Brooklyn Journal of International Law

Volume 2 | Issue 2 Article 7

1976

CASE COMMENT: *Bersch v. Drexel Firestone, Inc.*

Kathleen M. Paolo

Bersch v. Drexel Firestone, Inc.—The antifraud provisions of the federal securities laws will not be applied extraterritorially to losses from sales of securities to foreign investors which occur outside the United States unless acts within the United States directly caused such losses.

INTRODUCTION

The recent surge of foreign investment in United States securities has prompted foreign investors to demand protection under United States securities laws. Such investments are often in the form of offshore mutual funds or hedge funds[1] which are incorporated in favorable tax locations such as the Bahamas or Panama. The Securities and Exchange Commission [hereinafter referred to as SEC] does not require these funds to comply with its registration requirements, which entail substantial periodic disclosure of financial activities. The securities laws do not expressly create transnational jurisdiction.[2] United States courts,

1. "An offshore mutual fund is a mutual fund which (1) is incorporated in a foreign country, (2) does not sell to Americans, and (3) does not aim its sales campaign primarily at residents of the country in which it is incorporated. Note, *Offshore Mutual Funds: Extraterritorial Application of the Securities Exchange Act of 1934*, 13 B.C. IND. & COM. L. REV. 1225 (1972) (footnote omitted). *See* Comment, *The Offshore Hedge Fund*, 8 COLUM. J. TRANSNAT'L L. 79 (1969). Many of these funds have appeared subsequent to the enactment of the Foreign Investors Tax Act of 1966, 80 Stat. 1541 (1966) (codified in scattered sections of 26 U.S.C.). This legislation "broadened the qualifications for the favorable tax treatment accorded foreigners 'not engaged in a trade or business within the United States' to encompass large scale investment vehicles as well as individual investors," and "ended the taxation of dividend distributions by a corporation with United States source income if the corporation was not engaged in a domestic business." Note, *United States Taxation and Regulation of Offshore Mutual Funds*, 83 HARV. L. REV. 404, 405 (1969) (footnote omitted). These funds invest heavily in United States securities and property. *Id.* at 406. For example, "it was reported in 1967 that fund subsidiaries of Investors Overseas Services (I.O.S.) held over twenty per cent of the shares of several American mutual funds and significant percentages of many others." *Id.* at 439 (footnote omitted). *See also* SEC v. United Financial Group, 474 F.2d 354, 355-56 (9th Cir. 1973).

2. "The Congress that passed these extraordinary pieces of legislation [The Securities Exchange Acts of 1933 and 1934] in the midst of the depression could have hardly been expected to foresee the development of off-shore funds thirty years later." Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 993 (2d Cir.), *cert. denied*, 96 S. Ct. 453 (1975). At the turn of the century, United States courts often invoked a presumption that statutes were not intended to be applied extraterritorially in the absence of a clear congressional intent to the contrary. *See* Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 COLUM. L. REV. 94, 97 (1969). *See, e.g., American Banana Co. v. United Fruit Co.*, 213 U.S. 347 (1900), in which the Supreme Court refused to give the Sherman Act extraterritorial application. This presumption was initially eroded in antitrust and trademark cases. *See, e.g.,* Steele v. Bulova Watch Co., 344 U.S. 280 (1952) (Lanham Trade-Mark Act, 15 U.S.C. §§ 1501 *et seq.* (1970)); United States v. Pacific & Arctic Ry.

however, have demonstrated some interest in protecting the integrity of the securities market through the extraterritorial application of the antifraud provisions.

Extraterritorial application of regulatory legislation necessarily involves considerations of comity among nations.[3] In *Bersch v. Drexel Firestone, Inc.*,[4] the Court of Appeals for the Second Circuit discussed whether a decision by a United States court in favor of the defendants would bind the foreign plaintiffs in their own courts. While a United States court need not abstain from resolving a controversy simply because the decision might not be recognized in a foreign court, one reason the Second Circuit in *Bersch* did abstain was the "near certainty" that a foreign court would not recognize a United States decision.[5] "Ultimately, the concern is that domestic law be applied only to transactions with which the United States has a significant connection or interest."[6]

& Navigation Co., 228 U.S. 87 (1913) (Sherman Act, 15 U.S.C. §§ 1-7 (1970)). In the landmark decision of *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir. 1945), the Second Circuit, sitting for the Supreme Court, applied antitrust legislation to conduct carried out by foreign defendants on foreign soil. The two jurisdictional requirements were stated to be an intent to affect and an actual effect upon United States commerce. In explaining the court's decision, Judge Learned Hand wrote:

> We should not impute to Congress an intent to punish all whom its courts can catch, for conduct which has no consequences within the United States . . . . On the other hand, it is settled law . . . that any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders that has consequences within its borders which the state reprehends; and these liabilities other states will ordinarily recognize.

