REPORT

Futures & Derivatives Law

The Journal on the Law of Investment & Risk Management Products

February 2018 ▪ Volume 38 ▪ Issue 2

CLASS CERTIFICATION AND *MORRISON*: WHAT FOREIGN ISSUERS NEED TO KNOW AFTER *IN RE PETROBRAS SECURITIES LITIGATION*

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Petróleo Brasileiro S.A., more widely known as Petrobras, rang in 2018 by entering into one of the largest securities class action settlements in history. On January 3, 2018, Petrobras agreed to pay $2.95 billion to settle securities fraud class action claims arising out of its ongoing corruption scandal in Brazil—reportedly, the largest such payout by a foreign issuer in history.[1]

With the litigation now at an end, it is worthwhile to consider *Petrobras'* impact on securities class actions in the United States. Indeed, commentators have already debated *Petrobras'* contribution to the long-simmering debates about the viability and efficacy of the fraud on the market presumption, the ascertainability requirement for class certification, and the scope of opinion liability under *Omnicare*.[2] Additional analysis on each of these topics is no doubt still to come. Less discussed, but equally important, is the impact of *Petrobras* on the way class actions brought in U.S. courts against non-U.S. companies whose securities trade in over-the-counter markets ("OTC") will be litigated in the future. *Petrobras* is the first case of which we are aware to raise the question of "domesticity"—i.e., whether the plaintiffs purchased the securities about which they sue in a domestic transaction, within the meaning of *Morrison v. National Australia Bank*[3]—as a defense to class certification, and not simply as a basis for a motion to dismiss.

In *Petrobras*, the Second Circuit vacated the Southern District of New York's (Rakoff, J) grant of class certification, holding that the District Court was required to consider domesticity as part of the predominance requirement of class actions. The Second Circuit determined that "[o]n the available record, the investigation of domesticity appears to be an 'individual question' requiring putative class members to 'present evidence that varies from member to member.' "[4] The Second Circuit further held that a court considering whether to certify such a class must consider such "individual questions" as part of its "predominance analysis," "par-

ticularly when they go to the viability of each class member's claims."[5]

The Second Circuit's introduction of domesticity as a factor to be considered in adjudicating class certification provides a new and powerful tool for defendants to use in resisting class certification—particularly where, as in *Petrobras*, the defendant's securities were traded in the global OTC markets. It remains to be seen whether the domesticity requirement will become as powerful an arrow in the defendants' quiver with respect to class certification as it has become in the context of dismissal motions. In this article, we consider a few possible implications of the Second Circuit's groundbreaking decision.

Factual Background

Petrobras is a Brazilian state-owned entity whose common and preferred shares are listed on the Brazilian stock exchange, and whose American Depository Shares are listed on the New York Stock Exchange. In addition, Petrobras issued multiple debt securities which were underwritten by syndicates of U.S. and foreign banks, and which do not trade on any U.S. exchange, but which are instead traded in the OTC markets. As the District Court observed, "[a]t its height in 2009, Petrobras' market capitalization was approximately $310 billion, making it the world's fifth-largest company."[6]

However, the value of Petrobras declined precipitously after the exposure in 2014 of a multi-year, multi-billion dollar money laundering and kickback scheme. By March 2015, Petrobras' market capitalization had fallen to $39 billion—a decline of nearly 90 percent.

In December 2014 and January 2015, Petrobras' investors filed putative class actions asserting claims under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") in connection with the purchase and sale of Petrobras' debt and equity securities. After the lead plaintiff filed a consolidated class action complaint, defendants moved to dismiss arguing, *inter alia*, that some of plaintiffs' claims were precluded by the Supreme Court's decision in *Morrison*.

Morrison and its Progeny

Morrison involved a so-called F-cubed fact pattern:[7] Australian shareholders who had purchased shares of an Australian bank on the Sydney Stock Exchange brought suit in the United States alleging securities fraud arising from the conduct of the Australian bank's foreign subsidiary. In affirming the dismissal of the plaintiffs' claims, the Supreme Court rejected decades of circuit court precedent and reaffirmed and emphasized the presumption against the extraterritorial application of U.S. law.

