Client Update
U.S. Federal Court Denies Immunity to Sovereign Wealth Funds

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The U.S. Court of Appeals for the Second Circuit has held that sovereign wealth funds are not automatically immune from securities fraud claims, even if the underlying alleged misstatements were made outside the United States to non-U.S. investors.

In a decision announced earlier this month,[1] the federal appeals court ruled that non-U.S. investors, in this case Panamanian investment funds, could pursue claims against a Kazakhstani sovereign wealth fund in the United States because the alleged fraud had a "direct effect" in the United States.

The decision affirms that:

- The U.S. Foreign Sovereign Immunities Act (the "FSIA") applies to securities fraud claims brought against sovereign wealth funds in the United States.
- Although sovereign wealth funds are generally immune from suit, this immunity is lost when misrepresentations made in connection with commercial activity outside the United States cause economic harm to U.S. investors.

We outline below the salient points of the decision and its potential implications for investors and sovereign wealth funds.

BACKGROUND

The plaintiffs, which included Panama-based investment funds and individuals residing in Florida and Illinois, alleged that Sovereign Wealth Fund Samruk-Kazyna JSC ("SK Fund"), a sovereign wealth fund of the Republic of Kazakhstan,

1 *Atlantica Holdings Inc. v. Sovereign Wealth Fund Samruk-Kazyna JSC*, No. 14–917–cv, --- F.3d ---, 2016 WL 403445 (2d Cir. Feb. 3, 2016).

misrepresented the value of subordinated notes issued by BTA Bank JSC ("BTA Bank"), a Kazakhstani corporation majority owned by SK Fund, in connection with a 2010 restructuring of BTA Bank's debt.

According to the plaintiffs, SK Fund siphoned millions of dollars from BTA Bank at the expense of its creditors, despite having promised in an offering memorandum for the subordinated notes that such payments would not be made until the notes were fully paid. When the payments were disclosed, the value of the notes allegedly decreased to less than 10% of their face value and BTA Bank subsequently became bankrupt.

The plaintiffs brought suit against SK Fund in the Southern District of New York under U.S. securities laws, alleging, among other things, misrepresentations in the offering memorandum. SK Fund moved to dismiss the complaint on the basis of its immunity under the FSIA. The District Court found that SK Fund was not entitled to immunity and SK Fund appealed the District Court's decision.

SECOND CIRCUIT'S ANALYSIS

The main issue before the Second Circuit Court was whether SK Fund, an instrumentality of a foreign state, is immune from suit (that is, immune from participation in court proceedings) under the FSIA.

The Court observed that the FSIA provides the sole basis for asserting jurisdiction over a foreign state in the United States. U.S. courts have subject matter jurisdiction over an action against a foreign state only if one of the exceptions set forth in the FSIA applies. For purposes of immunity from suit, an instrumentality of a foreign state, such as SK Fund, is treated as the state itself.

These exceptions include explicit or implicit waivers by the foreign state. The only relevant exception to immunity in the *Atlantica* case, however, was the "commercial activity exception," which provides, in relevant part, that a foreign state is not immune from suit "based upon" its commercial activity outside the United States that has a "direct effect" in the United States. In the Court's view, the plaintiffs' claims against SK Fund were based upon the alleged misrepresentations, which were made in connection with SK Fund's commercial activity outside the United States.

Accordingly, the central question was whether the alleged misrepresentations caused a "direct effect" in the United States. The Court concluded that the plaintiffs had adequately shown that SK Fund contemplated investment by U.S. persons and that at least some investors in the subordinated notes had suffered

economic loss in the United States as a result of SK Fund's alleged misrepresentations.

Interestingly, the Court rejected SK Fund's argument that some investors could not have been injured in the United States because they were not U.S. persons and were based in Panama. The Court noted that an FSIA plaintiff need only show a direct effect on someone, plaintiff or not, in the United States. Thus, although, in this case, certain U.S. individual investors participated as plaintiffs along with the Panamanian investment funds, under this decision the Panamanian funds alone apparently could have successfully invoked the commercial activity exception even if there had been no U.S. plaintiffs.

Finally, the Court rejected SK Fund's contention that the distribution of offering documents through a third-party intermediary broke the causal chain between SK Fund's actions and the plaintiffs' loss, thereby rendering the effect in the United States not "direct." In the Court's view, such interpretation "could effectively result in near-blanket immunity for foreign states against securities fraud claims." This result would "be inconsistent with, much less required by," FSIA precedents.

PRACTICAL CONSIDERATIONS

The Second Circuit's decision provides additional U.S. protection for investors—whether U.S. or not—of securities issued by sovereign wealth funds or their subsidiaries. As the Court made clear, it does not matter if the investors commencing suit against a sovereign wealth fund have not themselves suffered a loss in the United States, provided that they can establish the existence of U.S. investors so affected.

Since most international debt offerings involve sales to at least a handful of U.S. investors, it should be easier following this decision for investors from any jurisdiction to invoke the broad antifraud protections of U.S. law against sovereign entities who have issued or guaranteed public debt.

Sovereign wealth funds, for their part, should be aware that they may not be immune from suit in the United States. Even in situations where a sovereign entity has neither waived its immunity explicitly (for example, in a side letter) nor implicitly (for example, by filing a responsive pleading in an action without raising sovereign immunity as a defense), it may find itself subject to suit in U.S. courts under the commercial activity exception, on the basis of activities it may have thought were primarily non-U.S.

In such circumstances, however, a sovereign entity may still be effectively shielded by immunity from enforcement of judgment. This second type of immunity arises when a creditor seeks to enforce a judgment against the U.S.-based assets owned by a sovereign entity. The FSIA requirements for overcoming immunity from enforcement continue, even after the *Atlantica* decision (which did not address this issue), to be stricter than those necessary to overcome immunity from suit. In other words, even if a sovereign entity loses its immunity from suit in the United States, its U.S. or other assets may still be protected from enforcement.

The U.S. requirements for overcoming immunity from enforcement vary depending on whether the sovereign entity whose assets are subject to enforcement is the foreign state itself or an instrumentality (such as SK Fund). Whether a creditor will be able to enforce a judgment against U.S.-based assets owned by a sovereign wealth fund will depend on whether such requirements are met. In general, suits for enforcement against an instrumentality are more likely to succeed in the United States than those against a foreign state.

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We would be happy to answer any questions you may have regarding the above.