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CLIENT UPDATE

ABSOLUTE ACTIVIST: THE SECOND CIRCUIT CLARIFIES THE TERRITORIAL LIMITS OF SECTION 10(b) IN PRIVATE LAWSUITS

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To Our Clients and Friends:

Yesterday, the United States Court of Appeals for the Second Circuit issued its much-anticipated decision in *Absolute Activist Value Mater Fund Ltd. v. Ficeto* (Docket No. 11-0221-cv). The Second Circuit's opinion provides welcome clarity on the limited circumstances in which transactions by foreign investors in securities not listed on a U.S. exchange will qualify as "domestic" pursuant to the Supreme Court's opinion in *Morrison v. National Australian Bank Ltd.* After *Morrison,* only "domestic" transactions in unlisted securities may be the subject of private litigation under section 10(b) of the Exchange Act. The Second Circuit made clear that, no matter what other U.S. contacts or connections may attend a transaction in securities not listed on a U.S. exchange, the transaction is "domestic" only if "irrevocable liability is incurred or title passes within the United States."

In *Morrison*, the Supreme Court overturned almost 40 years of Circuit and district court development and application of "conduct" and "effects" tests to determine whether section 10(b) applied to particular extraterritorial securities transactions. The Supreme Court rejected these judicial tests – which focused, respectively, on whether substantial misconduct occurred, or effects of wrongdoing were felt, within U.S. borders – as inconsistent with the longstanding principle that U.S. statutory law does not apply extraterritorially absent a contrary expression of intent in the statute. Finding no such expression of intent in section 10(b), the Supreme Court held that section 10(b) applies only to "transactions in securities listed on domestic exchanges and domestic transactions in other securities." The *Morrison* opinion, however, offered no guidance on the circumstances that might render a transaction in securities not listed on a U.S. exchange "domestic," and thus subject to section 10(b).

The *Absolute Activist* case, which involved transactions in unlisted securities, presented this question squarely. Plaintiffs, nine Cayman Islands hedge funds, sued their investment manager and U.S.-based broker, and certain of these firms' respective principals, under section 10(b) for fraudulently causing the funds to purchase penny stock directly from U.S. companies, through the U.S.-based broker, in private investment in public equity ("PIPE") transactions. On appeal from the U.S. District Court for the Southern District of New York, the Second Circuit held that, to sufficiently allege that a transaction in securities unlisted on a U.S. exchange is

"domestic," "a plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States." The Court found that the complaint lacked sufficient factual allegations to satisfy this requirement, including because the complaint contained no allegations "concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money." The Court, however, directed the district court to allow the funds to amend their complaint, at least in part because plaintiffs had represented to the Court that trading records, private placement memoranda and other documents indicated that the PIPE purchases were irrevocable upon payment and that the funds' purchase payments were made through the U.S.-based broker.

Importantly, the Second Circuit squarely rejected various attempts by the funds to bring their existing allegations within the scope of *Morisson*. In particular, the Court rejected plaintiffs' suggestion that the broker's U.S. location was sufficient, holding that although this factor could be relevant, it alone did not demonstrate where the contracts were executed. The Court also rejected as insufficient the facts that the PIPE securities were issued by U.S. companies and registered with the SEC – facts the Court found irrelevant to where the transactions in those securities took place. The Court similarly found irrelevant plaintiffs' allegations that various investors in the funds had been solicited in, and wired their investments to, the U.S., because the funds' investments in the PIPE transactions, not their investors' investments in the funds, were the securities transactions underlying the claims.

In short, the Second Circuit's *Absolute Activist* opinion significantly limits the circumstances under which U.S. connections to a securities transaction will render that transaction "domestic," and thus subject to private section 10(b) liability, under *Morrison*. Mere allegations of U.S. connections to a securities transaction, whether via the issuer, the broker, or otherwise, will not suffice. Only factual allegations making it plausible that the purchaser or seller became irrevocably bound in the U.S., or received or passed title to the securities in the U.S., will survive a motion to dismiss.

With this said, it remains unclear what facts will suffice in any particular case to establish the U.S. nexus to a securities transaction that *Absolute Activist* requires. In transnational securities transactions involving both foreign investors and U.S. participants, the parties may never leave their own jurisdictions, and their communications often will cross borders. Thus, determining where a contract was formed or title was passed may not always be a straightforward task, and a court could construe *Absolute Activist* expansively in this context. We expect these questions to be the focus of ongoing litigation, as the courts continue their attempts to define the exact contours of *Morrison's* territorial limits.

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Please feel free to contact us with any questions.

Washington, D.C.

Paul R. Berger
+1 202 383 8090
prberger@debevoise.com

Colby A. Smith
+1 202 383 8095
casmith@debevoise.com

Jonathan R. Tuttle
+1 202 383 8124
jrtuttle@debevoise.com

Scott N. Auby
+1 202 383 8053
snauby@debevoise.com

New York

Jeffrey S. Jacobson
+1 212 909 6479
jsjacobson@debevoise.com

London

John B. Missing
+44 20 7786 9160
jmissing@debevoise.com

Moscow

Alan V. Kartashkin
+7 495 956 3858
avkartashkin@debevoise.com