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EXTRATERRITORIAL BOUNDARIES OF FEDERAL SECURITIES LAW

Bersch v. Drexel Firestone, Inc.

IIT v. Vencap, Ltd.

Unusually complex jurisdictional issues arise when a securities transaction involves conduct in several countries, foreign purchasers or sellers, or the securities of issuers not incorporated in the United States.¹ In determining whether a given transaction falls within the intended scope of federal securities law,² courts have focused upon the transaction's relation to American investors, domestic securities markets, and interstate commerce,³ thereby narrowing the inquiry traditionally allowed by general principles of international jurisdiction.⁴ Accordingly, among the factors consid-

¹ For discussions of cases involving extraterritorial application of securities law, see 3 A. BROMBERG, *SECURITIES LAW FRAUD: SEC RULE 10b-5* § 11.2(570), at 246.11 (1974); Mizrack, *Recent Developments in the Extraterritorial Application of Section 10(b) of the Securities and [sic] Exchange Act of 1934*, 30 BUS. LAW. 367 (1975); Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 COLUM. L. REV. 94 (1969); Note, *American Adjudication of Transnational Securities Fraud*, 89 HARV. L. REV. 553 (1976) [hereinafter cited as *American Adjudication*]; Comment, *The Transnational Reach of Rule 10b-5*, 121 U. PA. L. REV. 1363 (1973).

² The early approach of American courts was to presume that laws had no extraterritorial application absent clear congressional intent to the contrary. *American Banana Co. v. United Fruit Co.*, 213 U.S. 347, 357 (1909). Under more modern principles, however, a court's finding that the consequences of extraterritorial conduct fall within the intended scope of the congressional regulation in question is sufficient to rebut such a presumption. See, e.g., *Steele v. Bulova Watch Co.*, 344 U.S. 280 (1952) (Lanham Trade-Mark Act of 1946); *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972) (securities law); *United States v. Watchmakers of Switzerland Info. Center, Inc.*, 1963 Trade Cas. 77,414, 77,456-57 (S.D.N.Y.) (Sherman Anti-Trust Act).

³ The purpose of federal securities law is to regulate transactions "affected with a national public interest" in order to provide fair and honest markets and protect interstate commerce. Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1970), as amended, (Supp. IV, 1974). When confronted with alleged extraterritorial violations of securities law, courts will therefore search for a relationship between the transaction and American stock exchanges, interstate commerce, or American investors.

In *Investment Props. Int'l, Ltd. v. I.O.S., Ltd.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,011 (S.D.N.Y. 1971), the court refused to take jurisdiction over a claim, brought by a foreign corporation against its parent, arising out of a transaction which was substantially foreign and had no domestic impact. Although there were some American shareholders in the plaintiff corporation, none came forward to allege any injury. *Id.* at 90,726. See also *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 515-17 (1974), in which a narrowly divided Court held that an arbitration clause in a contract negotiated in foreign countries, and concerning the sale of business enterprises whose activities were directed to foreign commercial markets, precluded application of federal securities law.

⁴ The foundation of a nation's jurisdiction is its sovereign power to prescribe rules of conduct within its territory, no matter where the effects of such conduct occur. RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 17 (1965) [hereinafter cited as RESTATEMENT (SECOND)]. A nation may similarly regulate conduct beyond its borders when such conduct has direct and foreseeable consequences within its territory. *Id.* § 18(b)(ii). Jurisdiction also extends to the conduct of a country's nationals anywhere in the world. *Id.* § 30. Based upon this principle, the acts or conduct of foreign corporations owned or controlled by American nationals may be regulated by the United States. *Id.* § 27,

ered are the nationality of the plaintiff,⁵ the losses allegedly suffered by American investors,⁶ the nature of the specific conduct within the United States,⁷ and whether the stock is registered on a domestic securities exchange.⁸

In *Bersch v. Drexel Firestone, Inc.*⁹ and *IIT v. Vencap, Ltd.*¹⁰ the Second Circuit considered the evolving prerequisites for subject matter jurisdiction in actions arising out of substantially foreign transactions.¹¹ The principal significance of these decisions lies in

comment *d*. In the absence of explicit congressional direction, these notions define the outer limits of a federal statute's extraterritorial application. *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972).

In some instances, however, the judiciary has refused to apply congressional regulation to the fullest extent permitted by international law. The Second Circuit, in particular, has exercised such restraint with respect to federal securities law. *See, e.g., id.*, wherein the then Chief Judge Friendly noted that

the language of § 10(b) of the Securities Exchange Act is much too inconclusive to lead us to believe that Congress meant to impose rules governing conduct throughout the world in every instance where an American company bought or sold a security.

Id. at 1334. Thus, a mere finding that the seller is an American national, or that an American purchaser has been adversely affected, will not automatically bring the transaction within the ambit of federal securities law. *See also* *Investment Props. Int'l, Ltd. v. I.O.S., Ltd.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,011 (S.D.N.Y. 1971).

