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Second Circuit Defines "Domestic Transaction" Under Morrison

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On March 1, the Second Circuit issued a decision setting the standard for pleading a "domestic transaction" sufficient to withstand a motion to dismiss based on *Morrison v. National Australia Bank Ltd*.[1]. In *Absolute Activist Value Master Fund Ltd. v. Ficeto*[2], the court held that "plaintiffs must allege facts suggesting that either irrevocable liability was incurred or title transferred within the United States,"[3] explaining that they could do so by alleging that some of the following occurred in the United States: the formation of the contract, the placement of purchase orders, the passing of title, or the exchange of money. This test is more flexible than that many district courts in the Second Circuit had been applying. This flexibility likely will make it easier for plaintiffs to survive a motion to dismiss when bringing a fraud claim concerning securities that are not listed on U.S. exchanges, but the Second Circuit's approach is also likely to generate new challenges for plaintiffs seeking to litigate their claims as class actions.

Background

Absolute Activist involved nine Cayman Islands hedge funds that purchased and sold securities through a U.S. broker-dealer. The defendants included the broker-dealer and certain of its employees, one of whom was a California resident and registered securities agent. The plaintiffs alleged that the defendants artificially inflated the prices of securities in a scheme that caused the funds to lose approximately $195 million.

"Domestic Transactions"

In *Morrison*, the Supreme Court adopted a "transactional test" in holding that Section 10(b) of the Securities Exchange Act of 1934 does not apply extraterritorially but only to "transactions in securities listed on domestic exchanges and domestic transactions in other securities"[4]. The Second Circuit interpreted *Morrison's* second prong to hold that a transaction is "domestic" if "irrevocable liability is incurred or title passes within the United States"[5].

Given *Morrison's* lack of guidance as to what constitutes a domestic purchase or sale, the Second Circuit relied on the Exchange Act's definitions of "buy" and "purchase" as including "any contract to buy, purchase or otherwise acquire" and its definitions of "sale" and "sell" as including "any contract to sell or otherwise dispose of"[6]. These definitions suggest that the act of purchasing or selling securities "is the act of entering into a binding contract" and therefore a purchase or sale "take[s] place when the parties become bound to effectuate the transaction"[7]. The court reasoned that the moment when the parties become bound is "the point of irrevocable liability" for the contract[8].

Importantly, the court did not hold that a plaintiff must allege that the contract had been formed entirely (i.*e*., both offer and acceptance) in the United States in order to survive a motion to dismiss based on *Morrison*. Instead, the court explained that it is sufficient to plead "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"[9]. Thus, allegations from which the court could infer that *either* party agreed in the United States to be bound could be sufficient at the pleading stage. The court suggested, for example, that it could be sufficient merely to allege that some of the following took place in the United States: the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money.

The court rejected the plaintiffs' allegations as insufficient to plead "domestic" transactions. The plaintiffs had alleged that the defendant broker-dealer was registered, and one of its principals resided, in California. But the court found the parties' residence irrelevant, since it did not make it more likely that the purchase or sale had occurred there[10]. Similarly, the court found the plaintiffs' allegations that the underlying securities were issued by U.S. companies and were registered with the SEC did not demonstrate that the purchases or sales had occurred here[11]. The Second Circuit clearly was not inclined to establish bright-line rules for determining whether a transaction is "domestic" for purposes of *Morrison*. The court reversed the dismissal of the plaintiffs' case so that the plaintiffs could be given the opportunity to amend their complaint to attempt to meet the *Absolute Activist* standard.

Practical Significance

Although the test articulated by the *Absolute Activist* court previously had been adopted and applied by a few district courts in the Second Circuit[12], others have dismissed complaints containing allegations that might now be sufficient after the Second Circuit's ruling.

In *Cornwell v. Credit Suisse Group*[13], for example, the court dismissed a complaint based on *Morrison* despite the plaintiff's allegations that it made a decision to invest in, and initiated the purchase of, the securities at issue in the United States. The court explained that it was inconsistent with *Morrison* for courts to conduct the "extensive analysis required . . . to assess quantitatively how many and which parts or events of transactions occurred within the United States . . . and then to apply value judgments to determine whether the cluster of those activities sufficed to cross over the threshold of enough domestic contacts to justify extraterritorial application" [14].