148 F.2d at 443.

3. "[A]n act of Congress ought never to be construed to violate the law of nations if any other possible construction remains . . . ." Murray v. Schooner Charming Betsy, 6 U.S. (2 Cranch) 64, 118 (1804). *See also* Note, *American Adjudication of Transnational Securities Fraud*, 89 HARV. L. REV. 553, 554 (1976).

4. 519 F.2d 974 (2d Cir.), *cert. denied*, 96 S.Ct. 453 (1975).

5. 519 F.2d at 996. Uncontroverted affidavits submitted by England, France, the Federal Republic of Germany, Italy, and Switzerland indicated that these countries would refuse to recognize a decision adverse to defendants as "a bar to an action by their own citizens." Further affidavits disclosed the existence of numerous claims, including claims of United States citizens, pending in Switzerland against one of the defendants. The possible application of a statute of limitations in a foreign country was viewed by the *Bersch* court as an inadequate answer to the problem. In France, for example, the applicable statute of limitations will continue to run until 1999. The court's position that defendants in a case of this type deserve an early adjudication of the claims of foreign plaintiffs was an added consideration behind its decision to eliminate the foreign investors from the plaintiff class. 519 F.2d at 996-97.

6. Bersch v. Drexel Firestone, Inc., 389 F. Supp. 446, 453 (S.D.N.Y. 1974).

I. Background

In *Bersch*, the Court of Appeals for the Second Circuit was required to determine the extent to which federal securities laws can be applied extraterritorially to protect investors whose losses are due to fraudulent acts committed abroad. Three categories of purchasers were described as members of the class bringing suit: Americans resident in the United States, Americans resident abroad, and foreigners, with the foreign purchasers representing the majority of the class.[7]

Defendant I.O.S., Ltd. [hereinafter referred to as IOS] was created in 1956 by defendant Bernard Cornfeld as "an international sales and financial service organization principally engaged in the sale and the management of mutual funds and complementary financial activities."[8] Organized under Canadian law, IOS had its principal place of business in Geneva.[9] Prior to 1968, the stock of IOS and its subsidiaries had been held by Cornfeld, his associates, and their employees.[10] These shares were distributed to the employees as "partial compensation" and "performance incentive" with the understanding that in the near future IOS' principal subsidiaries, and later IOS itself, would be taken public.[11] The employees would have an opportunity to profit substantially as the result of such a public market in IOS. In 1968, IOS floated 600,000 shares of IOS Management, Ltd., one of its principal subsidiaries.[12] Partly because of the overwhelming success of this offering,[13] the plan to offer shares of each of the subsidiaries publicly was abandoned and it was decided that IOS itself would be taken public as soon as it appeared feasible.

Accordingly, a plan encompassing three stock offerings was formulated.[14] The first and largest was an offering of 5,600,000

7. 519 F.2d at 977-78 n.2.

8. *Id.* at 978. I.O.S. Ltd. [hereinafter cited as IOS] was being liquidated in New Brunswick, Canada, as the result of proceedings brought by the Public Trustee of the Province of Ontario. *Id.* at n.4.

9. *Id.* at 978.

10. *Id.*

11. *Id.* at 978-79.

12. The shares of IOS Management, Ltd., were first offered at $12.50, trading opened at $75.00, and by March, 1969, they had reached a peak of $180.00. *Id.* at 979.

13. The other motivation was a successful offering by a recently created competitor. Gramco Management, Ltd., was an offshore mutual fund whose original offering price initially doubled but soon fell drastically. *Id.* at n.6.

14. The offering plan was restricted by a prior settlement order between IOS and the Securities and Exchange Commission [hereinafter cited as SEC] entered in May, 1967,

shares underwritten by six United States and foreign defendants [hereinafter referred to as Drexel Group].[15] Shares were sold to nationals of Europe, Asia, and Australia by prospectuses which were printed abroad, but substantial activities related to the preparation of the offering occurred in the United States. A secondary offering of 1,450,000 shares, the prospectus for which was prepared in compliance with Canadian securities laws, was underwritten by defendant J.H. Crang and Co., a Canadian investment house [hereinafter referred to as Crang].[16] All shares were sold in Canada to foreign nationals. The third distribution was another secondary offering of 3,950,000 shares by defendant Investors Overseas Bank, Ltd. [hereinafter referred to as IOB], a Bahamian subsidiary of IOS.