⁵ *See, e.g.,* *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972). When securities actions seeking damages have been initiated by resident American plaintiffs, courts have had comparatively little difficulty in finding a sufficient connection with the intended scope of federal securities law. In actions by foreign citizens or corporations, however, courts have generally demanded a more substantial nexus with the interests of the United States. *Compare* *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515 (8th Cir. 1973) *with* *Investment Props. Int'l, Ltd.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,011, at 90,735 (S.D.N.Y. 1971).

⁶ *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208-09, *rev'd on rehearing on other grounds*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). In *Schoenbaum*, a stockholder's derivative action brought by an American plaintiff, the court extended jurisdiction to a claim arising out of a securities transaction between two Canadian corporations, one of which had shares traded on the American Stock Exchange. The impairment of American shareholders' equity in domestically registered stock, caused by fraudulent foreign transactions, was held to have a sufficiently serious and foreseeable effect on United States commerce to warrant the court's assumption of jurisdiction. *But see* *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972), where the court suggested that mere losses by American investors, without conduct, registration, purchase, or sale in the United States, would not bring the transaction within the scope of federal securities law.

⁷ *See, e.g.,* *Garner v. Pearson*, 374 F. Supp. 591, 599 (M.D. Fla. 1974) (jurisdiction based on three securities transactions occurring in Florida which were part of overall scheme to deplete foreign bank's assets); *Wandschneider v. Industrial Incomes, Inc.*, of North America, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,422 (S.D.N.Y. 1972) (jurisdiction based on domestic conduct consisting of devising fraudulent scheme and preparing fraudulent prospectus for sale abroad).

⁸ *See, e.g.,* *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206, *rev'd on rehearing on other grounds*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); *Madonick v. Denison Mines Ltd.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,550 (S.D.N.Y. 1974).

⁹ 519 F.2d 974 (2d Cir.), *cert. denied*, 96 S. Ct. 453 (1975).

¹⁰ 519 F.2d 1001 (2d Cir. 1975).

¹¹ No precise definition can be given which will clearly differentiate between a substantially domestic and substantially foreign transaction. In *Scherk v. Alberto-Culver Co.*, 417

the development therein of distinct standards — determined by the nationality and residence of the plaintiff — to be utilized in evaluating the nature and degree of domestic conduct required as a predicate for subject matter jurisdiction.¹² More particularly, the Second Circuit held that a foreign plaintiff must demonstrate that his losses were “directly caused” by fraudulent conduct within the United States.¹³ In contrast, an American plaintiff may invoke the court’s jurisdiction “whether or not [conduct] of material importance occurred in this country”¹⁴ For Americans residing abroad, the court, imposing an intermediate standard, ruled that such nonresidents must show that domestic conduct “significantly contributed” to their losses.¹⁵

The *Bersch* action was brought by an American plaintiff on behalf of a class of predominantly foreign investors¹⁶ and sought damages against a foreign corporation¹⁷ and its underwriters¹⁸ and

U.S. 506 (1974), the Supreme Court described the contract in question as a “truly international agreement” since it had been negotiated in several countries (including the United States) and was concerned with the purchase of a business enterprise directed at foreign commercial markets. *Id.* at 515. In a vigorous dissent, Justice Douglas described “the international aura” which the Court gave the contract as “ominous,” *id.* at 533 (Douglas, J., dissenting), and voiced the fear that the Court was denying protection to investors in multinational corporations with global spheres of operation. When “sufficient [domestic] contacts” exist, Justice Douglas continued, our securities laws should be applied. *Id.* at 534. Although *Scherk* is the only Supreme Court case to deal with the extraterritorial reach of federal securities law, its application may be quite limited since the purchase contract there involved contained an agreement to arbitrate any disputes before the International Chamber of Commerce in Paris. Notably absent from both the *Bersch* and *IIT* opinions was any mention of the *Scherk* decision.

¹² 519 F.2d at 993; *id.* at 1018.

¹³ *Id.* at 993; *accord, id.* at 1018. The presence of significant American shareholder participation in a foreign corporate plaintiff will usually be persuasive in a court’s evaluation of the jurisdictional question. Compare *Garner v. Pearson*, 374 F. Supp. 591, 599 (M.D. Fla. 1974) (court assumed jurisdiction where 50% of all corporate investment generated by American residents) with *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1016-17 (2d Cir. 1975) (0.2% American shareholder participation did not constitute sufficient impact upon American interests to warrant court’s assumption of jurisdiction).

¹⁴ *Bersch*, 519 F.2d at 993. While the exact nature of the domestic conduct, if any, which will be required by the Second Circuit where American residents are plaintiffs is unclear, it is unlikely that the court intended to permit the assumption of jurisdiction based solely on the fact that the plaintiff is a resident. See *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972), *quoted in note 4 supra*. In any case, other considerations such as the registration of the securities, the foreseeability of the plaintiff’s losses, and the nationality of the defendant will presumably still be relevant.

¹⁵ *Bersch*, 519 F.2d at 993. Clearly, more of a demonstration that the transaction was involved with the domestic community will be required of nonresident than of resident American plaintiffs.

¹⁶ The vast majority of the sales in question in *Bersch* were made to citizens of Canada, Australia, England, France, Germany, Switzerland, and other countries in Europe, Asia, Africa, and South America. *Id.* at 978.

