ALERT
JULY 8, 2011

GLOBAL INSURANCE GROUP
News Concerning
Recent Professional Liability Issues

COZEN O'CONNOR
www.cozen.com

THE APPLICABILITY OF MORRISON V. NAB TO FOREIGN-CUBED CLAIMS BY THE SEC

Angelo G. Savino • 212.908.1248 • *asavino@cozen.com*

On June 10, 2011, Judge Barbara Jones of the U.S. District Court for the Southern District of New York issued a decision in the case *SEC v. Goldman Sachs & Co.*, No. 10-3229 (*Goldman Sachs*), that applied the Supreme Court's *Morrison* decision to claims by the SEC under both the Securities Exchange Act of 1934 and the Securities Act of 1933. Goldman Sachs had previously settled the claims against it for $550 million, but left Fabrice Tourre, a Goldman Sachs vice president who had worked at its New York headquarters, to face the SEC's claims.

The decision is noteworthy because it is the first to apply *Morrison*, which held that section 10(b) of the Exchange Act does not apply extraterritorially, to claims by the SEC. It is also the first decision to provide a detailed analysis of the second prong of *Morrison*'s transactional test involving domestic transactions in securities that are not listed on an exchange. Lastly, the decision is the first to apply *Morrison* to section 17(a) of the Securities Act.

The SEC alleged that in 2007, Goldman Sachs structured and marketed a synthetic collateralized debt obligation (CDO) called Abacus 2007-ACI (Abacus) that was based on the performance of subprime residential mortgage-backed securities (RMBS). CDOs are debt securities collateralized by other debt obligations such as, in this case, RMBSs. The complaint also alleged that Goldman Sachs was assisted by a hedge fund, Paulson & Co. Inc. (Paulson) in selecting the RMBSs that would collateralize the CDO. At the same time, Paulson allegedly entered into a credit default swap (CDS) that essentially bet that the RMBSs would perform poorly. According to the SEC, Goldman Sachs and Tourre marketed the CDOs without disclosing to investors that the underlying portfolio of mortgage-backed securities had been selected by Paulson while Paulson was betting against their performance. Tourre was allegedly the Goldman Sachs employee principally responsible for structuring and marketing the Abacus securities.

The SEC also alleged that Goldman Sachs and Tourre marketed and sold $150 million worth of Abacus notes to IKB, a German commercial bank, and $42 million worth of notes to ACA Capital Holdings, Inc. (ACA Capital), a U.S.-based entity. ACA Capital also entered into a credit default swap involving a $909 million super senior tranche of Abacus. Essentially, ACA Capital assumed the credit risk associated with that portion of Abacus's capital structure in exchange for premium payments. Thereafter, through a series of credit default swaps among ABN, Goldman, and ACA Capital, ABN assumed the credit risk regarding that $909 million tranche. ABN is a Dutch bank.

The closing for Abacus occurred in New York City and Goldman Sachs delivered the notes through the book entry facilities of Depository Trust Company in New York City. Tourre, however, provided the court with a trade confirmation indicating that Goldman Sachs International, located in London, was listed as the seller of the notes to an IKB affiliate based on the Island of Jersey, a British dependency. Similarly, the CDS confirmations regarding the ABN transaction listed the seller as Goldman Sachs International and the purchaser as the London branch of ABN.

The SEC claimed that Tourre had violated section 17(a) of the Securities Act and section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and aided and abetted violations of section 10(b). Tourre moved to dismiss and for judgment on the pleadings based on *Morrison* on the grounds that the complaint failed to state a claim because it did not allege securities transactions that took place in the United States.

Judge Jones first analyzed the SEC's Exchange Act claims against Tourre. She noted that the Supreme Court, in *Morrison*, had adopted a clear transactional test: "whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange." Nevertheless, Judge Jones also noted that, because the securities at issue in *Morrison* were traded only on foreign exchanges, the Supreme Court was largely silent regarding how lower courts should determine whether a purchase or sale is made in the United States. That, however, was the issue she faced because the Abacus securities were not traded on an exchange.

The court began its analysis of the issue by looking to the statutory definitions of "purchase" and "sale" in the Exchange Act, which were relatively "unhelpful." The court then turned to case law and determined that the concept of "irrevocable liability" was at the core of both a "sale" and a "purchase." The court noted that at some time a purchaser incurs irrevocable liability to take and pay for a security while a seller incurs irrevocable liability to deliver a security.

In applying this concept to the IKB transaction, the court rejected the SEC's arguments based on Tourre's presence in New York while he engaged in structuring and marketing of Abacus on the grounds that it was merely conduct, which had been rejected as the determinative factor in *Morrison*. Judge Jones also rejected the SEC's argument that courts must look to the "entire selling process" to determine whether a securities transaction is foreign or domestic. The court observed "in reality, the SEC's 'entire selling process' argument is an invitation for this court to disregard *Morrison* and return to the 'conduct' and 'effects' tests."

