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Second Circuit Grafts "Predominance" Test on to Morrison, Precluding Claims Founded on Domestic Securities Transactions Manipulated by Foreign Conduct

In 2010, the United States Supreme Court issued its decision in *Morrison v. National Australia Bank, Limited*, 561 U.S. 247 (2010), which set forth a bright-line test for determining when a particular case impermissibly relied on an extraterritorial application of Section 10(b) of the Securities Exchange Act. The Court held that Section 10(b) applies only if the claim is based on the "purchase or sale of a security listed on a domestic exchange," or if the claim is based "on a domestic purchase or sale of another security." Morrison, 561 U.S. at 267. The Morrison decision forced institutional investors with losses on securities transactions on foreign exchanges to seek remedies in foreign jurisdictions based on foreign law, even if much of the fraudulent conduct occurred in the United States or was directed at United States investors.[1]

In reaching this decision, the Supreme Court overruled the Second Circuit's standard for determining whether a case involved the improper extraterritorial application of federal securities laws. Prior to Morrison, the Second Circuit had established a conduct-and-effects test: courts were to evaluate whether the allegations demonstrated that the wrongful conduct upon which the claim is based occurred in the United States, and whether the effects of the conduct (though occurring abroad) were substantial on the United States or United States citizens. Id. at 257-58. The Supreme Court eschewed the conducts-and-effects test for a transactional test, which requires that the securities transaction at issue take place in the United States for Section 10(b) to apply.

On August 15, 2014 the United States Court of Appeals for the Second Circuit was confronted with a case where the securities transaction undoubtedly took place in the United States. In addition, the securities transaction was between two parties residing in the United States. Yet, the court held that the case was an improper attempt by the plaintiffs to apply Section 10(b) extraterritorially because, despite the domestic transaction, the profit or loss on the security was tied to the share price of a company listed on a foreign exchange and foreign aspects of the claim otherwise "predominated."

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The Second Circuit thus effectively revived the conduct portion of its earlier test, but applied it in reverse—despite a domestic transaction, there can be no Section 10(b) claim if the underlying conduct and securities tied to the domestic transaction are both foreign.

This case, *Parkcentral Global Hub Limited, et al. v. Porsche Automobile Holdings SE, et al*, No. 11-397-CV, __ F.3d __, 2014 WL 3973877 (2d Cir. August 15, 2014), will be important to other courts around the country in applying Morrison to different factual scenarios.

Porsche's Facts: Investors Made Domestic Purchases of Derivative Contracts Tied to Foreign Stock

In the *Porsche* case, the plaintiffs were various investors that purchased securities-based swap agreements tied to the stock of Volkswagen AG ("VW"), a German car manufacturer. VW's stock was listed on various European stock exchanges, but was not listed on any United States exchanges. The investors used the swap agreements to place bets that the price of VW's stock would decline, similar to shorting the stock directly. *Id*. at *1-2.

Importantly, however, the securities-based swap agreements were separate and distinct securities from the underlying VW stock. The swaps were private contracts between two parties in which they "agree[d] to exchange cash flows that depend on the price of a reference security, here the VW shares." *Id*. at *3. The investors entered into the swap agreements in the United States, and their counter-parties were banks based in the United States. Id. at *6. The swap agreements contained New York choice-of-law provisions and forum selection clauses designating New York federal and state courts as the forum in which legal disputes would be resolved. *Id*.

The investors alleged that they were deceived into taking their positions in the swap contracts tied to VW's stock by Porsche Automobile Holding SE ("Porsche"), another European car manufacturer. Porsche allegedly made fraudulent statements in early 2008 denying that the company had any interest in acquiring VW. *Id*. at *1-2. In addition, the investors alleged that Porsche deceptively manipulated the market in VW shares through a complex strategy of using put and call options to hide how the company was surreptitiously acquiring a large block of shares in VW at the same time it was denying any interest in acquiring the

company. Then, in October 2008, Porsche announced that it did intend to acquire VW. VW's shares rose significantly because of this news and subsequent "short squeeze" resulting from Porsche's options trading. Consequently, the investors that purchased securities-based swaps betting on a decline in VW's share price incurred significant losses. *Id*. at *4-5.