¹⁷ The defendant foreign corporation was I.O.S., Ltd. (IOS), the issuer of the securities involved in the challenged transactions. Drexel Firestone, Inc., the first-named defendant, was one of the corporation’s underwriters.

¹⁸ Six banking houses, known as the “Drexel Group,” underwrote one of three related

accountants.¹⁹ Defendants had been involved in three related international public offerings²⁰ of stock in I.O.S., Ltd. (IOS).²¹ Whereas the defendants' conduct within this country was preparatory in nature and concerned the initial organization and coordination of the offerings,²² the vast majority of sales and misrepresentations were made outside the territorial boundaries of the United States.²³ Although the offerings were not directed to the United States investment public,²⁴ and of the estimated class of purchasers of 50,000, only 386 were Americans,²⁵ plaintiff alleged that defen-

public offerings of IOS. See note 20 *infra*. Of the six banks, two were American and four were European. Subsidiaries of two of the European banks maintained offices in New York City, although both banks contended that their subsidiaries were in no way involved in the IOS offering. 519 F.2d at 979-80 n.9. The other two offerings of IOS were underwritten individually, one by a Canadian investment house and the other by a Bahamian bank, a subsidiary of IOS. *Id.* at 980.

The action against the Canadian underwriter was dismissed for lack of in personam jurisdiction. *Id.* at 998-1000. The court held that: (1) the underwriter lacked sufficient contacts with the United States to be considered "doing business" here; (2) its acts in the United States with regard to the IOS underwriting, two short meetings in which no decisions were made, were insufficient to confer jurisdiction; and (3) its connection with the two other offerings in which the American plaintiffs purchased their stock was insufficient to be considered a cause of the plaintiffs' losses. *Id.*

¹⁹ The accountants were described as "an international accounting firm with its principal office in the United States." *Id.* at 980. In failing to discuss the relevance of the American citizenship of some of the accountants and underwriters, the court impliedly rejected the concept of a defendant's nationality as a basis for extending the subject matter jurisdiction of securities law. See note 4 *supra*. *But cf.* *Finch v. Marathon Sec. Corp.*, 316 F. Supp. 1345, 1347 (S.D.N.Y. 1970); *SEC v. Gulf Intercontinental Fin. Corp.*, 223 F. Supp. 987, 995 (S.D. Fla. 1963), wherein both district courts, in deciding the jurisdictional question, placed some emphasis on determining the true nationality of the defendants by piercing the corporate veil.

²⁰ The three offerings were made at approximately the same time and at the same price, \$10 per share. Although the Canadian prospectus differed insofar as was necessary to comply with Canadian regulations, the three prospectuses were substantially identical; all three contained the IOS balance sheet and a report prepared by the defendant accountant. 519 F.2d at 980. The three underwritings were initially successful in that they were fully subscribed. Trading stabilized briefly at \$14 per share, but after several weeks collapsed below the \$10 level. Three weeks later the stock was unsaleable. *Id.* at 981.

²¹ IOS was an international financial service company, organized under Canadian law with its main office in Geneva, which controlled and managed a subsidiary complex of mutual funds. Prior to the public offerings, the stock of IOS and its subsidiaries was owned by its organizer, Bernard Cornfeld, also a defendant, and his employees. *Id.* at 978. Following the collapse, control of IOS passed into the hands of Robert L. Vesco, who, at the time of trial, was, as the court noted, "currently a resident of Costa Rica, and a defendant in a substantial number of actions for fraud pending in this circuit." *Id.* at 981. IOS is now in the hands of Canadian liquidators who are proceeding with the liquidation of IOS with the assistance of informal representatives of governments and regulatory agencies having authority over its interconnected subsidiaries. *Id.* at 978 n.4. For journalistic accounts of the IOS story see R. HUTCHISON, *VESCO* (1974); *BUS. WEEK*, Mar. 30, 1974, at 78-80; *BUS. WEEK*, July 7, 1973, at 32; *NEWSWEEK*, Dec. 11, 1972, at 85-86.

²² 519 F.2d at 985 n.24.

²³ *Id.* at 980.

²⁴ *Id.*

²⁵ Bersch brought the action in the name of all purchasers, foreign and domestic. *Id.* at 977-78 n.2.

dants were subject to, and had in fact violated, the antifraud provisions of the Securities Act of 1933²⁶ and the Securities Exchange Act of 1934.²⁷ The Second Circuit acknowledged its jurisdiction over the claims of the American plaintiffs,²⁸ but eliminated all foreign members from the class action on the ground that it lacked subject matter jurisdiction over their claims.²⁹

The *IIT* case was initiated by the liquidators of IIT,³⁰ an offshore mutual fund with, at most, 0.5 percent American investment participation,³¹ to recoup a \$3 million loss resulting from IIT's investment in Vencap, Ltd., a Bahamian corporation.³² Plaintiff alleged that Vencap's founder, Richard Pistell, had defrauded IIT in the initial investment agreement,³³ had improperly converted \$600,000 of Vencap funds to his own use,³⁴ and had wasted a substantial portion of Vencap's funds by investing approximately a third of its capital in other corporations under his control.³⁵ Although the oral agreement between Pistell and IIT was reached

²⁶ 15 U.S.C. §§ 77a *et seq.* (1970).

