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SECOND CIRCUIT REAFFIRMS THAT SECTION 10(B) DOES NOT APPLY TO PREDOMINANTLY FOREIGN TRANSACTIONS

On January 25, 2021, the Court of Appeals for the Second Circuit held, in *Cavello Bay Reinsurance Ltd. v. Stein*, that an off-shore securities transaction structured to avoid U.S. registration requirements was "so predominantly foreign" as to fall beyond the territorial reach of the general antifraud provision of the federal securities laws, even though the alleged fraud concerning investment contracts governed by U.S. state law took place on U.S. shores. *Cavello* is the latest decision from the federal appeals court in New York to identify geographic restraints on U.S. lawsuits concerning cross-border securities transactions.[1]

Extraterritorial Reach of U.S. Securities Laws

Section 10(b) of the Exchange Act of 1934, and SEC Rule 10b-5 thereunder, prohibit making "any untrue statement of material fact" or engaging in any act that "would operate as a fraud or deceit . . . in connection with the purchase or sale of any security." But it contains no clear expression of extraterritorial effect beyond U.S. borders. As a result, courts have long grappled with the question of how the statute applies to alleged fraud in connection with cross-border securities transactions.

In 2010, the Supreme Court in *Morrison v. National Australia Bank* dramatically cabined Section 10(b)'s cross-border reach.[2] The *Morrison* Court reaffirmed the "presumption against extraterritorial effect": that when a statute contains no "clear statement" of cross-border effect, it applies only domestically. The Court explained that the proper "domestic application" of such statutes must identify domestic activity that implicates a statute's "focus of congressional concern." Concluding that Section 10(b) was focused on "purchases and sales of securities in the United States," the *Morrison* Court laid down a bright-line rule: a suitably

[1] No. 20-1371, 2021 WL 232551 (2d Cir. Jan. 25, 2021).
[2] 561 U.S. 247 (2010).

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domestic application of Section 10(b) obligates plaintiffs to plead a domestic U.S. transaction—on an exchange, or over the counter.

In 2014, the Second Circuit further clarified that a "domestic" securities transaction is necessary—but not alone sufficient—to state a proper Section 10(b) claim under the *Morrison* framework. In *Parkcentral Global Hub Limited v. Porsche Automobile Holdings SE*, the plaintiffs transacted in domestic swap agreements.[3] They alleged that defendants (a foreign company and its executives) had made false statements "primarily in Germany" affecting the price of the issuer's stock "trad[ing] only on exchanges in Europe," which had in turn affected the price of their domestic swaps. The court held that the "facts constituting the defendant's alleged *violation*" rendered the claim "so predominantly foreign as to be impermissibly extraterritorial."

The *Parkcentral* decision marked an encouraging second step away from the longtime practice of domestic U.S. plaintiffs seeking to sue foreign issuers for claims untethered to the U.S. But *Parkcentral* left unanswered questions about its application beyond the bespoke swaps at issue there.

The *Cavello* Case

The *Cavello* case presented dramatically different facts: a private securities offering between plaintiff and defendant, featuring allegations of domestic misconduct. *Cavello* concerned a private offering: a plaintiff-buyer purchased shares from the defendant-seller (a holding company). The plaintiff claimed the defendant-seller's pitch deck contained material misrepresentations concerning the seller's management fees.

The circumstances of the transaction "ping-pong[ed] between New York and Bermuda." Plaintiff-buyer was headquartered and incorporated in Bermuda. The defendant-seller was incorporated in Bermuda, but was headquartered in New York, maintained an investment portfolio consisting of "U.S. insurance-related assets," and was managed by a Delaware portfolio manager.