All three offerings were made at approximately the same time and for the same price, and each prospectus referred to the other two offerings. The Drexel Group and IOB prospectuses were substantially the same,[17] and both stated that the offerings were not registered under United States securities laws.[18] Each prospectus contained a balance sheet, a financial statement, and a report by defendant Arthur Andersen and Co., a United States-

---

to prevent distribution in the United States. "Upon entry of the Order based on this stipulation, IOS and all its affiliates shall cease all sales of securities to United States citizens or nationals wherever located, except for (i) offers and sales outside of the United States . . . to officers, directors and full-time personnel of IOS and its subsidiaries." *Id.* at 979.

15. *Id.* The Drexel Group included two American banking houses, Drexel Firestone, Inc. and Smith, Barney and Co. (both of which had offices abroad), as well as four foreign houses: Banque Rothschild; Hill Samuel and Co., Ltd.; Guinness Mahon and Co., Ltd.; and Pierson Heldring and Pierson.

16. 519 F.2d at 980. The circuit court in *Bersch* eventually held that it lacked personal jurisdiction over this defendant. *See* note 29 *infra*.

17. Crang's prospectus differed slightly to comply with the requirements of Canadian securities law. *Id.* at 980.

18. It appears that these securities did not have to be registered with the SEC. In a 1964 release the SEC stated that it

> has traditionally taken the position that the registration requirements of Section 5 of the [Securities] Act [of 1933] are primarily intended to protect American investors. Accordingly, the Commission has not taken any action for failure to register securities of United States corporations distributed abroad to foreign nationals, even though use of jurisdictional means may be involved in the offering. It is assumed in these situations that the distribution is to be effected in a manner which will result in the securities coming to rest abroad.

Id. at 981 n.12, *quoting* SEC Rel. No. 33-4708 & 34-7366 (1964), 1 CCH FED. SEC. L. REP. ¶ 1362. The fact that a security need not be registered does not preclude the application of the antifraud provisions of the securities laws, particularly rule 10b-5, where parties engage in fraud. 519 F.2d at 986 n.28. *See also* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1335-37 (2d Cir. 1972).

based accounting firm, certifying that the statements made therein fairly represented IOS' financial condition. The initial offerings were fully subscribed, but the price of the shares gradually dropped and by May, 1970, they were "virtually unsaleable."[19] IOS eventually passed into the control of Robert L. Vesco, a resident of Costa Rica and a defendant in a number of actions for fraud.[20]

Plaintiff Howard Bersch, a citizen of the United States and a resident of New York, purchased 600 shares of IOS common stock through the IOB offering. Characterizing the three distributions as the "IOS Public Offering," Bersch brought a class action on his own behalf and on behalf of all other purchasers regardless of their nationality or residence.[21] The complaint alleged violations of the Securities Act of 1933 and the Securities Exchange Act of 1934, including section 10(b), as well as common law fraud.[22] Charging the underwriting group with failure to exercise due diligence, Bersch asserted that the underwriters " 'impliedly represented to the public that IOS was a suitable company for public ownership' when, in part as a result of the refusal of other investment houses to participate, they should have known that it was not."[23] The complaint further alleged that the records of IOS and its subsidiaries were in such chaotic condition that determination of IOS' financial condition was rendered impossible. The plaintiffs claimed that Arthur Andersen and Co. failed to

19. 519 F.2d at 981.

20. *Id.*

21. *Id.* The number of purchasers in the proposed class was estimated by Bersch to be 100,000. *Id.* at 977-78 n.2. This was later revised to about 50,000. *Id.*

22. Specifically, the complaint alleged violations of sections 12, 15, and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77*l*, 77o, and 77q (1970); sections 10(b), 15(c)(1), and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §§78j(b), 78o(c)(1), and 78t (1970); and SEC Rules 10b-5 and 15c*l*-z, 17 C.F.R. 240.10b-5, 240.15c*l*-2 (1975). Bersch v. Drexel Firestone, Inc., 389 F. Supp. 446, 449 (S.D.N.Y. 1974).

Section 10(b), 15 U.S.C. § 78j(b) (1970), is enforced through the application of SEC Rule 10b-5, 17 C.F.R. 240.10b-5 (1975), which provides:

> It shall be unlawful for any person . . . by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device [or] scheme . . . to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

23. 519 F.2d at 981.

follow customary accounting procedures when performing the audit, resulting in false and misleading financial statements. Finally, it was asserted that negligent preparation of the prospectus by the Drexel Group failed to reveal damaging illegal activity by IOS and its officers.[24]

The initial issue before the district court was one of subject matter jurisdiction. Pursuant to a motion for class certification, in opposition to which the defendants first raised the issue of excluding foreign nationals as members of the class, Judge Frankel of the Southern District of New York allowed the case to proceed as a class action but left for later determination three basic issues: whether the court had subject matter and personal jurisdiction, whether foreign purchasers should remain members of the plaintiff class, and "whether and how the court's ultimate judgment may be made binding upon foreign class members."[25]