²⁷ *Id.* §§ 78a *et seq.*, as amended, (Supp. IV, 1974). While the court, in its opinion, did not specify which provisions of the securities Acts were allegedly violated, the complaint alleged that the underwriters misrepresented to the public that IOS was suitable for public ownership when they knew it was not, that the prospectuses failed to disclose illegal activities which had damaged IOS, that the books of IOS were in a chaotic condition, that the officers had "touted" the company's prospects, and that the accountant had not observed generally accepted accounting principles in preparing the financial statement. 519 F.2d at 981.

²⁸ 519 F.2d at 1001.

²⁹ *Id.*

³⁰ When the action was commenced, IIT, part of the IOS complex, was in the process of liquidation in Luxembourg. *Id.* at 1003. The liquidators' claim against Vencap was presumably for the benefit of IIT's creditors and shareholders.

³¹ *Id.* at 1016.

³² *Id.* at 1005.

³³ *Id.* at 1011-14. The agreement was decidedly favorable to Vencap. In return for its \$3 million investment, which would supply 99.9% of Vencap's capital, IIT received no vote at meetings of stockholders, no representation on the board of directors, and no current income unless declared by the board. The board, moreover, was to be elected solely by the common stockholders who had invested only \$4000. Pistell, who had invested \$2000, was president, chairman, and treasurer. In the event dividends were declared, IIT would receive a 6% noncumulative dividend plus a third of the earnings above that dividend, and the common shareholders, who had invested .1% of the capital, would receive two-thirds of the remaining earnings. *Id.* at 1011. Because the conditions were clearly disclosed to IIT, a sophisticated investor, the court held that such an agreement was not fraudulent. *Id.*

³⁴ Although there was conflicting evidence regarding the mechanics of Pistell's conversion, he succeeded in funneling \$600,000 of Vencap's investment capital, through another corporation which he controlled, into his own hands for the payment of income and property taxes, several bank loans, and a judgment against him. Vencap received only 7% interest and a small stock option in return. *Id.* at 1008-09. In connection with his employment with Vencap, Pistell received, in addition to his annual salary, a home in the Bahamas worth \$150,000, payments amounting to \$10,000 for alimony to his ex-wife, and \$2000 for the telephone bills of his present wife. *Id.* at 1009 & n.14.

³⁵ *Id.* at 1010. The *IIT* court noted that at the time of the hearing one of Pistell's investments in corporations under his control had an unrealized loss of approximately \$340,000. *Id.* at 1010 & n.16.

abroad,³⁶ and the confirmatory memorandum was prepared in the Bahamas, at least part of the stock purchase agreement was drafted by IIT's attorneys in New York.³⁷ Moreover, Vencap's business, including the alleged misuse of funds, was managed from a New York law office.³⁸ Since the fraudulent diversion of assets had taken place in the United States, the court here, in contrast to *Bersch*, extended jurisdiction to the foreign plaintiff.³⁹

In reaching its holdings in *Bersch* and *IIT*, the court first analyzed the effects within the United States of the various transactions in question to determine whether these effects might serve as a basis for jurisdiction under the 1933 and 1934 Acts.⁴⁰ The court examined a previous decision of the Second Circuit, *Schoenbaum v. Firstbrook*,⁴¹ wherein it was held that the impairment of American shareholder equity produced a sufficiently serious and foreseeable effect on United States commerce to warrant the assumption of jurisdiction over claims of all investors, both foreign and domestic.⁴² Applying this principle to the *IIT* case, the court determined that the effects on American economic interests were unsubstantial, since at most 0.2 percent of IIT's fundholders were American citizens whose contributions represented no more than 0.5 percent of the firm's total investment capital,⁴³ and concluded that adverse economic effects alone did not support a finding of subject matter jurisdiction over the claims asserted by the foreign liquidators of IIT.⁴⁴ In *Bersch*, however, the investment losses of the American members of the plaintiff class were considered sufficient to warrant

³⁶ *Id.* at 1005. Although the precise location of the oral agreement between IIT and Pistell was not ascertained by the court, no party contended that it had taken place in the United States. *Id.* at 1005 n.5.

³⁷ *Id.* at 1006. Much of the evidence indicated that the substance of the purchase agreement was prepared in the Bahamas. No conclusive determination of this fact was possible from the record, however, since none of IIT's lawyers had testified in the district court. *Id.*

³⁸ "The [district] court found that '[l]iterally hundreds of transactions and pieces of mail for Vencap . . . were initiated, directed and consummated from [the New York office of Vencap's lawyers]" *Id.* at 1018.

³⁹ The *IIT* court stated:

Our ruling on this basis of jurisdiction is limited to the perpetration of fraudulent acts themselves and does not extend to mere preparatory activities or the failure to prevent fraudulent acts where the bulk of the activity was performed in foreign countries such as in *Bersch*.

