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SECOND CIRCUIT REVIEW

Expert Analysis

'Predominantly Foreign' Securities Claims

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In *Cavello Bay Reinsurance Ltd. v. Shubin Stein*, 986 F.3d 161 (2d Cir. Jan. 25, 2021), the U.S. Court of Appeals for the Second Circuit affirmed its prior holding that the Securities Exchange Act of 1934 (the Exchange Act) does not apply to securities claims that are "predominantly foreign." In an opinion written by Circuit Judge Dennis Jacobs and joined by Circuit Judges Rosemary S. Pooler and Joseph F. Bianco, the Second Circuit affirmed the dismissal of Exchange Act claims asserted by a foreign company against another foreign company with its principal place of business in New York.

The Second Circuit assumed the companies' transaction giving rise to the claims was "domestic" under *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012), but held that §10(b) of the Exchange Act did not apply because those claims were nonetheless "predominantly foreign" under *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, 763 F.3d 198 (2d Cir. 2014). This opinion continues the Second Circuit's trend of taking a narrow approach to the extraterritorial reach of the federal securities laws.

The Exchange Act's Reach

The Exchange Act regulates the purchase and sale of securities in the United States. Section 10(b) of the Exchange Act and its implementing regulation, SEC Rule 10b-5, prohibit making any untrue statement or omission of material fact in connection with a securities transaction. Prior to 2010, the Second Circuit used a conduct-and-effects test to assess the extraterritorial reach of §10(b) and SEC Rule 10b-5. That test considered "'(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens.'" *Cavello Bay*, 986 F.3d at 166 (citation omitted). In 2010, however, in *Morrison v. National Australia Bank Ltd.*, the Supreme Court adopted a narrower, transaction-based test and ruled that §10(b) and SEC Rule 10b-5 apply only to "transactions in securities listed on domestic exchanges[] and domestic transactions in other securities." 561 U.S. 247, 267 (2010).

The Second Circuit in *Absolute Activist* later concluded that, under *Morrison*, "a securities transaction is domestic when the parties incur irrevocable liability to carry out the transaction within the United States or when

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title is passed within the United States." 677 F.3d at 69. We previously analyzed *Absolute Activist*'s interpretation of *Morrison* in our March 28, 2012 column.

Two years after *Absolute Activist*, the Second Circuit in *Parkcentral* further interpreted *Morrison*'s transaction-based test. 763 F.3d at 216. It held that §10(b) and SEC Rule 10b-5 do not apply to claims that are "so predominantly foreign as to be impermissibly extraterritorial," even if the claims are based on "domestic" transactions under *Absolute Activist*. Id. The court declined to offer a test for determining when a claim is "predominantly foreign" and instead instructed future courts to consider each case's facts so as to eventually develop a consistent set of standards. Id. at 217. The Second Circuit's decision in *Cavello Bay* provides further guidance on what claims are considered "predominantly foreign."

Background

Plaintiff Cavello Bay Reinsurance Ltd. (Cavello Bay) is a company organized under Bermuda law, with its principal place of business in Bermuda. Cavello Bay is a subsidiary of a Bermudan global insurance group named Enstar Group Ltd. (Enstar). Defendant Spencer Capital Ltd. (Spencer Capital) is a private holding company also organized under Bermuda law and has its principal place of business in New York. Spencer Capital invests in U.S. insurance-related assets. Spencer Management, a Delaware entity, manages Spencer Capital's investment portfolio. Defendant Kenneth Shubin Stein is CEO of Spencer Capital and owner/manager of Spencer Management. 986 F.3d at 164.

In 2015, Spencer Capital contacted Cavello Bay through Enstar with a private offering to purchase shares in Spencer Capital. Cavello Bay signed a subscription agreement in Bermuda purchasing 250,000 shares for $5 million, and Shubin Stein countersigned the agreement for Spencer Capital in New York. Spencer Capital's shares were not listed on a domestic exchange, but the companies' subscription agreement stated it was governed by New York law. The agreement also required Cavello Bay to register the shares with the SEC if Cavello Bay wanted to resell them. Title to the shares was transferred at closing in Bermuda. Id.

