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Unsponsored ADR programmes and Rule 10b-5

Non-US companies with unsponsored ADR programmes may be more likely to face US securities fraud claims but risk of liability may not have changed

What has happened?

In *Stoyas v Toshiba* decided in July 2018, the US federal appeals court for the Ninth Circuit partially reversed a 2016 lower court decision that had been favourable to non-US companies with unsponsored American Depositary Receipt (ADR) programmes.

As a result, such companies may be more likely to face securities fraud claims from ADR investors and may find it more difficult to dispose of such claims at an early stage by arguing that the ADR transactions are outside the territorial reach of the US Securities and Exchange Act of 1934 (the Exchange Act), at least for lawsuits brought in Ninth Circuit courts, ie those in the western US. (Unsponsored ADR programmes are set up, generally without the company's involvement, by financial institutions that want to establish a US over-the-counter market in the ADRs).

The case arose from the **plunge in the value of Toshiba ADRs** following the 2015 revelation of Toshiba's **accounting fraud**, which led to a restatement of its accounts for financial years 2008 – 2014. In the restatements, Toshiba's pre-tax profits were reduced by roughly one third. Toshiba's ADRs are not 'sponsored' by the company and are traded over-the-counter in the US. Toshiba's common stock is listed only in Tokyo and Nagoya. The plaintiffs, representing a class of purchasers of Toshiba's ADRs, alleged that they purchased their ADRs in reliance on the accuracy of Toshiba's financial statements, and were damaged when Toshiba's fraud was revealed.

'Domestic transaction' within the Morrison test

In *Morrison v National Australia Bank* (2010), the US Supreme Court decided that section 10(b) of the Exchange Act does not apply extraterritorially, ie to securities transactions outside the US, but only to:

- transactions in securities listed on domestic exchanges
- domestic transactions in other securities

In *Toshiba*, the company moved to dismiss the plaintiffs' complaint, arguing, that the plaintiffs failed adequately to allege that they had engaged in a domestic transaction within the territorial scope of Section 10(b).

The lower court found that the plaintiffs failed to allege such a transaction because Toshiba was not involved in the ADR transactions in the US, and granted Toshiba's motion to dismiss. The lower court also found that giving leave for the ADR holders to amend their complaint would be futile, and therefore dismissed the plaintiffs' securities claims with prejudice. (Being able to dispose of a securities class action complaint with a pre-discovery motion to dismiss is a significant victory because failure to win a dismissal motion very often leads to settlement.)

The appeals court disagreed, finding that all that is required for there to be a domestic transaction under *Morrison* is that one party to the ADR transaction must have **incurred irrevocable liability in the US** (irrespective of whether Toshiba was involved). Because both the buyer and seller were located in the US, the appeals court found that an amended complaint could 'almost certainly' allege a domestic transaction within the territorial scope of the Exchange Act. So the appeals court remanded the case back to the district court to allow the plaintiffs to amend their complaint. It remains to be seen whether

the ADR holders can satisfactorily make out all elements of their claim once it has been amended, including the requirement for a domestic transaction.

What has changed?

The Ninth Circuit court of appeals has weakened the viability of one argument that non-US companies can make on a motion to dismiss if holders of their unsponsored ADRs assert Section 10(b) claims against them in courts within the purview of the Ninth Circuit.

Nevertheless, at this time it **is unclear whether the *Toshiba* decision has materially increased the exposure to securities fraud liability** for companies with unsponsored ADR programs. For example, the Ninth Circuit's decision in *Toshiba* suggested that a non-U.S. company's lack of connection to ADR transactions may affect whether plaintiff ADR purchasers can establish the required substantive elements of a Section 10(b) claim, including whether plaintiffs can show that their transaction occurred **'in connection with'** the alleged fraud. And, of course, a non-US issuer may also be able to assert personal jurisdiction and forum defences.

Can non-US companies with unsponsored ADR programmes mitigate this potentially increased exposure?

Most unsponsored ADR programmes comprise a relatively small percentage of a company's share capital, and recent direct sales of ordinary shares by an issuer and its affiliates pursuant to Rule 144A or another exemption from SEC registration are a more straightforward path to Rule 10b-5 liability exposure for the typical non-US issuer, both in the legal analysis and by quantum of exposure.

However, if, on balance, a non-US issuer decides that this potentially increased risk of Section 10(b) liability exposure outweighs the liquidity and investor relations benefits of its unsponsored ADR programmes, it could consider one or more of the following steps to mitigate (but, particularly in the Ninth Circuit, not eliminate) the risk **by distancing itself from any unsponsored programmes**:

- If approached by a depositary bank wanting to establish an unsponsored programme, issuers **should not give any consent** requested by the bank
- Issuers can give **notice on their Investor Relations website** to any current and potential investors in any unsponsored ADR programmes that they have no involvement in or responsibility for any such programmes (where this is, in fact, the case)
- If issuers have already given such consent, they could **consider withdrawing their consent**.

What happens next?

Split in approach between Ninth and Second Circuits

The 2018 *Toshiba* court (Ninth Circuit) agreed with the Second Circuit's decision in the *Absolute Activist* case (2012) that, for a securities transaction to be 'domestic' for the purposes of *Morrison*, plaintiffs must allege (and ultimately prove) that **irrevocable liability** to consummate the transaction occurred in the US. However, the *Toshiba* court rejected the Second Circuit's subsequent decision in the *Parkcentral* case (2014) that a **domestic transaction is not necessarily sufficient** to bring a transaction within the territorial scope of the Exchange Act when the alleged conduct in question is **predominantly foreign**. Accordingly, in the Ninth Circuit, a plaintiff can allege that there is a securities transaction within the territorial scope of the Exchange Act so long as either the buyer or seller incurs irrevocable liability in the US, even if the non-US company accused of committing the fraud did not engage in *any* activity in the US. In the Second Circuit, plaintiffs will not always be able to do so.

Appeal to the US Supreme Court possible

In October 2018 Toshiba petitioned for Supreme Court review of the Ninth Circuit's decision, although the Supreme Court will not consider whether to review the case for several months. If the Supreme Court agrees to review the Ninth Circuit's decision, **a final decision may not come until 2020**. If the Supreme Court rejects the petition for an appeal, the case will be remanded to the district court, and the circuit split described above will remain unresolved. Unless and until the Supreme Court resolves this split of authority, we expect that courts outside the Ninth and Second Circuits will be called upon to choose whether to apply the *Parkcentral* or *Toshiba* test to cases involving claims of fraudulent activity taking place predominantly outside the US.

In the meantime, as noted above, non-US companies may face a potentially increased risk of claims brought by ADR holders under unsponsored programmes in US federal courts, particularly those under the jurisdiction of the Ninth Circuit. However, it remains to be seen whether any such claims would be more likely to succeed.

Please do not hesitate to reach out to your usual Freshfields contacts if you have any questions.

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