Id.

⁴⁰ *Bersch*, *id.* at 987-90; *IIT*, *id.* at 1016-17.

⁴¹ 405 F.2d 200, *rev'd on rehearing on other grounds*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969), *discussed in* note 6 *supra*.

⁴² 405 F.2d at 208-09.

⁴³ 519 F.2d at 1016-17.

⁴⁴ *Id.* at 1017. The *IIT* court did, however, recognize the existence of jurisdiction based on other grounds. See text accompanying notes 38-39 *supra*.

the exercise of jurisdiction over their individual claims.⁴⁵ Nevertheless, the court was unwilling to use the effects on a small number of Americans as a basis for extending jurisdiction to the claims of the 50,000 foreign members of that class.⁴⁶

The plaintiffs in *Bersch* had also alleged that the collapse of the IOS public offering had *general* adverse effects within the United States,⁴⁷ including destruction of investor confidence, decrease of foreign investment, and the consequent upset of America's balance of payments.⁴⁸ While the court did not doubt the negative impact of the IOS collapse on the domestic economy, it concluded that such generalized effects would not sustain a finding of subject matter jurisdiction over a federal securities law damage suit brought by foreigners.⁴⁹ Although the generalized effects argument finds some support in section 2 of the 1934 Act, which provides for regulation necessary to protect the "national public interest,"⁵⁰ the court's requirement that the plaintiff demonstrate a more specific domestic injury in a private suit for damages appears to be the stronger approach. As the *Bersch* court noted, there may be agreements beyond the nation's borders which, although not intended to have any domestic impact, have definite economic repercussions here.⁵¹ Attempts by Congress to regulate all such international transactions would go beyond the principles of international justice.⁵²

⁴⁵ 519 F.2d at 989, 993.

⁴⁶ *Id.* at 996.

⁴⁷ *Id.* at 987-89. Plaintiffs in *Bersch* relied upon an affidavit of a professor at the Wharton School of Finance and Commerce of the University of Pennsylvania to support the allegation of *general* adverse effects.

⁴⁸ *Id.*

⁴⁹ As the *Bersch* court noted, activity outside the boundaries of the United States does not support subject matter jurisdiction if there was no intention that the securities should be offered to anyone in the United States, simply because in the long run there was an adverse effect on this country's general economic interests or on American security prices.

Id. at 989.

⁵⁰ 15 U.S.C. § 78b (1970), *as amended*, (Supp. IV, 1974).

⁵¹ 519 F.2d at 989 n.33.

⁵² RESTATEMENT (SECOND), *supra* note 4, § 18(b)(iii) provides that only effects which are direct and foreseeable may serve as a basis for subject matter jurisdiction. The *Bersch* court expressed concern over the international complications which could result from a contrary finding. 519 F.2d at 989 n.33. In addition, the court observed that the antifraud provisions of the 1933 and 1934 Acts refer to acts in connection with the "offer or sale," Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1970), or "purchase or sale," Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1970), of any security. This led the court to conclude that, as opposed to general adverse effects, there must be an injury to a purchaser or seller in whom the United States has a protective interest. 519 F.2d at 989. Regarding an analogous situation concerning the extraterritorial application of the Lanham Trade-Mark Act of 1946, the *Bersch* court noted that in *Steele v. Bulova Watch Co.*, 344 U.S. 280 (1952), the use of the Bulova name on watches assembled in Mexico was deemed an actionable violation because it had a direct and foreseeable effect on Bulova's watch business in Texas and not because it gave the American watch business a "bad name." 519 F.2d at 989 n.35.

Were this the extent of the Second Circuit's analysis, the foreign plaintiffs in both *Bersch* and *IIT* would have been precluded from obtaining the protection of American securities law. The panel was convinced, however, that Congress never intended "to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners."⁵³ Hence, the court considered, as an alternative jurisdictional nexus, the *nature* of the defendants' domestic conduct. It reasoned that foreign plaintiffs,⁵⁴ not being within the explicit framework of the statutes' protection,⁵⁵ must be able to show that conduct occurring within the United States was the direct cause of their injury.⁵⁶ In the case of nonresident American plaintiffs, however, mere preparatory conduct was held to be a sufficient jurisdictional predicate as long as it substantially contributed to their losses.⁵⁷ While the standards enunciated by the court appear to draw a workable distinction between the types of conduct required in cases involving nonresident American plaintiffs and those involving foreign plaintiffs, they may be difficult to apply or to justify when the preparatory conduct is indispensable to the consummation of the entire transaction.⁵⁸

Both *IIT* and *Bersch* contained examples of what the Second Circuit categorized as preparatory conduct. In *Bersch*, representatives of IOS met in New York with its underwriters, legal representatives, and accountants on numerous occasions to initiate and structure the offerings.⁵⁹ Other preparatory conduct, also in New York, included a meeting between the underwriters and the Securities Exchange Commission, preliminary discussions concerning underwriting commissions, and the performance of various accounting functions. Moreover, sections of the prospectus were

⁵³ *Bersch*, 519 F.2d at 1017.

