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Second Circuit Applies *Morrison* to Affirm Dismissals of Securities Fraud Claims Arising out of Foreign Transactions

A pair of recent decisions by the Second Circuit have affirmed the dismissal of securities fraud claims for failure to plead a sufficiently domestic securities transaction to which the federal securities laws could apply — *Cavello Bay Reinsurance Ltd.* v. *Shubin Stein*, 986 F.3d 161 (2d Cir. 2021) ("*Cavello Bay*") and *Banco Safra S.A.-Cayman Islands Branch* v. *Samarco Mineracao S.A.*, No. 19-3976-CV, 2021 WL 825743 (2d Cir. Mar. 4, 2021) (summary order) ("*Banco Safra*"). In the two rulings, the Second Circuit clarified the scope of *Morrison* v. *National Australia Bank Ltd.,* 561 U.S. 247 (2010) ("*Morrison*"), in which the Supreme Court held that Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") applies only to (i) "transactions in securities listed on domestic exchanges" and (ii) "domestic transactions in other securities."

In *Cavello Bay*, the Second Circuit held that Section 10(b) could not reach a private securities transaction between the seller, a Bermuda corporation with its principal place of business in New York, and the Bermuda-based buyer because, even assuming the transaction was domestic under *Morrison*, it was "predominantly foreign." In so holding, the Second Circuit rejected the petitioner's argument that, because the alleged misrepresentations were made from New York, petitioner's federal securities claim was sufficiently domestic.

In *Banco Safra*, the Second Circuit held that Section 10(b) could not reach a private securities transaction between the seller, a Brazilian mining company, and the buyer, a Cayman Islands branch of a Brazilian bank, because the transaction's links to the United States offered by plaintiff failed to sufficiently allege a domestic transaction under *Morrison*.

Cavello Bay and *Banco Safra* both rely on and expand the guidance from the Second Circuit's first two significant decisions applying *Morrison*. In the first such case, *Absolute Activist Value Master Fund Ltd.* v. *Ficeto*, 677 F.3d 60 (2d Cir. 2012) ("*Absolute Activist*"), the Second Circuit held that "to sufficiently allege a domestic securities transaction in securities not listed on a domestic exchange" in satisfaction of *Morrison*'s second prong, "a plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States." 677 F.3d at 68. In the second, *Parkcentral Global Hub Ltd.* v. *Porsche Auto. Holdings SE*, 763 F.3d 198 (2d Cir. 2014) ("*Parkcentral*"), the Second Circuit Court held that pleading a domestic transaction under *Morrison* was a threshold requirement to the application of Section 10(b), as

even a domestic transaction may be so "predominantly foreign" as to render a Section 10(b) claim impermissibly extraterritorial. 763 F.3d at 216.

In *Cavello Bay*, the Second Circuit reaffirmed its interpretation of the rule set forth in *Parkcentral* that the contacts relevant to an extraterritoriality analysis are those that relate to the purchase and sale of securities. And in *Banco Safra*, the Second Circuit reaffirmed its "irrevocable liability" test for domestic transactions set forth in *Absolute Activist*.

I. *Cavello Bay*: Inapplicability of Section 10(b) to "Predominantly Foreign" Transactions Reaffirmed

A. Facts and Procedural History

Defendant Kenneth Shubin Stein was CEO of defendant Spencer Capital ("Spencer"), a Bermuda holding company with its principal place of business in New York that maintained an "investment portfolio consisting of U.S. insurance-related assets."[1] Delaware-based Spencer Management, also controlled by Shubin Stein, managed the investment portfolio held by Spencer. In 2015, Spencer pitched a private offering to a prospective investor firm, plaintiff Cavello Bay, which was a subsidiary of a Bermuda insurance group with its principal place of business in Bermuda. On behalf of Spencer, Shubin Stein made the investment pitch by telephone from New York to Cavello Bay in Bermuda and sent along a PowerPoint presentation about Spencer (the "PowerPoint") from New York to Cavello Bay in Bermuda.

Shubin Stein convinced Cavello Bay to invest in Spencer and sent a draft subscription agreement (the "Agreement") from New York to Bermuda. Cavello Bay signed the Agreement in Bermuda, and Spencer signed it in New York. The executed Agreement was then physically mailed to Cavello Bay in Bermuda, and title to the shares was formally transferred to Cavello Bay at closing in Bermuda.

Cavello Bay asserted claims against defendants Shubin Stein and Spencer under Section 10(b) and Rule 10b-5 under the Exchange Act, alleging that the PowerPoint it received during the offering pitch misrepresented Spencer's fee arrangement with Shubin Stein-controlled Spencer Management.