In December, 1972, the Drexel Group entered into a consent order with plaintiff Bersch. Six months later, after extensive discovery and with a motion to dismiss still pending, the Drexel Group agreed to a stipulation of settlement.[26] During settlement negotiation, the district court determined that it had subject matter jurisdiction over the claims of both the foreign and United States citizens in the class. The district court viewed the three offerings as "sufficiently integrated and intertwined" to be considered as one for the purposes of examining jurisdictional issues.[27] Its finding that subject matter jurisdiction existed was grounded on three bases: (1) sufficient activity within the United States in connection with the Drexel Group offering; (2) sales of stock to an estimated 386 United States citizens; and (3) sufficient adverse effect on the United States securities market generated by the collapse of the price of IOS shares offered.[28] Upon

24. The complaint alleged that IOS officers participated in the smuggling of currency in developing nations, "in violation of their restrictive currency laws," and that as a result those countries barred IOS from doing business within their territories. *Id.* at n.15.

25. 389 F. Supp. at 450. *See* text accompanying notes 3 & 5 *supra*.

26. 519 F.2d at 983. The settlement stipulation provided for a number of conditions including a payment of $700,000 against an original claim for $110,000,000 plus interest from 1969, an entry of final judgment against the settling defendants, and the "dismissal with prejudice and on the merits of any other action brought in any court arising out of any of the events described in the complaint." In addition, the settling defendants were permitted to withdraw from the settlement if members of the class holding more than 300,000 shares of IOS common stock should withdraw.

27. 389 F. Supp. at 451.

28. *Id.* at 457-58. In addition, the court rejected the claims of Crang and Smith, Barney and Co., a Drexel Group underwriter, to exemptions from liability under section

motions to dismiss, the district court found IOS, but not Crang, to be subject to in personam jurisdiction, and ordered the action against Crang dismissed.[29]

The Second Circuit granted leave for interlocutory appeal under 28 U.S.C. § 1292(b) and consolidated all pending appeals, including plaintiff's appeal from the determination that Crang was not subject to in personam jurisdiction. The district court's finding that subject matter jurisdiction extended to all three categories of plaintiffs was restricted by the circuit court. The court rejected the lower court's conclusion that subject matter jurisdiction existed "with respect not only to the relatively few Americans who had purchased IOS shares but to the many thousands of foreign purchasers whom plaintiff sought to represent"[30] and found instead that jurisdiction existed only with respect to American residents and Americans residing abroad.

30(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78dd(b) (1970). *Id.* at 459. With respect to a foreign transaction, section 30(b) exempts from the scope of the Act any person "insofar as he transacts a business in securities without the jurisdiction of the United States," unless by doing so he violates Commission rules promulgated to prevent evasion of the Act. "Business in securities" has been construed so strictly as to be effectively limited to foreign securities professionals, and not "persons who engage in isolated foreign transactions." Schoenbaum v. Firstbrook, 405 F.2d 200, 207 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). It is also clear that transactions involving foreign issuers and/or foreign investors executed on a United States stock exchange are subject to the full scope of liability under United States securities laws. Roth v. Fund of Funds, Ltd., 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975 (1969); Selzer v. Bank of Bermuda, Ltd., 385 F. Supp. 415 (S.D.N.Y. 1974); 15 U.S.C. § 78*l*(b) (1970).

29. 389 F. Supp. at 461. The district court, while conceding that neither IOS nor Crang was "present" or "doing business" in the United States, recognized another way for a party to subject himself to the personal jurisdiction of the court: "[W]here a defendant has acted within a state or sufficiently caused consequences there, he may fairly be subjected to its judicial jurisdiction even though he cannot be served with process in the state . . . ." *Id.* at 460, *quoting* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d at 1340. The court determined, however, that Crang's activities within the United States were limited to "*de minimus* preliminary discussions" which could "hardly be considered acts out of which the cause of action arose." The second half of the test presented in *Leasco* allows the exercise of in personam jurisdiction where the defendant's conduct abroad had a "substantial, direct, and foreseeable result in the United States." 389 F. Supp. at 461. The court concluded that Crang took special precautions to prevent its sale of IOS shares to Americans, and had been assured that the Drexel Group and IOB would observe this restriction. In addition, any impact which may have resulted from the sales of IOS shares was neither direct nor could it have reasonably been foreseen by Crang. The court therefore dismissed the complaint against Crang for lack of in personam jurisdiction, and the Second Circuit affirmed this order. 519 F.2d at 1000. On the other hand, personal jurisdiction existed as to IOS because its meetings in the United States were "directly related to the offerings, and information was discussed which later was incorporated into the prospectuses." 389 F. Supp. at 460.

30. 519 F.2d at 986.