Adopting similar logic, several courts have dismissed complaints that included allegations that certain aspects of a transaction had occurred domestically. *See, e.g., Elliott Assoc. v. Porsche Automobil Holdings* (complaint dismissed despite allegation that plaintiff' signed confirmations for securities swap agreements in New York)[15]; *In re Societe General Sec. Litig.* (allegation that "buy order" was placed domestically was insufficient)[16]; *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.* (same)[17]; *In re Alstom SA Sec. Litig.* (complaint dismissed despite allegation that securities purchases "were initiated" in U.S.)[18].

While it is not clear whether any of these cases would have been decided differently in light of *Absolute Activist*, it does seem clear that courts will be required to determine which parts or events of transactions occurred in the United States in order to access the point of irrevocable liability or where title passed. Moreover, given the wide range of transaction-related facts that the Second Circuit held could tend to demonstrate irrevocable liability, the bar for plaintiffs to survive a motion to dismiss seems to have been significantly lowered.

The Second Circuit's decision is also likely to make it more difficult for plaintiffs pursuing claims under *Morrison's* second prong to achieve class certification. Under *Absolute Activist*, determining what constitutes a "domestic transaction" is usually a fact-intensive inquiry dependent on the particular circumstances surrounding a purchase or sale. But class certification requires that class members be readily ascertainable (i.e., identifiable by courts in a non-burdensome and practical matter)[19]. Plaintiffs will be hard-pressed to come up with a class definition for which the class can satisfy *Absolute Activist* and be sufficiently ascertainable.

[1] 561 U.S. __, 130 S. Ct. 2869 (2010).
[2] No. 11-0221, __F.3d __ (2d Cir. Mar. 1, 2012) ("Opinion").
[3] Opinion at 3.
[4] *Morrison*, 130 S. Ct. at 2884.
[5] Opinion at 11.
[6] *Id.* at 12 (citing 15 U.S.C. § 78(c)(13) - (14)).
[7] Opinion at 13.
[8] *Id.*
[9] *Id.* (emphasis added).
[10] *See id.* at 17.
[11] The plaintiffs did not argue that they had satisfied *Morrison's* first prong because their claim was based on transactions in securities listed on domestic exchanges, so the Second Circuit only discussed the second prong. *See* Opinion at 11 n.4.
[12] *See, e.g., SEC v. Goldman Sachs & Co.,* 790 F. Supp. 2d 147, 159 (S.D.N.Y. 2010) (applying irrevocable liability test to determine when domestic transaction has occurred). The Eleventh Circuit Court of Appeals also recently applied a similar analysis, determining that *Morrison* "established a bright-line test based exclusively on the location of the purchase or sale of the security." *Quail Cruises Ship Mgmt., Ltd. v. Agencia de Viagens CVC Tur Limitada,* 645 F. 3d 1307, 1310-11 (2011). In *Quail Cruises*, the court reversed the dismissal of a Section 10(b) claim because the closing took place in Florida and therefore the sale of securities was consummated in the United States. *See id*. A U.S. closing is just one example that would satisfy the Second Circuit's *Absolute Activist* standard.
[13] 729 F. Supp. 2d 620 (S.D.N.Y. 2010).
[14] *Id.* at 624.
[15] 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010).
[16] 2010 WL 3910286 at *6 (S.D.N.Y. 2010).
[17] 753 F. Supp. 2d 166, 177 (S.D.N.Y. 2010).
[18] 741 F. Supp. 2d 469, 471 (S.D.N.Y. 2010).
[19] *See, e.g., In re Initial Public Offering Sec. Litig.,* 471 F.3d 24, 45 (2d Cir. 2006) (vacating class certification based on ascertainability requirement); *Charrons v. Pinnacle Group NY LLC*, 269 F.R.D. 221, 229 (S.D.N.Y. 2010) (finding that for class to be ascertainable, it must be "readily identifiable," "defined by objective criteria that are administratively feasible," and not subject to "mini-hearing on the merits of each case" (internal quotation marks omitted)).