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# Who Should Pay When Federally Insured Pension Funds Go Broke: A Strategy for Recovering from the Wrongdoers

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# Who Should Pay When Federally Insured Pension Funds Go Broke?: A Strategy for Recovering from the Wrongdoers

*An unknown portion of the \$1.6 trillion in assets that are currently in private pension plans . . . may be at risk . . . . Unless steps are taken now, today's S&L bail-out may become tomorrow's ERISA nightmare.*<sup>1</sup>

For twenty-two years George Hohol worked as a welder for DuPage Boiler Works, located in the suburbs of Chicago.<sup>2</sup> When his wife became gravely ill, George considered quitting his job so he could withdraw the \$29,000 in his pension plan and use the money to pay his wife's medical bills.<sup>3</sup> However, after conferring with his wife, George kept working to maintain the family's health insurance. Shortly thereafter, DuPage Boiler stopped paying its health insurance premiums and the insurance company cancelled the policy covering George and his co-workers.<sup>4</sup> Next, DuPage Boiler's payroll checks to George began to bounce, and finally the company closed its operations.<sup>5</sup> A bad situation became worse when George tried to collect his pension money. Two years earlier, DuPage Boiler had been purchased by Morton Scherl, who turned out to be a white-collar criminal with a twenty-five year arrest record.<sup>6</sup> Scherl and his attorney misappropriated \$741,000 from DuPage Boiler's pension

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1 UNITED STATES DEPT. OF LAB., SEMIANNUAL REP., OFF. OF INSPECTOR GEN. 3 (1989) [hereinafter OIG REPORT].

The Seventh Circuit observed the same problem: "this case . . . traces a pattern which seems distressingly prevalent today: the savings of working men and women are pilfered, embezzled, parlayed, mismanaged and outright stolen by unscrupulous persons occupying positions of trust and confidence." *Thornton v. Evans*, 692 F.2d 1064, 1065 (7th Cir. 1982). In an analogous context, a Presidential Commission found that:

Fraud is especially vicious when it attacks, as it so often does, the poor or those who live on the margin of poverty. Expensive nostrums for incurable diseases, home-improvement frauds, frauds involving the sale or repair of cars and other criminal schemes create losses which are not only sizable in gross but are also significant and possibly devastating for individual victims.

PRESIDENT'S COMMISSION ON LAW ENFORCEMENT AND ADMINISTRATION OF JUSTICE, *THE CHALLENGE OF CRIME IN A FREE SOCIETY* 33-34 (1967). With respect to white collar crime in general, the same committee observed:

[T]he rather vague term 'white-collar crime' is now commonly used to designate those occupational crimes committed in the course of their work by persons of high status and social repute [that] . . . are only rarely dealt with through the full force of criminal sanctions.

. . . .

Serious erosion of morals accompanies [the white collar offender's] violations. [Those who so] flout the law set an example for other business and influence individuals, particularly young people, to commit other kinds of crime on the ground that everyone is taking what he can get.

*Id.* at 47-48.

2 Frantz & Jackson, *Pension Plans Looted as Safeguards Weaken*, L.A. Times, Oct. 29, 1989, at A1, col. 3 [hereinafter *Plans Looted*]. Mr. Hohol is a Polish immigrant who spent most of World War Two in German labor camps. *Id.*

3 *Id.*

4 *Id.*

5 *Id.*

6 *Id.*

fund.<sup>7</sup> Although George's testimony helped put the wrongdoers in jail, George never collected any of his \$29,000.<sup>8</sup>

Scherl's corrupt activities are but one example of how white collar criminals are stealing the retirement benefits of thousands of workers. The existence of such corruption illustrates the need to guarantee the pension benefits of American workers.<sup>9</sup> Although the Pension Benefit Guarantee Corporation (PBGC), the government agency that insures

7 *Id.* According to court records, within two weeks of taking control of DuPage Boiler, Scherl began raiding the firm's profit-sharing account. Scherl transferred \$350,000 to another account and used some of the money to pay the debts of another company that he owned. Scherl also used some of the money to purchase a fur coat for himself and \$45,000 worth of clothes for his wife. Of the \$741,000 in the fund when Scherl took over, only \$35,000 went to pay retirees to silence their complaints about not getting their pensions. *Id.*

8 Scherl pleaded guilty to misusing DuPage Boiler's pension funds and other charges and is awaiting sentencing. *Id.* As a result of his involvement with DuPage Boiler and other companies, William B. Goodstein, the lawyer, was charged with bankruptcy fraud, conversion of profit sharing funds, mail and wire fraud, and interstate transportation of fraudulently obtained securities. A jury found him guilty on all counts and he was sentenced to three years in prison and five years probation. *United States v. Goodstein*, 883 F.2d 1362, 1365 (7th Cir. 1989). Hohol testified at Goodstein's trial. *Plans Looted*, *supra* note 2. For further details on the illegal activities of Goodstein, see *Goodstein*, 883 F.2d at 1363-65.