The circuit court held specifically that the antifraud provisions of the federal securities laws:

> 1. Apply to losses from sales of securities to Americans resident in the United States whether or not acts (or culpable failures to act) of material importance occurred in this country; and
> 2. Apply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but
> 3. Do not apply to losses from sales to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses.[31]

In reaching its holding, the Second Circuit evaluated the three jurisdictional bases relied upon by the district court.

II. The Extent of Activity Occurring within the United States

The first basis of jurisdiction found by the district court was premised upon the subjective territorial principle, as codified in section 17 of the *Restatement (Second) of Foreign Relations Law of the United States* [hereinafter referred to as *Restatement*].[32] The court concluded that IOS, which was incorporated in the Bahamas, was not simply a foreign corporation dealing in securities but one whose existence depended upon a large amount of United States activity.[33] In a series of decisions prior to *Bersch*, the Second Circuit and Southern District of New York had gradually adopted the subjective territorial principle in applying federal securities laws to foreign transactions. *Kook v. Crang*,[34] decided in 1960, was one of the first decisions to consider the extraterritorial application of the federal securities laws. The *Kook* court refused to extend the protection of federal securities

31. *Id.* at 993.

32. Restatement (Second) of Foreign Relations Law of the United States § 17 (1965) provides that: "[a] state has jurisdiction to prescribe a rule of law (a) attaching legal consequences to conduct that occurs within its territory . . . and (b) relating to a thing located, or a status or other interest localized, in its territory."

33. 389 F. Supp. at 455-58. Although the district court viewed each individual act as being of minimal significance, it concluded that United States activity *in toto* was essential in preparing the defrauding prospectuses. *Id.* at 457.

34. 182 F. Supp. 388 (S.D.N.Y. 1960). Crang, also a defendant in *Bersch*, had a branch office in New York and was registered with the SEC at the time *Kook* was decided. Crang's New York office was closed in 1969.

laws to an American investor because all of the alleged fraudulent acts of a foreign brokerage house had been conducted in Canada. The court based its decision on a finding that Congress, in passing legislation, was primarily concerned with domestic problems.[35]

In *Leasco Data Processing Equipment Corp. v. Maxwell*,[36] the Second Circuit went beyond *Kook* and ruled that where there were material misrepresentations committed by a foreign defendant within the United States, jurisdiction would extend not only to such misrepresentations but would also encompass conduct without the United States arising from the same transaction.[37] Thus, while the court remained within the framework of section 17 of the *Restatement* and relied on the existence of United States activity, it adopted a more expansive view as to the propriety of applying federal securities laws extraterritorially. The court asserted that it is incorrect to assume that congressional intent never extends beyond the *Restatement*; a court is "bound to follow the Congressional direction unless this would violate the due process clause of the Fifth Amendment."[38]

Leasco was not decisive in *Bersch* because it concerned foreign defendants rather than foreign plaintiffs, but it did demonstrate a trend toward broader application of the securities laws. The district court in *Bersch*, while emphasizing that *Leasco* predicated jurisdiction upon "significant conduct within the territory," chose to follow this broader trend. While finding the United States activity to be "less direct" than that in *Leasco*, the district court in *Bersch* reasoned that conduct within the United States providing an "essential link" in the commission of fraudulent activity is jurisdictionally sufficient to afford protection to

35. *Id.* at 390. "[U]nless a contrary intent appears, [legislation of Congress] is meant to apply only within the territorial jurisdiction of the United States . . . ." Foley Brothers v. Filardo, 336 U.S. 281, 285 (1949). *See also* Blackmer v. United States, 284 U.S. 421, 437 (1931).

36. 468 F.2d 1326 (2d Cir. 1972).

37. The particular statute involved was section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970). *See* note 22 *supra* for the text of rule 10b-5. Within the language of 10(b) itself, the court found legislative intent to provide broad antifraud protection on the purchase or sale of securities "whether or not these were traded on organized United States markets . . . ." 468 F.2d at 1336.

38. 468 F.2d at 1334. The court concluded that in a situation in which material acts occurred in the United States, "if Congress had thought about the point, it would . . . have wished to protect an American investor if a foreigner comes to the United States and fraudulently induces him to purchase securities abroad . . . ." *Id.* at 1337. On the other hand, it would be erroneous to assume that the legislature always intends to go to the full extent permitted [by the *Restatement*]." *Id.* at 1334. *See also* Travis v. Anthes Imperial, 473 F.2d 515 (8th Cir. 1973).

foreign investors.[39] The Second Circuit took a different view, determining that the fraud, if any, was perpetrated by delivering the final defrauding prospectus to the purchasers in the United States.[40] It concluded that the source of the final fraudulent statement, in this case a foreign source, was the key to determining the issue of jurisdiction;[41] all of the activities in the United States prior to the issuance of the defrauding prospectus were found to be only preliminary, and "relatively small in comparison to those abroad."[42] In describing this transaction as predominantly foreign, the Second Circuit in effect found that the requirements of section 17 had not been met.