⁵⁴ Presumably, the court did not intend to draw a distinction between Americans and foreigners in the domestic setting since domestic distinctions based on alienage are constitutionally suspect. See *Graham v. Richardson*, 403 U.S. 365 (1971). One commentator asserts that even in the international setting such a distinction cannot be harmonized with American treaty commitments or international legal norms. *American Adjudication*, *supra* note 1, at 569 & nn.95 & 96.

⁵⁵ While the court acknowledged that Congress did not expressly consider the extraterritorial application of the securities Acts, see text accompanying note 85 *infra*, the court construed the purchaser-seller requirements in the 1933 and 1934 Acts to encompass only those parties "in whom the United States has an interest . . ." *Bersch*, 519 F.2d at 989.

⁵⁶ 519 F.2d at 992-93; *IIT*, *id.* at 1018.

⁵⁷ *Bersch*, *id.* at 993.

⁵⁸ The difficulty in application of the Second Circuit's test has indeed already been suggested by one student author. See *American Adjudication*, *supra* note 1, at 570-71.

⁵⁹ 519 F.2d at 985 n.24.

drafted in New York and conveyed via telephone to Geneva.⁶⁰ In *IIT*, the domestic preparatory conduct consisted primarily of drafting portions of a purchase contract which had been orally agreed upon in London and was eventually signed in the Bahamas.⁶¹ It would appear that the domestic preparatory activity in *Bersch* had far greater qualitative and quantitative impact upon the entire transaction than the domestic preparatory activity in *IIT*. Whereas the domestic preparatory conduct in *IIT* was essentially the drafting of a written agreement which had been fully negotiated elsewhere, the domestic preparatory conduct in *Bersch* involved organizational activity without which the transaction may never have occurred. Thus, even the factual circumstances considered by the Second Circuit suggest that the preparatory activity, itself, may, or may not, be directly causative.

Other decisions, apparently mindful of the factual complexity present in multinational securities cases, have avoided the establishment of so rigid a distinction between causative and preparatory acts. In *Leasco Data Processing Equipment Corp. v. Maxwell*,⁶² an earlier Second Circuit decision, the court held the question of where the "critical misrepresentations"⁶³ took place not to be decisive since it was "impossible to say that conduct in the United States was not 'an essential link' . . . in inducing Leasco to make the open-market purchases . . ."⁶⁴ Similarly, in *SEC v. United Financial Group, Inc.*,⁶⁵ the Ninth Circuit relied upon the "substantial activities . . . carried on by [the defendants] in the United States in order to facilitate the sales of securities abroad"⁶⁶ to sustain its

⁶⁰ *Id.* Some courts would take the position that the transmission to Geneva, by telephone, of portions of a fraudulent prospectus, a clear use of an instrumentality of interstate commerce, should be held an actionable violation of the 1934 Act regardless of the nationality of the plaintiff. See *SEC v. Gulf Intercontinental Fin. Corp.*, 223 F. Supp. 987 (S.D. Fla. 1963), discussed in notes 68-69 and accompanying text *infra*.

⁶¹ 519 F.2d at 1005-07.

⁶² 468 F.2d 1326 (2d Cir. 1972).

⁶³ *Id.* at 1334.

⁶⁴ *Id.* at 1335 (citation omitted). Initial misrepresentations were made in the United States to Leasco, a domestic corporation, in the course of attempts to form a joint venture which never materialized. More extensive negotiation concerning a tender offer, as well as the eventual open market purchase, took place in London. Although the court expressed doubt about extending jurisdiction where no fraud had been "practiced" in the United States, *id.* at 1334, its analysis suggests a broader approach. See *id.* at 1335.

⁶⁵ 474 F.2d 354 (9th Cir. 1973).

⁶⁶ *Id.* at 358. The defendants' domestic conduct consisted of the management and control of offshore mutual funds through a domestic corporation and the use of the mails to facilitate sales of the funds. The court was not persuaded by the defendants' argument that jurisdiction should be declined because of the small number of American investors involved. *Id.* at 356-57.

finding that the court had subject matter jurisdiction.⁶⁷ And, in *SEC v. Gulf Intercontinental Finance Corp.*,⁶⁸ a Florida district court said in dicta that any scheme which employed the mails or other interstate facilities, directly or indirectly, would be within the subject matter jurisdiction of the court.⁶⁹

Another approach to the jurisdictional question, which has been adopted by the American Law Institute (ALI) in its Proposed Federal Securities Code,⁷⁰ is to examine whether the domestic conduct is a "substantial constituent element" of the entire transaction.⁷¹ Section 1604(a)(1)(D)(i) of the proposed code would extend jurisdiction to extraterritorial transactions "whose constituent elements occur to a substantial (but not necessarily predominant) extent within the United States."⁷² Of course, the "substantial constituent elements" test is not without its own definitional problems. The ALI never fully defines "substantial constituent elements." It is pointed out in a note to the section, however, that constituent elements are "not limited to acts essential to the establishment of the prohibited, required or actionable conduct."⁷³ Presumably

⁶⁷ *Id.* at 358.