9 In addition to the white collar crime that causes pension plans to fail, organized crime may be involved in the wrongdoing. Also consider that pension plans can fail for financial or economic reasons.

As an illustration of the influence of organized crime, consider the career of Joseph Hauser. In 1979, the Senate Permanent Subcommittee on Investigations scrutinized Hauser's activities. See LABOR UNION INSURANCE ACTIVITIES OF JOSEPH HAUSER AND HIS ASSOCIATES, S. REP. NO. 426, 96th Cong., 1st Sess. (1979) [hereinafter HAUSER REPORT]. Through his companies, Hauser provided insurance to union pension funds. Of some \$39 million in union insurance premiums collected by Hauser's companies, \$11 million was illegally diverted. *Id.* at 2. The \$11 million diversion had a significant effect on certain unions. For example, the Teamsters Central States Southeast and Southwest Areas Health and Welfare Fund lost \$7 million. Also, the Laborers' Union in Florida lost \$1 million. The Committee found that "individual policy holders suffered significant financial losses and great personal hardship when their insurance companies failed in the wake of Hauser's scheme." *Id.* Ultimately, Hauser was convicted of bribery in connection with illegal payoffs made to trustees of union benefit plans in California.

Despite the investigation that led to his conviction, Hauser gained control of two insurance companies—one in Florida and one in Arizona. Hauser's acquisition of the Florida firm was approved by Thomas D. O'Malley, the then Florida State Insurance Commissioner, despite a recommendation that questioned Hauser's "integrity, competency, and experience." *Id.* at 64. O'Malley eventually resigned after the Florida House of Representatives impeached him. *Id.* at 64 n.8. For a discussion of Hauser's links to organized crime, see Blakey, *The RICO Civil Fraud Action in Context: Reflections on Bennett v. Berg*, 58 NOTRE DAME L. REV. 237, 318 n.177 (1982) [hereinafter *Civil Action*].

With respect to the failure of a pension plan for economic reasons, consider the case of LTV Steel, the nation's second largest steel manufacturer. At the end of 1986, LTV shocked its pensioners by disclosing it had only \$7,700 in assets to pay \$2 million in monthly pension benefits. PENSION BENEFIT GUAR. CORP., ANN. REP. 5 (1987) [hereinafter ANNUAL REPORT]. Shortly thereafter, LTV refused to make further contributions to three of its other massive underfunded plans and informed the Pension Benefit Guaranty Corporation (PBGC) that it "could not and would not" make any more pension contributions. *Id.* As a result, the PBGC was forced to become trustee of the plans and to pay \$380 million annually for LTV's retirees. Perlman, *PBGC Terminates Three LTV Plans*, 23 PENSION WORLD 12 (Mar. 1987). Subsequent disclosures revealed that LTV did not comply with government mandated minimum funding requirements in either 1984 or 1985. *Id.* In all, LTV abandoned four pension plans covering over 100,000 workers and promising over \$2 billion dollars in benefits. ANNUAL REPORT, *supra*, at 5.

The PBGC attempted to restore responsibility for these plans to LTV. Although the Second Circuit rejected this plan, the Supreme Court will ultimately decide the issue. *Pension Benefit Guar. Corp. v. LTV Corp.*, 875 F.2d 1008, 1021 (2d Cir.), *cert. granted*, 110 S. Ct. 321 (1989). See Wermiel, *High Court to Rule on Whether LTV Should Fund \$2.3 Billion Pension Gap*, Wall St. J., Oct. 31, 1989, at A3, col. 2.

pension funds, provides such a guarantee, the government does not take adequate steps to ensure the wrongdoers, and not the taxpayers, pay the bill.<sup>10</sup> As a Congressional Committee investigating fraud in labor union pension funds concluded, the "present State insurance regulatory network does not provide adequate protection to employee benefit plans."<sup>11</sup>

In the context of the huge risk threatening pension benefits in this country, this Note will outline a comprehensive strategy to enable government agencies to recover from those responsible for pension plan failures.<sup>12</sup> Before outlining this strategy, Part I of this Note explores the context of the problem by focusing on the growth in pension fund assets and the increasing burden placed upon the PBGC.

