

# New Circuit Split Complicates Domestic Securities Test

By **Eric Belfi and David Saldamando** (May 25, 2021)

Two recent holdings have cemented a circuit split regarding one key issue: whether the Second Circuit's "predominantly foreign" test in its 2014 decision in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*[1] is an additional hurdle that plaintiffs must satisfy to demonstrate that a transaction is domestic under the second prong[2] in the U.S. Supreme Court's 2010 decision in *Morrison v. National Australia Bank Ltd.*, even if they meet the traditional irrevocable liability test.



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The implications of this circuit split are important, as plaintiffs are undoubtedly aware of the inherent vagueness of the *Parkcentral* inquiry and the relative clarity of the irrevocable liability test.

In short, the U.S. Court of Appeals for the First Circuit just this month in *U.S. Securities and Exchange Commission v. Morrone*[3] affirmed the irrevocable liability test as the sufficient — and only — standard needed to make out a finding of a domestic transaction under the second prong of *Morrison*. [4]



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In contrast, in *Cavello Bay Reinsurance Ltd. v. Shubin Stein*[5] the U.S. Court of Appeals for the Second Circuit reaffirmed *Parkcentral* as an additional standard to take into consideration during a *Morrison* analysis, and in doing so, expanded *Parkcentral*'s reach, rendering it more difficult for plaintiffs to establish a finding of a domestic transaction. [6]

## Background

*Morrison* held that Section 10(b) of the Securities Exchange Act applies only to (1) "transactions in securities listed on domestic exchanges," and (2) "domestic transactions in other securities." [7] The Supreme Court based this finding upon "the focus of the Exchange Act," which focuses "not upon the place where the deception originated, but upon purchases and sales of securities in the United States." [8]

*Morrison*'s second prong has become a focal point for litigation throughout the last decade, as courts sought to define what exactly constitutes a domestic transaction such that it falls within *Morrison*'s ambit. What arose became known as the "irrevocable liability" test.

The irrevocable liability test was first established in 2012 in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, [9] where the Second Circuit held that for a transaction to be considered domestic, the plaintiff must plausibly allege "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." [10]

Key to the irrevocable liability test under *Absolute Activist* would be factual allegations "concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money." [11]

The irrevocable liability test has been explicitly adopted by the U.S. Court of Appeals for the Third Circuit in *U.S. v. Georgiou*, [12] by the U.S. Court of Appeals for the Ninth Circuit in

Stoyas v. Toshiba Corp.,[13] and now, most recently, by the First Circuit in SEC v. Morrone.[14]

### **The Circuit Split**

The affirmation of the irrevocable liability test by Absolute Activist, however, would not be the end of the road for the Second Circuit. The court in 2014 would go on to assert the "predominantly foreign" test in its Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE[15] decision.

In essence, the Second Circuit in Parkcentral did not even reach the question of whether the Parkcentral transactions — which were securities-based swap agreements — satisfied the irrevocable liability test of Absolute Activist, "because we think it clear that the claims in this case are so predominantly foreign as to be impermissibly extraterritorial." [16]

The court based its finding on the sufficient-versus-necessary premise, stating that "while a domestic transaction or listing is necessary to state a claim under §10(b), a finding that these transactions were domestic would not suffice to compel the conclusion that the plaintiffs' invocation of § 10(b) was appropriately domestic." [17]

### **Cavello Bay**

Earlier this year, the Second Circuit in Cavello Bay reaffirmed Parkcentral's applicability. The court found that the shares at issue in Cavello Bay did not trade on a domestic or foreign exchange, yet the Second Circuit recognized that "the transaction arguably took place in the United States," and assumed, without deciding, "that the parties' transaction was domestic under Absolute Activist." [18]

Nevertheless, the court found that the plaintiff's claims were predominately foreign under Parkcentral and thus, were not domestic transactions. [19]

The Second Circuit in Cavello Bay, instead of honoring Parkcentral's cautionary language that the "[t]he conclusion we have reached on these facts cannot, of course, be perfunctorily applied to other cases based on the perceived similarity of a few facts," [20] characterized Parkcentral's holding as that of establishing a doctrinal rule for all situations — and hinged this leap on equating Parkcentral's conclusion with Morrison's "focus on the Exchange Act" principle. [21]

Indeed, the Cavello Bay court described Morrison as asserting a rule whereby "courts [must] use the 'focus' of the [Section 10(b)] statute to determine whether a case involves a domestic application of § 10(b)." [22]

To that end, the Second Circuit asserted that Parkcentral "is a gloss on Morrison's rule," that "Parkcentral's so-foreign inquiry must be viewed that way," and that "Parkcentral nonetheless uses Morrison's focus on the transaction rather than surrounding circumstances." [23]

Cavello Bay's holding is puzzling because Morrison itself never held that the focus of the statute is what determines what constitutes a domestic transaction, i.e., that the definition of a domestic transaction can be provided by analyzing the focus of the Exchange Act.

