Financial Lines

European Public Companies and US Securities Class Actions

A hidden risk?

European listed companies face the risk of US securities class actions via ADRs traded in the US

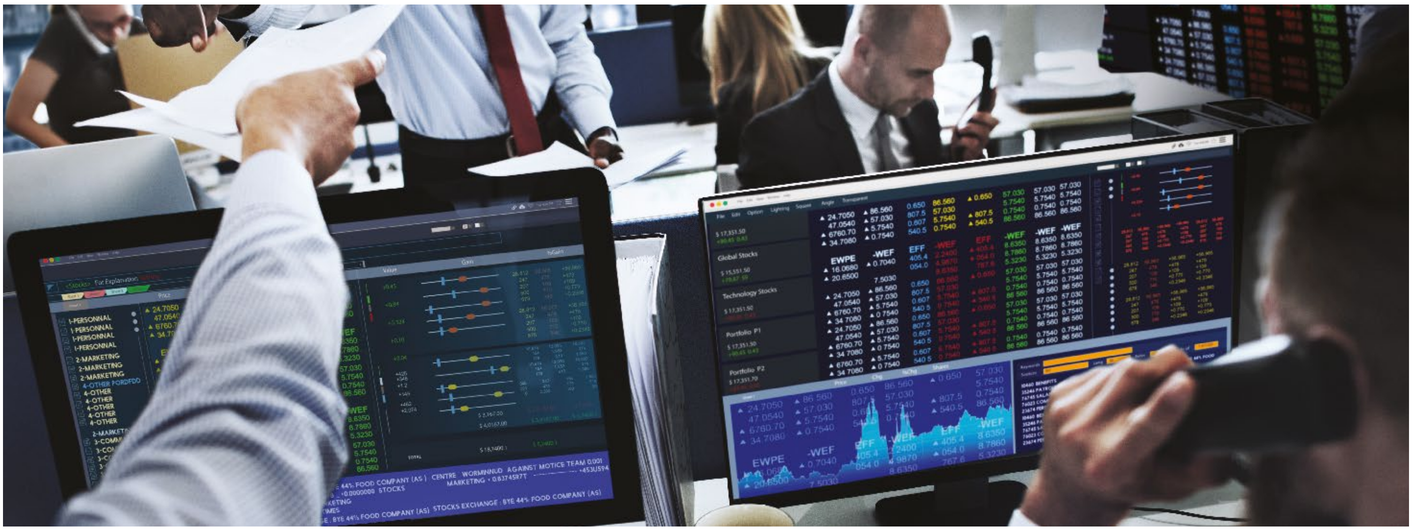
An established way for non-US companies to provide access for US investors to invest in their shares is for them to issue American Depository Receipts (ADRs). The least regulated ADRs are Level I ADRs which are traded over the counter and not listed on a national exchange such as the NYSE or Nasdaq. A recent court ruling in the US found that foreign companies with ADRs available in the US market could be brought into a US court even if the company itself did not seek to sell the ADRs to US investors.

American investors can currently purchase Level I ADRs for over 900 European companies, the majority of which are large cap. Where ADRs are not sponsored by the company, but instead registered solely by the depository institutions, that company's European board members may think they have limited exposure to US securities laws. However, a recent ruling involving the unsponsored ADRs of Toshiba should make directors of all listed companies stand up and take notice.

Following allegations of false and misleading financial statements, a securities class action was brought in California against Toshiba and certain named executive officers. Although the trial court dismissed the case, that decision was reversed on appeal. The appellate court found that the ADRs were securities within the meaning of the US securities laws and that the plaintiffs should be allowed to amend their pleadings to show that the transactions in which they purchased the ADRs were domestic U.S. purchases. The case has been appealed to the US Supreme Court. The uncertainty around the outcome of the case may cause an increased number of claims to be brought by ADR holders against non-US companies. This could potentially lead to European directors being dragged into court in the US despite the company itself not seeking to sell its shares to US investors.

At a Glance

- Most large cap European public companies have American Depository Receipts (ADRs) traded in the US
- Because these certificates are not listed on a national exchange, some European companies and their directors and officers may not appreciate the danger of having a class action brought against them in the US based on these ADRs
- A recent appellate court case in the US found that the fact that the ADRs were not sponsored by the company was not in itself sufficient to have the claim dismissed, and the court instead allowed the plaintiffs to amend their pleading rather than having their case dismissed



What is an ADR?