⁶⁸ 223 F. Supp. 987 (S.D. Fla. 1963). In *Gulf Intercontinental* the SEC sought, *inter alia*, an injunction against Florida citizens who had created a Canadian corporation in order to raise money by the issuance of notes advertised in Canadian newspapers.

⁶⁹ *Id.* at 995. The *Gulf Intercontinental* court based jurisdiction on the filtering back of Canadian newspaper advertisements to the United States notwithstanding the fact that no showing was made of any reliance on, or acceptance of, the offers. *Id.* at 994-95. The "use of interstate commerce facilities" theory encompassed by rule 10b-5, 17 C.F.R. § 240.10b-5 (1975), and to which the court referred in dicta, is based upon the plenary power of Congress to keep interstate commerce free from fraud, however incidental the use, and is generally recognized as a sufficient basis for jurisdiction over claims arising from domestic transactions which are clearly within the scope of the Acts. 3 A. BROMBERG, SECURITIES LAW FRAUD: SEC RULE 10b-5 § 11.2, at 245 (1974). The Florida district court, however, also noted that there was "nothing within the Acts in question which would appear to limit the protection offered by [the antifraud provisions] to residents of the United States." 223 F. Supp. at 995.

Other courts have been reluctant to reach such a sweeping conclusion where foreign transactions and purchasers are involved. *See, e.g.*, *SEC v. United Financial Group, Inc.*, 474 F.2d 354, 357 (9th Cir. 1973). This reluctance may flow from the fact that such transactions are not clearly within the Acts' intended scope. The Second Circuit, rejecting the type of approach suggested in *Gulf Intercontinental*, has answered the jurisdictional question with a two-step analysis. The court will first inquire whether there is subject matter jurisdiction over the transaction and then look into whether there has been sufficient use of interstate commerce to trigger application of the antifraud provisions. *Schoenbaum v. Firstbrook*, 405 F.2d 200, 210 (2d Cir. 1968).

⁷⁰ ALI PROPOSED FED. SECURITIES CODE (Reporter's Revisions of Text of Tent. Drafts Nos. 1-3, 1974) [hereinafter cited as ALI CODE]. Of course, the ALI proposal focuses on its view of what the law should be. But on a question such as this, devoid of real congressional consideration, the courts might be wise to give strong weight to the opinion of the Institute, since it has considered the problem in depth.

⁷¹ *Id.* § 1604(a)(1)(D)(i).

⁷² *Id.*

⁷³ *Id.*, note at 233.

then, the fact that the misrepresentation and reliance, essential elements of a traditional fraud action,⁷⁴ took place outside the United States would not be decisive where a substantial number of conceivably "constituent elements," such as organizational meetings and the preparation of prospectuses and the financial statements contained therein, took place within the jurisdiction.⁷⁵ A determination that there was a jurisdictional nexus to support the claims of the foreign plaintiffs in *Bersch* might therefore be possible under the ALI test even though the prospectus emanated from foreign countries and the bulk of activities occurred abroad. Finding that the preparatory acts there involved constituted a "substantial" portion of the constituent elements might still be problematic, however, in view of the *Bersch* court's observation that foreign conduct outweighed the domestic preparatory activity.⁷⁶

Equally troublesome to the Second Circuit was the procedural posture of the foreign purchasers' claims in *Bersch*. Presentation of the claims through the use of the class action device⁷⁷ created a serious problem, in the court's opinion, because of "the dubious binding effect of a defendants' judgment (or a possibly inadequate plaintiff's judgment) on absent foreign plaintiffs . . ."⁷⁸ An attempt by either party to obtain recognition of the *Bersch* judgment as a final adjudication on the merits in any subsequent foreign litigation could open a Pandora's box of jurisdictional attacks. As

⁷⁴ *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-64 (2d Cir.), cert. denied, 382 U.S. 811 (1965). In a securities fraud, a misrepresentation may take several forms, including, but not limited to, the distribution of a deceptive prospectus. The actual purchase of securities made in response to information contained in the prospectus constitutes the reliance element of the fraud.

⁷⁵ Cf. ALI CODE, *supra* note 70, § 1604(a)(2), which states, in part, that offers to buy or sell extended outside the United States would be actionable if initiated in the United States.

⁷⁶ 519 F.2d at 987.

⁷⁷ FED. R. CIV. P. 23. Before a plaintiff can maintain the type of class action employed in *Bersch*, the court must find that such an action is "superior to other available methods for the fair and efficient adjudication of the controversy." *Id.* 23(b)(3). See also CLASS ACTIONS §§ 2.62-70 (Ill. Inst. for C.L.E., 1974). The *Bersch* court noted that 395 claimants of 22 nationalities, including 18 Americans, had intervened in a Swiss proceeding against Bernard Cornfeld, the founder of IOS, for damages resulting from their purchases. 519 F.2d at 997 n.49. Furthermore, IOS was in liquidation in Canada, presumably for the benefit of creditors and shareholders. 519 F.2d at 978. This indicates that alternate procedures were available and that certain claimants might desire to control their own actions. See CLASS ACTIONS, *supra*, §§ 2.63-64, 7.11.