Instead, a fair reading of Morrison leads to the conclusion that the court first analyzed the focus of the Exchange Act statute — which then led to the conclusion that "Section 10(b)

does not punish deceptive conduct," but rather seeks to regulate "purchase-and-sale transactions" — which then led to the creation of Morrison's actual rule: that Section 10(b) applies only to domestic transactions.[24]

In other words, Cavello Bay seems to reverse the order of the framework of analysis in Morrison, and in doing so, opens the door to asserting Parkcentral's "predominantly foreign" inquiry as an additional requirement in the domestic analysis.

In this manner, the Second Circuit expands Parkcentral's applicability to other cases with other fact patterns — most notably holding that Morrison's "'domestic transaction' rule operates [only] as a threshold requirement, and as such may be underinclusive." [25]

### **Morrone**

The First Circuit recently rejected this method of analysis in SEC v. Morrone. It found that the Supreme Court's reasoning in Morrison was simple, straightforward, and most of all, sufficient: (1) Morrison stated that Section 10(b)'s focus is on regulating transactions; (2) Morrison explicitly held that "if a transaction is domestic, § 10(b) applies"; (3) and thus, the First Circuit reasoned, "[t]he existence of a domestic transaction suffices to apply the federal securities laws under Morrison. No further inquiry is required." [26]

Thus, the First Circuit reverted back to the traditional standard that plaintiffs need to meet: the irrevocable liability test.[27] Applying this standard, the First Circuit found that facts concerning the stock subscription agreements, which were sent from the defendants located in Boston to foreign investors in Europe, gave rise to irrevocable liability in the U.S.[28]

The stock subscription agreements stated that the company had no obligation under it until the company executes and delivers to the investor an executed copy of the agreement.[29]

It was undisputed that the subscription agreements were executed in Boston on behalf of the company, and that the defendants issued shares from Boston to the investors.[30] Because the company became irrevocably liable to deliver the shares in Boston, Section 10(b) was applicable.[31]

### **Analysis and Implications**

What started as a desire by the Supreme Court in Morrison to provide a bright-line rule to put an end to the "vague formulations"[32] of the "conduct and effects"[33] test has slowly morphed at the circuit level into an equally unsettled interpretation of what Morrison itself demands.

Ultimately, the disagreement between the circuits stems from a rejection of Parkcentral as being inconsistent with Morrison.[34] Indeed, the Ninth Circuit in Stoyas held that the:

[T]he principal reason that we should not follow the Parkcentral decision is because it is contrary to Section 10(b) and Morrison itself. It carves-out "predominantly foreign" securities fraud claims from Section 10(b)'s ambit, disregarding Section 10(b)'s text: the domestic "purchase or sale of any security registered on a national securities exchange or any security not so registered." The basis for the carve-out was speculation about Congressional intent, Parkcentral, an inquiry Morrison rebukes. ... And Parkcentral's analysis relies heavily on the foreign location of the allegedly deceptive conduct, which Morrison held to be irrelevant to the Exchange Act's applicability, given Section 10(b)'s exclusive focus on transactions.[35]

The First Circuit in *Morrone* adopted the above rationale of the Ninth Circuit, also rejecting *Parkcentral* as inconsistent with *Morrison*.<sup>[36]</sup>

With this step, the First Circuit's recent affirmation of irrevocable liability further entrenches in the developing jurisprudence that the irrevocable liability test may still be the defining test for when a transaction is deemed domestic — with *Morrone*, two circuits have expressly considered *Parkcentral*'s applicability and have rejected it.

Should other circuits continue to adopt the *Stoyas* viewpoint on this issue, as exemplified above, the Second Circuit's "predominantly foreign" test may simply be a supplementary test exclusive to litigants in the Second Circuit.

Alternatively, other circuits may be persuaded by the reasoning of *Cavello Bay* and *Parkcentral*. In a sense, the Second Circuit's decision in *Cavello Bay* seems to harken back to the pre-*Morrison* conducts and effects test, in that the affirmation of the *Parkcentral* foreignness-inquiry takes steps to distance itself from a purely transaction-based approach.

This would explain the Second Circuit's noticeable efforts in seemingly preempting this point, where the court takes pains to reassure the reader that "*Parkcentral* nonetheless uses *Morrison*'s focus on the transaction rather than surrounding circumstances."<sup>[37]</sup>

Yet, despite this claim, it seems that the ultimate catalyst for the Second Circuit's underlying rationale is a desire to have judges "flexibly"<sup>[38]</sup> consider whether a claim is foreign or domestic, and move away from a rigid and formulaic transactionally based test.

Regardless of which circuit plaintiffs find themselves in, it would be wise for them to consider, identify, and plead the best transactionally based facts possible that would target the irrevocable liability test, as such remains the threshold<sup>[39]</sup> standard in the Second Circuit, and a sufficient standard in the other circuits.

