SULLIVAN & CROMWELL LLP

January 3, 2011

Extraterritorial Application of Section 10(b) to Security-Based Swap Agreements

Following *Morrison* v. *National Australia Bank*, Court in the Southern District of New York Holds that Section 10(b) Does Not Apply to Certain Security-Based Swap Agreements

SUMMARY

On December 30, 2010, Judge Harold Baer, Jr. of the United States District Court for the Southern District of New York granted a motion dismissing with prejudice six complaints seeking more than $2.5 billion in damages against Porsche Automobil Holding SE ("Porsche") and two of its former executives. In so doing, the Court held in a question of first impression that, in light of the U.S. Supreme Court's decision in *Morrison* v. *National Australia Bank*, 130 S. Ct. 2869 (2010), Section 10(b) of the U.S. Securities Exchange Act of 1934 ("Exchange Act") does not apply to security-based swap agreements referencing shares traded on foreign exchanges merely because plaintiffs allege that they signed confirmations in the United States. The Court ruled that the swap agreements at issue in the case are the "functional equivalent" of trading the underlying shares on a foreign exchange, and, therefore, the "economic reality" is that such agreements are "essentially transactions conducted upon foreign exchanges and markets, and not domestic transactions that merit the protection of § 10(b)."

Sullivan & Cromwell represented Porsche in successfully briefing and arguing this motion. Our team included Vince DiBlasi, Robert Giuffra, John Warden and Suhana Han.

BACKGROUND

Judge Baer issued his decision in *Elliott Associates, L.P., et al.* v. *Porsche Automobil Holding SE, et al.*, 10 Civ. 0532 (HB) and *Black Diamond Offshore Ltd., et al.* v. *Porsche Automobil Holding SE, et al.*,

10 Civ. 4155 (HB).[1] Plaintiffs in those actions were hedge funds, the majority of which were organized under the laws of foreign jurisdictions, but managed by entities based in the United States. Plaintiffs alleged, among other things, that Porsche and its former Chief Executive Officer and former Chief Financial Officer violated Section 10(b) of the Exchange Act when defendants, in connection with Porsche's acquisition of a stake in Volkswagen ("VW"), misrepresented Porsche's intention to take over VW and its ownership stake in VW. Plaintiffs alleged that following Porsche's October 26, 2008 press release announcing the extent of its holdings in VW, the price of VW ordinary shares shot up, resulting in a massive "short squeeze" forcing plaintiffs to cover their short positions at artificially high prices and causing them enormous losses.

Plaintiffs allegedly obtained their short positions through short sales of VW shares and security-based swap agreements referencing VW ordinary shares that would have increased in value if the price of the VW shares had declined. A security-based swap agreement is a private contract in which counterparties agree to exchange cash flows that depend on the price of a referenced security. Plaintiffs alleged that they signed confirmations and took all steps necessary to transact their swap agreements in the United States, and that the security-based swap agreements were governed by New York law.

THE COURT'S OPINION

In *Morrison*, the U.S. Supreme Court held that the Exchange Act's antifraud provisions concerning misstatements and omissions do not cover the claims of "foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges." In doing so, the Court adopted a "transactional test" and held that the scope of Section 10(b) is limited to "purchases and sales of securities in the United States."

In the *Elliott* and *Black Diamond* actions, because there was no dispute that VW ordinary shares did not trade on a U.S. exchange, the Court considered whether plaintiffs' security-based swap agreements referencing those same shares constituted "domestic transactions" for purposes of *Morrison*. In his opinion, Judge Baer rejected plaintiffs' argument that by signing confirmations for their security-based swap agreements in New York, they engaged in "domestic transactions" under *Morrison*. The Court stated that plaintiffs' narrow reading of *Morrison* was inconsistent with the Supreme Court's intention to curtail the extraterritorial application of Section 10(b) and "to avoid interference with foreign securities regulation that application of § 10(b) abroad would produce." The Court stated that applying Section 10(b) to plaintiffs' claims "would extend extraterritorial application of the Exchange Act's antifraud

[1] The parties in four related actions, asserting substantially similar allegations, agreed that Judge Baer's ruling on the motion to dismiss in the *Elliott* and *Black Diamond* actions also would apply to their actions, to the extent applicable, as if the Court had issued the same ruling in their actions. Accordingly, Judge Baer dismissed the complaints in those four actions for the same reasons that he dismissed the *Elliott* and *Black Diamond* actions.

provisions to virtually any situation in which one party to a swap agreement is located in the United States."

In determining how to apply *Morrison* to security-based swap agreements that reference stocks traded abroad, the Court stated that "[s]ince the economic value of securities-based swap agreements is intrinsically tied to the value of the reference security, the nature of the reference security must play a role in determining whether a transnational swap agreement may be afforded the protection of § 10(b)." The Court concluded that plaintiffs' swap agreements "were the functional equivalent of trading the underlying VW shares on a German exchange," and, therefore, the "economic reality" is that such agreements are "essentially transactions conducted upon foreign exchanges and markets, and not domestic transactions that merit the protection of § 10(b)."

Recognizing that the Exchange Act was not intended to regulate foreign securities exchanges, the Court refused to adopt "a rule that would make foreign issuers with little relationship to the U.S. subject to suits here simply because a private party in this country entered into a derivatives contract that references the foreign issuer's stock." The Court stated that "domestic transactions in other securities" do not include "transactions in foreign-traded securities—or swap agreements that reference them—where only the purchaser is located in the United States."

The Court also declined to exercise supplemental jurisdiction over plaintiffs' common law fraud claims. In support of this decision, the Court cited the "strong connection of all aspects of this action to Germany." Both the issuer of the referenced security, VW, and Porsche are located in Germany. The Court also noted that the German Consulate had submitted a letter to the Court, discussing steps that the German government had taken with respect to regulation of its own securities markets.

IMPLICATIONS

Judge Baer's decision represents an important application of the Supreme Court's decision in *Morrison* in the context of security-based swap agreements and closed a loophole that threatened to substantially undercut *Morrison's* holding. By plaintiffs' logic, issuers all over the world could be subjected to Section 10(b), no matter where their shares traded and regardless of their adherence to local law, simply by virtue of a contract entered into between private parties. By rejecting this argument, the Court remained faithful to *Morrison*'s presumption against the extraterritorial application of Section 10(b) to transactions in foreign-traded securities.

The Court's decision also was consistent with an analogous group of decisions issued in the Southern District of New York rejecting the claim that taking certain actions in the United States, such as placing a buy order for a foreign-traded security, is sufficient to render such transactions "domestic" for purposes of Section 10(b). Judge Baer's decision reaffirmed the importance of *Morrison* as a limitation on the application of the U.S. securities laws to non-U.S. transactions and issuers.

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