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# It's Official: Circuits are Split on Domestic Transaction Test

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## Summary

The U.S. Courts of Appeal for the First and Second Circuits have split on the issue of whether a plaintiff must satisfy the Second Circuit's "predominantly foreign" test (set forth in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*<sup>[i]</sup>) to demonstrate that a transaction is "domestic" under the U.S. Supreme Court's "domestic transactions in other securities" [second] prong from *Morrison v. National Australia Bank Ltd.*<sup>[ii]</sup> — even if this plaintiff has already satisfied the traditional "irrevocable liability" test.

Earlier this year on January 25, the Second Circuit reaffirmed *Parkcentral* in *Cavello Bay Reinsurance Ltd. v. Shubin Stein*<sup>[iii]</sup>. In *Cavello Bay*, the court held that the "predominantly foreign" test is an additional standard to be considered when applying *Morrison*. The decision broadened *Park Central's* applicability and presents an additional hurdle for a plaintiff to overcome in pleading facts to demonstrate a domestic transaction.

Then on May 10, in *U.S. Securities Exchange Commission v. Morrone*<sup>[iv]</sup>, the First Circuit affirmed the "irrevocable liability" test as the only standard a plaintiff must meet to demonstrate that a transaction is domestic under *Morrison's* second prong.

Plaintiffs should take note of this important circuit split because compared to the more bright-line "irrevocable liability" test, *Parkcentral's* "predominantly foreign" test is vague and will be more challenging for Second Circuit litigants to satisfy.

## Pre-Split Background

### Absolute Activist and the "Irrevocable Liability" Test

In 2010, the Supreme Court held in *Morrison* that Section 10(b) of the Exchange Act only applies to:

1. "truncations in securities on domestic exchanges;" and
2. "domestic transactions in other securities."<sup>[v]</sup>

This second prong has spurred much litigation, the result of which is the "irrevocable liability" test first set forth by

the Second Circuit in *Absolute Activist Value Master Fund Ltd. v. Ficeto*.<sup>[vi]</sup> In that case, the court held that in order for a transaction to be considered “domestic,” the plaintiff must demonstrate “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.”<sup>[vii]</sup> This “irrevocable liability” test has been adopted by the Third, Ninth, and [now] First circuits.<sup>[viii]</sup>

### Parkland and the “Predominantly Foreign” Test

While the Second Circuit affirmed the “irrevocable liability” test in *Absolute Activist*, the court went further and set forth the “predominantly foreign” test in *Parkcentral* in 2014.<sup>[ix]</sup> In *Parkcentral*, the court found that the relevant swap agreements satisfied the “irrevocable liability” test because “the claims in [Parkcentral] are so predominantly foreign as to be impermissibly extraterritorial.”<sup>[x]</sup> Notably, the court also stated that “a bright-line rule would perversely offer safe harbors for fraud,” ultimately determining that *Morrison* did not prohibit “the use of a flexible, multi-factor test to ensure that § 10(b) not be applied extraterritorially.”<sup>[xi]</sup>

### **Today’s Circuit Split**

#### The Second Circuit and *Cavello Bay*

In *Cavello Bay*, the Second Circuit again affirmed *Parkcentral* and the “predominantly foreign” test’s continued applicability. While the court ultimately found that the plaintiff’s claims were “predominantly foreign” under *Parkcentral*, the court did note that the transactions involving the relevant shares “arguably took place in the United States” and could be considered “domestic under *Absolute Activist*.”<sup>[xii]</sup>

The court characterized *Morrison* as requiring courts to “use the ‘focus’ of the statute to determine whether a case involves a domestic application of § 10(b).”<sup>[xiii]</sup> Along these lines, the opinion stated that *Parkcentral* “is a glass on *Morrison*’s rule … [t]hat rule directs courts to use the ‘focus’ of the statute to determine whether a case involves a domestic application of § 10(b).”<sup>[xiv]</sup> The court continued, saying: “[P]ut differently, courts must evaluate whether the domestic activity involved implicates the ‘focus’ of the statute.”<sup>[xv]</sup>

The manner of this holding seems to assert that satisfying this “predominantly foreign” analysis is an additional step required to determine whether a transaction can be classified as domestic. Indeed, *Cavello Bay* held that “*Morrison*’s ‘domestic transaction’ rule operates as a threshold requirement, and as such may be underinclusive,” while “*Parkcentral* nonetheless uses *Morrison*’s focus on the transaction rather than surrounding circumstances, and flexibly considers whether a claim — in view of the security and the transaction as structured — is still predominantly foreign.”<sup>[xvi]</sup> Thus, *Cavello Bay* broadens *Parkcentral*’s reach.

