subsequently converted to an unsponsored ADR,[24] because drawing such an inference against the plaintiffs was improper at the pleading stage.[25]

Second, in addressing the "in connection with" requirement, the district court held that the plaintiffs properly conformed their complaint to the Ninth Circuit's order, by sufficiently alleging "the nature of the [Toshiba] ADRs, the OTC Market, the Toshiba ADR program, including the depositary institutions that offer Toshiba ADRs, the Form F-6s, the trading volume, the contractual terms, and Toshiba's plausible consent to the

[16] *Stoyas*, 896 F.3d at 951.

[17] *Id.* at 951-52.

[18] *Id.* at 952 n.25.

[19] *Id.* at 952.

[20] SAC, *Stoyas*, No. 15-cv-04194-DDP(JCx) (C.D. Cal. Aug. 8, 2019), ECF No. 75.

[21] F-shares are foreign securities offered by U.S. brokers that are denominated in U.S. currency to facilitate trading on the U.S. OTC Market. Purchases and sales of the underlying foreign shares are affected by the U.S. broker on the foreign exchange where they are listed, and those trades are cleared and settled in the issuer's foreign jurisdiction.

[22] SAC, *supra* note 20, at 1, 12-13.

[23] *Stoyas v. Toshiba Corp*., No. 15-cv-4194 DDP (JCx), 2020 WL 466629, at *3 (C.D. Cal. Jan. 28, 2020) (internal quotation marks and citations omitted).

[24] *Id.*

[25] *Id.*

sale of its stock in the United States as ADRs."[26] The district court also credited plaintiffs' further claim that, as one of Toshiba's largest shareholders during the class period, the depositary institution could not have acquired as many shares as it did on the open market without Toshiba's involvement.[27] Additionally, the district court held plaintiffs sufficiently alleged that Toshiba's improper accounting methods concealed "the true condition of the company and risks associated with its stock," which evidenced "'some causal connection' between [Toshiba's] conduct and the purchase or sale of the ADRs at issue."[28]

Finally, the district court rejected Toshiba's argument that comity required dismissal even if plaintiffs sufficiently pleaded claims under the Exchange Act.[29] The district court held that the nationality of the plaintiffs and the proposed class, comprised entirely of U.S. nationals, weighed in favor of proceeding in the United States. The district court further stated "[i]n the absence of an identifiable foreign or public policy interest in relation to the regulation of securities, specifically, the court concludes that the United States has significant interests in regulating securities transactions made in the United States."[30]

The district court also rejected Toshiba's arguments that the court should dismiss the JFIEA claim under the principles of comity and *forum non conveniens*,[31] allowing the plaintiffs to continue to represent a putative class of U.S. investors who purchased Toshiba common stock on the Tokyo and Nagoya exchanges. Because, as noted, the defendant chose not to support its comity and *forum non convienens* arguments with respect to the Japanese law claim, the court gave them short shrift, appearing to treat them as decided by the fact that "[p]laintiffs have sufficiently alleged Securities Exchange Act claims."[32]

TAKEAWAYS

The *Stoyas* district court decision has several significant implications for foreign issuers. *First*, the *Stoyas* decision provides guidance on the actions or inactions that may subject a foreign issuer to liability for domestic transactions in unsponsored ADRs.[33] In particular, the district court stated the plaintiffs had sufficiently alleged that Toshiba provided "plausible consent to the sale of its stock in the United States as ADRs" by pleading upon "information and belief" that "one or more of the Depositary Banks, consistent with their business practices and the custom in the industry, contacted Toshiba before the [unsponsored ADR] program was established" and "Toshiba either provided its affirmative consent . . . or its consent may be implied under the circumstances," given that it "published its quarterly and annual results and regulatory filings in English, as required to support the sale of unsponsored ADRs in the United States."[34] The district court also found it significant that one of the depositary banks was one of Toshiba's largest shareholders during the class period. Ultimately, however, it is unclear whether each factor on its own would be sufficient to establish the foreign issuer's requisite connection to the domestic transaction.