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Cavello Bay alleged that when Shubin Stein pitched the transaction, Shubin Stein represented that Spencer Management's management fees would be tied to Spencer Capital's profits when in fact they were tied to book value. Consequently, while operating at a loss, Spencer Capital paid Spencer Management $4.4 million from the proceeds Spencer Capital raised in the private offering by selling shares to, among other investors, Cavello Bay. Cavello Bay sued Shubin Stein and Spencer Capital for allegedly violating §10(b) and SEC Rule 10b-5. Cavello Bay's complaint also asserted claims under the Exchange Act for rescission against Spencer Capital under §29(b) and control person liability against Shubin Stein under §20(a). These additional Exchange Act claims were predicated on the alleged violation of §10(b). Id. at 164-65.

The district court granted defendants' motions to dismiss on two independent grounds: it held that (1) the transaction giving rise to the §10(b) claims was not "domestic" pursuant to the Second Circuit's decision in *Absolute Activist*, and (2) even if the transaction was "domestic," Cavello Bay's §10(b) claims were "predominantly foreign" and therefore were impermissibly

extraterritorial under *Parkcentral*. Because Cavello Bay failed to demonstrate a predicate violation of §10(b), the district court dismissed Cavello Bay's other claims under the Exchange Act as well. Id. at 165.

Second Circuit's Opinion

The Second Circuit affirmed the dismissal of Cavello Bay's claims. As to the §10(b) claims, the court assumed that the transaction was domestic under *Absolute Activist*, but held that Cavello Bay's Exchange Act claims were "predominantly foreign" under *Parkcentral*. Id.

Before analyzing Cavello Bay's claims, the Second Circuit summarized the current state of the law on the extraterritorial reach of §10(b). It described *Parkcentral*'s holding as "a gloss on *Morrison*'s rule." Id. at 166. The Second Circuit affirmed *Parkcentral*'s conclusion that "*Morrison*'s 'domestic transaction' rule operates as a threshold requirement, and as such may be underinclusive." Id. (citation omitted).

The Second Circuit also explained, however, that *Parkcentral* nonetheless applies *Morrison*'s transaction-based test when determining whether a claim "in view of the security and the transaction as structured" is "predominantly foreign." Id. at 166-67.

The Second Circuit then applied *Parkcentral* to *Cavello Bay*'s facts and offered important insight into what factors future courts should consider when determining whether a securities claim is "predominantly foreign."

The Second Circuit noted that Cavello Bay's claims were based on a private agreement formed between two Bermudan companies in a private offering. While Shubin Stein countersigned the agreement on behalf of Spencer Capital in New York and acts evincing contract formation are relevant to determining whether a transaction is domestic, these acts do not resolve the question of whether a §10(b) claim is "predominantly foreign." Id. at 167-68.

According to the Second Circuit, the Exchange Act claims' main connection to the United States was that the agreement required Cavello Bay to register Spencer Capital's shares with the SEC or identify an exception if Cavello Bay wanted someday to resell. Id. at 167. This contingent and future restriction was not sufficient to trigger a U.S. interest, however.

Accordingly, the court concluded that because the transaction implicated the interests of only Bermuda and the two foreign companies, the district court properly held that Cavello Bay could not demonstrate that Spencer Capital had violated §10(b). Id. at 167-68. Since Cavello Bay did not challenge the district court's decision to dismiss Cavello Bay's other Exchange Act claims that were predicated on demonstrating a violation of §10(b), the Second Circuit affirmed the dismissal of the entire case. Id. at 168.

Conclusion

The Second Circuit's decision in *Cavello Bay* reinforces the Second Circuit's jurisprudence that the Exchange Act does not apply to "predominantly foreign" §10(b) claims even if the claims are based on nominally domestic transactions. The opinion also provides additional insight into what factors make a §10(b) claim so "predominantly foreign" as to be impermissibly extraterritorial. As securities transactions become increasingly international, *Cavello Bay* is an important reminder that the Second Circuit is wary of extending the Exchange Act's application outside the United States.