Financial Lines | Claims trends series

Is there an increased risk of US securities class actions against Nordic listed companies?

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An established way for non-US companies to provide access for US investors to invest in their shares is for such companies to issue American Depository Receipts (ADRs). The least regulated ADRs are the unsponsored Level I ADRs and they have for a long time been considered an effective method with low legal risks from an underwriting and board perspective. Level I ADRs are currently available for approximately 140 Nordic companies including most of the region's large cap. However, following recent US court rulings, a new era with increased legal risks attached to both unsponsored and sponsored Level I ADRs might be coming to age.

The legal developments regarding the unsponsored Level I ADR market started with a case involving Toshiba following allegations of false and misleading financial statements issued between 2012 and 2015. Class action and legal court cases where brought in the Central District Court of California (the District Court) which were followed by a ruling by the US Court of Appeals for the Ninth Circuit, which was disadvantageous to Toshiba. Currently it is not known if the Supreme Court will review the case (see a summary below). The uncertainty around the outcome of the case may lead to an increased risk of claims by ADR holders against non-US companies, particularly those under the jurisdiction of the US Court of Appeals for the Ninth Circuit. This could potentially lead to high defense costs and substantial fines and penalties under the US Securities and Exchange Act (the Exchange Act), compared to those imposed outside of the U S..

Listed companies, underwriters and brokers may want to pay attention to and follow the development of these cases closely. Some of the steps to consider for clients with unsponsored ADRs (see a definition below) are to distance themselves by e.g. considering the following steps:

- If approached by a depository bank who wants to establish an unsponsored program, the client should not give consent to the requesting bank.
- If such consent has for some reason already been given, the client might want to consider withdrawing such consent.
- The client can make sure to be clear on its Investor Relations website that it has no involvement or responsibility for any unsponsored ADR program so that investors are aware.

Uncertainty whether non-US issuers are subject to the Exchange Act

There is currently an uncertainty whether non-US issuers could be subject to the Exchange Act. For many years, the view on unsponsored Level I ADRs has been that they are connected to low risks seen from an underwriting perspective, but also from a board perspective. The final ruling on the Toshiba case may change the view of the market, though. Even if the case would be dismissed, as was the case in the *Morrison* ruling which had reference to that US securities laws apply to transactions in "securities listed on domestic exchanges" or "domestic transactions in other securities" and where the defendants in the *Morrison* case argued that none of the two prongs were fulfilled, there is potentially still a significant amount of defense costs incurred.

Background ADRs

An ADR is a certificate of a stock issued and held by a US bank. It represents a share (or several shares) in a foreign stock traded on a US exchange. 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, I being the lowest and III the highest. There are currently close to 140 Nordic companies that offer Level I ADRs:

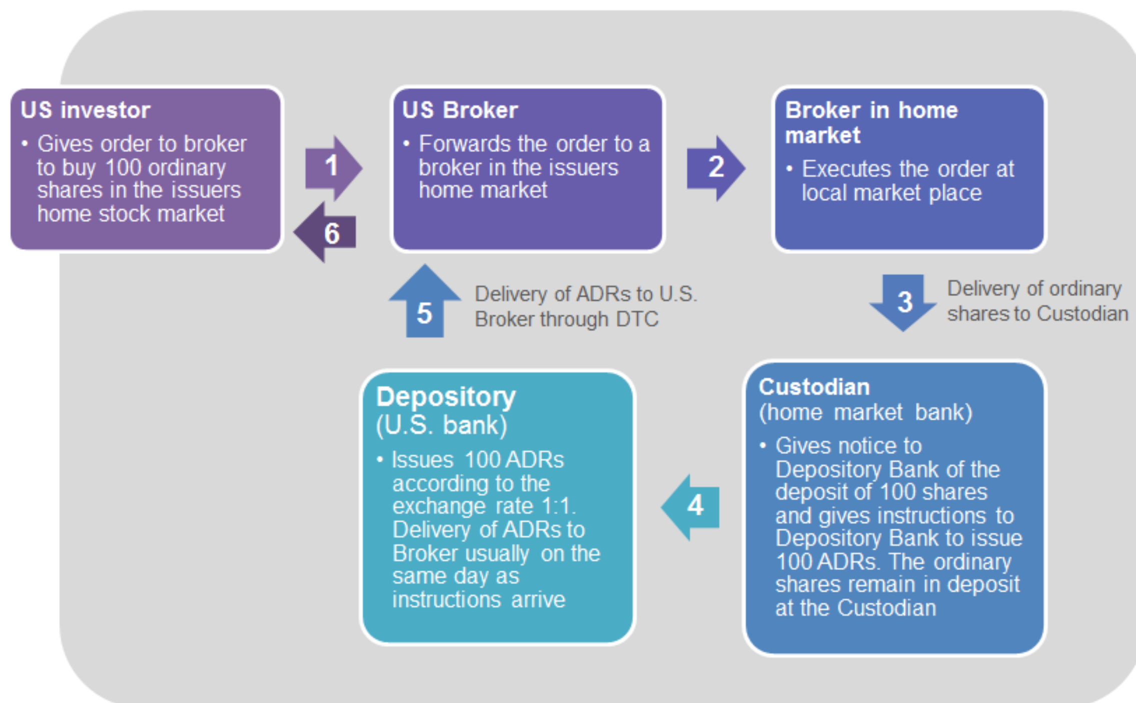
- Swedish companies with Level I ADRs
- Norwegian companies with Level I ADRs
- Danish companies with Level I ADRs
- Finnish companies with Level I ADRs