On the basis of its conclusion that the United States activity was preparatory, the Second Circuit stated that none of the misrepresentations occurred in the nation "whose law is sought to be applied."[43] The significant United States activity found in *Leasco* was not deemed present in *Bersch*. Further, the "essential link" theory espoused by the district court in *Bersch* with regard to United States activity was rejected by the circuit court. Although the Second Circuit stated that congressional intent need not be constrained solely by the *Restatement*, it did recall the assertion in *Leasco* that legislation need not always reach to the full limits of due process.[44] The court acknowledged that the Congress did not intend that the United States serve as a "base for fraudulent securities schemes even when the victims are foreigners."[45] However, it refused to extend the protection of the securities laws to foreign plaintiffs upon the first basis relied upon by the district court in view of the predominantly foreign nature of the transaction. Perhaps the real consideration underlying this determination was the question of "whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to . . . [predominantly foreign transactions] rather than leave the problem to foreign countries."[46]

39. 389 F. Supp. at 458.

40. 519 F.2d at 987.

41. The Drexel Group prospectus emanated from either London or Brussels, the IOB prospectus from the Bahamas and Geneva, and the Crang prospectus from Toronto. *Id.*

42. *Id.*

43. *Id.*

44. 468 F.2d at 1334.

45. 519 F.2d at 987.

46. *Id.* at 985. "The management of a class action with many thousands of class members imposes tremendous burdens on overtaxed district courts, even when the class

III. Adverse General Effects

The only evidence considered by the Court of Appeals to determine the existence of adverse general effects, the third jurisdictional basis found by the district court, was an affidavit by an expert in the field of finance.[47] On the basis of the affidavit, the district court concluded that jurisdiction was proper because the offering of false prospectuses and the collapse of IOS severely impaired the confidence of investors, particularly foreign investors, in the American securities market. This loss of confidence threatened to reduce or curtail the large inflow of foreign capital into the American securities market with attendant "breakdown in the entire structure . . . of [the] offshore investing industry . . . ."[48] The circuit court rejected the affidavit, and with it the third basis of jurisdiction.

The district court's theory of subject matter jurisdiction, which is predicated upon a substantial and foreseeable effect within the United States from fraudulent conduct committed abroad by foreign defendants, would seem to fit within the objective territorial principle of section 18 of the *Restatement*.[49] This

members are mostly in the United States and still more so when they are abroad." *Id.* at 996 (footnote omitted).

47. Professor Morris Mendelson concluded, *inter alia*, that:

> (1) The aftermath of the Drexel offering "was a debacle of monumental proportions which resulted in a deterioration of investor confidence in American underwriters at home and, particularly, abroad," and increased the problems of United States corporations in seeking to raise capital abroad.
>
> (2) "The false and misleading prospectus issued in connection with the Public Offering impaired investors' confidence and trust and contributed to a steep decline in the purchase of United States securities by foreigners" with attendant adverse effects on the balance of payments and the price of American securities generally.
>
> . . . .
>
> (4) Part of the attraction of American securities to foreigners has been the superior disclosures afforded by SEC registration requirements. The collapse of IOS after the offering undermined this confidence since IOS was "identified as an American company in the minds of investors" . . . .
>
> (5) The collapse of IOS after the offering "contributed to a breakdown in the entire structure of building up an offshore investing industry whereby funds of European investors were channeled into American securities markets."

519 F.2d at 987-88.

48. *Id.* at 988.

49. Restatement (Second) of Foreign Relations Law of the United States §18 (1965) provides that:

> A state has jurisdiction to prescribe a rule of law attaching legal consequences to conduct that occurs outside its territory and causes an effect within its territory, if either

approach was relied upon by the Second Circuit in *Schoenbaum v. Firstbrook*.[50] In that case, an American investor in a Canadian corporation which was registered with the SEC and listed on the American Stock Exchange brought a derivative action which charged the corporation with rule 10b-5 violations. Although there was no illegal activity in the United States, the court held that the negative effects on the value of the American plaintiff's stock which directly resulted from the foreign conduct was sufficient to justify a finding that jurisdiction existed. The court thus applied rule 10b-5 extraterritorially where there was a loss suffered by an American investor.[51] In *Bersch*, the Second Circuit distinguished *Schoenbaum* and refused to find subject matter jurisdiction.[52]

The argument that jurisdiction could be grounded upon the general detrimental effects on American investors was rejected by *Bersch* as being overly broad. As the *Leasco* court stated,

> 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.[53]

Bersch rejected the argument that the "*generalized* effects . . . [were] sufficient to confer subject matter jurisdiction over a damage suit by a foreigner under the anti-fraud provisions of the

---

(a) the conduct and its effect are generally recognized as constituent elements of a crime or tort under the law of states that have reasonably developed legal systems, or

(b) (i) the conduct and its effect are constituent elements of activity to which the rule applies; (ii) the effect within the territory is substantial; (iii) it occurs as a direct and foreseeable result of the conduct outside the territory; and (iv) the rule is not inconsistent with the principles of justice generally recognized by states that have reasonably developed legal systems.

