US Court of Appeals for the Second Circuit Clarifies Standard for "Domestic Transactions" Prong of *Morrison*

In *Morrison v. National Australia Bank Ltd.*, the US Supreme Court sharply restricted the extraterritorial applicability of the antifraud provisions of the securities laws. *Morrison* held that § 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) only applies to "transactions in securities listed on domestic exchanges and domestic transactions in other securities."[1] This holding has since been used by defendants with great success. But while *Morrison* pretty clearly excluded certain claims from US courts, it did not provide guidance as to when the purchase or sale of a security that is not listed on a domestic exchange should be considered sufficiently "domestic" for the US courts to exercise jurisdiction over them, leaving that task to the lower federal courts.[2]

In the recent case of *Absolute Activist Value Master Fund Ltd. v. Ficeto*, the Second Circuit Court of Appeals for the first time addressed the ambiguity created by *Morrison*'s off-market transactions prong, announcing a standard for "domestic transactions" that combined the tests proposed by the Eleventh Circuit and the Southern District of New York.[3] According to the Second Circuit, in order to establish the existence of a "domestic transaction in other securities," a plaintiff "must allege facts suggesting that either **irrevocable liability was incurred** or **title transferred within the United States**."[4] In addition to clarifying the legal standard, the opinion provides useful guidance as to what Second Circuit defendants may now argue in *Morrison*-based motions to dismiss.

Ficeto involves an alleged "pump and dump" scheme that caused plaintiffs, a group of nine Cayman Islands hedge funds, to suffer losses of at least $195 million through cycles of fraudulent securities trading. Over the course of approximately three years, defendant investment managers allegedly caused plaintiff funds to purchase billions of shares of thinly capitalized US-based companies (referred to by the opinion as "US Penny Stock Companies") directly from those companies in a series of private investment in public equity (PIPE) transactions. All of the US Penny Stock Companies involved were incorporated in the United States and their shares were listed on the Over-the-Counter Bulletin Board or by Pink OTC Markets, Inc. Additionally, during the time that plaintiffs purchased their stocks, these companies had registered their shares with the SEC.

After causing plaintiffs to purchase shares of the US Penny Stock Companies, defendants, who held and controlled substantial portions of these companies' shares, proceeded to artificially inflate the prices of the US Penny Companies' stocks by trading and re-trading them, in many cases between the plaintiff funds, each time at a higher price to create the appearance of a high trading volume. The complaint alleged that this scheme enabled defendants—who had purchased the US Penny Companies' stock for little to nothing—to falsely obtain profits by selling

shares to the plaintiff funds for a windfall, through price inflation and manipulation. The complaint also claimed that other defendants raised funds from investors, including investors located in the United States, in furtherance of the scheme.

The Southern District of New York trial court dismissed the complaint in its entirety, reasoning that, in light of *Morrison*, it lacked subject matter jurisdiction over the case.[5] On January 20, 2011, the plaintiff funds appealed the district court's ruling to the Second Circuit Court of Appeals.

In its March 1, 2012, opinion, the Second Circuit held that the district court erred in dismissing the case for lack of subject matter jurisdiction because *Morrison* clarified that whether § 10(b) applies to certain conduct is a "merits" question.[6] Furthermore, all parties had asked the Second Circuit to address the issue of whether the district court erred in dismissing the complaint because it found that the transactions at issue fell outside of the territorial reach of § 10(b).[7] Thus, the real challenge before the Second Circuit was to "determine under what circumstances the purchase or sale of a security that is not listed on a domestic exchange should be considered 'domestic' within the meaning of *Morrison*."[8]

In its "domestic transactions" analysis, the Second Circuit first noted that, because the Supreme Court failed to clearly do so in *Morrison*, it was necessary to define the terms "purchase" and "sale."[9] Based upon the Exchange Act's definition of the terms, the Second Circuit reasoned that a "purchase" and a "sale" take place "when the parties become bound to effectuate the transaction," e.g., when they incur "irrevocable liability."[10]

In further support of this proposition, the Second Circuit cited *Radiation Dynamics, Inc. v. Goldmuntz*,[11] in which it had held that the district court properly instructed the jury that "the time of a 'purchase or sale' of securities within the meaning of Rule 10b-5 is to be determined as the time when the parties to the transaction are committed to one another."[12] Thus, because a purchase or sale becomes complete at the point where irrevocable liability incurs, the court held that "the point of irrevocable liability can be used to determine the locus of a *securities* purchase or sale."[13]

To adequately allege the existence of a domestic securities transaction, then, a plaintiff must allege "facts leading to the plausible inference that the parties incurred irrevocable liability within the United States: that is, that the purchaser incurred irrevocable liability within the United States to deliver a security."[14] This "irrevocable liability" test was the test that had been employed and previously adopted in the Southern District of New York.[15]

In addition to the irrevocable liability test, the court recognized the differing analytical paths taken by federal courts outside of the Second Circuit. For example, in *Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, the Eleventh Circuit held that plaintiffs' allegation that title to the shares was transferred within the United States was sufficient to survive a *Morrison*-based motion to dismiss.[16] Citing the fact that *Black's Law Dictionary* defines sale as "[t]he transfer of property or title for a price," the Second Circuit concluded that a sale of securities can be understood to transpire at the location in which title is transferred.[17]

Thus, finding merit to the approaches of both the Southern District of New York and the Eleventh Circuit, the standard ultimately articulated by the Second Circuit combined the two tests: "to sufficiently allege a domestic securities transaction in securities not listed on a domestic exchange … [a plaintiff] must allege facts suggesting that irrevocable liability was incurred **or** title was transferred within the United States."[18]

The Second Circuit did not stop there, however. The court provided additional reasoning as to why other standards proposed by the

parties should be rejected, and, in so doing, further clarified what *may* versus what *may not* likely suffice for an allegation of a "domestic transaction."