The Level I ADRs are traded on the over-the-counter (OTC) market, i.e. not directly on 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 stock broker to acquire the ADRs rather than providing direct access for the purchaser as would be the normal procedure on a stock exchange.

Level I ADRs can be either "sponsored" or "unsponsored". Unsponsored ADRs are ADRs where the depository bank, without the involvement or consent of the company, issues ADRs meaning the company has no control over them.

The reason for issuing Level I ADRs is often lower costs and requirements and avoidance of the risk of expensive litigations under US securities laws, or at least it was thought so until recently. The Level II and III ADRs require companies to fulfill all registration and reporting requirements imposed by the SEC such as a 20-F and an F-6. Such ADRs are usually traded directly on a major US stock exchange such as Nasdaq or NYSE. Level III ADRs also provide companies with the possibility to raise capital through a public offering in the US.



The Toshiba case

Toshiba is a Japanese company listed in Tokyo and Nagoya and with unsponsored Level I ADRs traded on the OTC market. In 2015, Toshiba was targeted by a securities class action in the Central District Court of California (the District Court) for alleged false and misleading financial statements between 2012 and 2015. The allegations led to a significant stock price dip, the resignation of nine executives, including, the CEO and a fine of $60 million imposed by Japanese securities regulators. Toshiba filed a motion to dismiss arguing that the US securities laws do not apply to the OTC transactions in Toshiba's ADR's and in 2016 the District Court granted the motion to dismiss. This was based on two important pillars:

1) The OTC market is not a national exchange.
2) There was no transaction in the US between Toshiba and the plaintiffs.

The distinction between ADRs and common stock was critical to the District Courts dismissal.

However, the US Court of Appeals for the Ninth Circuit reversed the decision of the District Court and determined that the ADRs in fact were transacted in the US and that irrevocable liability could in fact have been incurred which is an important aspect from other rulings such as the *Morrison* ruling and the Absolute Activist Investor case. The Appeal Court argued, contrary to the *Morrison* and the Absolute Activist Investor ruling, that the ADRs were purchased in the US, that the plaintiffs were US companies located in the US, that the OTC platform on which the ADRs were traded was located in the US and that the depositary banks that provided the ADR trading was located in the US. The Appeal Court also determined that ADRs are included in the definition of security, especially as a stock, under the Exchange Act.

Toshiba had argued that the Exchange Act should not apply to its ADRs because these were unsponsored. The Appeal Court dismissed this argument; however, the court asked the plaintiffs to clearly state the allegations establishing Toshiba's connection to the ADR transactions which had been vaguely stated in the complaint. Furthermore, the Appeal Court allowed the plaintiffs to amend their

complaint to show that there had been a domestic violation of the Exchange Act.