An ADR[1] is the receipt for a negotiable certificate representing a beneficial interest in a specified number of shares in a non-US company. The ADRs are issued by a US depository institution, usually a bank. The bank itself holds the shares of the non-US company. Unlike the underlying foreign stock itself, which is traded on an exchange outside the US, the ADR is traded in the US. ADRs have many of the same characteristics as stocks e.g. they pay dividend and include voting rights for the ADR holder.

There are three different levels of ADRs, with Level I, the type at issue in *Toshiba*, having the lowest regulatory filing requirements, as they are typically exempt from registration under the Securities Exchange Act of 1934. There are currently over 900 companies in Europe whose Level I ADRs are available for purchase in the US.

Level I ADRs are traded on the over-the-counter (OTC) market, i.e. not directly on a national exchange such as the Nasdaq or the New York Stock Exchange (NYSE). An OTC market:

1) Does not require the company to comply with the full Security Exchange Commission (SEC) reporting requirements,

2) Does not allow the company to raise capital and,

3) Usually requires the use of a stockbroker to acquire the ADRs rather than providing direct access for the purchaser

Level I ADRs can be either "sponsored" or "unsponsored". Unsponsored ADRs are ADRs where the depository bank, without the involvement or possibly even the consent of the company, issues the ADRs. This means the non-US company may have no control over the decision to offer ADRs in the US. Sponsored ADRs are at the request of and with the cooperation of the foreign company.

ADR programs facilitate the trading of shares listed outside the United States in the American market

Non-US companies can also issue Level II ADRs, which trade directly on one of the national exchanges, or Level III ADRs which can be used to raise capital. Although an uptick in securities claims against Level II and Level III ADR issuers has been seen in recent years, this paper focuses on the developments with regard to Level I ADRs only. They have historically been viewed as less of a target for securities class actions.

Unsponsored ADRs and the *Toshiba* case

Toshiba is a Japanese-headquartered multinational company with its common stock traded on the Tokyo Stock Exchange. Four investment banks had registered and issued ADRs, and accordingly Toshiba had unsponsored Level I ADRs traded on the OTC market. In 2015, Toshiba disclosed substantial accounting fraud in its prior reporting requiring it to restate both pre-tax profit and shareholder equity for the period 2008-2014. As a result, Toshiba's stock price declined by over 40%. A securities class action was filed against Toshiba and certain officers in the U.S. District Court for the Central District Court of California (the District Court) alleging violations of US securities laws. Toshiba filed a motion to dismiss the case, arguing that the US securities laws do not apply to the OTC transactions in Toshiba's unsponsored ADRs. In 2016, the District Court granted the motion to dismiss. The District Court's dismissal was based on two important conclusions:

1) the OTC market is not a national exchange, and

2) there was no transaction in the US between Toshiba and the plaintiffs.

1. As explained by the court in *Toshiba*, ADRs are receipts that evidence ownership of an "American Depository Share" or "ADS" but for consistency with the commentary around this case as well as usage and discussion in the case we will use the acronym ADR with regard to the receipt and the share.

The plaintiffs appealed the dismissal to the US Court of Appeals for the Ninth Circuit (the Ninth Circuit), which reversed the dismissal. Both courts agreed that the relevant precedent was the U.S. Supreme Court's opinion in *Morrison v. National Australia Bank, Ltd.*,[2] which addressed the question of when the U.S. Securities Exchange Act 1934 (the Exchange Act), the same securities law the plaintiffs in *Toshiba* relied on for their case, applied to foreign companies whose securities were traded on non-US exchanges. The Court in *Morrison* held that the Exchange Act would apply only in connection with the purchase or sale of securities (1) registered on a national exchange; or (2) a domestic transaction in securities not so registered.

The Ninth Circuit concluded that the ADRs were, in the first instance "securities" within the meaning of the Exchange Act.

The court then also determined that the OTC market on which Toshiba's ADRs were traded was not a national exchange, so the first prong of *Morrison* was not met.

