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Second Circuit Reaffirms that Federal Securities Laws Do Not Apply to Predominantly Foreign Transactions

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The U.S. Court of Appeals for the Second Circuit reaffirmed yesterday that the federal securities laws do not apply to "predominantly foreign" securities transactions even if those transactions might have taken place in the United States. The ruling in *Cavello Bay Reinsurance Ltd. v. Shubin Stein* (No. 20-1371) reinforces the Second Circuit's prior decisions concerning the scope of the transaction-based test that the U.S. Supreme Court announced in *Morrison v. National Australia Bank* in an effort to curb the extraterritorial application of the federal securities laws.

Legal Background

For several decades before the Supreme Court's 2010 decision in *Morrison*, courts had allowed securities plaintiffs to bring "extraterritorial" claims under the federal securities laws based on some version of the "conduct and effects" test. That test examined whether significant wrongful *conduct* related to non-U.S. securities transactions had occurred in the United States or whether wrongful conduct outside the United States had had a substantial *effect* on U.S. markets or investors.

In 2010, the Supreme Court threw out the "conduct and effects" test and announced a new "transactional" test for determining the federal securities laws' reach. *Morrison* held that the securities laws apply only to alleged misstatements or omissions made "in connection with the purchase or sale of [*i*] a security listed on an American stock exchange, and [*ii*] the purchase or sale of any other security in the United States." Most of the subsequent litigation has involved the second prong, for unlisted securities.

Four years later, in *Parkcentral Global HUB Ltd. v. Porsche Automobile Holdings SE*, the Second Circuit held that, even if a transaction might technically have been “domestic” (in that irrevocable liability to pay for or deliver the security was incurred in the United States, or the transaction closed in the United States), the U.S. securities laws still will not apply if the transaction was predominantly foreign.

The *Cavello Bay* Decision

Case Background

Cavello Bay (the buyer), a Bermudian company, bought shares in another Bermudian company that operates out of New York and invests in U.S. insurance services. The transaction was a private transaction, and the seller’s shares were not listed on a U.S. exchange. Complaining that the seller’s pitch deck had contained misrepresentations, the buyer sued in New York under the Securities Exchange Act of 1934. The buyer asserted that the Exchange Act applied because the transaction was a domestic one under *Morrison*’s second prong.

The factual allegations showed the following:

- The seller had pitched the investment to the buyer by telephone from New York and had sent the allegedly false pitch deck from New York to the buyer in Bermuda.
- The seller had sent a draft subscription agreement from New York to the buyer in Bermuda.
- The buyer had signed the agreement in Bermuda and then emailed it to the seller’s owner in New York.
- The seller’s owner had countersigned the agreement in New York on the seller’s behalf and then sent it back to Bermuda.
- The subscription agreement stated that it was governed by New York law and that the shares would be issued in accordance with the Securities Act of 1933.
- The transaction had closed in Bermuda.

The District Court dismissed the case, holding that (*i*) the parties had incurred irrevocable liability on the transaction in Bermuda, so the transaction was not “domestic” under *Morrison*, and (*ii*) even if the transaction was domestic, the claims still were “so predominantly foreign” as to be impermissibly extraterritorial under *Parkcentral.* The Second Circuit affirmed solely on the second ground.

The Second Circuit's Decision

The Second Circuit assumed, without deciding, that the transaction was a domestic one. The court noted the buyer's argument that the subscription agreement did not become binding until the seller had countersigned it in New York, but it also noted the seller's argument that the agreement became binding under New York law only when sent to Bermuda and received there. "The particulars of this case illustrate how locating the 'meeting of the minds' can be arranged or confused by the parties, or can become enmeshed in state contract law. . . . Here, the place of transaction is difficult to locate, and impossible to do without making state law."

Accordingly, the court simply assumed that the transaction satisfied *Morrison*'s second prong, but nevertheless held that the deal was "predominantly foreign" and therefore outside the Exchange Act's scope. The court reiterated *Parkcentral*'s holding that *Morrison*'s domestic-transaction rule operates only "as a threshold requirement, and as such may be underinclusive." It also stressed that a court must "focus on the transaction rather than surrounding circumstances, and flexibly consider[] whether a claim – in view of the security and the transaction as structured – is still predominantly foreign."

The Second Circuit viewed the transaction here as predominantly foreign: it involved "a private agreement for a private offering between a Bermudian investor . . . and a Bermudian issuer . . . ." The subscription agreement's requirement that the shares be registered with the SEC (or meet an exemption) "may set up a future invocation of U.S. law," but it operated only as "a mere contractual impediment to resale," rather than as a core transactional fact. "[T]he transaction [was] structured to avoid the bother and expense (and taxation) of U.S. law. If either of these sophisticated institutional investors had wanted the regulatory hand of U.S. law, they could have bargained for it and structured a U.S. transaction. The transaction implicates only the interests of two foreign companies and Bermuda."

The Second Circuit also observed that most of the buyer's locational allegations were "vestiges" of the conduct/effects test that *Morrison* had rejected and were no longer relevant to the extraterritoriality analysis. Allegations about where the alleged misstatements were made, the nature of the securities in which the buyer's money would be invested, and the seller's principal place of business did not involve the *transactional* facts on which *Morrison* and its progeny require courts to focus. "The contacts that matter are those that relate to the purchase and sale of [the] securities" at issue in the fraud claim.

Implications

The *Cavello Bay* decision does not break new ground, but it is another reminder that determining whether a securities-law claim seeks impermissible extraterritorial application of U.S. law requires parties and courts to focus only on *transactional* allegations (not on allegations concerning the underlying fraud) – and that even such allegations will not necessarily be dispositive if the transaction otherwise seems predominantly foreign. The opinion acknowledges that parties – especially sophisticated ones – have some leeway to structure predominantly foreign transactions even if certain elements might touch the United States.

The decision also might underscore the existing tension between the Second Circuit's *Parkcentral* ruling and the Ninth Circuit's 2018 decision in *Stoyas v. Toshiba Corporation*, a case involving unlisted, unsponsored American Depositary Receipts. Unlike the Second Circuit, the Ninth Circuit seems to have viewed the existence of a domestic transaction as the end of the *Morrison* inquiry, rather than as merely a "threshold requirement." *Stoyas* did not contemplate the additional analysis of "predominant foreignness" that the Second Circuit conducted in *Parkcentral* and *Cavello Bay* even after assuming the existence of a domestic transaction under *Morrison*'s second prong. (However, the Ninth Circuit shifted consideration of some of those issues to Exchange Act § 10(b)'s separate requirement that the alleged fraud have occurred "in connection with" the purchase or sale of securities.)

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