#### The First Circuit and *Morrone*

In *Morrone*, the First Circuit disagreed with the Second Circuit’s reasoning in *Cavello Bay*. The court embraced *Morrison* and “reject[ed] *Parkcentral* as inconsistent with *Morrison*,” going as far as to say that *Parkcentral* is “contrary to *Morrison* itself.”<sup>[xvii]</sup> The court goes even further, stating that “[t]he existence of a domestic transaction suffices to apply the federal securities laws under *Morrison*,” and that “[n]o further inquiry is required.”<sup>[xviii]</sup>

Specifically, the court found that the relevant stock subscription agreements gave rise to “irrevocable liability” in the United States because they were sent from the defendants in Boston to European investors.<sup>[xix]</sup> Section 10(b) applied because the subscription agreements were executed in Boston on behalf of the company, and the defendants then issued the relevant shares from Boston — thus obligating the company to deliver the shares domestically in Boston.<sup>[xx]</sup> The court made it clear that the location and timing of a purchase or sale is critical to domestic transaction analysis.

## Going Forward

The gravamen of the difference between *Cavello Bay* and *Morrone* is a fundamental disagreement regarding whether *Parkcentral* and its “predominantly foreign” test is consistent with *Morrison* and the courts’ subsequent adoption of the “irrevocable liability” standard.

*Morrone* could mark the beginning of a trend to re-anchor today’s jurisprudence to *Morrison* without the further complication and hurdle presented by adding *Parkcentral*’s test to a plaintiff’s checklist. Indeed, the First Circuit in *Morrone* joins the Ninth Circuit, which held in *Stoyas w. Toshiba Corp.* that *Parkcentral* runs afoul of *Morrison* in part because *Morrison* rejects the very kind of vague “congressional intent” inquiry that the “predominantly foreign” test requires.

If other circuits follow suit by reaching decisions akin to *Morrone*, then the “predominantly foreign” test may be relegated only to a hurdle for Second Circuit litigants alone.

Or perhaps, other circuits will be persuaded by the Second Circuit’s analysis in *Cavello Bay* and require plaintiffs in their respective jurisdictions to satisfy the “predominantly foreign” test. If that is the case, then litigants should plan for their analysis to focus more on the pre-*Morrison* “conducts and effects test,” and less on the bright-line “irrevocable liability” test, which places more weight on the timing and location of transaction.

Ultimately, this circuit split may need to be resolved by the Supreme Court. In the meantime, plaintiffs can best prepare for any jurisdiction by alleging facts that satisfy the “irrevocable liability” test. That test is still an appropriate standard in all circuits, and remains the minimum threshold standard in the Second Circuit.

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

[ii] 561 U.S. 247 (2010).

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

[iv] No. 17-2007, 2021 WL 1850551 (1st Cir. May 10, 2021).

[v] *Morrison*, 561 U.S. at 267.

[vi] 677 F.3d 60 (2d Cir. 2012).

[vii] *Id.* at 70.

[viii] *U.S. v. Georgiou*, 777 F.3d 125, 137 (3d Cir. 2015); *Stoyas v. Toshiba Corp.*, 896 F.3d 933, 949 (9th Cir. 2018); *SEC v. Morrone*, 2021 WL 1850551, at \*6 (1st Cir. May 10, 2021).

[ix] *Parkland*, see *supra* note i.

[x] *Id.* at 216.

[xi] *Id.* at 221.

[xii] *Cavello Bay*, 986 F.3d at 165.

[xiii] *Id.* at 166.

[xiv] *Id.*

[xv] *Id.* (internal citations omitted).

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

[xvii] *Morrone*, 2021 WL 1850551, at \*60.

[xviii] *Id.*

[xix] *Id.* at \*6.

[xx] *Id.*

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