Plaintiffs had argued that the broker-dealer's location could be used to locate securities transactions, but the Second Circuit rejected that suggestion based upon the fact that the location of a broker, alone, does not automatically determine where a contract was executed; the court did note that the location could be relevant to where the broker dealer has completed tasks that irrevocably bind the parties to buy or sell securities. The Second Circuit similarly rejected plaintiffs' argument that the identity of the securities—in this case, the fact that the stocks were US stocks—should be used to determine whether a securities transaction is domestic. The court stated that it "cannot conclude that the identity of the security necessarily has any bearing on whether a purchase or sale is domestic within the meaning of *Morrison*," because the second prong of *Morrison* refers to "'domestic transactions in other securities,' not 'transactions in domestic securities' or 'securities … registered with the SEC.'"

Next, the court dismissed a test proposed by the defendants: that the identity of the buyer or seller should be used to determine the domesticity of a transaction. Citing *Plumbers' Union*, the court held that citizenship and residency of a purchaser do not affect where a transaction occurs, because a foreign resident can make a purchase domestically, just as US residents can make purchases abroad. (Elsewhere in the *Ficeto* decision, the court also noted that residency could not be used to allege "domestic transactions" under the new standard: the fact that two of the defendants resided in California "does not lead to the plausible inference that the Funds became irrevocably bound to purchase US Penny Stocks in the United States.") Finally, the court rejected one defendant's proposal to return to a pre-*Morrison* style "conduct and effects" approach that would examine whether each individual defendant engaged in conduct within the United States.[19]

Applying its newly announced standard to the facts of the case, the Second Circuit concluded that plaintiffs had **not** sufficiently alleged "domestic transactions." Although the complaint had adequately alleged domestic purchases, the court found that the allegations did not "sufficiently allege that purchases or sales took place in the United States," because the complaint's sole allegation that affirmatively stated transactions transpired in the United States was conclusory. Absent allegation of facts suggesting that plaintiffs became irrevocably bound or that stock title transferred within the United States, a mere assertion that transactions "took place in the United States" would not suffice to adequately plead the existence of domestic transactions. Quoting *Morrison*, the court emphasized 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."[20]

Nonetheless, the court granted plaintiffs leave to amend their complaint based upon the fact that the standard for "domestic transactions" had contained substantial ambiguity at the time of filing the complaint.[21] It will be interesting to see whether, on remand, the plaintiffs allege sufficient facts to meet the Second Circuit's newly articulated standard.

Ficeto provides a useful framework for defendants seeking to test the sufficiency of securities claims involving domestic transactions in non-US securities. The Second Circuit has arguably increased the potential number of circumstances that may qualify as "domestic transactions in other securities" by combining the two tests proposed by the Eleventh Circuit and the Southern District of New York to create a standard that is broader than the sum of its parts. On the other hand, by clarifying the contours of the legal standard, the Second Circuit has made clear that not all allegations of domestic transactions will suffice—only those

that adequately allege irrevocable liability was incurred, or that title to the off-market securities at issue transferred, within the United States. Due to the large volume of post-*Morrison* cases brought by plaintiffs alleging that US securities laws should apply to non-market transactions, the Second Circuit's holding in *Ficeto* could have a wide-ranging impact.

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Endnotes

[1] 130 S. Ct. 2869, 2884 (2010).

[2] *See Plumbers' Union Local No. 12 Pension Fund v. Swiss Reins. Co.*, 753 F. Supp. 2d 166, 176 (S.D.N.Y. 2010).

[3] *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 11-0221-cv, 2012 WL 661771 (2d Cir. Mar. 1, 2012).

[4] *Id.* (emphasis added).

[5] *Absolute Activist Value Master Fund Ltd. v. Homm,* No. 09 Civ. 08862 (GBD), 2010 WL 5415885, *1 & n. 3 (S.D.N.Y. Dec. 22, 2010).

[6] *Ficeto*, 2012 WL 661771.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] 464 F.2d 876, 891 (2d Cir. 1972).

[12] *Ficeto*, 2012 WL 661771.

[13] *Id.* (emphasis added).

[14] *Id.*

[15] *See SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 159 (S.D.N.Y. 2011); *Plumbers' Union*, 753 F. Supp. at 177.

[16] 645 F.3d 1307, 1310-11 (11th Cir. 2011).

[17] *Ficeto*, 2012 WL 661771.

[18] *Id.* (emphasis added).

[19] *Id.*

[20] *Id.* (citing *Morrison*, 130 S. Ct. at 2884).

[21] The plaintiffs had filed their complaint on November 19, 2009, well in advance of the Supreme Court's decision in *Morrison*, and the Second Circuit observed that the complaint seemed to have been drafted with the now-defunct "conduct and effects" test in mind. *See id.*