ALERT MEMORANDUM

Second Circuit Provides Guidance on Identifying "Predominantly Foreign" Transactions that are Outside the Scope of the Federal Securities Laws

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On January 25, 2021, the Second Circuit issued an opinion in *Cavello Bay Reinsurance Ltd. v. Stein* affirming the dismissal of a claim under Section 10(b) of the Exchange Act, holding that a private sale of restricted shares between two Bermudan companies was "so predominantly foreign" as to be impermissibly extraterritorial under the facts presented, despite a defendant's principal place of business being in New York and the parties entering a subscription agreement that was partially signed in New York, governed by New York law, and that required any resales to be registered with the SEC.[1]

The decision is notable because it provides additional guidance on the factors that are relevant to considering when a domestic transaction may be so predominantly foreign that it falls outside the scope of the federal securities laws under the Supreme Court's decision in *Morrison*.[2] The decision underscores that, in an increasingly remote world, participants in securities transactions must pay careful attention to how their agreements are structured in considering whether their transactions may be subject to the liability provisions of the federal securities laws.

[1] *Cavello Bay Reinsurance Ltd. v. Stein*, No. 20-1371-cv (2d Cir Jan. 25, 2021), ECF No. 74-1 [hereinafter *Second Circuit Opinion*].
[2] *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010).

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Background and Procedural History

Morrison and Its Progeny

In its 2010 decision in *Morrison*, the Supreme Court held that Section 10(b) of the Exchange Act is presumed to have no extraterritorial reach and therefore only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."[3] In adopting this holding, the Supreme Court rejected the prior conducts-and-effects test for determining the extraterritorial scope of the federal securities laws, which it criticized as hard to administer or apply, and liable to yield unpredictable results.[4]

In the decade that followed, lower courts have nonetheless struggled with a number of issues under *Morrison*, including how to determine the location of securities transactions that do not occur on an exchange and the circumstances under which foreign issuers can be sued for domestic transactions in which they had no or only limited involvement.[5]

In the main decision addressing what constitutes "domestic transactions in other securities," *Absolute Activist Value Master Fund Ltd. v. Ficeto*, the Second Circuit held that a transaction that takes place off of an exchange is domestic if "irrevocable liability was incurred or title was transferred within the United States."[6] In that decision, the Second Circuit identified a number of factors that could be relevant to making this determination, including "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money."[7]

Two years later, in *Parkcentral*, the Second Circuit addressed the issue of when the federal securities laws can be applied against foreign issuers with limited or no involvement in the domestic transaction, holding that the presence of a domestic transaction was a necessary – but not sufficient – condition to properly invoke Section 10(b).[8] There, the Second Circuit held that a plaintiff investor in a domestic swap transaction that referenced shares of a foreign company listed on a foreign exchange could not sue that foreign issuer concerning allegedly deceptive conduct that occurred in Germany, stating that although those claims met the standard for a "domestic transaction" under *Absolute Activist*, they were "so predominantly foreign as to be impermissibly extraterritorial."[9] The court reached this result by concluding that applying Section 10(b) under those circumstances "would require courts to apply the statute to wholly foreign activity clearly subject to regulation by foreign authorities solely because a plaintiff in the United States made a domestic transaction, even if the foreign defendants were completely unaware of it," a rule that "would

[3] *See id.* at 267.
[4] *See id.* at 258-59.
[5] Jared Gerber, Roger Cooper & Andy Bernstein, *Foreign Securities Class Actions 10 Years After Morrison*, Law 360 (Sept. 24, 2020), https://www.law360.com/articles/1312570/foreign-securities-class-actions-10-years-after-morrison.
[6] 677 F.3d 60, 68, 71 (2d Cir. 2012).
[7] *Id.* at 70.
[8] *Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 215-16 (2d Cir. 2014).
[9] *Id.* The Ninth Circuit subsequently issued a decision in the related context of an unsponsored ADR program declining to follow *Parkcentral*, which it characterized as being "contrary to Section 10(b) and *Morrison* itself." *Stoyas v. Toshiba Corp.*, 896 F.3d 933, 950 (9th Cir. 2018). In particular, the Ninth Circuit criticized *Parkcentral* for creating a "carve-out" to the federal securities laws based on "speculation about Congressional intent," which is "an inquiry *Morrison* rebukes," and relying on "an open-ended, under-defined multi-factor test . . . akin to the vague and unpredictable tests that *Morrison* criticized and endeavored to replace with a 'clear', administrable rule." *Id.* The Ninth Circuit further criticized *Parkcentral* for "rel[ying] heavily on the foreign location of the allegedly deceptive conduct, which *Morrison* held to be irrelevant to the Exchange Act's applicability, given Section 10(b)'s exclusive focus on transactions." *Id.* Instead, the Ninth Circuit held that the presence of a domestic transaction was sufficient to satisfy the extraterritoriality requirement of *Morrison*, and that any question concerning the involvement of a foreign issuer in the domestic transaction should be resolved under the Exchange Act's separate "in connection with" requirement, which requires the challenged conduct to "touch the sale – i.e., it must be done to induce the purchase at issue." *Id.* at 951.

