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ALERT MEMORANDUM

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Second Circuit Holds That Kazakh Sovereign Wealth Fund Is Not Immune From Securities Fraud Suit

Addressing an issue of first impression, on February 3, 2016, the United States Court of Appeals for the Second Circuit held that the Foreign Sovereign Immunities Act of 1976 ("FSIA") did not immunize an instrumentality of a foreign sovereign against claims that it had violated federal securities laws by making representations outside the United States concerning the value of securities purchased by investors within the United States. In *Atlantica Holdings, Inc. v. Sovereign Wealth Fund Samruk-Kazyna JSC*,[1] the Second Circuit found that the defendant's issuance of debt securities outside of the United States had a "direct effect" in the United States, for purposes of the exception to sovereign immunity under section 1605(a)(2) of the FSIA, where the defendant's alleged misrepresentations in connection with the debt offerings caused losses to secondary market purchasers in the United States. The decision follows other recent precedents interpreting the commercial activity exception, most notably the December 1, 2015 decision by the Supreme Court in *OBB Personenverkehr AG v. Sachs*,[2] and presents important questions concerning the types of commercial activities that may strip foreign states and state-owned entities of sovereign immunity and subject them to the jurisdiction of U.S. courts.

Background

Investors sued Sovereign Wealth Fund Samruk–Kazyna JSC ("SK Fund"), a sovereign wealth fund of the Republic of Kazakhstan, in the Southern District of New York, over alleged misrepresentations made by BTA Bank JSC ("BTA Bank"), in which SK Fund has a controlling stake, in connection with a 2010 restructuring of BTA Bank's debt. In April 2009, BTA Bank announced that it had ceased principal payments on all of its outstanding financial obligations. In 2010, BTA Bank undertook a restructuring of its capital structure, through which SK Fund would receive additional equity in BTA Bank and preexisting holders of BTA Bank's debt would receive, in exchange for their old securities, newly issued securities, including certain subordinated notes. Two of the investor plaintiffs, Panamanian investment funds Atlantica Holdings Inc. ("Atlantica") and Baltica Investment Holding Inc. ("Baltica"), were holders of BTA Bank debt securities and agreed to exchange their debt for the new subordinated notes. Other plaintiffs, some of whom were United States residents, purchased subordinated notes on the secondary market.

The plaintiffs all claimed that they purchased the subordinated notes in reliance on statements by SK Fund and BTA Bank that BTA Bank would not pay SK Fund any dividends on its equity holdings until the bank's newly issued securities, including the subordinated notes, were paid in full. Plaintiffs alleged that this statement in addition to other financial disclosures

[1] No. 14-917-CV, 2016 WL 403445 (2d Cir. Feb. 3, 2016).

[2] 136 S. Ct. 18 (2015).

about the restructuring were false in light of a complex and undisclosed series of transactions between BTA Bank and SK Fund, pursuant to which BTA Bank paid interest on SK Fund deposits at a much higher rate than BTA Bank was earning on bonds it had purchased from SK Fund. BTA Bank eventually defaulted on its debt in January 2012 and the value of these subordinated notes plummeted.

The original note holders and the secondary market purchasers all acquired their interests through the Miami office of UBS Financial Services ("UBS"). UBS's Miami office then sent the plaintiffs' orders to its broker-dealer in New York. The orders were filled and the transactions were completed in New York. The plaintiffs alleged that BTA Bank and SK Fund marketed the subordinated notes "extensively in the United States, and directed that marketing to U.S. investors." Plaintiffs alleged further that these efforts were successful because United States investors held 17% of the subordinated notes.

On March 10, 2014, the district court issued an opinion denying SK Fund's motion to dismiss the lawsuit,[3] holding most pertinently that it had subject-matter jurisdiction over the case under the third prong of the FSIA's commercial activity exception, which provides that a foreign state is not immune from suit in actions "based upon" the state's commercial activity outside the United States that has a "direct effect" in the United States. 28 U.S.C. § 1605(a)(2).[4]

Second Circuit's Opinion

Atlantica Holdings Inc. presented a question of first impression in the Second Circuit: "whether the [FSIA] immunizes an instrumentality of a foreign sovereign against claims that it violated federal securities laws by making misrepresentations outside the United States concerning the value of securities purchased by investors within the United States."[5] In holding that SK Fund was not immune from suit, the Second Circuit applied the Supreme Court's reasoning in *Sachs*, that "an action is 'based upon' the 'particular conduct' that constitutes the 'gravamen of the suit,"[6] to the context of securities fraud cases.