The SEC had also conceded at oral argument that the closing in New York, by itself, was not sufficient to make IKB note purchases domestic transactions for purposes of *Morrison*. For good measure, however, the court noted *Quail Cruises Ship Mgmt. v. Agencia De Viagens CVC Tur Limitada*, which also rejected the place of closing as determinative under *Morrison*. Accordingly, the court concluded as follows:

> In view of the fact that none of the conduct or activities alleged by the SEC, including the closing, constitute facts that demonstrate where any party to the IKB note purchases incurred "irrevocable liability[,]" . . . the SEC fails to provide sufficient facts that allow the court to draw the reasonable inference that the IKB note "purchase[s] or sale[s were] made in the United States."

Turning to the ABN transaction, the court stated that the SEC provided no facts from which the court could draw the reasonable inference that any party to the ABN CDS transaction incurred irrevocable liability in the United States. Thus, Judge Jones ruled that the SEC failed to allege that the ABN CDS transaction constituted a domestic transaction under *Morrison* for the same reasons as the IKB purchases.

Because ACA Capital was based in the United States, there appears to have been no opportunity for the court to apply *Morrison* to those transactions. Instead, the court analyzed whether the SEC had sufficiently pled the elements of a violation of section 10(b), and found that it had.

The court also analyzed the sufficiency of the SEC's claim under section 17(a) of the Securities Act, and whether *Morrison* applied to that statutory section. The court observed that *Morrison* did not involve or consider section 17(a), none of the parties had cited any cases applying *Morrison* to section 17(a), and the court was not aware of any such case. Judge Jones observed that *In re Royal Bank of Scotland Grp. PLC. Litig.* applied *Morrison* to sections 11, 12, and 15 of the Securities Act, but did not address section 17(a). Nevertheless, the court agreed with Tourre that *Morrison* applies to section 17(a), stating that "*Morrison* itself expressly states that the Exchange Act and the Securities Act share '[t]he same focus on domestic transactions.'" Because *Morrison* focused on whether sales of securities were domestic or foreign, Judge Jones concluded that, to the extent section 17(a) applied to sales, it does not apply to sales that occur outside the United States. The court therefore dismissed the section 17(a) claim, but only to the extent that it was based on sales to IKB and ABN.

The court continued its analysis, however, observing that section 17(a), unlike section 10(b), applies not only to sales of securities, but also to offers to sell securities. The court examined the definition of the term "offer" in the Securities Act, which states that an offer includes "every attempt to offer or dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The court stated that this definition left no doubt that the focus of offer, under the Securities Act, was on the person or entity attempting, or offering, to dispose of, or soliciting an offer to buy, securities. Applying this definition to the allegations of the complaint, the court noted that the SEC alleged Tourre, acting from New York City, offered Abacus notes to IKB and solicited ABN's participation in Abacus CDSs. The court observed that Tourre

allegedly engaged in numerous communications from New York City that constituted domestic offers of securities or swaps. Thus, Judge Jones permitted the section 17(a) claim to survive to the extent that it was based on such "offers."

Conclusion

This case adds significantly to the jurisprudence applying the Supreme Court's *Morrison* decision. As an initial matter, the case represents the first time that any court has applied *Morrison* to claims by the SEC. Because this action was brought prior to the enactment of Dodd-Frank, which purports to grant subject matter jurisdiction over extraterritorial claims by the SEC, it remains to be seen whether subsequent post-enactment SEC cases will follow this decision. It is arguable that Dodd-Frank should not change the *Morrison* analysis as applied to the SEC. Although Dodd-Frank purports to grant subject matter jurisdiction over extraterritorial securities claims by the SEC, the Supreme Court, in *Morrison*, held that district courts already had subject matter jurisdiction, but that section 10(b) itself had no extraterritorial reach. Nothing in Dodd-Frank modified section 10(b) in that regard. Thus, courts in post-enactment cases may conclude that they are able to follow Judge Jones's decision in *Goldman Sachs*.

In addition, the *Goldman Sachs* decision is significant for its analysis of how *Morrison* applies to transactions in securities that are not listed on an exchange. As Judge Jones noted, because *Morrison* involved securities traded on foreign exchanges, the decision is essentially silent on the second prong of its transactional test involving the purchase or sale of any other security in the United States. The *Goldman Sachs* decision furnishes a well reasoned analytical roadmap for other courts to follow in this respect.

Lastly, the decision is noteworthy for its articulation of the applicability of *Morrison* to claims under section 17(a) of the Securities Act involving sales of securities, and to the Securities Act generally.

A year after it was decided, *Morrison* is continuing to find new and significant applications in the district courts. This makes it essential for D&O and E&O insurers to remain alert to the evolving jurisprudence to be better able to evaluate the exposure presented by securities actions.

To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact Angelo G. Savino, a member in our New York office, at asavino@cozen.com or 212.908.1248. Angelo focuses his practice on Directors and Officers Liability Insurance.