Writing for the unanimous Supreme Court, Justice Scalia explained that "when a statute gives no clear indication of an extraterritorial application, it has none."[8] Applying this guidance, the Supreme Court held that since there is "no affirmative indication in the Exchange Act that Section 10(b) applies extra-territorially, it does not."[9] Thus, the Supreme Court concluded that Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."[10]

Morrison left what would constitute "domestic transactions in other securities" undefined. That gap was later filled by the Second Circuit Court of Appeals in *Absolute Activist Value Master*

Fund Ltd. v. Ficeto. There, the Second Circuit held that a domestic transaction in securities occurs when (i) a party incurs irrevocable liability within the United States to purchase or deliver a security, or (ii) title to a security is transferred within the United States.[11] Under the *Absolute Activist* test, the location or residency of the buyer, seller, or broker will not necessarily establish the situs of the transaction.[12] Rather, a plaintiff can demonstrate the location of where irrevocable liability was incurred or legal title was transferred by producing evidence "including, but not limited to, facts concerning the formation of the contracts, the placement of purchase orders, . . . or the exchange of money."[13]

Over the years, *Morrison* and its progeny have provided a powerful weapon to the defense bar. Subsequent decisions have applied *Morrison* to limit the extraterritorial reach to other portions of the securities laws, including Section 11 of the Securities Act.[14] Further, in less than a decade since the Supreme Court decided *Morrison*, defendants have successfully used the extraterritoriality defense to limit the reach of other statutes, including the Commodities and Exchange Act,[15] the civil remedy provided for in the Racketeer Influenced and Corrupt Organizations Act,[16] the Bankruptcy Code,[17] and the Alien Tort Statute[18]—to name just a few.

Petrobras —*the Dismissal Motions*

At the District Court level, the *Petrobras* defendants sought to dismiss the complaint, in part, on the basis that the plaintiff had failed to allege that "they purchased the relevant securities in domestic transactions."[19] The District Court concluded that the "CAC fail[ed] to plead that plaintiffs purchased the relevant securities in . . . domestic transactions," but permitted the plaintiffs to amend the complaint.[20]

The class action plaintiffs filed an amended complaint, including factual allegations and supporting evidence, designed to demonstrate that the OTC securities transactions were domestic. Defendants moved to dismiss. In a decision issued on October 19, 2015, the District Court held that certain plaintiffs failed to sufficiently allege they had purchased the relevant securities in domestic transactions. Adhering to *Morrison*, the District Court limited the classes to "members [who] purchased Notes in domestic transactions."[21] Thus, the District Court permitted claims brought by plaintiffs who purchased Petrobras' debt securities directly from U.S. underwriters in securities offerings taking place in the United States. On the other hand, the District Court dismissed claims brought by a non-US plaintiff who purchased the securities in U.S. dollars, but whose securities were held "abroad." Judge Rakoff also refused to accept the generalized arguments forwarded by the plaintiffs, such as that evidence that a class member purchased the security in the offering at the offering prices was sufficient to establish the existence of a domestic transaction or that irrevocable liability to transfer the securities attached in the United States because the securities were transferred through a U.S.-based securities depository, the DTC. Ultimately, two of the named plaintiffs survived *Morrison*-based dismissal motions.

Petrobras—*Class Certification*

Having survived dismissal, Plaintiffs moved to certify two classes—a class alleging Securities Act claims, and a class alleging claims under the Exchange Act.

To confirm a class, plaintiffs were required to establish by a preponderance of evidence the requirements of Federal Rule of Civil Procedure 23(a): (i) numerosity, (ii) commonality, (iii) typicality, and (iv) adequate representation. In addition, to certify a class in the context of a securities class action seeking monetary damages for a wrong suffered by the class as a whole, the lead plaintiffs also had to establish (i) predominance—i.e., that "the questions of law or fact common to class members predominate over any questions affecting only individual members" and (ii) superiority—that proceeding by way of a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.[22]

The *Petrobras* defendants resisted certification by identifying what they believed to be a number of deficiencies in the lead plaintiff's argument—two of which directly implicated *Morrison*. First, the *Petrobras* defendants argued that a class action was not "superior" because the plaintiffs had failed to establish the probability that foreign courts will recognize the *res judicata* effect of a U.S. class action judgment.[23] The District Court rejected the Defendants' concern that foreign courts would not give effect to a U.S. court class action judgment thereby leaving the defendants with the risk of being found liable multiple times. Instead, the District Court concluded that "*Morrison* materially lessens the foreign *res judicata* concerns animating *In re Vivendi Universal, S.A.*," and rejected the defendants' argument.