The seller's CEO (a co-defendant, who was also the owner/manager of the Delaware investment manager) acted entirely in New York: he (1) pitched the investment to the buyer's Bermudan parent company by phone from New York; (2) emailed the buyer a PowerPoint presentation—containing the alleged misrepresentation—from New York; (3) sent the draft subscription agreement from New York; (4) countersigned the agreement in New York; then (5) mailed the agreement back to Bermuda (where title was transferred). The shares were "restricted": the subscription agreement required the buyer to register them with the SEC as a prerequisite to resale.

The district court dismissed the claims as impermissibly extraterritorial, holding that (a) the transaction was not adequately "domestic"; and that (b) even if domestic, the claims still were "so predominantly foreign" as to be impermissibly extraterritorial.[4]

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[3] 763 F.3d 198 (2d Cir. 2014).
[4] 18-cv-11362, 2020 WL 1445713 (S.D.N.Y. Mar. 25, 2020).

The Appeals Court Decision

The Second Circuit affirmed on the latter ground. First, the panel assumed that the transaction was properly "domestic." In so doing, the court acknowledged the difficulty of identifying a properly "domestic" transaction, explaining the "place of transaction"—the location of the "meeting on the minds"—was "difficult to locate, and impossible to do without making [new] state law" on contract formation (which the court declined to do).

But the *Cavello* court concluded that *Morrison's* "'domestic transaction' rule operates as a threshold requirement," and as a result "may be underinclusive." Explaining that *Parkcentral* reinforces *Morrison's* "focus on the transaction" and not the "surrounding circumstances," the appeals court held itself bound to "flexibly consider[]" whether a claim premised on a domestic security is "still predominantly foreign," when considered "in view of the security and the *transaction as structured*."

The court emphasized the transaction "implicate[d] only the interests of two foreign companies and Bermuda." Plainly, the most important fact to the court was that the parties—sophisticated institutional investors—had structured the transaction to "avoid the bother and expense (and taxation) of U.S. law." Had the parties wanted "the regulatory hand of U.S. law, they could have bargained for it and structured a U.S. transaction." But instead, the transaction's "main link" to the U.S. was the clause requiring the buyer to register the shares with the SEC before reselling them. However, the *Cavello* court characterized that as—at best—"set[ting] up a *future* invocation of U.S. law," and found that the purchaser in this transaction had, instead, "made the purchase in a way that avoids regulation by the United States." And the designation of New York law in the contract was "neither here nor there."

In those circumstances, the *Cavello* court reasoned that applying Section 10(b) to the transaction would neither "enhance confidence in U.S. securities markets" nor "protect U.S. investors." The court flatly disregarded that the seller's conduct took place in New York, saying "that is not enough." Instead, the *Cavello* court said that "the contacts that matter are those that relate to the purchase and sale of securities." Likewise, the complaint's allegations regarding contract formation in New York, at best, bore upon the "threshold question" of whether the transaction was "domestic," not whether the claims were nevertheless "predominantly foreign."

Finally, the court distinguished its own prior opinion in *Giunta v. Dingman*, where claims concerning a private offering by a Bahamian company satisfied the *Morrison* and *Parkcentral* framework.[5] The court explained that unlike in *Cavello*, the plaintiff in *Giunta* was a U.S. citizen (and though *Cavello* did not say so, the alleged misrepresentations in *Giunta* also occurred in New York). Thus, the fact that *Cavello's* defendant had supposedly solicited some U.S. investors suggested, at best, that "someone (else)" other than the Bermudan plaintiff "might have an appropriately domestic claim."

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[5] 893 F.3d 73 (2d Cir. 2018).

Conclusion

Cavello is the latest Second Circuit decision identifying that the facts and circumstances surrounding a U.S.-connected securities transaction may place the transaction beyond the reach of the federal securities laws. The decision is notable both in its focus on the steps taken by the parties to "avoid" U.S. law, and for appearing to suggest the outcome may have differed had the plaintiff-buyer been a "U.S. investor." One thing remains certain: investors in cross-border securities transactions will continue to test *Morrison's* limits. Market participants should continue to watch future developments on these topics and structure their transactions accordingly.

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