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3 SK Fund moved to dismiss the suit for lack of subject-matter jurisdiction, lack of personal jurisdiction, failure to state a claim, and failure to plead fraud with particularity.

4 The district court also held that it had subject-matter jurisdiction under the first prong of the commercial activity exception, which strips a foreign state's immunity in actions "based upon" its commercial activity in the United States; however, the Second Circuit affirmed on the basis of the third prong, and therefore did not address the lower court's holding as to the first prong of section 1605(a)(2).

5 *Atlantica Holdings, Inc.*, 2016 WL 403445, at *1.

6 *Sachs*,136 S. Ct. at 396 (quoting *Saudi Arabia v. Nelson*, 507 U.S. 349, 357 (1993)). *Sachs* involved a personal injury suit brought by a California resident against OBB Personenverkehr AG, the Austrian state-owned railway, after she suffered an accident while trying to board a train in Austria. The plaintiff had purchased a Eurail pass over the Internet from a Massachusetts-based travel agent. Despite this U.S.-based transaction, the Supreme Court held that her action was not "based upon" the railway's conduct, for purposes of section 1605(a)(2), because "the conduct constituting the gravamen of Sachs's suit plainly occurred abroad." *Id.*

The Second Circuit found that in the securities fraud context, the gravamen of the plaintiffs' complaint was "that they were misled as to the value of the Subordinated Notes by certain misrepresentations made by SK Fund and BTA Bank."[7] All the parties agreed that the alleged misrepresentations occurred outside the United States; therefore, the only question remaining was whether "that act cause[d] a direct effect in the United States." 28 U.S.C. § 1605(a)(2). Relying on prior precedents, the Second Circuit reasoned that the question turned on the locus of the tort—the alleged misrepresentations actionable under Section 10(b) of the Securities Exchange Act—which it held "is the forum where loss is sustained, not where fraudulent misrepresentations are made."[8]

The plaintiffs had argued and the district court held that losses suffered by United States investors as a result of SK Fund's alleged misrepresentations about the subordinated notes' value satisfied the "direct effect" test under 1605(a)(2) of the FSIA, and that SK Fund was therefore not immune from suit. The Second Circuit agreed. In so holding, the court rejected SK Fund's argument that the relationship between its alleged misrepresentations and the plaintiffs' financial loss was too attenuated for that loss to qualify as a "direct effect." Specifically, SK Fund argued that the U.S. investors could only have obtained the financial disclosures from third-party intermediaries such as UBS, whose conduct was an intervening act between the commercial activity and any resulting effect in the United States. The court noted that "intervening actions of a third party may sometimes break the causal chain" between the defendant's actions and an effect felt in the United States where that third party "takes some independent action that causes a further effect in the United States." The court found, however, that in this case, UBS's distribution of the financial disclosures containing the purported misrepresentations was not undertaken as a result of the misrepresentations, and thus "SK Fund's misrepresentations acted directly on those whom they allegedly affected," namely the U.S. investors induced to purchase the subordinated notes that were worth less than advertised. In doing so, it analogized the situation to products-liability cases where a defective product may reach the plaintiff only through a multi-step distribution chain that does not attenuate the causal chain between the manufacturing defect and the plaintiff's injury.

The court arguably cabined its holding by acknowledging that "locating an economic injury within the United States, without more, will not suffice" for purposes of triggering the commercial activity exception; however, it found plaintiffs' additional allegations that BTA Bank and SK Fund had extensively marketed the subordinated notes in the United States and directed that marketing to U.S. investors adequate to satisfy the direct effect clause of section 1605(a)(2).

Take Away

Atlantica Holdings Inc. may make it easier for plaintiffs to sue foreign states and state-owned entities for alleged violations of federal securities laws in connection with debt offerings that are otherwise exempt from U.S. registration requirements. Critically, the case

[7] *Atlantica Holdings, Inc.*, 2016 WL 403445, at *6.

[8] *Id.*, at *8 (internal quotation marks and citation omitted).

demonstrates how secondary market trading of foreign sovereign debt in the United States may under certain circumstances trigger the commercial activity exception to sovereign immunity—even where all other relevant conduct, including the initial sale of the debt, occurs abroad. In particular, sovereign wealth funds should carefully consider the implications under U.S. federal securities laws of marketing efforts designed to encourage secondary market trading of sovereign debt in the United States.

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If you have any questions, please feel free to contact Christopher Moore (cmoore@cgsh.com) in London, Jonathan Blackman (jblackman@cgsh.com) in New York, or any of your regular contacts at the firm. You may also contact our partners and counsel listed under "Sovereign Governments and International Institutions" located in the "Practices" section of our website at http://www.cgsh.com.

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