The formulation of a litigation strategy usually begins with consideration of five basic questions: (1) who can sue, (2) whom can they sue, (3) under what causes of action, (4) with what remedies, and (5) with what limitations? However, when the suit involves a pension plan, this basic analytical structure must be modified since ERISA—acting like an umbrella over the suit—imposes special duties upon plan fiduciaries and preempts certain causes of action. Accordingly, Part II of this Note begins with an analysis of who can sue and whom can be sued in the context of an ERISA cause of action. Part III examines causes of action other than ERISA. Part IV examines the available remedies while Part V reviews the limitations of these causes of action. Part VI concludes by setting forth a strategy for maximizing recovery from the responsible parties.

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10 The goal of making the wrongdoers pay the bill will not be easy to achieve. Addressing the issue of fraud losses of the nation's savings and loan associations, Attorney General Richard Thornburgh lamented: "we'd be fooling ourselves to think any substantial portion of those assets are going to be recovered, notwithstanding our best efforts." Bartlett, *Savings Fraud Losses Seen as Lost for Good*, N.Y. Times, Feb. 10, 1989, at D1, col. 4. Although the government can seize assets purchased with the illegally obtained funds, some funds are "simply not recoverable." *Id.* "In many cases, the fraud involved investments in inflated commercial real estate that is now worthless. In addition, some money may have been taken out of the country." *Id.*

11 HAUSER REPORT, *supra* note 9, at 58. In reaching its conclusion, the Committee cited the "relative ease with which diversions of assets of business entities and payments for influence can be disguised" and "the difficulty . . . of . . . recovering funds that have been improperly diverted." *Id.* at 40. For a comprehensive review of government efforts to investigate the Teamsters Pension Fund since 1955, see generally OVERSIGHT INQUIRY OF THE DEPARTMENT OF LABOR'S INVESTIGATION OF THE TEAMSTERS CENTRAL STATES PENSION FUND, S. REP. NO. 177, 97th Cong., 1st Sess. (1981).

12 Although this Note focuses on the ability of the Department of Labor (DOL) and the government insurance agency, the PBGC, to recover from those responsible for pension plan failure, many of these same concepts apply to the efforts of the Federal Deposit Insurance Corporation (FDIC) to recover for bank failures, the efforts of the recently established Resolution Trust Corporation (RTC) (one of the successors to the Federal Savings and Loan Insurance Corporation) to recover from those responsible for the failure of savings and loans, and the efforts of the Securities Investor Protection Corporation (SIPC) to recover from those responsible for the failure of investment companies. For a general description of the duties of the RTC, see Thomas, *Thrift Bailout, Lacking a Chief and Floundering as Officials Feud, Slows and Grows More Costly*, Wall St. J., Oct. 11, 1989, at A20, col. 1. See generally Note, *Insider Abuse and Criminal Misconduct in Financial Institutions: A Crisis?*, 64 NOTRE DAME L. REV. 222 (1989) [hereinafter *Insider Abuse*]; S. PIZZO, M. FRICKER & P. MUOLO, *INSIDE JOB: THE LOOTING OF AMERICA'S SAVINGS AND LOANS* (1989).

In addition, with respect to certain suits against nonfiduciaries, this Note will address the common law causes of action that could be brought by the plan itself. See *infra* notes 146-61 and accompanying text for discussion of the common law actions of negligent misrepresentation and fraud.

## I. The Pension Benefit Guarantee Corporation

As part of a broad program to "protect . . . the interests of participants in employee benefit plans,"<sup>13</sup> the Employee Retirement Income Security Act of 1974 (ERISA)<sup>14</sup> established the Pension Benefit Guaranty Corporation (PBGC), a federal insurance fund.<sup>15</sup> In setting up the fund, Congress sought to prevent a "great personal tragedy"<sup>16</sup> by "making sure that if a worker has been promised a defined pension benefit upon retirement . . . he actually will receive it."<sup>17</sup> The PBGC insures the retirement benefits of thirty-one million workers and retirees in 110,000 single employer-pension plans.<sup>18</sup> To appreciate the scope of the burden on the PBGC, one must consider the history of pension funds in this country, the explosive growth of these funds in recent years, and the sheer size of the pension assets the PBGC insures.

Pension plans for American workers in the private sector were first introduced in the nineteenth century by railroads and express firms.<sup>19</sup> Initially, many union leaders were hostile toward employer financed plans because the plans were seen as a departure from traditional union goals.<sup>20</sup> Although these plans grew, the expansion of pension plans to other industries was slow. By 1930, a mere 2.7 million active workers—

<sup>13</sup> 29 U.S.C. § 1001(b) (1985).

