

# RICO'S ROLE IN SECURITIES FRAUD LITIGATION: SHOULD IT BE FACILITATED OR RESTRICTED?

## I. INTRODUCTION

Congress enacted the Racketeer Influenced and Corrupt Organizations Act (RICO) as Title IX of the Organized Crime Control Act of 1970.<sup>1</sup> RICO constituted part of a comprehensive endeavor to eradicate organized crime in the United States.<sup>2</sup> This legislative innovation targeted a wide range of racketeering activities, including murder, kidnapping, gambling, extortion, telephone and wire fraud, and the subject of this article, fraud in the sale of securities.

A circuit split exists on the requirements a plaintiff must meet to have standing to sue for securities fraud under RICO. Specifically, the courts are split on whether a RICO plaintiff must have been a purchaser or seller of the securities to have standing. A primary reason for this pending controversy is that section 1961(1)(D) of RICO does not specify what "fraud in the sale of securities" exactly means for potential RICO plaintiffs. Must plaintiffs themselves be the purchasers or sellers of the securities at issue? Or, must plaintiffs merely be injured by a fraudulent sale of securities?

This circuit split has been long standing.<sup>3</sup> The Fourth and Eighth Circuits hold that plaintiffs must be purchasers or sellers of securities to have standing. The Second, Ninth, and Eleventh Circuits maintain that the purchaser/seller requirement should not apply in RICO securities fraud cases. In 1992, in *Holmes v. Securities Investor Protection Corp.*,<sup>4</sup> the Supreme Court granted certiorari to resolve this circuit split. However, the majority opinion only focused on issues of causation and refused to rule on the buyer/seller requirement as applied to RICO securities cases. Therefore, the circuit split still remains well entrenched.

The difficulty in interpreting RICO's provision for "fraud in the sale of securities" has serious ramifications. One of the most troubling consequences is that with the indecision on how to interpret this section of the statute, the eligible class of RICO plaintiffs and potentially liable defendants is unclear. The courts need to come to a uniform manner of interpreting this provision, especially considering the importance of RICO claims, which can reward plaintiffs enormously and stigmatize or financially ruin defendants.

This article will discuss the conflict among the courts and propose a legislative solution to this circuit split: the courts should not impose a purchaser/seller limitation on standing to bring RICO cases based on securities fraud. The statute itself does not

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1. Pub. L. No. 91-452, 84 Stat. 922 (1970) (codified at 18 U.S.C. §§ 1961-68 (1988 & Supp. V 1993)).

2. Congressional Statement of Findings and Purpose, Pub. L. No. 91-452, 84 Stat. 922 (1970). RICO sought to achieve its goals "by strengthening the legal tools in the evidence-gathering process, by establishing new penal prohibitions, and by providing enhanced sanctions and new remedies."

3. While the reader should be aware of the recent development in the House, unless the bill becomes a law, the circuit split discussed in this article remains relevant.

4. *Holmes v. Securities Investor Protection Corp.*, 112 S. Ct. 1311 (1992).

include such a limitation, and the legislative history does not show such an intent. Therefore, assuming that Congress did not originally intend for such a restriction to be read into the statute, Congress should amend section 1961(1)(D) to specifically state that a plaintiff need not be a purchaser or seller of the securities to have standing to sue under RICO.

## II. DISCUSSION OF THE CIRCUIT SPLIT

### A. How the RICO Purchaser/Seller Debate Arose

The purchaser/seller standing requirement actually arose from a different context in securities law, independent from RICO. In *Blue Chip Stamps v. Manor Drug Stores*,<sup>5</sup> the Supreme Court limited the class of private plaintiffs that could bring securities fraud suits under Rule 10b-5 of the 1934 Securities Exchange Act.<sup>6</sup> It is settled that for standing in 10b-5 cases, the plaintiffs must be purchasers or sellers of the securities at issue. However, whether that same purchaser/seller limitation must be applied to RICO claims based on predicate acts of securities fraud was unclear after *Blue Chip Stamps*.

The policies behind restricting 10b-5 causes of action with the purchaser/seller limitation arguably could be applicable to securities claims under RICO as well.<sup>7</sup> First, since the mere pendency of a securities fraud suit can seriously damage the defendant's business, plaintiffs who can avoid early dismissal on grounds of standing may force settlements even when they would unlikely succeed at trial. Both Rule 10b-5 and RICO have strong "settlement value" which can be abused in this manner by plaintiffs. Second, if standing is not restricted in some way, defendants and courts may suffer from floods of frivolous claims. Third, without a limit, non-buyers or non-sellers may file strike suits, alleging that but for the alleged fraudulent conduct, they would not have entered into a certain transaction.

Thus, there may exist some sound policies to impose the *Blue Chips Stamps* standing requirement on RICO claims based on securities fraud. However, not all courts have chosen to do so, for good reason.

### B. The Fourth and Eighth Circuits Require RICO Plaintiffs to Be Purchasers or Sellers of Securities<sup>8</sup>

In *International Data Bank v. Zepkin*,<sup>9</sup> the Fourth Circuit Court of Appeals ruled that a plaintiff must be either a purchaser or seller of securities to have standing to bring a RICO claim for securities fraud. In this case, defendants Eugene Zepkin and

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5. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

6. 15 U.S.C. § 78(j) (1988 & Supp. V. 1993) (commonly known as Rule 10b-5). Rule 10b-5 the 1934 Act provides that "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . ."