The desirability of consolidating the litigation in one forum also becomes an issue when concurrent forums are available and is a matter for the court's discretion. *Id.* § 11.16. The court must consider questions of convenience, the connection of its own forum to the underlying controversy, and, in the international context, whether its views of the merits should prevail. Von Mehren & Trautmann, *Recognition of Foreign Adjudications: A Survey and a Suggested Approach*, 81 HARV. L. REV. 1601, 1603-04 (1968) [hereinafter cited as *Recognition*].

⁷⁸ 519 F.2d at 986.

has been observed in an article relied upon by the Second Circuit in *Bersch*,⁷⁹ "[o]ne universal requirement for recognition of a judgment [by a foreign tribunal] is that the rendering court have had adjudicatory jurisdiction."⁸⁰ The uncontested affidavits of the *Bersch* defendants indicated the "near certainty"⁸¹ that foreign courts would refuse to recognize a judgment purporting to bind foreign plaintiffs whose only connection with the forum was their purchase of stock in a multicontinental offering which involved preparatory activities in the United States and a few American purchasers.⁸² Indeed, the class action notice procedure utilized in *Bersch*, which requires a plaintiff to affirmatively opt out if he desires to avoid adjudication of his claim by an American tribunal,⁸³ might be found to be particularly objectionable in this regard.⁸⁴

The Second Circuit's holding that foreign investors do not come within the scheme of congressional securities protection unless they can show that a defendant's domestic conduct was the direct cause of their losses seems to be a pragmatic conclusion. The mere fact that some American investors are adversely affected by a multinational stock fraud should not lay a jurisdictional foundation for foreigners so affected where the volume of American investors is insignificant as compared to the total number of investors. In light of the dearth of actual legislative consideration the Second Circuit relied upon its own "best judgment as to what Congress would have wished if these problems had occurred to it,"⁸⁵ but

⁷⁹ *Recognition*, *supra* note 77, cited in *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 997 (2d Cir. 1975).

⁸⁰ *Recognition*, *supra* note 77, at 1610.

⁸¹ 519 F.2d at 996.

⁸² *Id.* at 996-97. Several other recognition problems may have a bearing on a case like *Bersch*. For example, bases for jurisdiction may differ among countries and courts may be faced with whether they will recognize a foreign judgment in which the jurisdictional basis asserted by the rendering court would not have been adequate for the recognizing court to have taken original jurisdiction. *Recognition*, *supra* note 77, at 1614. Findings of jurisdictional facts are generally reviewable in international practice, *id.* at 1624-29, and nonappearing parties in multiparty litigation may contest the appropriateness of basing jurisdiction on such factual findings even if they are upheld by the recognizing court. *Id.* at 1635. Choice of law problems may also present obstacles to recognition, particularly in civil law countries which stress the relationship of the forum to the underlying transaction as a basis for jurisdiction. Hypothetically, if a civil law court perceives that it had a stronger relationship with the controversy than did the rendering forum, and thus desires its policies to prevail, it might refuse to recognize the judgment. *Id.* at 1637.

⁸³ FED. R. CIV. P. 23(c)(2).

⁸⁴ The *Bersch* defendants' affidavits indicated that foreign courts might be more receptive to a judgment based upon an opt-in form of notice. 519 F.2d at 997 n.48. Such a procedure might assure greater fairness — a basic prerequisite for foreign recognition — in the court's decision to extend jurisdiction. *Recognition*, *supra* note 77, at 1610.

⁸⁵ *Bersch*, 519 F.2d at 993.

acknowledged that reasonable men might disagree with its interpretation. Designed to remove from the shoulders of the United States courts the burden of policing substantially foreign investment transactions, the direct causation test may indicate that diplomatic agreements will be necessary to protect the international investor from securities fraud.⁸⁶

Nevertheless, it is submitted that, faced with the prospect of freeing a guilty party, the Second Circuit should reexamine the direct causation test in the case of a complex scheme to defraud pursuant to which many constituent elements of the transaction coalesce to cause plaintiffs' injury. In *IIT*, this was not necessary since the fraudulent diversion of assets occurred within the United States. In *Bersch*, severe doubts concerning jurisdiction over absent foreign class plaintiffs militated against such a broad interpretation. Nonetheless, the principle of preventing fraudulent schemes from being exported from our shores is firmly rooted in case law⁸⁷ and falls within a rational interpretation of legislative intent. Hopefully, the courts will not permit the obstruction of such an admirable goal by conservative application of causation principles.

Charles Ferris

⁸⁶ There appears to be a trend toward increased regulation of securities in Europe, although in most cases such regulation is directed towards prescribing higher standards of conduct for securities dealers. See *American Adjudication*, *supra* note 1, at 565-66 & n.82.

⁸⁷ *SEC v. United Financial Group, Inc.*, 474 F.2d 354 (9th Cir. 1973); *Wandschneider v. Industrial Incomes, Inc., of North America*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,422 (S.D.N.Y. 1972); *SEC v. Gulf Intercontinental Fin. Corp.*, 223 F. Supp. 987 (S.D. Fla. 1963).