Toshiba is waiting to see if the US Supreme Court's will grant review although it may take several months for the Supreme Court to consider whether to review the case or not. If the Supreme Court agrees to review the Appeal Court's decision, a final decision may not come until 2020. If the Supreme Court rejects the appeal, the case will be remanded to the District Court, and the indecision between the District Court and the Ninth Circuit Court will remain unresolved for now. Before there is a final decision, non-US companies may face an increased risk of claims brought by ADR holders under at least unsponsored programs in US District Courts, particularly those under the jurisdiction of the US Court of Appeals for the Ninth Circuit.

There is no guarantee that plaintiffs in the Toshiba case will eventually prevail, however, the case shows that even a foreign company with only Level I ADRs may still be subject to US laws if the pleadings show the misconduct was in connection with the purchase or sale in the US. Non-US entities dealing with any type of security that might possibly be bought in the US would thus benefit from paying close attention to how the legal landscape develops. For now, there seems to be an opening for ADR holders to recover some losses and not get dismissed as per the *Morrison* ruling, at least according to the US Court of Appeals for the Ninth Circuit.

In the Nordics

It was recently reported in the news that Danske Bank, holding sponsored level I ADR's, is getting prepared for a securities class action in the US.

The plaintiffs are investors that traded Danske Bank's sponsored ADRs between 2014 and 2018. The proposed complaint alleges that the bank has violated federal securities laws in connection with its ongoing $230 billion money laundering investigation in the Baltics. The proposed complaint alleges that Danske Bank made false and misleading statements and failed to disclose that the bank's internal controls related to anti-money-laundering were weak, that the anti-money-laundering operations did not comply with applicable laws and that the board of directors in the bank failed to monitor and address these issues.

The ADR price of Danske Bank dropped almost 50% between February and October 2018 causing a significant loss to ADR holders. One significant difference between the Danske Bank case and the Toshiba case is that Danske Bank, as it has sponsored ADRs, has explicitly asked U S depository banks to issue the ADRs and has thus been collaborating with these banks. One of the main points in recent filings have been the discussions around if the issuers have been involved in setting the ADRs up and in sponsored programs such involvement and consent have been provided. It remains to be seen if Danske Bank will file a motion to dismiss and whether that motion will be dismissed or not.

We have seen an increase in sponsored ADR level I claims during the last couple of years. The judges come to different conclusions based on the circumstances of the specific case. The last couple of years both *Volkswagen* and *Damiler* have been ruled by judges to be subject to US securities laws while others have been successful in their motion to dismiss.

US securities laws apply to transactions in “securities listed on domestic exchanges” or “domestic transactions in other securities”. The two sets of transaction requirements described in the *Morrison* ruling are generally referred to as *Morrison's* first and second prongs. The defendants focus on these two prongs to argue that the OTC transactions in which the investor plaintiffs acquired their ADRs do not satisfy either of *Morrison*'s two prongs. With respect to the first prong the defendants argue that an OTC market, in which Level I ADRs are traded, is not a domestic exchange and with respect to the second prong the defendants argue that it's not a domestic transaction since the shares are listed outside the US.

We have seen several cases where foreign companies with Level I ADRs in the US try to find a settlement as soon as possible, in order to avoid the costs and complexity in connection with US securities class actions. 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 be subject to US securities laws. **It's important for underwriters, clients and brokers to put emphasis on the recent activities in the US and take the necessary precautionary actions.**

The renewed focus on D&O insurance

As a market leader on D&O insurance, we often see the overall trends developing and have the ability to act accordingly.

With our leading position we have great experience defending the directors and officers against US claims, regardless of the complexity and size. With the general increase in claims against companies with ADRs trading OTC, and the new risk of US jurisdiction for companies with unsponsored ADR programs, the need for experienced D&O claims handling is more important than ever.

AIG has extensive experience from handling US claims and have handled over 100 securities class actions during the last couple of years. Our extensive panel of law firms in the US, with expertise in handling different type of D&O claims, is at service to our clients. It is vital to have experienced defense counsels with strong knowledge of US law when defending these types of claims.

Whereas D&O insurance occasionally has been seen as a commodity product in recent years, the risk of large and complex personal lawsuits in the US, for non US issuers, is expected to change the view on D&O insurance.

Going forward we expect to see much more emphasis on the actual experience of the D&O insurer to defend the insureds in these types of claims compared to recent years focus on coverage and premium negotiations**, taking D&O insurance back to the core of its purpose**.

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