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US securities law liability for securities issuers outside of the United States in a post-*Toshiba* environment

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Public companies outside of the United States often contemplate whether to sell their securities in the US to access new sources of capital. Many companies choose not to do so to limit their exposure to liability under US securities laws. So long as a company is not actively selling its securities in the US, the thought was that it was unlikely to face lawsuits – meritorious or not – from an active plaintiffs' securities bar. This was true even if its securities were being traded by others as American Depository Receipts (ADRs) on over-the-counter markets in the US.

A recent decision from a US appellate court may change the way that non-US companies view the sale of their securities in the US. That case, *Stoyas v. Toshiba Corp.*, found that a foreign issuer could be liable under US securities laws for a sale of its securities in the US, even if the company was not involved in the sale. This creates real risk for publicly-traded, non-US companies.

This white paper discusses the recent decision in *Toshiba* and the circumstances under which US courts have decided that a foreign issuer can be held liable for transactions in its securities under US securities laws. We will also identify ways in which a foreign issuer can mitigate its exposure risk to US securities laws. For more background on the risk of securities class actions and public companies via ADRs please see AIG's white paper, which also highlights the need for specialist D&O claims experience.

Background on extraterritorial application of US securities laws

For a number of years, it was unclear whether public companies listed on non-US markets could be subject to liability under the US securities laws in connection with the sale of their securities. This all changed when the US Supreme Court issued its decision in *Morrison v. National Australia Bank Limited*.

In that case, a group of Australian investors who had purchased shares of National Australia Bank on the Australian Stock Exchange claimed that an executive of the bank's Florida-based subsidiary had made false and misleading statements, which were repeated in the bank's securities filings in violation of Section 10(b) of the Securities Exchange Act of 1934. The bank argued that the claims should be dismissed because the plaintiffs' shares had been purchased on the Australian Stock Exchange outside of the US.

The Supreme Court agreed and affirmed the dismissal of the plaintiffs' claims. In doing so, the Court set forth two scenarios under which a company listed outside of the US could be liable in connection with the sale of its securities under the anti-fraud provisions of US securities laws. These scenarios occur when: (1) the company lists its foreign securities on a domestic exchange through ADRs or (2) the company otherwise engages in a domestic transaction of securities.

The Court's decision made it clear to foreign issuers that companies could actively subject themselves to liability under the US securities laws by listing ADRs on a US exchange (e.g., the New York Stock Exchange and the Nasdaq Stock Market). The Court's decision provided little guidance on when these companies could be subject to liability by "otherwise engaging in a domestic transaction of securities."

Federal courts have begun interpreting that language. What emerged from these court decisions was that companies listed outside of the US could be subject to liability if they established a "sponsored" ADR program to sell shares on the over-the-counter market in the US. Under these "sponsored" programs, a company enters into a depository agreement with an investment bank to provide the bank its non-US-listed shares. The bank sells ADRs – which represent rights in the shares – to US investors.

It was generally understood that companies that did not establish a "sponsored" ADR program could not be subject to liability, even if their shares were sold in the US on the over-the-counter market. In other words, if an investment bank decided to purchase a block of the shares of a foreign issuer on its own, and package up those shares to sell as "unsponsored" ADRs, the foreign issuer was thought to be at little risk of liability under US securities laws.

In *Toshiba*, a US appellate court dramatically altered the landscape with respect to "unsponsored" ADRs. In that case, a group of investors who had purchased "unsponsored" Toshiba ADRs from an investment bank filed a lawsuit against the Japan-based company Toshiba for allegedly making false and misleading statements in violation of the US securities laws. Toshiba defended the claims, in part, by arguing that it had not participated in the sale of the ADRs to the US investors. Instead, the US investors purchased their ADRs from an investment bank that had acquired Toshiba shares on the Tokyo Stock Exchange.

While Toshiba believed this should absolve it from liability, the appellate court disagreed. The court held that a foreign issuer could be liable for the sale of "unsponsored" ADRs if two conditions are met. First, the purchase of the securities occurred in the US, measured by where the purchaser incurred liability to take and pay for the ADRs and where the sellers incurred liability to deliver the ADRs. Second, the foreign issuer was sufficiently involved in the transaction of the ADRs.

The *Toshiba* court did not spell out when a foreign issuer is sufficiently involved in an ADR transaction so as to trigger liability, but said that the company must act "in connection with" and "touch" the ADR sale. The court noted a few factors that could indicate that a foreign issuer acted in connection with an "unsponsored" ADR sale, such as whether it gave consent to the investment bank to establish the "unsponsored" ADR program, whether it issued a letter of "non-objection" to the "unsponsored" ADR program, and whether it facilitated the sale of the "unsponsored" ADRs.