Second, the *Petrobras* defendants also argued that certification was foreclosed because it was "administratively unfeasible" for the District Court to determine whether an individual class member satisfied the domesticity requirement of *Morrison*—that is, that the security transaction in question was domestic. The District Court also rejected this argument, stating that it was "confident" that the *Morrison* determination is "administratively feasible."

The Second Circuit Decision

Defendants appealed.

In a significant victory for defendants, the Second Circuit held that the District Court committed legal error in failing to "meaningfully address" the question of whether a class member that purchased Petrobras securities in a "domestic transaction" was "susceptible to generalized class-wide proof."[24] Absent that determination, the Second Circuit continued, the District Court could not properly determine whether plaintiffs satisfied the predominance requirement.

While acknowledging that it was not taking a position on whether certification would ultimately be appropriate, the Second Circuit went further, stating that "on the available record," the question of domesticity appeared to be an "individual question requiring putative class members to present evidence that varies from member to member" and is one that is "not obviously susceptible to class-wide proof."[25]

In reaching this conclusion, the Second Circuit appears to have been swayed by defendants' arguments that the classes, as currently constituted, "include[] numerous foreign and domestic entities that purchased securities from other foreign and domestic entities, possibly through foreign and domestic intermediaries, using different methods, under different circumstances, and reflected in different types of records."[26] The Second Circuit went further, identifying one par-

ticular distinction between those defendants who purchased Petrobras securities in the original offerings versus those who purchased them in the secondary markets, suggesting that class-wide proof may be available in the former case, but not the latter. The Second Circuit then concluded, "[i]n this case, the potential for variation across putative class members—who sold them the relevant securities, how those transactions were effectuated, and what forms of documentation might be offered in support of domesticity—appears to generate a set of individualized inquiries that must be considered within the framework of Rule 23(b)(3)'s predominance requirement."[27] Finally, the Second Circuit noted that the *Petrobras* plaintiffs had failed to "suggest a form of representative proof that would answer the question of domesticity for individual class members."[28] In the absence of common, or at least representative, proof establishing domesticity, the Second Circuit held that the District Court was obligated to expressly consider whether a need for individualized domesticity determinations—which go to the merits of a class member claims—made certification impossible.

Before considering the implications of the Second Circuit's decision, it is worth noting the impact that the District Court's decision on the *Morrison* dismissal motion had on the Second Circuit analysis. When challenged to plead the existence of domestic transactions, class plaintiffs responded with new allegations and documentary evidence regarding their transactions in Petrobras' debt securities. Some of this evidence involved documentation of a specific transaction by a class plaintiff, such as evidence that the securities were acquired by the plaintiffs' U.S.-based personnel directly from U.S. underwriters. However, as noted above, class plaintiffs also argued that the existence of a domestic transaction could be established as a matter of law by pointing to certain structural features of how securities are transferred, including that the beneficial title for the securities at issue transferred through a U.S.-based securities depository ("DTC"). The District Court rejected that argument finding that because "most securities transactions settle through the DTC or similar depository institutions, the entire thrust of *Morrison* and its progeny would be rendered nugatory if all DTC-settled transactions" satisfied the requirements of a domestic transaction.[29] Had the District Court ruled differently on this issue, it would have reframed the domesticity requirement at the class certification stage such that the outcome may well have been different.

What Happens Next?

In light of the *Petrobras* settlement, and the accompanying withdrawal of the appeal to the United States Supreme Court, the Second Circuit's decision will likely provide some guidance in the domesticity area for some time. The impact of the decision remains hard to gauge absent additional precedent.

As an initial matter, it is worth noting that the District Court's decision notwithstanding, *Morrison* provides little basis for a court's refusal to exclude from the certified class nationals of jurisdictions that will not recognize the *res judicata* effect of a class action judgment. The District Court found these concerns ameliorated by *Morrison*, but in fact what motivated the district court in *In re Vivendi Universal, S.A.*, was not the extraterritorial nature of the securities transactions. Rather, there the district court was motivated by a concern that courts in France and elsewhere would not give effect to a class action

settlement, thereby exposing defendants to double liability.[30] This concern arises out of the belief in certain jurisdictions that "opt out" class actions violate unnamed class members' due process rights, irrespective of where those plaintiffs purchased their securities. To address this concern, the *Vivendi* court has excluded nationals of such jurisdictions from the definition of a class—a position adopted by a number of other courts that have considered similar fact patterns.[31] Therefore, the *Petrobras* court's decision notwithstanding, we expect that foreign issuers with substantial amount of foreign security-holders will continue to make *Vivendi* based arguments in the future.

