Update: Federal District Court Holds That Purchasers of Volkswagen's Sponsored Level 1 ADRs Are Not Precluded From Maintaining Private Federal Securities Claims Under *Morrison v. National Australia Bank*

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On January 4, the U.S. Federal District Court for the Northern District of California issued a decision in a case brought by shareholders against Volkswagen arising out of the well-publicized diesel emissions controversy.[1] The *VW* opinion is significant because it is the first to consider thoroughly how the Supreme Court's 2010 *Morrison v. National Australia Bank Ltd.* opinion should be applied in the context of private federal securities claims under the antifraud provisions of the Securities Exchange Act of 1934 with respect to the purchase of American Depositary Receipts ("ADRs") in the over-the-counter ("OTC") market in the United States, where the ADR program is "sponsored," or contractually authorized, by the issuer of the underlying securities, in this case VW.

The court determined that the *Morrison* presumption against extraterritoriality does not preclude private claims brought under the antifraud provisions of the Exchange Act (*i.e.*, Section 10(b)) arising out of the purchase in the U.S. OTC market of VW-sponsored ADRs. Given the prevalence of ADR programs, the *VW* opinion is an important milestone in the post-*Morrison* battle regarding how expansive the presumption of extraterritoriality will be in limiting private federal securities litigation against foreign issuers.

The Prelude to the *VW* Opinion: The *Morrison* Case and Its Aftermath

As is now well-known, *Morrison* adopted a bright-line transactional test to determine when Section 10(b) is applicable. Specifically, the Court ruled that Section 10(b) and Rule 10b-5 apply "only in connection with a purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." *Morrison* thus created a two-prong test to determine whether private civil claims are within the scope of Section 10(b) – namely, is the claim in connection with (1) the purchase or sale of a security listed on a U.S. stock exchange or (2) the purchase or sale of any other security in the United States.

With respect to the first prong, there were some early post-*Morrison* efforts by plaintiffs to argue that, regardless of whether or not the transactions at issue occurred on a U.S. stock exchange, *Morrison* did not bar Section 10(b) claims so long as the same securities were cross-listed (even if not for trading purposes) on a U.S. exchange. Courts have uniformly rejected that so-called listing theory argument. Thus, the post-*Morrison* case law under the first prong is now largely settled. To the extent the plaintiffs asserting the claim purchased the underlying securities on a U.S. exchange, they may maintain a claim under Section 10(b), but if they purchased the securities on a foreign exchange, they may not.

The second prong of *Morrison* is less settled. There continues to be a significant amount of litigation to determine whether or not the purchase or sale of a security occurring off-exchange satisfies *Morrison's*

[1] Order Re: Motions to Dismiss the Consolidated Securities Class Action Complaint, *In re: Volkswagen "Clean Diesel" Marketing, Sales Practices, and Products Liability Litigation*, MDL No. 2672 CRB (C.D. Cal. Jan. 4, 2017) ("*VW*").

second prong – *i.e.*, whether that purchase or sale occurred within the United States. The Second Circuit's 2012 ruling in *Absolute Activist Value Master Fund Ltd v. Ficeto* addressed the question of under what circumstances the purchase or sale of a security that is not traded on a domestic exchange should be considered domestic within the meaning of *Morrison*. The Second Circuit held that "transactions involving securities that are not traded on a domestic exchange are domestic if irrevocable liability is incurred or title passes within the United States." Given the complexities of securities transactions in the global capital markets, figuring out the locus of an off-exchange transaction involving parties resident in various countries and/or using intermediaries, clearing processes and wire transfers around the world may, in any particular case, be challenging. It is also quite possible that such challenges could lead to difficulties in attempting to satisfy federal class certification requirements. In any event, the determination of the locus of the relevant transaction under *Morrison*'s second prong will, in particular cases, continue to be an important threshold issue in many securities cases involving foreign issuers.

In addition, post-*Morrison*, an additional wrinkle developed as a result of certain decisions providing a more expansive construction of *Morrison* – that is, whether the presumption against extraterritoriality bars Section 10(b) claims even if the parties agree that the underlying securities transaction occurred within the United States. This so-called "predominantly foreign" extension of *Morrison* is most clearly articulated in the Second Circuit's 2014 decision in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, where the Second Circuit determined that the existence of a domestic transaction is a necessary but not necessarily sufficient condition to the application of Section 10(b). There, although it was conceded that the plaintiffs' purchases of certain swaps referencing VW common stock occurred in the United States, the Second Circuit determined that claims against Porsche for alleged misstatements and omissions regarding its intentions concerning a takeover of VW lacked a sufficient nexus to the United States to come within the scope of Section 10(b) under *Morrison*. In May 2016, a California federal district court extended the analysis of *Parkcentral* to preclude claims against Toshiba arising out of the purchase of *unsponsored* Toshiba ADRs, even though it was conceded that the purchases occurred in the OTC market within the United States. There, the court ruled that Toshiba did not take sufficient steps to expose itself to U.S. federal securities litigation under Section 10(b).

The *VW* Opinion

Against that landscape, the court in *VW* confronted whether the *Morrison* presumption against extraterritoriality should preclude claims against VW and its executives arising out of the purchase of VW ADR's in the OTC market in the United States. The parties conceded that the transactions in question occurred within the United States. That, said the court, arguably ends the inquiry under *Morrison*'s second prong, but given the Second Circuit's "predominantly foreign" test in *Parkcentral*, the court went further to analyze the presumption against extraterritoriality under the *Parkcentral* standard as well.

The court determined that *Parkcentral* was readily distinguishable. There, the defendant Porsche was not a party to the securities transactions, and had no involvement or role in the creation of the swaps that referenced the securities of a different company, VW. In contrast, the ADRs in the *VW* case are not independent from VW's foreign securities or VW itself. VW sponsored the ADRs and thus was directly involved, according to the court, in the domestic offering of the ADRs. The fact that the ADR program was only a Level 1 program, as opposed to a Level 2 or Level 3 program, did not change the result in the court's view. The court pointed to the creation of deposit agreements between VW and the ADR depositary governed by New York law, the filing of Form F-6 registration statements, and VW's need to comply with SEC Rule 12g3-2, which requires the issuer to provide English-translated versions on its website of disclosure documents required in the issuer's home country, as support for its conclusion that the transactions at issue were not predominantly foreign.

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Conclusion

Foreign issuers have long used sponsored ADR programs to increase their exposure to U.S. investors and, in the case of Level 2 and Level 3 programs, for capital-raising purposes, and we believe most foreign issuers appreciate the risk of liability under U.S. securities laws that this entails. The *VW* opinion underlines this risk.

If you have any questions regarding this newsflash, please contact **Michael S. Flynn** or any of the lawyers listed below or your regular Davis Polk contact.

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