A study of the recent district court case on remand from the Ninth Circuit after the *Stoyas* opinion illustrates the importance of such factual allegations.<sup>[40]</sup> The U.S. District Court for the Central District of California found that the purchase of unsponsored Toshiba Level 1 American depository receipts, which traded in the U.S. on the over-the-counter market, was a domestic transaction under the irrevocable liability test.<sup>[41]</sup>

The court specifically focused on facts in the amended complaint regarding:

- The U.S.-based location of both the investment manager who bought the ADRs on the plaintiff's behalf;
- The U.S.-based location of the broker who placed the buy order;
- That the placement of the buy order, payment of the purchase price, and transfer of title to the securities all took place within the U.S.; and
- That the over-the-counter market trading platform was based in New York.<sup>[42]</sup>

As for litigants specifically in the Second Circuit, it remains to be seen how the district courts will grapple with the myriad questions posed by *Cavello Bay* and its endorsement of *Parkcentral*.

As the Ninth Circuit critiqued, the Second Circuit's test for whether a claim is foreign is "an open-ended, under defined multi-factor test ... akin to the vague and unpredictable tests that Morrison criticized and endeavored to replace." [43]

Most notably, even with the facts similar to the ones plead above in the district court Stoyas case, a court within the Second Circuit may nevertheless find that "the transaction implicates only the interests of [foreign parties]," such that "acts evincing contract formation do not resolve the question whether claims are nevertheless so predominantly foreign." [44]

Moving forward, courts wrestling with the implications of Cavello Bay and Parkcentral should consider that the issue of nonforeignness may not need to be fully resolved at the pleading stage as a matter of law. As the Supreme Court in Morrison found, the domestic transaction inquiry has nothing to do with the court's jurisdiction — rather, it "is a merits question." [45]

Such merits-based questions may ultimately be more appropriately resolved by the fact-finder, especially considering the fact-intensive nature of the Parkcentral inquiry.

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[1] Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE , 763 F.3d 198 (2d Cir. 2014).

[2] Morrison v. National Australia Bank Ltd. , 561 U.S. 247 (2010).

[3] No. 19-2007, 2021 WL 1850551 (1st Cir. May 10, 2021).

[4] Morrone, 2021 WL 1850551, at \*6.

[5] 986 F.3d 161 (2d Cir. 2021).

[6] Cavello Bay, 986 F.3d at 166-67.

[7] Morrison, 561 U.S. at 267. The Court based this finding upon "the focus of the Exchange Act," which focuses "not upon the place where the deception originated, but upon purchases and sales of securities in the United States." Id.

[8] Id.

[9] Absolute Activist Value Master Fund Ltd. v. Ficeto , 677 F. 3d 60 (2d Cir. 2012).

[10] Id. at 68. Absolute Activist also held that alleging that title to the shares was transferred within the United States meets the "domestic" requirement. Id.

[11] Id. at 70.

[12] 777 F.3d 125, 137 (3d Cir. 2015) ("We now hold that irrevocable liability establishes the location of a securities transaction.").

[13] 896 F.3d 933, 949 (9th Cir. 2018) ("We are persuaded by the Second and Third Circuits' analysis and therefore adopt the irrevocable liability test to determine whether the securities were the subject of a domestic transaction.").

[14] 2021 WL 1850551, at \*6 (1st Cir. May 10, 2021) ("We agree with the reasoning of the Second, Third, and Ninth Circuits and hold that a transaction is domestic under Morrison if irrevocable liability occurs in the United States.").

[15] 763 F.3d 198 (2d Cir. 2014).

[16] *Id.* at 216.

[17] *Id.*

[18] *Id.* at 165.

[19] *Id.*

[20] *Parkcentral*, 763 F.3d at 217.

[21] See *Cavello Bay*, 986 F.3d at 166.

[22] *Id.*

[23] *Id.* at 166-67.

[24] *Morrison*, 561 U.S. at 266-67.

[25] *Cavello Bay*, 986 F.3d at 166 (citing *Parkcentral*, 763 F.3d at 220-21).

[26] *Morrone*, 2021 WL 1850551, at \*6.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.* On that note, the *Morrone* fact pattern highlights the importance of the interplay between the timing and location of a purchase or sale, as courts have recognized that "the point [in time] at which the parties become irrevocably bound ... can [also] be used to determine the locus of a securities purchase or sale." *Absolute Activist*, 677 F.3d at 68; see *Georgiou*, 777 F.3d at 136; *Stoyas*; 896 F.3d at 948.

[32] *Morrison*, 561 U.S. at 258.

[33] *Id.* at 255.

[34] Id.

[35] Stoyas, 896 F.3d at 950. Internal citations removed.

[36] Morrone, 2021 WL 1850551, at \*6.

[37] Cavello Bay, 986 F.3d at 166.

[38] Id.

[39] Id.

[40] Stoyas v. Toshiba Corp. , 424 F. Supp. 3d 821 (C.D. Cal. 2020).

[41] Id. at 827.

[42] Id. at 826-27.

[43] Stoyas v. Toshiba Corp., 896 F.3d 933, 950 (9th Cir. 2018).

[44] Cavello Bay, 986 F.3d at 167-68.

[45] Morrison, 561 U.S. at 254.