Porsche's alleged deceptive conduct occurred primarily in Germany, although some of the statements were made, or at a minimum available, in the United States. *Id*. at *7. Like VW, Porsche stock was also traded on European exchanges, rather than on exchanges in the United States. The Porsche executives named as defendants resided in Germany. Neither VW nor Porsche had any role in structuring or participating in the securities-based swaps. *Id*. at *1, *3-4.

The swaps investors sued Porsche and several of its executives in the United States District Court for the Southern District of New York, alleging that they violated Section 10(b) of the Securities Exchange Act of 1934 by making false and misleading statements and otherwise deceiving investors in connection with the value of VW's shares. The district court dismissed the case, and the investors appealed.

Second Circuit Says Morrison Transactional Test Should Not Be Read Too Literally

The Second Circuit affirmed dismissal of the investors' claims against Porsche, concluding that allowing the claims to go forward would be an improper extraterritorial application of Section 10(b) under *Morrison*.

In reaching this conclusion, the court acknowledged that, on its face, the complaint seemed to satisfy the "domestic transaction" test set forth in *Morrison* and the Second Circuit's *Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012) decision applying Morrison. In *Ficeto*, the court held that a transaction qualifies as a domestic purchase or sale where the purchaser of the security "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." *Id*. at 68.

But the court also cautioned that the *Morrison* transaction test cannot be read too literally. Unlike legislatures, which pass general laws for prospective application, courts establish rules retrospectively based on the facts and circumstances of the dispute before it. Thus, it stated that courts should "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." *Porsche*, 2014 WL 3973877 at *13.

Where Foreign Fraudulent Conduct Predominates, Domestic Transactions Insufficient to Invoke Section 10(b)

Then the court grafted on to Morrison's transactional test a "predominance" inquiry—if the claims are based so predominantly on foreign conduct, foreign defendants and the share price movement of a stock traded exclusively on a foreign exchange, the fact of a domestic transaction is insufficient to invoke Section 10(b). Id. at 43-45. The court reasoned that although a domestic transaction in a security is a necessary element, it is not a sufficient element to invoke Section 10(b). *Id*. at *14. The court wrote:

> If the domestic execution of the plaintiffs' agreements could alone suffice to invoke § 10(b) liability with respect to the defendants' alleged conduct in this case, then it would subject to U.S. securities laws conduct that occurred in a foreign country, concerning securities in a foreign company, traded entirely on foreign exchanges, in the absence of any congressional provision addressing the incompatibility of U.S. and foreign law nearly certain to arise. That is a result Morrison plainly did not contemplate and that the Court's reasoning does not, we think, permit.

Id. at *15. Absent the predominance inquiry, the court reasoned that finding a domestic transaction sufficient would ignore the Morrison court's concern about applying Section 10(b) in a way that would displace the securities laws and regulations of other countries which have primary responsibility for companies listed on foreign exchanges. *Id*.

Accordingly, the court held "we think that the relevant actions in this case are so predominantly German as to compel the conclusion that the complaints fail to invoke § 10(b) in a manner consistent with the presumption against extraterritoriality." *Id*.

Porsche Decision Continues Trend Limiting Reach of Securities Laws

With the *Porsche* decision, courthouse doors in the United States (at least within the Second Circuit) are closed to purchasers of domestic derivatives contracts that have been manipulated by foreign fraudulent conduct. Plaintiffs will not be able to invoke Section 10(b), even where the securities transactions undoubtedly took placed in the United States, if the defendants can demonstrate that foreign issues and conduct predominate such that permitting Section 10(b) liability could frustrate or conflict with the regulation of foreign issuers by countries in which they are listed. The *Porsche* case further amplifies the trend in United States courts to narrow the territorial coverage of the federal securities laws, forcing investors to litigate in state or foreign courts.

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[1] Under certain circumstances, some domestic investors have had success asserting claims in federal court making allegations of violations of state law or foreign law where the conduct focused on or emanated from the United States. *See In re BP p.l.c. Sec. Litig. (Alameda Cty. Emp. Ret. Assoc., et al. v. BP p.l.c., et al.)*, MDL No. 10-md-2185, Civ. Act. No. 12-CV-12561 (S.D. Tex. Dec. 5, 2013), decision available at Securities Litigation Alameda County Employees.