The District Court dismissed Cavello Bay's Section 10(b) and Rule 10b-5 claims as "impermissibly extraterritorial" on two grounds. First, because neither Shubin Stein's countersigning of the Agreement in New York nor any other transactional events resulted in irrevocable liability under *Absolute Activist*, the District Court held that Cavello Bay failed to adequately plead a domestic transaction as required under *Morrison*. *Cavello Bay Reinsurance Ltd*. v. *Stein*, No. 18-CV-11362, 2020 WL 1445713, at *7 (S.D.N.Y. Mar. 25, 2020). Second, even had Cavello Bay adequately pleaded a domestic transaction, its claims were still "so predominantly foreign" that they were impermissibly extraterritorial under *Parkcentral*. Id. at *8-*9."

B. The Second Circuit's Affirmance

On appeal, the Second Circuit affirmed the judgment of the District Court, but solely on its second ground. Without reaching the issue, the court assumed that Cavello Bay had adequately pleaded a domestic transaction

[1] Unless otherwise specified, quotes in Section I of this memorandum are taken from the Second Circuit's *Cavello Bay* decision.

under *Absolute Activist*, but nonetheless agreed with the District Court's analysis under *Parkcentral* that the private offering was so predominantly foreign that it was outside the reach of Section 10(b).

The Second Circuit summarized the interplay between *Morrison* and *Parkcentral* as follows: "*Morrison's* 'domestic transaction' rule operates as a threshold requirement, and as such may be underinclusive." As a result, an analysis under *Parkcentral*—which embraces *Morrison*'s focus on the "security and the transaction as structured" rather than the transaction's "surrounding circumstances"—should be undertaken to determine whether such a claim "is still predominantly foreign."

Under this framework, the Circuit Court rejected the argument that the parties' handful of contacts with the United States could give the transaction a sufficient nexus to the United States. First, the court held that the provision in the Agreement requiring Cavello Bay to register the shares with the Securities and Exchange Commission (the "SEC") before any resale did not trigger any United States interest and emphasized that Spencer and Cavello Bay were "sophisticated institutional investors" capable of bargaining for a domestic transaction had they so desired. Further, the court found that Cavello Bay's allegation that Spencer solicited investors in the United States was also insufficient to avoid dismissal and rejected Cavello Bay's arguments concerning Spencer and Shubin Stein's various New York contacts—including Spencer's principal place of business in New York, its management by a U.S. company, and that the Agreement was governed by New York law—as not relevant to the location of the purchase or sale of securities. Finally, the court held that, while the fact that the parties negotiated and executed the Agreement between New York and Bermuda was relevant to the threshold question of whether the transaction could be considered a domestic transaction, "acts evincing contract formation do not resolve the question whether the claims are nevertheless so predominantly foreign."

The Second Circuit concluded that, because "[t]he transaction implicates only the interests of two foreign companies and Bermuda," Cavello Bay's Section 10(b) claims were predominantly foreign and thus impermissibly extraterritorial under *Morrison*.

II. *Banco Safra*: "Irrevocable Liability" Test for Determining Whether Plaintiffs Allege a Domestic Transaction Under *Morrison* Reaffirmed

A. Facts and Procedural History

Between 2013 and 2015, plaintiff Banco Safra ("Safra")—a Cayman Islands branch of a Brazil-based bank—purchased debt securities (the "Samarco Bonds" or the "Bonds") issued by a Brazilian mining company, defendant Samarco Mineração S.A. ("Samarco").[2] The Samarco Bonds purchased by Safra in the secondary market were initially offered only outside the United States, though Safra alleged that it purchased some of the Bonds from counterparties or broker dealers in the United States. The value of the Bonds plummeted after one of Samarco's dams in Brazil collapsed, causing deaths, injuries, and significant property and environmental damage. Safra filed suit in the Southern District of New York, alleging that, in marketing these debt securities, defendant made material misstatements and omissions regarding the safety of its Brazilian mining operations.

Finding that Safra's allegations, even after multiple amendments, were "insufficient to show that irrevocable liability was incurred within the United States or that title transferred to the Bonds in the United States," the District

[2] Unless otherwise specified, quotes in Section II of this memorandum are taken from the Second Circuit's *Banco Safro* decision.

Court dismissed the action, but without prejudice to refile in state court. *Banco Safra S.A. - Cayman Islands Branch* v. *Samarco Mineracao S.A.*, No. 16 Civ. 8800, 2019 WL 2514056, at *5-*6 (S.D.N.Y. June 18, 2019).

B. The Second Circuit's Affirmance

The Second Circuit affirmed dismissal after analyzing the allegations relied on by plaintiff in support of its argument that it had adequately pleaded a domestic transaction under *Morrison*.

Citing *Absolute Activist*, the Second Circuit identified the following examples of allegations that could support a finding of a domestic transaction: "[d]etailed factual allegations describing contract formation in the United States," including where, for example, "two sides of [a] transaction are 'matched' —thus forming a binding contract — on an electronic exchange system within the United States"; and "facts concerning . . . the placement of purchase orders, the passing of title or the exchange of money." Conversely, the court observed, mere allegations that a United States entity was involved in the transaction will not satisfy the *Absolute Activist* test. The Second Circuit applied these considerations to plaintiff's supporting allegations.