<sup>14</sup> ERISA was originally enacted pursuant to the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829. Although ERISA was never codified, for convenience, the statute will be cited as title 29 of the United States Code.

<sup>15</sup> The relevant section of ERISA provides:

There is established within the Department of Labor a body corporate to be known as the Pension Benefit Guaranty Corporation. . . . The purposes of this subchapter, which are to be carried out by the corporation, are —

- (1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants,
- (2) to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under plans to which this subchapter applies, and
- (3) to maintain premiums established by the corporation under section 1306 of this title at the lowest level consistent with carrying out its obligation under this subchapter.

29 U.S.C. § 1302(a) (1985). The ERISA statute does not require the PBGC to insure all pension plans. For example, the insurance program does not apply to individual account plans such as 401(k) plans or Individual Retirement Accounts (IRA's), to plans covering government employees, to church plans, or to certain defined benefit plans. *Id.* § 1321(b). In addition, even with respect to covered plans, the PBGC only insures benefits up to a maximum amount. *See infra* note 85 for discussion of the maximum benefit amount that is covered.

<sup>16</sup> *Nachman Corp. v. Pension Benefit Guar. Corp.*, 446 U.S. 359, 374 (1980).

<sup>17</sup> *Id.* at 375.

<sup>18</sup> ANNUAL REPORT, *supra* note 9, at ii. The PBGC also insures the benefits of another 8.2 million workers in 2,300 multiemployer plans. *Id.* Historically, multiemployer plans were most often established in industries where there was little likelihood that meaningful benefits could be provided by single-employer plans. *Multiemployer Pension Plan Amendments Act of 1979: Hearing Before the Comm. on Ways & Means House of Representatives*, 96th Cong., 2d Sess. 72 (1980) (statement of Robert A. George, Chairman, National Coordinating Comm. for Multiemployer Plans). In some industries, such as construction, employees are generally hired for a specific project, and their employment terminates when the job is finished. In others, conditions of fierce competition, frequent business failures, or recurring layoffs prevent the establishment of a stable employer-employee relationship. In industries of these kinds, workers cannot obtain meaningful pension rights under a single-employer plan. Thus, collectively bargained, multiemployer plans were developed to provide pensions to workers in these highly volatile industries. *Id.*

<sup>19</sup> AMERICAN COUNCIL OF LIFE INS., 1981 PENSION FACTS 33 [hereinafter PENSION FACTS].

<sup>20</sup> 100 CONG. REC. 10,318-19 (1954) (quoting an article by Dubinsky entitled, *Safeguarding Union Welfare Funds*).

only fifteen percent of all privately employed nonfarm workers—were covered by private pension plans with reserves of \$800 million.<sup>21</sup> While pension plans grew during the 1930's<sup>22</sup> and 1940's,<sup>23</sup> the greatest growth in terms of coverage and assets occurred in the 1950's. A series of legal developments which made benefit plans particularly attractive precipitated this growth.<sup>24</sup> For example, high corporate taxes during and after World War Two and the Korean Conflict, coupled with deductions for contributions to these programs allowed under the Revenue Act of 1942,<sup>25</sup> made their establishment feasible at a relatively low after-tax cost. Accordingly, by 1960, private pension plans covered 20.5 million persons and reserves increased to \$52 billion.<sup>26</sup> Real growth slowed during the 1960's and 1970's but inflation caused the dollar value of pension assets to rise considerably.<sup>27</sup> To illustrate, from 1970 to 1975, pension fund reserves increased by fifty-seven percent to \$217.4 billion.<sup>28</sup> Even though inflation subsided, the value of plan assets continued to expand during the 1980's. From 1982 through 1986, total plan assets doubled again largely on the basis of the broad rise in the stock market.<sup>29</sup> As a result of this extensive growth, by 1987, there were about \$1.6 trillion in pension plan assets.<sup>30</sup> This growth is expected to continue with some suggesting the value of these funds may rise to \$4 trillion by the year 2000.<sup>31</sup> The enormous size of pension funds is illustrated by the percentage of securities fund fiduciaries purchase out of all stocks and bonds issued in the capital markets: nearly sixty-five percent.<sup>32</sup> In short, pension funds represent the largest source of funds for the New York Stock Exchange.<sup>33</sup>

At the same time that pension fund assets became larger than ever, the government agency that insures pension funds, the PBGC, faced the

21 PENSION FACTS, *supra* note 19, at 33.

22 By 1940, more than four million active workers participated in private pension plans which had reserves totaling \$2.4 billion. *Id.* at 34.

