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Recent Second Circuit Decision in *Parkcentral* v. *Porsche* Extends *Morrison* Test by Limiting Applicability of Section 10(b) Based on "Foreignness" of Claims

In *Parkcentral Global Hub Ltd.* v. *Porsche Automobil Holdings SE*, No. 11-397-cv (2d Cir. Aug 15, 2014), the Second Circuit added a layer of restrictions on the application of Section 10(b) of the Securities Exchange Act of 1934 to claims based in substantial part on extraterritorial conduct. The Supreme Court had imposed one layer of restriction in *Morrison* v. *Nat'l Australia Bank Ltd.*, 561 U.S. 247 (2010), which limited § 10(b) liability to cases predicated on a purchase or sale of a security listed on a domestic exchange and to domestic transactions in other securities. In *Parkcentral*, the Second Circuit ruled that even if the Morrison test is satisfied, claims may still be considered "predominantly foreign," and thus considered extraterritorial and immune to § 10(b) liability. It declined to lay out guidelines for determining whether a claim is "predominantly foreign," leaving that question for development in future cases.

Background

In *Morrison* v. *Nat'l Australia Bank Ltd.*, 561 U.S. 247 (2010), the Supreme Court held that § 10(b) has no extraterritorial application. *Id.* at 262. The Court rejected the "conduct and effects" test the Second Circuit and other lower courts had applied to determine whether the U.S. securities laws applied to arguably foreign activity. It held that "the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States." 561 U.S. at 266. It therefore concluded that § 10(b) applies only to purchases or sales of securities listed on an American stock exchange and purchases or sales of securities that take place in the United States. *Id.* at 273. In reaching this conclusion, it cited the longstanding judicial presumption against extraterritorial application of American law, and noted the risk that extraterritorial application would create "incompatibility with the applicable laws of other countries." *Id.* at 255, 269.

In *Parkcentral,* the Second Circuit considered the application of *Morrison* to certain domestic transactions in derivative securities whose value is based on the prices of foreign securities, and where the underlying allegedly fraudulent activity had occurred abroad. The plaintiff hedge funds had entered domestic "securities-based swap agreements" based on the price of the foreign-exchange-traded shares of Volkswagen AG ("VW"), which effectively gave them an economic short interest in VW. These swap agreements were entered in the United States with counterparties that did not include the defendants. The plaintiffs alleged that the defendants, Porsche Automobil Holding SE ("Porsche") and two of its executives, had falsely claimed that Porsche was not planning to acquire VW, while secretly accumulating

a large interest in VW's stock by buying call options and selling put options. The alleged conduct took place in Europe. Plaintiffs further alleged that when Porsche ultimately announced its effective interest in VW (approximately 74 percent) and its intention to acquire a controlling interest, the stock shot up, earning windfall profits for Porsche while causing a "short squeeze" that cost short sellers over $38 billion.

The plaintiffs filed suit in the Southern District of New York, and the defendants moved to dismiss on the basis that § 10(b) does not apply to the transactions. The district court granted the defendants' motion to dismiss, reasoning that because the swaps were intrinsically tied to the price of the foreign securities, they were effectively "transactions conducted upon foreign exchanges and markets," and not domestic transactions. *Elliott Associates* v. *Porsche Automobil Holding SE*, 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010) (quoting *Morrison*, 561 U.S. at 263, 267).

Second Circuit Decision

The Second Circuit affirmed the dismissal, but on different grounds. The court held that, while a domestic securities transaction (or transaction in a domestically listed security) is *necessary* under *Morrison* for § 10(b) to apply, such a transaction is not *sufficient* to support the application of § 10(b). The Second Circuit reasoned that applying §10(b) whenever a suit is predicated on a domestic transaction, "regardless of the foreignness of the facts constituting the defendant's alleged violation," would undermine the Supreme Court's rationale in *Morrison* by inevitably putting §10(b) in conflict with foreign securities regulations. The Second Circuit therefore found that the location of a transaction is not the sole factor in determining whether application of §10(b) would be impermissibly extraterritorial.

Applying this rationale to the domestic swap transactions at issue, the Second Circuit held that even if the transactions were domestic under the *Morrison* test, the plaintiffs' claims were "so predominantly foreign" that the application of § 10(b) would be impermissible. It noted that the complaints concerned statements "made primarily in Germany with respect to a stock in a German company traded only on exchanges in Europe."

The Second Circuit declined to propose a new "bright-line" test of extraterritoriality, stating that the determination would likely be highly factual until a reasonable body of law developed on the question. It remanded to give the plaintiffs an opportunity to amend their complaints.

Analysis

The Second Circuit's ruling reflects the difficulty of applying bright-line tests such as that of *Morrison* to complex and rapidly-evolving transactions in modern securities markets. In increasingly international securities markets, the result is a multi-factor test whose outcome is less predictable, but that recognizes

the importance of avoiding incompatibility with foreign law and regulation that has a stronger claim to application to the facts of the case.

The *Parkcentral* case presented a challenge because its facts satisfied the plain language of the *Morrison* test—the purchases and sales of the affected securities took place in the United States—but little or none of the challenged conduct occurred there, the underlying stock was not traded there, and the derivative securities at issue were not created, sanctioned or controlled by any of the defendants. The presumption and the policies on which the *Morrison* holding was based thus supported a result opposite to the language of the test articulated in that opinion.

The Second Circuit elected to follow the dictates of the presumption and the policies, and reconciled its conclusion with the language of *Morrison* by holding that the focus on where the purchases and sales took place is only a first step in the extraterritoriality analysis. It held that *Morrison* thus imposed a requirement that is necessary but not sufficient to state a claim under § 10(b). It ruled that even securities transactions that occur in the United States may still be insufficiently domestic in nature to apply § 10(b) liability.

The second step imposed by the Second Circuit in *Parkcentral* turns on the nature of the specific claims in the case. In *Parkcentral*, the Court focused on the fact that the claims involved "statements made primarily in Germany with respect to stock in a German company traded only on exchanges in Europe." It acknowledged, however, that it was unable "to proffer a test that will reliably determine when a particular invocation of § 10(b) will be deemed appropriately domestic or impermissibly extraterritorial." In this respect, its approach suffers from one of the very defects the Supreme Court had criticized when it rejected the Second Circuit's "conduct and effects" test in Morrison: the risk of "unpredictable and inconsistent application of § 10(b) to transnational cases." 561 U.S. at 260. Indeed, the factors cited by the Second Circuit are similar to those previously considered relevant to the "conduct" element of the rejected test.

The contours of this additional condition will necessarily develop by application in future cases. Defendants will have a basis to argue against application of § 10(b) in cases in which underlying conduct occurred abroad, underlying securities were listed abroad, other non-domestic elements are present, or foreign law or regulators may have a stronger claim to authority over the matter. Though this adds uncertainty to the application of § 10(b), that uncertainty is an inevitable result of the ongoing development and evolution of the creation and trading of securities in global commerce.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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