Next, the court considered whether the OTC sale of Toshiba's ADRs was a "domestic transaction in other securities" as to fall within the second prong of *Morrison*. The Ninth Circuit noted that the Supreme Court had not provided guidance on how to determine if a particular securities transaction was "domestic", but adopted a test which originated in the Second Circuit case *Absolute Activist Value Master Fund Ltd., v. Ficeto,*[3] which determined that a securities transaction occurs when the parties to the transaction incur "irrevocable liability". Hence, if the plaintiffs could show that either that the purchaser incurred irrevocable liability within the United States to pay for the security, or that the seller incurred irrevocable liability to deliver that security in the United States, this could be sufficient evidence of a domestic transaction in the securities under *Morrison*.

In some silver lining for Toshiba, the court did acknowledge that plaintiff's complaint required more specificity with regard to Toshiba's connection to the transaction, but the cure for this was allowing the plaintiffs to amend their complaint, rather than dismissal. Accordingly, the case was ordered back to the District Court to allow the plaintiffs to amend their complaint to add the required specificity.

The case has been appealed to the US Supreme Court. At the time of publishing the Court had not yet decided whether to hear the case and had invited the U.S. Solicitor General to file a brief with the Court expressing the views of the United States.

If there was any doubt about the seriousness of this precedent for European companies, the importance of this decision was acknowledged by EuropeanIssuers, a pan-European organisation that represents the interests of publically traded companies in Europe with nearly 8,000 members, and national associations and companies from fifteen nations of the EU. They filed an *amicus curiae* brief with the U.S. Supreme Court in *Toshiba* stating:

> Many of the foreign companies that will be affected by the Ninth Circuit's rule have made the deliberate choice to forgo the benefits of the U.S. securities market in order to avoid the risk of litigation in the United States under U.S. procedural and substantive law that may differ substantially from the law of the foreign companies' principal trading jurisdictions. *Stoyas [v. Toshiba Corp.]* opens the door for securities holders to subject foreign companies to that very risk based solely on trading that is entirely beyond the foreign issuers' control.

There is no guarantee that the plaintiffs in *Toshiba* will eventually prevail. However, the case shows that even a foreign company with only Level I ADRs may still be subject to US securities laws. European companies dealing with any type of security that might possibly be the basis for a US suit would thus benefit from paying close attention to how the law develops in this area.

2. 561 U.S. 247 (2010).
3. 677 F.3d 60 (2d Cir. 2012).

These types of claims have come as a surprise since many companies were not prepared that their Level 1 ADRs, sponsored or unsponsored, could be subject to US securities laws.

What About Sponsored Level 1 ADRs?

Whilst companies who sponsor their Level 1 ADRs should be aware of the possibility of being brought before a US court, European boards may not be aware that the frequency of such cases has increased in recent years. Following the *Morrison* ruling back in 2010, there was a reasonable expectation that the number of US securities class actions against non-US companies would decline. However, the figure is actually greater than the cases brought in the years prior to the ruling. Court decisions about whether any individual securities claim brought on the basis of Level 1 ADRs are allowed to proceed are very case-specific and courts have come to different conclusions based on the facts of each case. With reference to specific US securities actions in recent years against non-US companies, Volkswagen (emissions scandal), Tesco (accounting scandal), and Nissan (accounting and executive compensation scandal) have all been brought into US courts based on their Level 1 ADRs.

For many companies these types of claims come as a surprise since they were not prepared that their Level I ADRs, sponsored or unsponsored, could make the company and its directors and officers subject to US securities laws. As a result, we have seen several cases where foreign companies with Level I ADRs try to find a settlement as soon as possible in order to avoid the costs and complexity in connection with US securities class actions. It is important for the directors and officers of European public companies to learn the facts about their potential US exposure based on recent activities in the US and make sure they take the necessary precautionary actions, including insuring appropriate D&O insurance is in place.

Need for Specialist Claims Experience

As a D&O insurance market leader in Europe, AIG has considerable experience defending directors and officers as well as companies against US securities claims. With the general increase in claims against companies with OTC-traded ADRs, the need for experienced D&O claims handling is more important than ever. AIG's major loss claims handlers have wide-ranging experience and have handled over 100 securities class actions during the last couple of years. Our extensive panel of law firms in the US, including market-leading securities defence firms, is available for all our D&O clients. It is vital to have experienced defence counsel with strong knowledge of US law and the local courts when defending US class actions.

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