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ParkCentral v. Porsche: The Second Circuit Signals New Lines of Defense to Extraterritorial Securities Fraud Claims



In *ParkCentral Global Hub Ltd. v. Porsche Automobile Holdings SE* (“*ParkCentral*”),¹ the US Court of Appeals for the Second Circuit held that domestic securities transactions that did not involve the foreign defendant, whose alleged fraudulent actions occurred largely abroad and related to price movements in non-US securities, were beyond the territorial scope of Section 10(b) of the Securities Exchange Act of 1934. While the Second Circuit firmly declined to provide a “bright-line” rule as to when a claim is so foreign as to be beyond the scope of US securities laws, the holding is another in a series of Second Circuit decisions that should make it harder for claimants to sustain US securities claims against non-US issuers of non-US securities. However, it also shows that the extraterritorial scope of Section 10(b) is a fact-sensitive question that will require careful analysis in each case.

The Facts: Extraterritorial Actions Relating to Domestic Swap Trades

The *ParkCentral* plaintiffs included more than 30 international hedge funds that entered into “securities-based swap agreements” (the “swaps”) indexed to the price of Volkswagen AG (“VW”) shares as recorded on foreign exchanges.² The plaintiffs alleged that Porsche Automobil Holding SE (“Porsche”), a VW shareholder, made fraudulent statements with respect to its intention to buy more VW shares, which in turn affected the value of the swaps. Porsche’s statements occurred primarily in Germany, though some statements were alleged to have been “accessible in the United States” and repeated by other defendants here.³ Although Porsche was not involved in any of the trades,⁴ the plaintiffs argued that because their swaps were “domestic transactions in other securities,”⁵ their claims were sufficiently territorial under *Morrison v. National Australia Bank Ltd.*⁶

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¹ No. 11-397-CV L, — F3d—, Slip Op. (2d Cir. Aug. 15, 2014) (“Slip Op.”).

² *Id.* at *1, 5. The Court noted that VW shares were traded on exchanges in Germany, Switzerland, Luxembourg and the United Kingdom. *Id.* at *21. Although VW had sponsored unlisted ADR programs, the Court noted that the holder of an ADR “is not the title owner of the underlying shares” and that none of the swaps had been indexed to the ADRs. *Id.* at *21 n.9.

³ *Id.* at *5. The Court also noted that Porsche was subject to regulation in Germany and that German authorities had investigated Porsche with regard to the allegations about its statements about VW. *Id.* at *16.

⁴ *Id.* at *21.

⁵ Plaintiffs included US entities and alleged that the swaps were entered into in the United States with US counterparties, and that the swaps contained New York choice of law and forum clauses. *Id.* at *12, *20 – 21.

⁶ 561 U.S. 247 (2010).

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The defendants' motion to dismiss the claims was granted by the lower court because the court found that "the swaps were essentially transactions in securities on foreign exchanges" and hence beyond the reach of US securities laws.⁷

The Decision: Applying *Morrison's* "Transactional Test" to Domestic Trades

The Second Circuit affirmed the dismissal, but on other—and broader—grounds. The Court first reviewed the *Morrison* decision, noting that the Supreme Court adopted a "transactional test" under which Section 10(b) applies only to "domestic" transactions, which are either "transactions in securities listed on domestic exchanges" or "domestic transactions in other securities."⁸

The Court then reviewed its prior decision in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, in which it wrestled with the issue of when a securities transaction not involving US exchanges is "domestic" for purposes of stating a Section 10(b) claim.⁹ In that case, non-US hedge funds purchased shares which only traded over-the-counter directly from US issuers. Holding that plaintiffs had to replead their claims to add more facts, the Second Circuit in *Absolute Activist* concluded that the identity of the securities at issue was not determinative to establish whether the transactions at issue were "domestic." The Court also refused to find as determinative the identity of the buyer and seller, the identity of the broker or whether alleged fraudulent acts occurred in the United States.¹⁰

Turning to the case at hand, the Court focused on *Morrison's* statement that Section 10(b) applies to "domestic transactions in other securities" and whether this means that alleging a domestic transaction is only *necessary*—or *is in all cases sufficient* to state a domestic Section 10(b) claim. The Court rejected the idea

that alleging a domestic transaction is sufficient because if that were the case, then Section 10(b) would have broad application "regardless of the foreignness of the facts constituting the defendant's alleged violation."¹¹ This in turn also would "seriously undermine" *Morrison's* "insistence" that Section 10(b) was to have "no extraterritorial application."¹² Thus, the Court held that "while [*Morrison*] unmistakably made a domestic securities transaction (or transactions in a domestically listed security) necessary to a properly domestic invocation of §10(b), such a transaction is not alone sufficient to state a properly domestic claim under the statute."¹³