7. Harvey L. Pitt, Dixie L. Johnson, and Jonathan Shub, *Court Leaves Unlimited Private RICO's Reach*, N.J.L.J., May 18, 1992, p.7.

8. This article focuses on Fourth Circuit's discussion of the purchaser/seller standing requirement. However, see *Brannan v. Eisenstein*, 804 F.2d 1041 (8th Cir. 1986), for a discussion of the Eighth Circuit's reasoning for adopting this requirement.

9. *International Data Bank v. Zepkin*, 812 F.2d 149 (4th Cir. 1986).

Harold Grossman issued stock for their new corporation, International Data Bank (IDB). Outside investors later took control of IDB, ousted Zepkin and Grossman, and sued them, alleging violations of Rule 10b-5 because of a fraudulent prospectus.

However, IDB's injury was not related to its purchase or sale of securities. Instead, IDB complained that it was induced to repay Zepkin and Grossman for start-up costs which the defendants exaggerated in the prospectus. Since the fraudulent injury took place after the stock offering had already taken place, IDB sued neither as a purchaser nor a seller of securities.

The Fourth Circuit denied IDB standing on several grounds. First, it referred to the statutory language of RICO. The court concluded that "fraud in the sale of securities" was a purposely narrow phrase, which suggested a "pivotal role of the actual sales transaction."<sup>10</sup> Therefore, the court found that this statutory construction highlighted the necessity for plaintiffs to have been involved in the sale.

Second, the Fourth Circuit looked to the history of federal securities law, predating RICO. Almost a quarter century before RICO, and before the Supreme Court ruled on *Blue Chip Stamps*, the purchaser/seller requirement had been imposed on plaintiffs seeking standing for 10b-5 claims; the Second Circuit created this limitation in *Birnbaum v. Newport Steel Corp.*,<sup>11</sup> and a great majority of lower federal courts followed *Birnbaum*.

The Fourth Circuit reasoned that, based on this pervasive practice in securities law, the limitation on 10b-5 claims should extend to RICO securities claims as well. As the court stated, "we think the better view is that Congress meant for RICO to simply expand the range of remedies by allowing for treble damage and attorneys' fees, rather than to summarily overturn the settled law."<sup>12</sup>

Third, the Fourth Circuit looked to practical policy considerations. It noted that securities litigation presents a "danger of vexatiousness different in degree and kind from that which accompanies litigation in general."<sup>13</sup> The court sought to avoid disrupting business activity with lawsuits "designed to poison the atmosphere with accusations of fraud."<sup>14</sup> Also, it wanted to preclude meritless claims pursued merely for their "settlement value."<sup>15</sup> Fourth, problems of proof addressed in *Blue Chip Stamps* would also apply to RICO cases, according to the Fourth Circuit. The difficulty boils down to non-sellers and non-buyers attempting to prove a non-event, essentially their failure to buy or sell stock. For example, bystander plaintiffs could wait in the wings and then sue, claiming they missed golden investment opportunities because of fraudulent disclosure or unnecessarily pessimistic projections.

Finally, the Fourth Circuit noted the possibility that another test, such as determining whether the injury was "direct" or "remote," could serve to limit standing in RICO cases. However, the court concluded that this standard was too vague and that the purchaser/seller requirement, by contrast, was more clear-cut.

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10. *Id.* at 152.

11. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952).

12. *International Data Bank, Ltd. v. Zepkin*, 812 F.2d 149, 152 (4th Cir. 1987).

13. *Id.*

14. *Id.*

15. *Id.*

### C. The Second, Ninth, and Eleventh Circuits Do Not Require that Plaintiffs Be Purchasers or Sellers of Securities<sup>16</sup>

In *Securities Investor Protection Corp. (SIPC) v. Vigman*,<sup>17</sup> the Ninth Circuit held that SIPC had standing to assert a securities fraud claim under RICO even though it was not a purchaser or seller of the securities. In *Vigman*, SIPC sued seventy-five officers and directors of six publicly traded corporations. The defendants were allegedly involved in a conspiracy to manipulate the stock prices of these corporations.

Through the vehicle of two brokerage firms, the defendants created an illusion of active markets by engaging in misleading transactions in their corporate and customer accounts. When investors discovered the scheme, the stock prices dropped dramatically. The brokerage firms became defunct, and in the liquidation proceedings SIPC had to disburse nearly \$13 million to satisfy customer claims not covered by the brokerages' assets.

