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Virginia Federal Court Finds Insufficient Connection Between Alleged Misstatements and Issuer of Unsponsored ADRs

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A federal district court in Virginia recently held that the federal securities laws can apply to transactions in a foreign issuer's unsponsored American Depositary Receipts ("ADRs") that traded over the counter in the United States. However, the court ruled that statements by the foreign issuer's U.S. subsidiary had not been sufficiently attributed to the foreign parent so that they could be deemed to have been made "in connection with" purchases of the parent's ADRs.

The decision in *In re Volkswagen AG Securities Litigation* (E.D. Va. Mar. 14, 2023) adds to the evolving jurisprudence on whether transactions in unsponsored, unlisted ADRs are subject to the federal securities laws or whether they should be deemed predominantly foreign because the ADRs depend on transactions in the underlying foreign shares and do not necessarily involve the foreign issuer's participation or consent. The court's pleading-stage ruling necessarily was based on the allegations in the complaint and did not foreclose future factual development that could affect the analysis.

Legal Background

For several decades before the Supreme Court's 2010 decision in *Morrison v. National Australia Bank*, courts had allowed securities plaintiffs to bring "extraterritorial" claims under the federal securities laws based on some version of the "conduct/effects" test. That test had examined whether significant wrongful *conduct* related to non-U.S. securities transactions had occurred in the United States or whether wrongful conduct outside the United States had had a substantial *effect* on U.S. markets or investors.

In 2010, the Supreme Court rejected the conduct/effects test and announced a new "transactional" test for determining the federal securities laws' reach. *Morrison* held that the securities laws apply only to alleged misstatements or omissions made "in connection with the purchase or sale of [*i*] a security listed on an American stock exchange, and [*ii*] the purchase or sale of any other security in the United States." One month later, Congress reinstated the conduct/effects test for the government, but not for private litigants.

In 2014, the Second Circuit added a gloss to *Morrison* and held in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings* that, even if a "domestic transaction" under *Morrison* took place, U.S.

securities laws still should not apply if the claims "are so predominantly foreign as to be impermissibly extraterritorial." But other courts have rejected that potential escape hatch and have ended the analysis upon finding a "domestic transaction."

The *Volkswagen* Decision

Case Background

The *Volkswagen* litigation arose from allegedly false statements by Volkswagen Group of America, Inc. ("VWA") – a wholly owned subsidiary of the German parent Volkswagen AG ("VW") – that it would be changing its name to "Voltswagen." The announcements, on March 29 and 30, 2021, allegedly were intended to draw attention to VWA's new electric SUV without having to incur the costs and risks associated with rebranding.

After the close of market on March 30, VWA withdrew the announcements and characterized the supposed name change as an April Fool's joke. But the price of VW ADRs had risen upon the announcements, and it fell after VWA retracted the name change. Securities litigation ensued.

The court held that plaintiffs had sufficiently pled that VWA had made material misstatements with the requisite degree of scienter. But the court dismissed the claims against VW, holding that plaintiffs had not adequately pled that VW had exercised sufficient control over its subsidiary's statements to be deemed the "maker" of those statements under Supreme Court precedent.

Perhaps the more interesting aspects of the decision involve the court's discussion of *Morrison* issues in the context of unsponsored, unlisted ADRs.

The Discussion of Morrison *Issues*

The court first held – and plaintiffs did not dispute – that over-the-counter ("OTC") transactions in unsponsored, unlisted ADRs do not constitute transactions in securities "listed" on an American "exchange" under *Morrison*'s first prong. The court thus joined many others in holding that the OTC market is not an "exchange" for *Morrison* purposes.

The court then turned to *Morrison*'s second prong, for domestic transactions in securities not listed on a U.S. exchange. The court adopted the Second Circuit's standard and held that a domestic transaction occurs if (*i*) "title to the shares was transferred within the United States," (*ii*) "the purchaser incurred irrevocable liability within the United States to take and pay for a security," or (*iii*) "the seller incurred irrevocable lability within the United States to deliver a security." The court ruled that plaintiffs had adequately pled domestic transactions: they allegedly had instructed their U.S.-based brokers to buy VW ADRs on the OTC market in New York, "thereby facilitating transfer of title in the United States."

Defendants argued that, even if the transactions were "domestic" under *Morrison*, they should not fall within the federal securities laws because were predominantly foreign. *Unsponsored* ADRs are receipts for underlying foreign shares traded on foreign exchanges, and they are issued by depositary banks with little or no involvement by – and perhaps even without the consent of – the foreign issuer. VW previously had had a *sponsored* ADR program with U.S. depositary banks, but it had terminated that program three years earlier in an effort to avoid subjecting itself to U.S. securities laws. The depositaries then continued to offer ADRs on an *unsponsored* basis, supposedly without VW's involvement.

