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U.S. Appeals Court Rejects Bright-Line Test for Extraterritorial Reach of U.S. Securities Laws

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In its landmark 2010 decision in *Morrison v. National Australia Bank Ltd.*, the U.S. Supreme Court articulated what seemed to be a bright-line test for determining the extent to which the U.S. securities laws apply to transactions with international elements (*see WSLR, July 2010, page 9*). In so doing, the Court harshly rejected the fact-intensive "conduct/effects" tests propounded several decades ago by the U.S. Court of Appeals for the Second Circuit and followed by many other courts throughout the country.

On August 15, 2014, the Second Circuit got its revenge. In a long-awaited decision in *ParkCentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, the Second Circuit declined "to proffer a test that will reliably determine when a particular invocation of [the Securities Exchange Act of 1934's anti-fraud provision] will be deemed appropriately domestic or impermissibly extraterritorial." Instead, the Second Circuit held that courts must carefully consider the facts and circumstances of each case to avoid the very result that the Supreme Court had hoped to prevent in *Morrison*: promiscuous application of the U.S. securities laws to transactions that have little, if any, relationship to the United States (*see report in this issue*).

The *ParkCentral* decision illustrates the difficulties that the *Morrison* test created for determining whether U.S. law should apply to transactions involving unlisted securities and international elements. The decision reinforces the trend against extraterritorial application of U.S. law — while perhaps not closing the door to applying U.S. law where facts so warrant.

Background of the Second Circuit's Decision

Until June 2010, most courts throughout the United States had analyzed the applicability of the Securities Exchange Act of 1934 ("Exchange Act") to transnational securities transactions under the well-established "conduct/effects" tests. The conduct test had traditionally considered whether the defendant's conduct in the United States was so significant as to have been more than merely preparatory to the alleged fraud and to have directly caused non-U.S. investors' losses. The effects test had considered the alleged fraud's effects on U.S. markets or investors.

Morrison rejected the fact-specific conduct/effects tests, observing that "there is no more damning indictment of the 'conduct' and 'effects' tests than the Second Circuit's own declaration that 'the presence or absence of any single factor which was considered significant in other cases . . . is not necessarily dispositive in future cases.' " Instead, the Supreme Court adopted a supposedly "clear test," which the Court called "a transactional test": Section 10(b) of the Exchange Act applies

only to "transactions in securities listed on domestic exchanges, and domestic transactions in other [*i.e.,* non-U.S.-listed] securities."

The first prong of this transactional test — for U.S.-listed securities — has seemed relatively comprehensible, although it has generated some litigation. The second prong, however — "domestic transactions in other securities" — has raised many questions.

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In March 2012, in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, the Second Circuit attempted to clarify the second prong, and held that, "to sufficiently allege the existence of a 'domestic transaction in other securities,' plaintiffs must allege facts indicating that irrevocable liability was incurred or that title was transferred within the United States" (*see WSLR, April 2012, page 6*). A plaintiff can demonstrate that irrevocable liability was incurred in the United States by pleading facts showing that "the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security." A plaintiff can also satisfy *Morrison*'s second prong by showing that the United States was "the location in which title is transferred."

The *ParkCentral* Case

The *ParkCentral* case arose from an allegedly secret plan by Porsche, a German company, to take over Volkswagen ("VW"), another German company. The plaintiffs — U.S. and non-U.S. hedge funds managed in the U.S. — had entered into security-based swap agreements that referenced the price of VW shares. The swaps' value fluctuated with the price of VW shares: Their value rose as the price of VW shares declined, and fell as the price of VW shares rose. The swap agreements were not traded on any exchange — and thus were not subject to *Morrison*'s first prong.

So the Second Circuit bailed out the Supreme Court. The court looked beyond *Morrison*'s literal language to reach what it considered a result that was more in line with *Morrison*'s aim of avoiding inappropriately extraterritorial application of U.S. law.

The plaintiffs alleged that Porsche had violated Section 10(b) by secretly accumulating large amounts of VW's shares while falsely denying its intent to take over VW. When Porsche ultimately disclosed that it had acquired more than 74 percent of VW's shares, the price of VW's stock soared, and the value of the plaintiffs' swap contracts plummeted.