Second, the *Stoyas* decision did not explicitly address the plaintiffs' claims concerning F-shares and thus appears to have let these claims proceed. The district court's apparent decision to permit claims concerning these securities to proceed under the Exchange Act, at

[26] *Id.*, at *5.

[27] *Id.*

[28] *Id.* (citing *Ambassador Hotel Co., Ltd. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1026 (9th Cir. 1999)).

[29] *Id.* (citing *Mujica v. Airscan Inc.*, 771 F.3d 580, 605 (9th Cir. 2014)) (quoting *E.E.O.C. v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991)).

[30] *Id.*, at *6.

[31] The district court characterized Toshiba's arguments in this regard as "without significant argument or support," *id.*, at 7, noting that the defendant sought to incorporate its prior arguments from its previous motion to dismiss. The court declined "to review prior briefing made for a separate motion." *Id*., at *7, note 4.

[32] *Id.*, at *6.

[33] Because no named plaintiff was alleged to have purchased any F-shares, the court's decision was silent with respect to the F-shares regarding both the requisite domestic transaction and whether Toshiba's actions or inactions with respect to the F-shares were sufficient to subject it to liability under Rule 10b-5. Since the district court's opinion does not address F-shares in any way, claims by purchasers of F-shares remain to be considered.

[34] *Id.*, at *5; SAC at 21-22, *Stoyas*, No. 15-cv-04194-DDP(JCx) (C.D. Cal. Aug. 8, 2019), ECF No. 75. We note that the Ninth Circuit expressly concluded that a foreign company merely taking the steps necessary to avail itself of the Rule 12g3-2(b) exemption, without more, was *not* an indicia of Toshiba's requisite connection to the Toshiba ADR transactions. *Stoyas*, 896 F.3d at 952, n.24.

least until a ruling on a motion for class certification, conflicts with decisions from other courts holding that *Morrison* prohibits so-called "foreign squared" claims,[35] which are claims asserted by U.S. purchasers of the securities of foreign issuers on foreign exchanges. That is precisely what occurs with a purchase of F-shares: The U.S. broker whose offer on the OTC Market is accepted by a U.S. investor fills that order by purchasing the underlying shares on a foreign exchange, and the completed trade is cleared and settled in that foreign jurisdiction.

Third, the district court's decision allowing foreign law claims concerning securities traded on foreign exchanges to proceed in a U.S. court also raises considerable tension with the Supreme Court's decision in *Morrison*, which was motivated (at least in part) by the "fear" that the United States "ha[d] become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[36] That tension is further increased where, as in *Stoyas*, a plaintiff seeks to bring foreign law claims in a U.S. class action even though the foreign country itself does not recognize collective actions for such claims. In light of that tension and the likely complications in trying a Japanese statutory claim under the JFIEA that would not arise in trying the Exchange Act claims, we believe comity and *forum non conveniens* arguments merit more serious consideration whenever plaintiffs seek to expand the plaintiff class by including U.S. purchasers of securities outside the United States, in transactions governed by foreign law, to accompany Exchange Act claims arising out of domestic transactions. ■

[35] *See Cornwell v. Credit Suisse Grp.*, 729 F. Supp. 2d 620, 622-27 (S.D.N.Y. 2010) (granting motion to dismiss and holding that *Morrison*'s bar on the extraterritorial application of U.S. securities laws precludes foreign squared claims, even if securities are transacted by U.S. investors or the transaction occurred in the United States, because a contrary finding would resurrect the now overturned conduct and effects test); *see also City of Pontiac Policemen's and Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 176, 188-89 (2d Cir. 2014) (affirming district court's dismissal of Exchange Act claims and holding that *Morrison*'s bar on the extraterritorial application of U.S. securities laws precludes foreign squared claims brought under the Exchange Act, even if those shares were cross-listed on a U.S. exchange, because mere placement of a U.S. buy order in a foreign squared transaction was insufficient to allege irrevocable liability was incurred in the United States).

[36] *Morrison*, 561 U.S. at 270.