The court refused to add the Second Circuit's "'predominately foreign' framework" to the widely used "irrevocable liability" standard for domestic transactions, holding that such an addition would "mudd[y] the 'clear test'" that the Supreme Court had sought to propound in *Morrison*. That ruling is consistent with those of several other courts, such as the First Circuit (in *SEC v. Morrone*) and the Ninth Circuit (in *Stoyas v. Toshiba*, which also involved unsponsored, unlisted ADRs).

However, the Virginia court did not end its analysis with its conclusion that the plaintiffs had pled a domestic transaction. Instead, it went on to consider whether defendants' arguments about the nature of unsponsored ADRs prevented plaintiffs from satisfying the Securities Exchange Act's requirement that a securities-fraud claim be "in connection with" the purchase or sale of a security – an issue the Ninth Circuit had flagged in the *Stoyas* case.

The court held that "the distinction between a sponsored and unsponsored ADR program impacts the degrees of separation between the ADR and the foreign issuer, which implicates the 'in connection with' analysis under § 10(b)" of the Exchange Act. The court acknowledged that "a foreign issuer need not have any contact with a depositary bank offering an unsponsored ADR program." But "[t]hat reality . . . does not preclude the possibility that Volkswagen, in this case, did approve of the unsponsored ADR program."

The court held that, for pleading purposes, plaintiffs had sufficiently alleged VW's connection to the unsponsored ADRs.

- Plaintiffs had "systematically describ[ed] the nature of the ADRs and the contractual terms associated with owning such securities, . . . the specific depositary banks that have registered the ADRs with the SEC, . . . the details of said registration on Form F-6, . . . and the nature of the OTC markets in which the ADRs trade."

- Plaintiffs also had "specifically identified that one of the depositary banks offering the ADRs in this dispute confirmed to the SEC that best practice for it and other banks is to 'obtain the [foreign] issuer's consent before establishing an unsponsored ADR program.'"

Plaintiffs thus had alleged "a plausible basis that at least one of the involved depositary banks 'provided Volkswagen with an opportunity to object to and prevent the establishment of such program,' 'obtained a letter of non-objection or other evidence of consent from Volkswagen,' and/or 'took other actions intended to obtain Volkswagen's consent to the sale of unsponsored ADRs in the United States.'" "Whether or not such interactions occurred is likely near impossible to know at the pleading stage, making it a question best answered through discovery."

Nevertheless, the court ended up dismissing the claims because, as mentioned above, plaintiffs had not sufficiently tied VW to VWA's alleged misstatements. "Without a plausible theory of liability ascribed to the issuer [*i.e.*, VW], Plaintiffs' purchase or sale of [VW] ADRs cannot be said to 'touch[]' or 'coincide' with the alleged false statements of" the VWA defendants.

Implications

The *Volkswagen* case aligns the Eastern District of Virginia with the First, Second, Third, and Ninth Circuits on the definition of a "domestic transaction" under *Morrison*'s second prong. The "irrevocable liability" test is now widely used in securities cases involving extraterritorial elements. But the decision adds to the tension between the Second Circuit's *Parkcentral* ruling and the First

and Ninth Circuit positions on whether a domestic transaction alone suffices or whether something more is needed.

However, the *Volkswagen* decision follows the Ninth Circuit's *Stoyas* case in shifting consideration of "predominantly foreign" arguments to the Exchange Act's separate "in connection with" requirement. Those considerations periodically arise in cases involving unsponsored ADRs, for which foreign defendants might wish to disclaim responsibility.

The court's ruling on the "in connection with" requirement turned on the specific factual allegations in the complaint and was expressly intended to govern only at the pleading stage. Plaintiffs here had alleged facts suggesting that VW had expressly or implicitly consented to the depositaries' issuance of ADRs, had had an opportunity to object to the issuance, and had been affirmatively asked for consent by at least one bank. Whether those allegations can withstand scrutiny after discovery remains to be seen.

If a foreign issuer whose unsponsored ADRs trade OTC does not want the federal securities laws to apply to transactions in those securities, it might consider trying to make a record that it has not been involved in, has not consented to, and perhaps even has objected to, the depositaries' issuance of the ADRs. For purposes of a motion to dismiss, that record will need to be publicly available and judicially noticeable. Otherwise, a court might not be able to consider it at the pleading stage, although the record could become relevant in discovery and on summary judgment.

As the *Volkswagen* court observed, however, foreign issuers might have certain incentives not to discourage U.S. depositaries' interest in issuing unsponsored ADRs. The number of ADRs available for sale in the United States is limited by the number of foreign shares that the foreign issuer has issued and authorized for sale, so the foreign issuer "continues to receive the benefit of demand on its foreign shares from depositary banks seeking to distribute ADSs to U.S. markets by purchasing those foreign shares." Foreign issuers therefore need to consider the competing risks and benefits of allowing U.S. depositaries to issue unsponsored ADRs.

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