23 By the end of 1950, private pension plans covered 10.3 million persons, including 9.8 million active workers, which represented more than 30% of all persons employed in the United States. *Id.* The reserves of these plans reached \$12 billion. *Id.*

24 See SUBCOMMITTEE ON WELFARE AND PENSION FUNDS OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, FINAL REPORT ON WELFARE AND PENSION PLAN INVESTIGATION, S. REP. NO. 1734, 84th Cong., 2d Sess. 12 (1956).

25 Revenue Act of 1942, ch. 619, Pub. L. No. 753, § 165, 56 Stat. 798, 862-67.

26 PENSION FACTS, *supra* note 19, at 35.

27 *Id.*

28 *Id.*

29 The General Accounting Office concluded:

A major factor contributing to the increase in pension assets was the extensive growth of the stock market. The Dow Jones Industrial Average, an often-used indicator of the stock market's performance, more than doubled from 875 points at the beginning of 1982 to 1,927 points at the end of 1986.

UNITED STATES GENERAL ACCOUNTING OFFICE, PUB. NO. HRD-88-21, EFFECT OF THE 1987 STOCK MARKET DECLINE ON SELECTED LARGE PENSION PLANS 2 (1988). The GAO concluded that the increase in pension plan assets from 1982 through 1986 "likely had a much greater impact on increasing plan assets than the October 1987 stock market decline had on reducing them." *Id.* at 9.

30 *Id.* at 1.

31 See Corry, *NBC Looks at Power of the Pension Funds*, N.Y. Times, July 27, 1985, at A46, col. 5.

32 See Note, *The Employee Retirement Income Security Act of 1974 and Union Influence in Pension Fund Investment Decisions*, 12 FORDHAM URB. L.J. 151, 152 (1984).

33 See *id.*

"largest deficit . . . and the most threatening crisis of its 13-year history."<sup>34</sup> As of 1987, the PBGC had assumed responsibility for paying the pension benefits of 355,000 workers whose employers terminated their pension plans without enough funds to pay their workers.<sup>35</sup> In 1987, the failure of single-employer pension plans<sup>36</sup> forced the PBGC to pay more than \$300 million in benefits to 110,000 persons, to assume trustee responsibilities for another sixty pension plans, and to accumulate a deficit of \$1.5 billion.<sup>37</sup> In addition, the failure of multiemployer plans forced the PBGC to provide \$1.6 million in assistance to six plans covering 11,000 employees.<sup>38</sup>

The burden on the PBGC from failing single-employer funds is increasing. In 1986, for example, annual claims exceeded the total claims accumulated by the PBGC since its inception eleven years earlier.<sup>39</sup> In a report to Congress, the Pension Benefit Guaranty Corporation Advisory Committee<sup>40</sup> concluded, "we have no reason to think that this deficit will not move up to ten billion dollars or beyond just a few years in the future."<sup>41</sup>

As a federal insurance program, the PBGC functions much like a private insurance company. The PBGC collects premiums from all of its customers to pay for the failure of a relatively small number of pension programs.<sup>42</sup> When Congress established the PBGC, "the program was not expected to be big or costly."<sup>43</sup> As such, Congress set the initial premium for each plan year at "one dollar for each individual who is a

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34 ANNUAL REPORT, *supra* note 9, at 3. See generally Drew & Tackett, *Pension Insurer Struggles To Stay Solvent*, Chicago Tribune, Dec. 8, 1989, § 1, at 1, col. 2 (general overview of the obligations of the PBGC and the agency's efforts to maintain its financial integrity).

35 B. VAVRICHEK, FEDERAL INSURANCE OF PRIVATE PENSION BENEFITS 1-2 (1987) [hereinafter VAVRICHEK].

36 The PBGC insures both single-employer and multiemployer plans. With single-employer plans, the liability for contributions rests with one employer. Under multiemployer plans, the liability is allocated among the worker's former employers, often in a complicated manner. More specifically, multiemployer plans are collectively bargained pension agreements between a union and a group of employers while all other plans, including non-collectively bargained ones involving more than one employer, are categorized as single-employer plans. *Id.* at 6 n.7.

Single-employer plans dominate multiemployer plans in terms of the number of plans, the number of participants, and the level of plan assets. *Id.* at 6 n.8. In 1981, single-employer plans accounted for more than 99% of all plans, nearly 85% of plan participants, and over 90% of pension assets. *Id.* Due to the dominance of single-employer plans, this Note focuses primarily on their failure. Despite this focus on single-employer plans, the same concepts generally apply to multi-employer plans.

37 ANNUAL REPORT, *supra* note 9, at ii.

38 *Id.* At the close of 1987, the fund for multiemployer plans was solvent with assets of \$113.6 million and liabilities of \$45.2 million. *Id.*

39 *Id.* at 3.