Applying this principle to this case, the Court stressed that domestic swaps could not be the basis for a Section 10(b) claim with respect to "conduct that occurred in a foreign country, concerning securities in a foreign company, traded entirely on foreign exchanges."¹⁴ Although the Court refused to decide whether the swaps were truly "domestic transactions" under *Absolute Activist*, it did hold that the facts alleged did not allege a claim under Section 10(b) because the claims "concern statements made primarily in Germany with respect to stock in a German company traded only on exchanges in Europe."¹⁵ Thus, although plaintiffs alleged that "the false statements may have been intended to deceive investors worldwide," the "relevant actions in this case are so predominantly German as to compel the conclusion" that no claim for relief is stated under Section 10(b).¹⁶

Having rejected the claim, the Court then went to great lengths to make clear that its holding did not rule out all claims relating to similarly structured swaps or all claims with "foreign elements."¹⁷ Rather, the Court stressed that there was no bright-line test under *Morrison*, especially in "a world of easy and rapid transnational communication and financial innovation, [where] transactions in novel financial instruments—which

7 Slip Op. at *6.

8 *Id.* at *29.

9 677 F.3d 60 (2d Cir. 2012).

10 677 F.3d at 68-69, *cited in* Slip Op. at *33. Although not cited in *ParkCentral*, the Second Circuit recently clarified its decision in *Absolute Activist* to make clear that Section 10(b) cannot reach claims relating to securities traded on non-US exchanges simply because (i) the issuer is cross-listed on a US exchange or (ii) the order for the securities at issue was placed with a US broker. *City of Pontiac Policemen's & Firemen's Retirement Sys. v. UBS AG*, 752 F.3d 173 (2d Cir. 2014).

11 Slip Op. at *39, *41.

12 *Id.* at *41.

13 *Id.* at *40. The Court also noted that a contrary conclusion "would require 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." *Id.* at 41. Here, that also could raise serious issues of competing regulatory regimes as between US and German law. *Id.* at *41 – 42.

14 *Id.* at *42.

15 *Id.* at *44.

16 *Id.*

17 *Id.* at *45.

market participants can freely invent to serve the market's needs of the moment—can come in innumerable forms of which we are unaware and which we cannot possibly foresee.”¹⁸ Rather, noting that extraterritoriality is an “elusive question,” the Court said that each case will bear “careful attention to the facts...and to the combinations of facts” as courts formulate rules to apply *Morrison*.¹⁹

Implications

ParkCentral is another in a series of Second Circuit decisions (including *City of Pontiac*) that should make it harder for claimants to sustain US securities claims against non-US issuers of non-US securities. By stressing that a domestic transaction is only one necessary element of a Section 10(b) claim, the case makes clear that plaintiffs in securities fraud cases must clear two distinct hurdles:

- Absent a security traded on a US exchange, the plaintiffs must show a *domestic transaction*—which under *City of Pontiac* and *Absolute Activist* will not be a simple geographic test tied to where parties or brokers are located, but will involve an analysis of the underlying securities and transactions surrounding the transactions at issue in the claim.
- The plaintiffs also must show that the Section 10(b) *claim itself* is sufficiently domestic to come within *Morrison*'s stricture that Section 10(b) was not intended to have extraterritorial reach.

As a result, *ParkCentral* should make it harder for claims to be asserted as to non-US issuers using Regulation S for offshore sales to non-US persons and using Rule 144A for onshore sales to US investors because those types of claims often involve so many non-US facts and elements, and the decision did not give significant weight to the alleged local US statements and activities relating to the transactions.

At the same time, however, the Second Circuit's ruling makes clear that applying *Morrison* is not simple. Rather, this is a fact-based inquiry that will allow for nuanced results from case to case, as courts weigh the nature of the security at issue, its connection to the United States, and how the defendant's alleged improper conduct relates to the securities in question *and* the alleged claims. To the extent that this sounds like the “conduct and effects” test rejected in *Morrison*, the Second Circuit is arguing that this analysis is inherent in determining the extraterritorial reach of a Section 10(b) claim.

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¹⁸ *Id.* at *46.

¹⁹ *Id.* Recognizing that its decision represented an elaboration of the Court's thinking on *Morrison*, the Court remanded the case to the lower court to allow the plaintiffs an opportunity to amend their claims to plead additional facts that might state a claim. *Id.* at *6 – 7, *48.