The *Vivendi* issue aside, *Petrobras* raises a new spectrum of arguments that foreign issuers can assert in seeking to deny class certification—including, most notably, that the need to address where, and how, each class member purchased its securities predominates over questions that are subject to common proof. The need to establish domesticity by common proof raises the question of whether a class that includes non-U.S. purchasers of OTC securities ever be properly certified. On the one hand, the issues identified by the Second Circuit are likely to be present in any securities class action that involves non-U.S. purchasers of OTC securities. On the other hand, the Second Circuit implicitly acknowledged that its decision might have the unintended consequence of shutting the class action door on these purchasers.

We expect future class plaintiffs will seek to avoid the domesticity conundrum by aggressively arguing that the existence of domestic transactions can be established by means of common evidence—perhaps by resurrecting the argument that irrevocable liability occurs when the securities transactions were recorded at DTC, or some other clearinghouse. While the *Petrobras* district court rejected these arguments, it is possible that they will find acceptance by a different district court (at least, at the preliminary motion to dismiss stage), particularly when considered in light of the domesticity requirement to class certification announced by *Petrobras.* Defendants will, in turn, argue that the irrevocable liability attaches at the point that a transaction is entered into between a purchaser and seller of a security, not when the DTC records that transaction—the stronger argument, in our opinion.

Alternatively, the district court adjudicating a *Petrobras* case may take the Second Circuit up on its suggestion to apply a wide array of case management strategies, including potentially adjudicating the domesticity requirement at the same time, and in the same manner, that it addresses individual damages questions.

While the way in which this case law will develop remains unclear, what is clear is that post-*Petrobras,* non-U.S. purchasers of OTC securities now have to overcome new challenges to obtain class certification. Moreover, the impact of *Petrobras'* domesticity requirement is likely to be felt far beyond the context of securities class actions, as defendants facing class actions alleging commodities fraud, RICO, and other causes of action will no doubt mobilize *Petrobras* in their defense.

ENDNOTES:

[1]Brendan Piersan, *Petrobras to pay $2.95 billion to settle U.S. corruption lawsuit*, REUTERS (Jan. 3, 2018) at https://www.reuters.com/article/us-petrobras-classaction/petrobras-to-pay-2-95-b

illion-to-settle-u-s-corruption-lawsuit-idUSKBN1ES0L2.

[2]*See, e.g.*, Alison Frankel, Securities class action defendants, law profs claim 2nd Circuit has run amok, REUTERS (Dec. 6, 2017).

[3]*Morrison v. National Australia Bank Ltd.*, 561 U.S. 247, 130 S. Ct. 2869, 177 L. Ed. 2d 535, Fed. Sec. L. Rep. (CCH) P 95776, R.I.C.O. Bus. Disp. Guide (CCH) P 11932, 76 Fed. R. Serv. 3d 1330 (2010).

[4]*In re Petrobras Securities*, 862 F.3d 250, 272 Fed. Sec. L. Rep. (CCH) P 99811, 98 Fed. R. Serv. 3d 195 (2d Cir. 2017).

[5]*Id.* at 274.

[6]*In re Petrobras Securities Litigation*, 116 F. Supp. 3d 368, 373, Fed. Sec. L. Rep. (CCH) P 98587 (S.D. N.Y. 2015).

[7]Foreign cubed, or F-Cubed, actions involve foreign investors purchasing securities issued by foreign issuers on foreign exchanges.

[8]561 U.S. at 255.

[9]*Id.* at 265

[10]*Id.* at 267.

[11]*Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012).

[12]*Id.* at 68-69.

[13]*Id.* at 70.

[14]*U.S. v. Vilar*, 729 F.3d 62, 68-69, Fed. Sec. L. Rep. (CCH) P 97625 (2d Cir. 2013); *In re Smart Technologies, Inc. Shareholder Litigation*, 295 F.R.D. 50, 55-57, Fed. Sec. L. Rep. (CCH) P 97258 (S.D. N.Y. 2013); *In re Royal Bank of Scotland Group PLC Securities Litigation*, 765 F. Supp. 2d 327, 336 (S.D. N.Y. 2011).

