NINTH CIRCUIT ALLOWS PLAINTIFFS TO ARGUE THAT OVER-THE-COUNTER TOSHIBA ADRs ARE SUBJECT TO U.S. SECURITIES LAWS

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Eight years after the U.S. Supreme Court ruled that the federal securities laws only applied to securities acquired domestically, courts continue to differ over how to apply that "transactional test" to American Depositary Receipts ("ADRs"), tradeable certificates issued by U.S. banks that correspond to shares of foreign stock.

In the latest example, *Stoyas, et al. v. Toshiba Corp.*, the Ninth U.S. Circuit Court of Appeals has ordered a lower court to give purchasers of Toshiba ADRs the opportunity to pursue a case against the Japanese company under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"). The district judge had dismissed the lawsuit, which involves ADRs acquired on an over-the-counter ("OTC") market, not ones listed on a stock exchange.

In its July 17 ruling to reverse and remand, the Ninth Circuit said plaintiffs could successfully argue that their ADR purchases met the conditions established by the Supreme Court in its 2010 decision in *Morrison v. National Australia Bank Ltd.*, which found the Exchange Act could only apply to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." The three-judge panel cited plaintiffs' claims that the Toshiba ADRs were purchased in the United States by U.S. entities from depositary banks based in New York and stated, "Accordingly, an amended complaint could almost certainly allege sufficient facts to establish that [the plaintiffs] purchased [their] Toshiba ADRs in a domestic transaction."

The Ninth Circuit opinion explicitly rejected the Second Circuit Appeals Court's reasoning in *Parkcentral Global Hub v. Porsche Automobile Holdings*, and in so doing effectively created a different set of standards in the two federal jurisdictions where most traditional securities lawsuits are brought—the Ninth Circuit, which includes California, and the Second Circuit, based in New York. The Ninth Circuit panel put the *Stoyas* case on hold after Toshiba said it planned to ask the Supreme Court to resolve the split.

The *Stoyas* opinion, if it stands, amounts to a small dose of good news for investors, who since *Morrison* have largely been unable to use the U.S. securities laws as protection against foreign stock issuers who defraud them. The decision is particularly significant because it deals with so-called "unsponsored" ADRs, all of which trade only on OTC markets. Some "sponsored" ADRs, in contrast, can trade on U.S. exchanges. According to Deutsche Bank there were 1,642 unsponsored ADRs from 40 countries available at the end of 2017. Institutional investors had publicly reported investments of $11.9 billion in unsponsored ADRs at the end of September 2017, up from $7.9 billion a year earlier. That makes up a large portion of the overall ADR offering, which the SEC estimates at over 2,000.

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In its ruling, the Ninth Circuit soundly rejected the district court's reasoning that plaintiffs who made OTC purchases of Toshiba ADRs could not assert violations of the Exchange Act arising out of Toshiba's admitted fraudulent accounting practices in Japan. In doing so, the Ninth Circuit followed a three-step process. First, it found that Toshiba's ADRs "fit comfortably within the Exchange Act's definition of 'security'" because they "share many of the five significant characteristics typically associated with common stock." Next, the panel found that the OTC market where the unsponsored ADRs were purchased did not fall within the Exchange Act's definition of an "exchange." Finally, the Ninth Circuit applied the Supreme Court's reasoning in *Morrison* to find that purchases in ADRs may be "domestic transactions" if certain facts are pled.

In *Morrison*, the Supreme Court emphasized that "the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States." Where the transaction took place, therefore, is the threshold inquiry. *Morrison* instructs courts to apply a two-prong transactional test to determine location—whether the purchase or sale (1) involves a security listed on a domestic exchange or (2) takes place in the United States.

In *Stoyas*, the Ninth Circuit concluded that the OTC market on which the plaintiffs acquired the Toshiba ADRs is not an exchange. The appeals court then "adopted" the Second and Third Circuits' "irrevocable liability" test to determine whether the Toshiba ADR transactions on the OTC took place in the United States, i.e., were "domestic transactions." This test looks to "where purchasers incurred liability to take and pay for securities, and where sellers incurred the liability to deliver securities." But *Stoyas* rejected defendants' argument that, under the Second Circuit's 2014 *Parkcentral* opinion, plaintiffs must plead a link between Toshiba and the transactions themselves to survive a motion to dismiss. "For the Exchange Act to apply, there must be a domestic transaction; that Toshiba may ultimately be found not liable for causing the loss in value to the ADRs does not mean that the Act is inapplicable to the transactions," the Ninth Circuit reasoned. In addition, the court said, *Parkcentral* "relies heavily on the foreign location of the allegedly deceptive conduct" and imposes exactly the type of "vague and unpredictable" test the Supreme Court criticized in *Morrison*.

Even if *Stoyas* stands, the plaintiffs suing Toshiba still face challenges. The appellate court cautioned that to properly plead an Exchange Act claim, they must eventually demonstrate Toshiba's connection to the ADRs themselves, providing documentation to show that the company was involved in establishing the U.S. securities when they were issued. But the Ninth Circuit provides plaintiffs with a road map for amending their complaint against Toshiba which, if followed, should enable plaintiffs to survive a motion to dismiss and litigate the merits of the case—and other plaintiffs in its jurisdiction to properly plead similar claims.

In addition to the U.S. lawsuit, common stock purchasers are suing Toshiba in Japan over allegations that the company used improper accounting to inflate its profits by more than $2 billion over a six-year period before a 2015 financial restatement sent its stock plummeting. (Disclosure: Cohen Milstein is working with pension fund clients who have filed claims in Japan.)

If you would like further information about how this ruling affects your legal rights as an investor, please contact the attorneys of Cohen Milstein's Securities Litigation & Investor Protection Practice at information@cohenmilstein.com or 202.408.4600. ■

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