The plaintiffs contended that Section 10(b) applied to their transactions because their purchases of swaps constituted "domestic transactions in other [*i.e.,* unlisted] securities" under *Morrison*'s second prong: U.S.-based investment managers had allegedly made the investment decisions; all steps necessary to the transactions had allegedly been carried out in the United States; the investment managers had signed swap confirmations at their U.S. offices; and the swap agreements contained New York choice-of-law and forum-selection clauses.

The district court dismissed the case based largely on its view of how "the economics of the swaps" affect "securities-based swaps that reference stocks traded abroad." The parties had agreed that the swap contracts, "which reference VW shares, were economically equivalent to the purchase of VW shares." The court therefore concluded that "the nature of a reference security [the underlying VW stock] must play a role in determining whether a transnational swap agreement may be afforded the protection of § 10(b)." "Here, Plaintiffs' swaps were the functional equivalent of trading the underlying VW shares on a German exchange. Accordingly, the economic reality is that Plaintiffs' swap agreements are essentially transactions conducted upon foreign exchanges and markets, and not domestic transactions that merit the protection of § 10(b)."

The court was "loathe to create a rule that would make foreign issuers with little relationship to the U.S. subject to suits here simply because a private party in this country entered into a derivatives contract that references the foreign issuer's stock." The court thus read *Morrison*'s second prong to cover only "purchases and sales of securities explicitly solicited by the issuer in the U.S., rather than transactions in foreign-traded securities — or swap agreements that reference them — where only the purchaser is located in the United States."

The Second Circuit's Decision

The Second Circuit affirmed the dismissal of the claims, but for different reasons.

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Without accepting or rejecting the district court's "economic reality" analysis of swaps, the Second Circuit ruled that "the imposition of liability under § 10(b) on these foreign defendants with no alleged involvement in plaintiffs' transactions, on the basis of the defendants' largely foreign conduct, for losses incurred by the plaintiffs in securities-based swap agreements based on the price movements of foreign securities would constitute an impermissibly extraterritorial extension of the statute." The court "express[ed] no view whether we would have reached the same result if the suit were based on different transactions."

The Second Circuit essentially assumed that the plaintiffs' swap transactions might have met the *Absolute Activist* test for satisfying *Morrison*'s second prong: incurrence of irrevocable liability or transfer of title in the United States. But the possibility that the swaps might have constituted "domestic transactions" under *Morrison* created a problem for the court: Even if the transactions technically fell within the *Morrison* test, the court "[thought] it clear that the claims in this case are so predominantly foreign as to be impermissibly extraterritorial."

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The Second Circuit began its analysis by limiting *Morrison* to its facts: "the Supreme Court has said that it is 'acutely aware . . . that [it] sit[s] to decide concrete cases and not abstract propositions of law' and has therefore 'decline[d] to lay down . . . broad rule[s] . . . to govern all conceivable future questions in an area.' " *Morrison* had involved only common stock, not esoteric financial instruments. The Second Circuit therefore warned of the need to "proceed cautiously in applying teachings the *Morrison* Court developed in a case involving conventional purchases and sales of stock to derivative securities, like securities-based swap agreements, that vest parties with rights to payments based on changes in the value of a stock."

The court then considered "whether, under *Morrison*, a domestic transaction in a security (or a transaction in a domestically listed security) — in addition to being a *necessary* element of a domestic § 10(b) claim — is also *sufficient* to make a particular invocation of § 10(b) appropriately domestic" (emphasis in original). The court concluded that, while *Morrison* "unmistakably made a domestic securities transaction (or a transaction in a domestically listed security) *necessary* to a properly domestic invocation of Section 10(b), such a transaction is not alone *sufficient* to state a properly domestic claim under the statute" (emphasis added).

In other words, *Morrison*'s self-described "clear test" is not necessarily the whole story (at least for non-conventional securities). As the Second Circuit explained, "a rule making the statute applicable whenever the plaintiff's suit is predicated on a domestic transaction, regardless of the foreignness of the facts constituting the defendant's alleged violation, would seriously undermine *Morrison*'s insistence that § 10(b) has no extraterritorial application. It would require the courts to apply the statute to wholly foreign activity clearly subject to regulation by foreign authorities solely because a plaintiff in the United States made a domestic transaction, even if the foreign defendants were completely unaware of it. Such a rule would inevitably place § 10(b) in conflict with the regulatory laws of other nations."