50. 405 F.2d 200 (2d Cir.), *rev'd in part and remanded*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

51. *Id.* at 208. *See also* United States v. Clark, 359 F. Supp. 131 (S.D.N.Y. 1973), in which jurisdiction was grounded on the combination of clear fraudulent conduct in the United States and the detrimental effects of such conduct on American investors.

52. In *Schoenbaum*, the stock was listed on a national exchange and therefore defendant reasonably should have expected many Americans to invest in the corporation. In *Bersch*, sales of IOS shares were inexplicably made to 386 Americans; the court, in rejecting jurisdiction, was more concerned with the *intent* of IOS, as stated in its prospectus, to exclude American investors. Additionally, IOS was not listed on any national exchange nor was it registered with the SEC.

53. 468 F.2d at 1334.

securities laws."[54] The detrimental effects concept even when coupled with IOS' preparatory activity within the United States, was held insufficient to permit jurisdiction over this essentially foreign transaction.[55]

IV. Sales to Americans

The second basis for subject matter jurisdiction urged by the district court was that sales in the IOS Public Offering scheme were made to Bersch and an estimated 385 other United States citizens through the IOB secondary offering. The circuit court distinguished between the American purchasers living in the United States and those living abroad. As to the Americans resident in the United States, it was willing to presume that defrauding prospectuses were mailed to them in the United States.[56] In establishing a standard for determining subject matter jurisdiction as to this category of Americans, the court analogized to section 18 of the *Restatement* and stated that activity in the United States was "not necessary when subject matter jurisdiction is predicated on a *direct* effect here."[57] The recipients' reliance on the misrepresentations contained in the prospectuses was the required "direct effect," and thus the court held the protection of the securities laws to apply to Americans resident in the United States.[58]

The court next considered whether it had subject matter jurisdiction as to the nonresident American purchasers. Recognizing that the issue involved presented "a different and closer question,"[59] it noted that "Congress surely did not mean the securities laws to protect the many thousands of Americans residing in foreign countries against securities frauds by foreigners acting there" in the absence of sufficient activity within the United States.[60] The activities by defendants within the United States, though "merely preparatory," were deemed sufficient to warrant the exercise of the court's jurisdiction as to nonresident Americans in the class. The requisite proof entailed "acts of material

54. 519 F.2d at 988 (emphasis added, footnote omitted).

55. Had the *Bersch* court found substantial United States activity, perhaps the argument of "detrimental effects within from conduct without" would have been more readily accepted.

56. *Id.* at 991.

57. *Id.* (emphasis added).

58. *Id.*

59. *Id.* at 992.

60. *Id.*

importance" within the United States which "significantly contributed" to those plaintiffs' losses.[61] The court did not, however, explain how the preparatory activities within the United States met this standard.

Having found jurisdiction as to both categories of American purchasers in the class, the court turned to the question of whether to exercise its jurisdiction as to the large number of nonresident foreign investors. Reversing the district court, the Second Circuit held that "merely preparatory activities in the United States are not enough to trigger application of the securities laws for injury to foreigners located abroad . . . ."[62] The court prescribed a requirement that the losses to foreigners must have been "*directly caused*" by acts within the United States, a higher degree of causation than the "*significant contribution*" standard imposed in the case of nonresident Americans.[63] Without explaining the basis for its conclusion,[64] the court found that there was no direct causal link between the preparatory activities within the United States and the losses incurred abroad by the foreign purchasers.

V. IIT v. VENCAP, LTD.

It is not to be concluded from *Bersch* that in every instance foreign plaintiffs who have suffered losses due to violations of federal securities laws at the hands of foreign defendants will be denied access to United States courts. *Bersch's* importance lies in the fact that it is the first decision to recognize that a foreign investor has a cause of action where an "act" within the United States directly causes losses to that purchaser from sales made abroad. While the foreign plaintiffs in *Bersch* failed to meet this test, the case represents an expansive view of the extraterritorial application of federal securities laws. *Bersch* laid the foundation for the Second Circuit's decision in a companion case decided the

---

61. *Id.* at 993.

62. *Id.* at 992.

63. *Id.* at 993 (emphasis added).