40 The Committee was established pursuant to ERISA. See 29 U.S.C. §§ 1302 (h)(1)-(8) (1985). The Committee which prepared this report consisted of seven members from the private sector who were appointed by President Reagan. *PBGC Advisory Committee Urges Action*, 23 PENSION WORLD 14 (Apr. 1987).

41 *PBGC Advisory Committee Urges Action*, 23 PENSION WORLD 14 (Apr. 1987).

42 To illustrate, the PBGC reported that three events consisting of 11 plan terminations accounted for over \$800 million in single-employer net claims—or just over 40% of total net claims during the PBGC's entire 13-year history. ANNUAL REPORT, *supra* note 9, at 31.

43 K. Utgoff, Executive Director of the Pension Benefit Guarantee Corporation, Remarks before the Employee Benefits Conference of the Conference Board 2 (Mar. 16, 1987).

participant in such plan."<sup>44</sup> When the PBGC accumulated a deficit of \$95.3 million in just three years,<sup>45</sup> Congress approved the first premium increase to \$2.60 per participant in 1978.<sup>46</sup> Eight years later, when the PBGC's deficit ballooned to \$3,826.4 million,<sup>47</sup> Congress raised the premium to \$8.50 as part of the Pension Protection Act.<sup>48</sup> Past experience indicates it is unlikely premium increases alone will solve the PBGC's problems. In fact, the PBGC reported to Congress in 1987 that based on its claims experience over the previous six years, its deficit would continue to increase even with the most recent premium hike.<sup>49</sup>

In addition to premium increases, the PBGC is turning to the courts to help reduce its huge deficits. ERISA grants investigatory<sup>50</sup> power to the PBGC and allows the PBGC to sue plan sponsors for the amount of benefits the PBGC is forced to pay out.<sup>51</sup> The PBGC's claim reaches "any entity" fairly responsible for decision-making about the plan.<sup>52</sup> At the close of 1987, the PBGC had 140 cases in litigation—about the same number as in 1986.<sup>53</sup> The PBGC also had 484 uncontested bankruptcy cases pending at year-end—69 more cases than were pending at the end of 1986.<sup>54</sup> Although it did not specify a dollar amount, the PBGC reported to Congress that the pending litigation "could have significant financial implications" for the single-employer insurance program.<sup>55</sup>

In addition to the legal efforts of the PBGC, the Department of Labor's Pension and Welfare Benefits Administration (PWBA) has regulatory and enforcement authority for matters relating to the fiduciary and coverage requirements of ERISA.<sup>56</sup> The PWBA attempts to recover plan assets through litigation and through a voluntary compliance program. In 1986, the PWBA recovered \$13.7 million through its litigation efforts and another \$75.1 million from voluntary compliance for a total of \$88.8 million.<sup>57</sup> In comparison, in 1985, the PWBA recovered \$12.7 million

44 Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 4006, 88 Stat. 829, 1011. The PBGC has authority to revise the premium amounts whenever "necessary," 29 U.S.C. § 1306(a)(2) (Supp. 1989), but the revised rates can only become effective when approved by a joint resolution of Congress. *Id.* § 1322a(f)(2)(B).

45 See VAVRICHEK, *supra* note 35, at 28.

46 Multiemployer Pension Plan Amendments Act of 1980, Pub. L. No. 96-364, § 105, 94 Stat. 1208, 1264.

47 See VAVRICHEK, *supra* note 35, at 28.

48 Pension Protection Act, Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 9331, 101 Stat. 1330, 1330-367. The premium was raised again a year later. Beginning in 1988, the yearly premium for single-employer plans was \$16 per participant. 29 U.S.C. § 1306(a)(3)(A)(i) (Supp. 1989). In addition, a variable rate was imposed upon plans that had an unfunded vested benefit amount. Under this variable rate, the yearly premium could be as high as \$50 per participant. *Id.* § 1306(a)(3)(E).

49 ANNUAL REPORT, *supra* note 9, at 9.

50 29 U.S.C. § 1303(a) (Supp. 1989).

51 *Id.* § 1303(e)(1) (1985). See *infra* notes 81-84 and accompanying text for a discussion of the causes of action the PBGC can bring.

52 *In re International Harvester's Disposition of Wis. Steel Litig.*, 681 F. Supp. 512, 518 (N.D. Ill. 1988) (PBGC had a cause of action against a predecessor employer even though the corporation sold its pension-burdened division to a third party in a leveraged buyout transaction).