Based on its conclusion that satisfaction of the *Morrison* test was not *sufficient* to invoke Section 10(b), the Second Circuit examined the facts at issue, and held that they were so predominantly foreign as to preclude Section 10(b) liability. The alleged misrepresentations had been made primarily in Germany and had concerned the stock of a German company traded only on European exchanges. Moreover, the German defendant had not been a party to the plaintiffs' securities transactions, even if they were domestic transactions under *Morrison*.

Thus, the Second Circuit ... construed *Morrison* to allow — if not require — courts to "carefully make their way with careful attention to the facts of each case and to combinations of facts that have proved determinative in prior cases, so as eventually to develop a reasonable and consistent governing body of law on this elusive question."

Accordingly, the court refused to "permit the plaintiffs, by virtue of an agreement independent from the reference securities, to hale the European participants in the market for German stocks into U.S. courts and subject them to U.S. securities laws." But the Second Circuit cautioned that it had "neither the expertise nor the evidence to allow us to lay down, in the context of the single case before us, a rule that will properly apply the principles of *Morrison* to every future § 10(b) action involving the regulation of securities-based swap agreements in particular or of more conventional securities generally."

Potential Impact of the Second Circuit's Ruling

The Second Circuit's decision rejects the notion that bright-line rules can and should apply to all cases concerning Section 10(b)'s reach. The court concluded that slavish application of supposedly clear "tests" can lead to results that might be inconsistent with the underlying principles that the "tests" were designed to promote. Thus, the Second Circuit, while making due obeisances

to the Supreme Court, construed *Morrison* to allow — if not require — courts to "carefully make their way with careful attention to the facts of each case and to combinations of facts that have proved determinative in prior cases, so as eventually to develop a reasonable and consistent governing body of law on this elusive question."

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First, if satisfaction of the *Morrison* test is not *sufficient* for Section 10(b) liability, how wide an opening has the Second Circuit created for consideration of other facts about a transaction's foreign or domestic nature?

Second, in light of the Second Circuit's focus on the difference between the conventional securities at issue in *Morrison* (common stock) and various types of non-conventional securities, how much room exists to argue that the *Morrison* test is not itself dispositive for transactions involving American Depositary Receipts ("ADRs"), derivatives, swaps, *etc.*?

Third, the Second Circuit did not express any opinion on the district court's use of an "economic reality" test to analyze whether Section 10(b) should apply to U.S. transactions in securities that reference foreign securities listed only on foreign exchanges. The decision thus does not resolve whether the economic-reality analysis is consistent with *Morrison*.

Fourth, the Second Circuit held that its decision "in no way forecloses the application of § 10(b) to govern fraud in connection with securities-based swap agreements where the transactions are domestic *and* where the defendants are alleged to have sufficiently subjected themselves to the statute" (emphasis added). Will this language be used to distinguish sponsored ADRs from unsponsored ADRs (which can be issued by U.S. depositary institutions without the foreign issuer's involvement or even consent)?

Fifth, the Second Circuit took a passing swipe at Congress's apparent effort in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to partially overturn the *Morrison* case by reinstating the conduct/effects tests in actions brought by the Securities and Exchange Commission or the United States (but not by private plaintiffs). The Dodd-Frank Act gives federal courts "jurisdiction" over cases involving significant U.S.-based conduct or substantial effects within the United States. However, as *Morrison* held, the scope of the Exchange Act's extraterritorial effect is not a *jurisdictional* issue; it involves a substantive element of the claim. The Second Circuit therefore characterized "the import of this amendment [as] unclear." Does the Second Circuit mean to suggest that the amendment might *not* have accomplished what Congress presumably intended to do for actions brought by the government?

The text of the Second Circuit's decision in ParkCentral Global Hub Ltd. v. Porsche Automobile Holdings SE, 2d Cir., No. 11-403, Aug. 15, 2014, is available at http://www2.bloomberglaw.com/public/desktop/document/Parcentral_Global_Hub_Limited_v_Porsche_Automobil_Holdings_SE_Doc/2.

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