inevitably place § 10(b) in conflict with the regulatory laws of other nations."[10]

The District Court Decision in *Cavello Bay*

The *Cavello Bay* case involved a purchase of securities made by a Bermudan corporation in a private offering by a Bermudan holding company, Spencer Capital.[11] Although Spencer Capital's securities were not traded on an exchange in the United States, the plaintiff alleged that the company had a number of connections to the United States, including that its principal place of business was in New York, that it maintained an investment portfolio consisting of U.S. insurance-related assets, and that its portfolio was managed by a Delaware entity.[12] The plaintiff further alleged that the transaction had several connections to the United States, including that the defendants sent the draft subscription agreement from New York, that the plaintiff sent the signed agreement to New York, that the defendants countersigned the agreement in New York, that the agreement was governed by New York law, and that the agreement required that the shares be registered with the SEC before the plaintiff could resell them.[13]

Months after making the investment, the plaintiff allegedly learned the defendants made misstatements concerning the management fees payable by the company and brought claims under the Exchange Act, including under Sections 10(b) and 20(a).[14]

The defendants subsequently moved to dismiss arguing, among other things, that the transaction was extraterritorial and therefore beyond the Exchange Act's reach.[15] Relying on *Morrison*'s transactional test and the subsequent holdings of *Absolute Activist*, the district court granted the defendants' motion and dismissed the case, holding that the plaintiff failed to plead that its transaction was domestic, because the defendants retained the ability to reject the subscription even after it was signed in New York (meaning that irrevocable liability did not attach at that point).[16] Alternatively, the district court held that, even if the transaction were domestic, it would be predominantly foreign and remain beyond the scope of Section 10(b) under *Parkcentral* because the parties were Bermudan companies, the agreement concerned Bermudan shares, and the allegedly fraudulent statements were directed to and impacted the plaintiff in Bermuda.[17]

The plaintiff then appealed to the Second Circuit.

The Second Circuit Decision

In a decision issued on January 25, 2021, the Second Circuit affirmed, agreeing with the district court that even if there were a domestic transaction it was still "so predominantly foreign" as to be impermissibly extraterritorial under *Parkcentral*.[18]

Notably, in reaching this decision, the Second Circuit first assumed, without deciding, that the parties may have engaged in a domestic transaction. In declining to resolve this issue, the Second Circuit observed that "[t]he particulars of this case illustrate how locating the 'meeting of the minds' can be . . . confused by the parties, or can become enmeshed in state contract law."[19] Thus, based on its conclusion that "the place of transaction is difficult to locate, and impossible to do without making state law," the court did not reach whether the transaction at issue was domestic.[20]

Turning its attention to *Parkcentral*'s "so-foreign inquiry," the Second Circuit distilled two points from *Morrison* and *Parkcentral*: (1) that "*Morrison's* 'domestic transaction' rule operates as a threshold requirement, and as such may be underinclusive"; and (2) that "*Parkcentral* nonetheless uses *Morrison*'s focus on the transaction rather than surrounding

[10] *Parkcentral*, 763 F.3d at 215.
[11] *Cavello Bay Reinsurance Ltd. v. Stein*, No. 18-CV-11362, 2020 WL 1445713, at *3 (S.D.N.Y., Mar. 25, 2020) [hereinafter *District Court Opinion*].
[12] *Id.*
[13] *Second Circuit Opinion* at 5-6.
[14] *See District Court Opinion* at *3.
[15] *See id.* at *4.
[16] *Id.* at *7.
[17] *Id.* at *8-9.
[18] *Second Circuit Opinion* at 3.
[19] *Id.* at 8.
[20] *Id.* at 9.

circumstances, and flexibly considers whether a claim – in view of the securities and the transaction as structured – is still predominantly foreign."[21] Applying these principles to the facts before it, the Second Circuit concluded that the plaintiff's claims were "predominantly foreign" because they were "based on a private agreement for a private offering between a Bermudan investor . . . and a Bermudan issuer," involved restricted shares "in a private offering," "reflect[ed] only an interest in" a foreign company, and "are listed on no U.S. exchange and are not otherwise traded in the United States."[22] In the court's words, "[p]roviding a domestic forum ought to enhance confidence in U.S. securities markets or protect U.S. investors" and in this case "it would do neither."[23]

The Second Circuit reached this conclusion by stating that the "main link to the United States" was the subscription agreement's resale restriction clause, which required the plaintiff to register the shares with the SEC or meet an exemption should it wish to resell them.[24] But the court found this clause (and the "contingent and future" obligation that it included) to be insufficient to "trigger[] some U.S. interest or other interest that the [Exchange Act] is meant to protect."[25] The court similarly rejected the New York choice of law provision in the subscription agreement as "neither here nor there."[26] In reaching these holdings, the court noted that the parties were "sophisticated institutional investors," and stated that if they "had wanted the regulatory hand of U.S. law, they could have bargained for it and structured a U.S. transaction."[27]