[15]*Loginovskaya v. Batratchenko*, 764 F.3d 266 (2d Cir. 2014); *see also Starshinova v. Batratchenko*, 931 F. Supp. 2d 478, 485-86, Fed. Sec. L. Rep. (CCH) P 97335 (S.D. N.Y. 2013) (holding there is no basis to conclude the CEA applies abroad*); In re LIBOR-Based Financial Instruments Antitrust Litigation*, 935 F. Supp. 2d 666, 696, Comm. Fut. L. Rep. (CCH) P 32574, R.I.C.O. Bus. Disp. Guide (CCH) P 12350, 2013-1 Trade Cas. (CCH) ¶ 78323 (S.D. N.Y. 2013), vacated and remanded, 823 F.3d 759, 2016-1 Trade Cas. (CCH) ¶ 79642 (2d Cir. 2016), cert. denied, 137 S. Ct. 814, 196 L. Ed. 2d 599 (2017) (stating no indication of extraterritorial effect in the text of the CEA nor its legislative history), *vacated on other grounds*, 935 F. Supp. 2d 666 (2d Cir. 2016).

[16]*RJR Nabisco, Inc. v. European Community*, 136 S. Ct. 2090, 195 L. Ed. 2d 476, R.I.C.O. Bus. Disp. Guide (CCH) P 12729 (2016)

[17]*Securities Investor Protection Corp. v. Bernard L. Madoff Inv. Securities LLC*, 513 B.R. 222, 59 Bankr. Ct. Dec. (CRR) 194 (S.D. N.Y. 2014), supplemented, 2014 WL 3778155 (S.D. N.Y. 2014).

[18]*Kiobel v. Royal Dutch Petroleum Co.*, 569 U.S. 108, 133 S. Ct. 1659, 185 L. Ed. 2d 671 (2013).

[19]*In re Petrobras Securities Litigation*, 116 F. Supp. 3d 368, 386, Fed. Sec. L. Rep. (CCH) P 98587 (S.D. N.Y. 2015).

[20]*Id.*

[21]*In re: Petrobras Securities Litigation*, 312 F.R.D. 354, Fed. Sec. L. Rep. (CCH) P 99014, 93 Fed. R. Serv. 3d 1548 (S.D. N.Y. 2016), aff'd in part, vacated in part, 862 F.3d 250, Fed. Sec. L. Rep. (CCH) P 99811, 98 Fed. R. Serv. 3d 195 (2d Cir. 2017).

[22]Fed. R. Civ. P. 23(b)(3). In addition, certain courts of appeals have recognized an additional "implied requirement of ascertainability in Rule 23" requiring that a class be "sufficiently definite so that it is administratively feasible for the court to determine whether a particular individual is a member."

[23]*In re: Petrobras Securities Litigation*, 312 F.R.D. 354, 363, Fed. Sec. L. Rep. (CCH) P 99014, 93 Fed. R. Serv. 3d 1548 (S.D. N.Y. 2016), aff'd in part, vacated in part, 862 F.3d 250, Fed. Sec. L. Rep. (CCH) P 99811, 98 Fed. R. Serv. 3d 195 (2d Cir. 2017) (citing *In re Vivendi Universal, S.A.*, 242 F.R.D. 76, 95 (S.D. N.Y. 2007), aff'd, 838 F.3d 223, Fed. Sec. L. Rep. (CCH) P 99407 (2d Cir. 2016)).

[24]*In re Petrobras Securities*, 862 F.3d 250,

271, Fed. Sec. L. Rep. (CCH) P 99811, 98 Fed. R. Serv. 3d 195 (2d Cir. 2017).

[25]*Id.* at 272.

[26]*Id.* at 273.

[27]*Id.*

[28]*Id.* at 273.

[29]*In re Petrobras Litigation*, 150 F. Supp. 337, 342 (S.D.N.Y. 2015).

[30]*In re Vivendi Universal, S.A.*, 242 F.R.D. 76, 106 (S.D. N.Y. 2007), aff'd, 838 F.3d 223, Fed. Sec. L. Rep. (CCH) P 99407 (2d Cir. 2016).

[31]*Id.* at 107; *Anwar v. Fairfield Greenwich Ltd.*, 289 F.R.D. 105, 115 (S.D. N.Y. 2013), vacated and remanded, 570 Fed. Appx. 37 (2d Cir. 2014).