64. We freely acknowledge that if we were asked to point to language in the statutes, or even in the legislative history, that compelled these conclusions, we would be unable to respond . . . . Our conclusions rest on case law and commentary concerning the application of the securities laws and other statutes to situations with foreign elements and on our best judgment as to what Congress would have wished if these problems had occurred to it.

Id. (footnote omitted).

same day, by the same three-judge panel, *IIT v. Vencap, Ltd.*[65]

In *IIT*, a Luxembourg investment trust brought a rule 10b-5 action against Vencap, Ltd., a Bahamian venture capital organization. Subject matter jurisdiction was predicated upon the activities of Vencap in the United States. These included the preparation of a memorandum containing material misstatements and omissions in the United States, as well as the use of the New York office of defendants' attorneys as a base for initiating, directing, and consummating "literally hundreds of transactions."[66] It was concluded that where the United States is "used as a base for manufacturing fraudulent security devices for export," subject matter jurisdiction will attach even where these securities are "peddled only to foreigners."[67] The court reasoned that if Congress intended the enforcement of securities laws to "prevent the concoction of securities frauds in the United States for export," a necessary corollary would be subject matter jurisdiction of the United States courts over an action by a defrauded foreign plaintiff.[68] *Bersch* had laid down the vague standard that the antifraud provisions of the securities laws permit a cause of action to foreign investors only where the "*acts* . . . within the United States directly caused" the losses.[69] *IIT* attempted to clarify this test by finding that the acts necessary to confer subject matter jurisdiction must be fraudulent and also that the fraud contain the elements of a rule 10b-5 violation.[70]

---

65. 519 F.2d 1001 (2d Cir. 1975).

66. *Id.* at 1018.

67. *Id.* at 1017.

68. *Id.* at 1018.

69. 519 F.2d at 993 (emphasis added).

70. As originally viewed by the courts, the elements of a 10b-5 violation in private actions corresponded closely to the traditional elements of common law fraud: misrepresentation of a material fact, reliance, scienter, and damages. White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974). Several recent decisions have demonstrated a marked trend toward modifying or even rejecting some of these standard elements. *See, e.g.*, Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972); Superintendent of Insurance of the State of New York v. Bankers Life and Casualty, 404 U.S. 6 (1971); Green v. Santa Fe Industries, Inc., Civil No. 75-7256 (2d Cir., Feb. 18, 1976), *rehearing denied*, [Current] CCH FED. SEC. L. REP. ¶ 95,472 (2d Cir. Mar. 10, 1976). (The Second Circuit found the case to be of "such importance" that it was "confident that the Supreme Court [would] accept these matters under its certiorari jurisdiction," but a petition for certiorari has not yet been filed.); Sanders v. John Nuveen & Co., Inc., 524 F.2d 1064 (7th Cir. 1975); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc); Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969). It has become clear, however, that mere *negligence* will not support a 10b-5 complaint. The Supreme Court has recently held, in a case involving the conduct of a United States accounting firm, that such suits must

The *Bersch/IIT* analysis was applied by the courts for the first time in *F.O.F. Proprietary Funds Ltd. v. Arthur Young & Co.*,[71] where the foreign plaintiff, a Canadian mutual fund organization, sought relief for an alleged rule 10b-5 violation. In resolving the primary issue of subject matter jurisdiction, the District Court for the Southern District of New York followed *IIT* and *Bersch* in examining congressional intent as to the application of United States securities laws to the facts presented. The court determined that Congress would not have intended the securities laws to apply to this "predominantly foreign" transaction.[72] Plaintiff, a subsidiary of IOS, was "a foreign company which acquired its shares abroad, purchased from a foreign company . . . and purchased allegedly in reliance upon the offering circulars which apparently were distributed to it outside the United States."[73] Quite clearly, plaintiff failed to meet the jurisdictional standards promulgated in *Bersch* and *IIT* since the material acts allegedly causing plaintiff's losses occurred abroad. In denying subject matter jurisdiction, however, the court was not forced to reach the more specific problem posed by a *Bersch/IIT* analysis, *i.e.*, whether a particular instance of fraudulent activity within the United States is sufficiently within the ambit of a rule 10b-5 violation to permit subject matter jurisdiction as to foreign plaintiffs.[74]

While it appears that the Second Circuit has established a cause of action for the protection of foreign investors whose losses can truly be attributed to fraudulent acts committed in the United States, it will not extend the protection of United States securities laws to those transactions it deems essentially foreign.

Kathleen M. Paolo

---

allege an "intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976).

71. 400 F. Supp. 1219 (S.D.N.Y. 1975).

72. *Id.* at 1222.

73. *Id.* at 1222-23.

74. It is significant that in *F.O.F.* the court found that the plaintiff purchasers had *knowingly* purchased the securities in express violation of the federal securities laws. *Id.* at 1221.