Recommendations to limit exposure to liability under US securities laws

The *Toshiba* appellate court outlined its new standard for "unsponsored" ADR liability in July 2018. In January 2020, the lower court in *Toshiba* applied the appellate court's test for the first time. The lower court held that the plaintiffs could proceed with their lawsuit because they raised plausible allegations about the ADR's domestic nature and Toshiba's connection with the "unsponsored" ADR program. The *Toshiba* plaintiffs still have to prove their allegations, but the lower court's ruling means that they could extend the lawsuit past its initial stages. As a result, foreign issuers should take notice that courts may broadly subject them to potential liability even when they do not actively sell securities in the US. The following are some recommendations, in order of importance, that foreign issuers should consider adopting to limit this exposure.

1. **Do not list ADRs on a US exchange.** *Morrison* removed any doubt that a foreign issuer would subject itself to liability under the US securities laws by listing ADRs on a US exchange. To avoid this potential liability, foreign issuers should refrain from doing so.
2. **Monitor and manage relationships with depository institutions.** It is common for investment banks to establish "unsponsored" ADRs for foreign-issued shares. Generally, a foreign issuer will be made aware of an investment bank's intent to establish such a program. To minimize the risk of liability related to the sale of the "unsponsored" ADRs, a foreign issuer should take steps to limit its facilitation of the sale of the "unsponsored" ADRs.
   - *Refuse to provide consent or a letter of "non-objection" to the "unsponsored" ADR program:* The plaintiffs in Toshiba focused in on the fact that foreign issuers often provide letters of consent or "non-objection" to "unsponsored" ADR programs. To avoid allegations the company agreed to set up the "unsponsored" ADRs, a foreign issuer should consider refusing to provide a letter of consent or "non-objection" to an investment bank if asked.
   - *Avoid participation in sales of large blocks of securities to an investment bank:* The Toshiba plaintiffs focused on the fact that the investment bank that established the "unsponsored" ADR program was one of Toshiba's ten largest shareholders. The plaintiffs alleged that Toshiba must have helped the investment bank acquire shares with an understanding that the bank was going to use some of the shares for an ADR program. Even without evidence of explicit support for an ADR program, selling large blocks of securities to an investment bank might be cited as support for a claim that a foreign issuer intended to assist in the establishment of an "unsponsored" ADR program.
   - *Publish a formal dissociation from an "unsponsored" ADR program:* Once a foreign issuer becomes aware of the establishment of an "unsponsored" ADR program, it can take steps to indicate that it is not involved in the sale of the "unsponsored" ADRs. One of these steps involves publishing a formal dissociation from the program through press release, publication, or letter. Furthermore, companies whose shares are known to be traded as unsponsored ADRs should either:
   - 1) not formally acknowledge or identify those unsponsored ADRs in corporate securities filings, or
   - 2) if an issuer is required under relevant law to disclose the unsponsored ADRs, then the issuer should also include a disclaimer to the extent that is factually correct.
   - *Limit interaction with investment banks after establishment of an "unsponsored" ADR program.* An investment bank may want to set up meetings with a foreign issuer's executives to discuss marketing information about the company. Foreign issuers should consider limiting interactions between their employees and the investment bank to prevent allegations that the employees facilitated the sale of the "unsponsored" ADRs.

3. **Limit direct interaction with potential ADR investors:** In addition to monitoring its relationships with investment banks, a foreign issuer should consider limiting its interaction with potential purchasers of the "unsponsored" ADRs. The *Toshiba* decision clarified that posting documents in English could not be sole basis for finding that a foreign issuer was involved in the sale of "unsponsored" ADRs. More active involvement in the sale could trigger liability. As a result, a foreign issuer should consider taking the following steps to minimize the risk that a court will find the company facilitated the sale of "unsponsored" ADRs:
   - Establish company policies that control who can communicate with shareholders, potential shareholders, US media or US-based analysts
   - Prevent distribution of promotional materials that are directed at or could end up in the hands of the "unsponsored" ADR investors
   - Instruct employees not to take any actions or make any statements that are likely to generate interest in the "unsponsored" ADRs
   - Discontinue investor meetings that US-based investors are likely to attend

The *Toshiba* decision will encourage an enterprising plaintiffs' securities litigation bar to continue filing claims against foreign issuers for the sale of their securities in the US even when the companies are not directly involved. From the foreign issuer's perspective, claims that courts would have quickly dismissed in the past will likely become more frequent, more difficult, and more expensive. Because the cost of litigating these claims can be substantial, foreign issuers would be wise to adopt the protective measures mentioned in this article.

**The Norton Rose Fulbright team would like to thank their former colleague John Byron, who is now with Steptoe & Johnson LLP, for his contributions to this white paper.*

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