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New York Litigation News

NEWS, DEVELOPMENTS AND EVENTS IN THE NEW YORK MARKET | McKenna Long & Aldridge LLP

APRIL 2012

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Absolute Activist Value Master Fund Ltd. v. Ficeto[1]

In addressing an issue left open by the Supreme Court in *Morrison v. National Australia Bank Ltd*.[2], the Second Circuit held in *Absolute Activist Value Master Fund Ltd. v. Ficeto,* that to sufficiently allege the existence of a "domestic transaction in other securities" (i.e. securities not traded on a domestic exchange) a party must state facts in its complaint suggesting either irrevocable liability was incurred or title transferred within the U.S. This decision clarifies the extraterritorial reach of the provisions of the Securities Exchange Act of 1934 (the "1934 Act") dealing with fraud, specifically Section 10(b), and provides a "bright line" test as to when civil liability may arise for foreign participants in domestic transactions not listed on U.S. exchanges.

In *Morrison*, the Supreme Court held that Section 10(b) of the 1934 Act does not apply extraterritorially, and established a "transactional test" that confined Section 10(b)'s application to "domestic transactions," defined as (1) "transactions in securities listed on domestic exchanges" and (2) "domestic transactions in other securities." The Court, however did not address the meaning of "domestic transactions in other securities." In *Absolute Activist*, the Second Circuit construed that phrase to cover those transactions where irrevocable liability to purchase or deliver securities was incurred domestically or title was transferred in the U.S.

The Plaintiffs-Appellants in *Absolute Activist* were nine Cayman Islands hedge funds (the "Funds") that invested in a variety of asset classes on behalf of hundreds of international investors, including many in the U.S. The Funds lost $195 million in an alleged "pump and dump" scheme orchestrated by their investment manager. The Funds alleged that the defendants caused them to purchase billions of shares of thinly-capitalized domestic companies directly from those companies while the defendants had secretly

invested in the companies as well. Defendants then artificially inflated prices by trading and re-trading the stocks between the Funds, and then profited by selling their shares at artificially inflated prices.

Replying on *Morrison,* the Southern District of New York dismissed the Funds' original complaint holding that, although the securities at issue were domestic in origin, the complaint did not sufficiently allege that the foreign plaintiffs' "transactions" were "domestic." The fact that the shares at issue were purchased directly from the companies and not on a U.S. exchange was given as an additional reason to dismiss the complaint.

While the Second Circuit agreed with the district court that the complaint should be dismissed, it did so for different reasons. In making its ruling, the court relied on how the terms "buy" and "purchase" are defined in the 1934 Act, and then held that "in order to adequately allege the existence of a domestic transaction" a plaintiff must allege facts demonstrating "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."[3] The court continued that it did not believe that this is the "only way to locate a securities transaction," and that a domestic securities transaction can be alleged to have occurred through facts suggesting that "title was transferred within the United States" as well.[4]

The court rejected other potential tests suggested by the parties. For instance, the court made clear that the *Morrison* test is not based on the location of the person who made the trades, nor whether the securities in questions were issued by domestic companies or registered with the SEC. The court also disapproved of the suggestion that where both the buyer and seller are foreign, the transaction in question cannot be "domestic" (i.e., a purchaser's domesticity is not determinative of the location of a transaction). Because the complaint was drafted before *Morrison*, the court remanded and instructed the district court to grant the Funds leave to amend to see if they could meet the new test.[5]

The Second Circuit also reminded lawyers of the futility of raising appellate issues in footnotes. The court rejected the Fund's suggestion in its opening brief that the district court erred in dismissing certain common law claims, stating that "because '[w]e do not consider an argument mentioned only in a footnote to be adequately raised or preserved for appellate review,' *United States v. Restrepo*, 986 F.2d 1462, 1463 (2d Cir. 1993), we deem plaintiffs' argument concerning the common law claims to be forfeited."[6] Appellate lawyers should consider themselves on notice.

In *Absolute Activist* the Second Circuit explains the meaning of "domestic transaction" under *Morrison*, and in rejecting the parties' arguments and providing its

own framework, provides a clear rule for determining when securities transactions noted traded on domestic exchanges are subject to U.S. securities laws. Offshore funds, investors who trade in foreign securities or on foreign exchanges, issuers of securities, and other participants in securities transactions, should take note of the Second Circuit's clarifying ruling and how it may affect their potential claims or liabilities under federal securities laws.

1 No. 11-0221-cv, Slip. Op. (2d Cir. Mar. 1, 2012).
2 130 S. Ct. 2869 (2010).
3 *Absolute Activist*, Slip. Op. at 13.
4 *Id*. at 14.
5 *Id*. at 2.
6 *Id*. at 14 n.2.

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The litigation group at the New York office of McKenna Long & Aldridge LLP is comprised of attorneys with decades of experience in litigating business disputes in New York federal and state courts. They are supported by the full resources of McKenna Long and Aldridge's 575 attorneys.

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