53 ANNUAL REPORT, *supra* note 9, at 17.

54 *Id.*

55 *Id.* at 56.

56 EMPLOYEE RETIREMENT INCOME SECURITY ACT, 1986 REP. TO CONGRESS iii.

57 *Id.* at 19.



through litigation and \$38.6 million from voluntary compliance efforts.<sup>58</sup> While these amounts are significant, they pale in comparison to the PBGC's multi-billion dollar deficits.<sup>59</sup>

There are three major reasons why the government has not been able to make the wrongdoers pay. First, the arm of the Department of Labor (DOL) that oversees pension plans, the PWBA, does not have enough staff to properly monitor the plans under its jurisdiction.<sup>60</sup> Second, once a problem is discovered, there is a lack of coordination among the government agencies responsible for prosecuting the wrongdoers.<sup>61</sup> Third, the complexity of some of the fraud schemes makes devising a litigation strategy—which must consider ERISA as well as state and federal laws—a monumental administrative challenge.<sup>62</sup>

<sup>58</sup> *Id.*

<sup>59</sup> For example, although the PWBA recovered a total of \$88.8 million in 1986, *see supra* text accompanying note 57, the PBGC's deficit at the end of its 1986 fiscal year was \$3,826.4 million. ANNUAL REPORT, *supra* note 9, at 45. Thus, PWBA recoveries amounted to just 2.3% of the PBGC's deficit. Although there will be some lag time between when the PWBA collects and when the PBGC incurs a liability, the recovery percentage is still small.

<sup>60</sup> The DOL expressed the following concern:

A report issued by the Senate Governmental Affairs Committee in April 1986 found that inadequate staffing has dangerously compromised the Department's ability to enforce the Employee Income Retirement Security Act of 1974 (ERISA). Despite this finding, and similar ones in a 1984 OIG audit report, the Department of Labor still has only about 300 auditors and investigators to examine these funds: a number that permits the annual review of less than 1 percent of the ERISA-covered benefit plans.

OIG REPORT, *supra* note 1, at 1. In 1978, the PWBA conducted 8,598 reviews and investigations. *Plans Looted*, *supra* note 2. However, by 1988, the figure had plummeted to 1,632 despite the three-fold increase in pension fund assets. *Id.* When conducting its investigations, the PWBA concentrates on the largest 5% of the plans which hold about 90% of pension assets. *Id.* As a consequence, the 93% of the plans with fewer than 100 participants are the least likely to be reviewed. *Id.* To further compound the problem, in contrast to large pension plans, these small plans are not required to hire outside auditors to review the plan's operation. *See infra* note 70 for discussion of ERISA's annual report requirement. In addition, small plans are less likely to be insured by the PBGC. *See supra* note 15.

The lack of staffing problem may not be unique to the DOL. *See Gerth, Enforcement Lax, U.S. Auditors Say*, N.Y. Times, Oct. 4, 1989, at A9, col. 4 (internal inspectors of three federal agencies—the DOL, the Environmental Protection Agency, and the Department of Health and Human Services, tell Congress about serious weaknesses in the agencies' enforcement efforts). *See also Hall, Federal Mismanagement Could Cost Taxpayers Up to \$150 Billion, GAO Says*, Wall St. J., Nov. 30, 1989, at A8, col. 5 (GAO watchlist includes the Defense Department, the Internal Revenue Service, Medicare, NASA, Guaranteed Student Loans, and the PBGC).

<sup>61</sup> This lack of coordination is evidenced by the government's inefficiency in pursuing criminal actions. The DOL reported:

The FBI has authority to investigate potential criminal violations related to programs enforced by the Labor Department; however, the FBI does not generally exercise this authority and, in fact, has formally agreed to share their primary enforcement role with the OIG. Since . . . recent Secretaries have not vigorously pursued the criminal sanctions available under DOL program legislation, there would appear to be a wide range of Department of Labor program-related criminal offenses that will go uninvestigated if this opinion prevails.

OIG REPORT, *supra* note 1, at 4.

<sup>62</sup> At a Congressional hearing investigating pension plan fraud, Senator Warren Rudman explained the problem this way: "[y]ou need very special kinds of investigators for this kind of crime. You need people who understand the actuarial tables, audit procedures, [and] have [a] background in criminal law." *Hotel Employees & Restaurant Employees International Union: Hearings Before the Subcomm. on Investigations of the Senate Comm. on Governmental Affairs*, 98th Cong., 1st Sess., pt. 4, at 14 (1983) (statement of Sen. Warren Rudman). At the same hearing, the committee heard testimony that "[t]hese people [who steal from pension plans] are extremely imaginative, innovative, intelligent; they hire extremely qualified people in the field to use their brain[s] . . . experience . . . [and] knowl-

Thus, despite federal efforts to recover pension losses through insurance premium increases, litigation, and voluntary compliance, the pension benefits of millions of American workers are still in serious jeopardy. To broaden recoveries, the government must aggressively pursue those responsible for pension fund failures.