Finally, the Second Circuit rejected the other allegations that the plaintiff cited – including that the defendants made the alleged misstatements from New York, planned to use the funds to invest in U.S. insurance services, had its principal place of business, CEO and directors in New York, and the portfolio was managed by a U.S. company – as "vestiges from our now-defunct conduct and effects test," which were "not enough" because they did not "relate to the purchase and sale of securities."[28] Similarly, the court found irrelevant that "acts evincing contract formation" cited by the plaintiff occurred in the United States – including that it sent the signed agreements to New York and the defendants signed the agreements in New York – as merely "bear[ing] upon the threshold question whether the purchaser or seller incurred irrevocable liability in the United States, thereby rendering the transaction 'domestic,'" but not "resolv[ing] the question whether the claims are nevertheless so predominantly foreign" as to fall outside the scope of the federal securities laws.[29]

Implications

The Second Circuit's decision in *Cavello Bay* is notable for several reasons.

First, *Cavello Bay* is significant because it refocuses *Parkcentral*'s "so-foreign inquiry" on the structure of the transaction and the purposes of the federal securities laws, rather than on the location where the alleged fraud was committed and the location of the impact of that fraud (which it considered to be "vestiges" from the "now-defunct conduct and effects test") or on acts evincing contract formation (which it said only "bear upon the threshold question" of whether a domestic transaction occurred and not on whether that transaction is predominantly foreign).[30] Thus, *Cavello Bay* indicates that the touchstone of the "predominantly foreign" inquiry is whether applying the federal securities laws would "enhance confidence in U.S. securities markets or protect U.S. investors," rather than whether certain parts of the transaction touched the United States.[31] In this respect, the decision indicates that a critical factor in the "so-foreign inquiry" is whether the investor is located in

[21] *Id.* at 12.
[22] *Id.* at 13.
[23] *Id.* at 14.
[24] *Id.* at 13.
[25] *Id.*
[26] *Id.*
[27] *Id.* at 14.
[28] *Id.* at 14-15.
[29] *Id.* at 15.
[30] *See id.* at 12-15.
[31] *See id.* at 14.

the United States, such that it was intended to be protected by the federal securities laws. On the other hand, the court was willing to find the domestic transaction impermissibly foreign notwithstanding that the issuer had a number of contacts with the United States, including that its principal place of business, management team, and underlying assets were located in the United States.

Second, the decision provides additional guidance to foreign participants in securities transactions on other factors that may (or may not) bring a claim within the scope of the federal securities laws. In this respect, factors that the court considered to be irrelevant in determining whether a domestic transaction was impermissibly foreign included a contractual provision requiring SEC registration for resales of the securities or a choice-of-law clause applying U.S. law to the terms of the agreement.[32] And, the decision also indicates that, particularly with respect to private placements involving "sophisticated institutional investors," courts should respect the bargain struck by the parties, and not impose liability under the federal securities laws where the parties structured the transaction in a way "to avoid the bother and expense (and taxation) of U.S. law."[33]

Third, the Second Circuit's continued adherence in *Cavello Bay* to its prior decision in *Parkcentral*, notwithstanding the Ninth Circuit's rejection of that decision in *Stoyas*, further solidifies the existing circuit split on how courts should analyze the applicability of the federal securities laws to domestic transactions with foreign connections, and reflects that the Second Circuit may be more amenable to rejecting claims based on extraterritoriality than the Ninth Circuit. Indeed, assuming that a domestic transaction actually occurred in *Cavello Bay*, it is likely that a court applying *Stoyas* would have found the transaction to fall within the scope of the federal securities laws, given that there appears to be no question that the defendants were sufficiently involved in the domestic transaction to satisfy the "in connection with" requirement as interpreted by the Ninth Circuit. Further appellate review may therefore be necessary to resolve this disagreement.

Finally, although arising in the context of an individual action, the Second Circuit's recognition that determining the location of transactions in securities not traded on an exchange is "confused," "enmeshed in state contract law," "difficult to locate," and "impossible to do without making state law"[34] provides further support for the argument that the inquiry required by *Absolute Activist* raises individualized issues that can defeat the predominance requirement in securities class actions. In its prior decision in *In re Petrobras Securities*, the Second Circuit agreed that this inquiry raised individualized issues that a district court must consider in assessing predominance, but nevertheless left open the possibility that a district court could find this requirement satisfied.[35] The court's recognition in *Cavello Bay*, however, that these issues are "difficult" and "impossible to [decide] without making state law" should significantly strengthen the argument in future cases that these investor-by-investor and transaction-by-transaction issues are sufficient to defeat class certification.[36]

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[32] *Id.* at 13.
[33] *See id.* at 14.
[34] *See id.* at 8-9.
[35] 862 F.3d 250, 271-74 (2d Cir. 2017). Cleary Gottlieb represented the defendants in this action.
[36] *See Second Circuit Opinion* at 9.