The district court ruled that SIPC did not have standing to assert a RICO claim because SIPC was not a purchaser or seller of the securities. However, the circuit court reversed on two main grounds. First, looking to RICO's text, the court noted that RICO has no express purchaser/seller limitation. RICO's standing provision states that "[a]ny person injured in his business or property by reason of a violation of section 1962" may sue.<sup>18</sup>

Therefore, the Ninth Circuit followed the Eleventh Circuit's lead and said that anyone injured "by reason of" fraud in the sale of securities may sue under RICO, regardless of whether or not that person bought or sold the securities.<sup>19</sup> The court contrasted RICO's language to that of Rule 10b-5, which specifically requires that the unlawful conduct must be "in connection with the purchase or sale of any security."<sup>20</sup>

Second, in addition to the textual difference between RICO and Rule 10b-5, the remedies for these statutes are not alike. Congress created RICO's remedy of a private civil cause of action when it enacted the statute. Congress did not impose the purchaser/seller limitation on the standing requirements. The Ninth Circuit reasoned that it was therefore not appropriate for the courts to add in this additional standing prerequisite.

The 10b-5 remedy, on the other hand, is judicially created. Therefore, as the *Vigman* decision explained, it would be appropriate for the courts to alter its judicial remedy by circumscribing the class of plaintiffs that can bring 10b-5 claims. This is just what the Supreme Court did in *Blue Chip Stamps*.

### III. RESOLVING THE CIRCUIT SPLIT

It is axiomatic that statutory interpretation should begin with the language of the statute itself.<sup>21</sup> RICO purposely provides an express cause of action with a broad standing provision, available to any person injured "by reason of" a violation of a

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16. This article concentrates on the Ninth Circuit. See also, *In re Crazy Eddie Sec. Litig.*, 812 F. Supp. 338 (E.D.N.Y. 1993); *Warner v. Alexander Grant & Co.*, 828 F.2d 1528 (11th Cir. 1987), for additional support for the position that the purchaser/seller limitation should not be applied to standing in RICO cases.

17. *Securities Investor Protection Corp. (SIPC) v. Vigman*, 908 F.2d 1461 (9th Cir. 1990).

18. 18 U.S.C. § 1964(c) (1988).

19. 828 F.2d 1528, 1530 (11th Cir. 1987).

20. 17 C.F.R. § 240.10b-5 (1994).

21. See, e.g., *Blue Chip Stamps*, 95 S. Ct. at 756, (Powell, J., concurring).

RICO predicate offense.<sup>22</sup> Nowhere does RICO impose a further limitation on standing.

In Justice O'Connor's concurring opinion of *Holmes v. Securities Investor Protection Corp.*, she explained that *Blue Chip Stamps'* purchaser/seller standing limitation applied to 10b-5 claims, which have a judicially implied cause of action. The Justice noted that

if Congress had legislated the elements of a private cause of action for damages, the duty of the Judicial Branch would be to administer the law which Congress enacted; the Judiciary may not circumscribe a right which Congress has conferred because of any disagreement it might have with Congress about the wisdom of creating so expansive a liability.<sup>23</sup>

Justice O'Connor admitted that the problems of unrestricted standing for securities fraud plaintiffs are compounded in RICO cases. The threat of treble damages often leads plaintiffs to abuse RICO's "settlement value," and the stigma of labelling the defendant a "racketeer" increases the litigation's vexatiousness.

However, she concluded that since Congress specifically provided the elements of a private cause of action under RICO, then "despite the very real specter of vexatious litigation based on speculative damages, it is within Congress' power to create a private right of action for plaintiffs who have neither bought nor sold securities."<sup>24</sup>

A liberal reading of RICO is compatible with both its Congressional Statement of Findings and Purpose,<sup>25</sup> which describes RICO as an innovative crime-fighting weapon designed to provide additional remedies, and provisions of its Liberal Construction directive,<sup>26</sup> which mandates that RICO be liberally construed to effectuate its remedial goals. The 1952 *Birnbaum* decision created the purchaser/seller limitation for Rule 10b-5. This limitation was not designed for RICO securities fraud cases in the 1990's. When applied to RICO claims, this limitation fails to account for the novelty and uniqueness of RICO, as a stepped-up legislative measure against today's escalating crime.

#### IV. CONCLUSIONS AND STATUTORY REVISIONS

Unless the legislature decides otherwise, the RICO statute should be read and interpreted according to its language and its few interpretive guidelines, such as the Liberal Construction directive. Accordingly, the circuits should not enforce the purchaser/seller requirement on standing for RICO claims.

Section 1961(1)(D) could be amended to have the predicate act of racketeering read "fraud in the sale of securities, *whether or not the claimant is a purchaser or seller of the securities.*" (The emphasized portion represents the proposed amendment.) This amendment would thus solve the circuit split and allow RICO to be interpreted

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22. See *supra* note 18.

23. 112 S. Ct. at 1327 (1992), quoting *Blue Chip Stamps v. Manor Drug Stores*, 95 S. Ct. 1917, 1931 (1975).

24. 112 S. Ct. at 1327

25. According to the Statement of Findings and Purpose, the goal of RICO was "to seek the eradication of organized crime in the United States by strengthening the legal tools in the evidence-gathering process, by establishing new penal prohibitions, and by providing enhanced sanctions and new remedies to deal with the unlawful activities of those engaged in organized crime." 18 U.S.C. § 1961.

26. 84 STAT. 941 (1970) (codified at 18 U.S.C.A. § 1961) (West 1984).

most closely to the original intent of the drafters.

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