First, the court "easily dispense[d]" with plaintiff's argument that using U.S. dollars and New York-based bank accounts in connection with its purchase of the Bonds could establish a domestic transaction under *Morrison*, as neither fact was sufficient to show that either plaintiff/buyer or defendant/seller incurred liability in the United States in connection with the purchase of those securities.

Second, the court rejected the argument that the allegations that plaintiff "purchased Samarco Bonds from counterparties and/or broker dealers located in the United States" sufficed to establish a domestic transaction. The court explained that Safra failed to allege that those United States-based counterparties and/or broker-dealers acted as principals "who purchased the Samarco Bonds for their own accounts and then sold them to Safra" (and not as agents merely facilitating a transaction between the parties). Moreover, even if those United States-based entities acted as principals, Safra still failed to allege that the employees of those entities negotiated the transaction while in the United States.

Third, the Second Circuit rejected Safra's argument that, because it alleged "most of its after-market transactions in the Samarco Bonds were reported to FINRA's TRACE system," which requires reporting of only U.S. transactions,[3] it had plausibly alleged domestic transactions. The court observed that FINRA's reporting standard may differ from the *Absolute Activist* standard for identifying a domestic transaction and concluded that, "[o]n this record, that a transaction is reported to TRACE does not mean that either party to the transaction acted within the United States to incur irrevocable liability." The court qualified this holding, however, stating that the existence of TRACE reports "*could* be relevant to the domestic transaction inquiry" where the operative complaint alleges that TRACE reporting occurs "only, or even mostly, when a party incurs irrevocable liability or title passes within the United States."

Finally, and significantly, the Second Circuit expressly limited its holding to the particular facts alleged in *Banco Safra*'s complaint, leaving open the possibility that stronger allegations regarding a similar securities transaction could, in theory, satisfy *Absolute Activist* and thus *Morrison*.

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[3] According to the opinion, FINRA rules require members that are parties to a transaction in a "TRACE-Eligible Security," defined as "as debt securities denominated in U.S. dollars and issued by certain specified issuers," to report that transaction on TRACE. A FINRA notice explains that "'if a debt security originally sold in a Regulation S [offshore] transaction is subsequently purchased or sold as part of a U.S. transaction, the [subsequent transactions] must be reported to TRACE.'"

III. Implications

Cavello Bay and *Banco Safra* are significant for several reasons, both independently and when considered together.

First, following *Parkcentral*, questions remained as to whether alleging the existence of a domestic transaction sufficiently stated, without more, the domestic application of Section 10(b) under *Morrison*. For example, the Court of Appeals for the Ninth Circuit criticized *Parkcentral*'s "predominantly foreign" test as "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." *Stoyas* v. *Toshiba Corp*., 896 F.3d 933, 950 (9th Cir. 2018) (citations omitted). Indeed, both the First and Ninth Circuits have stated their unwillingness to follow *Parkcentral* and criticized it as "contrary to Section 10(b) and *Morrison* itself." Id.; *SEC* v. *Morrone*, No. 19-2006, 2021 WL 1850551, at *6 (1st Cir. May 10, 2021). Accordingly, the Second Circuit's continued reliance on *Parkcentral* in *Cavello Bay* adds to this developing circuit split about whether the *Morrison* test comprises all, or just part, of any extraterritoriality analysis.

Cavello Bay is instructive as to the nature of alleged contacts and considerations that Second Circuit courts may find persuasive in implementing the "predominantly foreign" test. Similarly, *Banco Safra* is instructive as to the particular facts that Second Circuit courts may find persuasive in implementing the "irrevocable liability" test from *Absolute Activist*, and the court's discussion of the operative complaint's shortcomings may provide guidance to future Exchange Act plaintiffs in their efforts to survive a motion to dismiss.

Finally, the differing posture of the two opinions is also notable. The *Banco Safra* decision was based on a holding that there had not been a "domestic transaction," while in *Cavello Bay*, the Second Circuit assumed for purposes of rendering its decision that plaintiff had adequately alleged a domestic transaction and therefore focused on whether the transaction was nonetheless "predominantly foreign." This dichotomy may provide some insight as to where the Second Circuit will draw the line on what constitutes a "domestic transaction" within the meaning of *Morrison* and suggests that the factual allegations in *Cavello Bay* are closer to that line than those in *Banco Safra*.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Joel Kurtzberg (Partner) 212.701.3120 or jkurtzberg@cahill.com; Lauren Perlgut (Counsel) at 212.701.3558 or lperlgut@cahill.com; or Harry Grabow (Associate) at 212.701.3275 or hgrabow@cahill.com; or email publications@cahill.com.