## II. The ERISA Cause of Action

To begin to determine who may be legally responsible for a pension plan failure, it is necessary to examine the structure of pension plans. This structure is governed by ERISA. ERISA mandates that employee benefit plans be maintained and established pursuant to a written plan.<sup>63</sup> The plan names the fiduciaries who have authority to control and manage the operation and administration of the pension program.<sup>64</sup> Fiduciaries have the power to hire advisors<sup>65</sup> and to appoint investment professionals to manage the pension plan assets.<sup>66</sup> With few exceptions,<sup>67</sup> pension plan assets are held in a separate trust<sup>68</sup> by the plan trustees.<sup>69</sup> In addition to the plan administrators, any advisors or investment managers, and the trustees, certain other parties are involved in running a pension plan. For example, plan administrators must file annual reports with the Secretary of Labor.<sup>70</sup> The report must contain a financial statement<sup>71</sup> prepared by an "independent qualified public accountant"<sup>72</sup> and an actuarial statement<sup>73</sup> prepared by an "enrolled actuary."<sup>74</sup>

Once the individuals who establish and run a pension plan are identified, it is necessary to determine if the government can hold these parties liable for a plan's failure and, if so, under which theories—ERISA, other federal claims for relief, or state law. ERISA permits the Secretary of Labor to bring a cause of action—under ERISA—against any party who violates the fiduciary provisions of the Act.<sup>75</sup> The Secretary has

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edge to find new and exciting ways to take money out of these plans." *Id.* at 8 (statement of Dennis Cook).

63 29 U.S.C. § 1102(a)(1) (1985).

64 *Id.*

65 *Id.* § 1102(c)(2).

66 *Id.* § 1102(c)(3).

67 *Id.* § 1103(b).

68 The trust is an entity separate from the employer that created it. See *Thompson v. Asbestos Workers Local No. 53 Pension Fund*, 554 F. Supp. 296, 299 (M.D. La.), *aff'd*, 716 F.2d 340 (5th Cir. 1983).

69 29 U.S.C. § 1103(a) (1985).

70 *Id.* § 1023(a)(1)(A). Under ERISA's regulations, the administrator of a plan that covers fewer than 100 participants at the beginning of the plan year is not required to comply with the annual report requirements. 29 C.F.R. § 2520.104-46(b)(2) (1987).

71 29 U.S.C. § 1023(a)(1)(B)(i) (1985).

72 *Id.* § 1023(a)(3)(A).

73 *Id.* § 1023(a)(1)(B)(ii).

74 *Id.* § 1023(a)(4)(A).

75 ERISA provides: "A civil action may be brought . . . by the Secretary, or by a participant, beneficiary or fiduciary for appropriate relief under section 1109 of this title." *Id.* § 1132(a)(2). Section 1109 provides:

Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and

standing and is authorized to bring suit on behalf of the plan against fiduciaries<sup>76</sup> and nonfiduciaries.<sup>77</sup> However, the Secretary must sue fiduciaries under ERISA or under other provisions of the federal law because ERISA preempts state common law claims. In addition, the Secretary can sue nonfiduciaries as knowing participants in ERISA violations.<sup>78</sup> ERISA confers broad authority on the Secretary to seek legal and equitable relief for ERISA violations.<sup>79</sup> The Secretary can delegate this power to other investigatory bodies.<sup>80</sup>

In addition to the Secretary of Labor, the PBGC can sue the plan sponsor or any member of the sponsor's control group—under ERISA—to recover any amount the PBGC was forced to pay to employees.<sup>81</sup> The

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to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

*Id.* § 1109(a).

76 *Donovan v. Bryans*, 566 F. Supp. 1258, 1268 (E.D. Pa. 1983) (the Secretary is authorized to maintain this action on behalf of the plan); *Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan*, 507 F. Supp. 378, 383 (D. Haw. 1980) (Secretary of Labor has standing to bring this action under ERISA).

77 *Donovan v. Schmoutey*, 592 F. Supp. 1361, 1390 (D. Nev. 1984) (Secretary is authorized to bring civil action under ERISA on behalf of the pension trust against certain of its trustees and against nonfiduciaries who received or benefitted from transfers of trust assets); *Donovan v. Daugherty*, 550 F. Supp. 390, 403 (S.D. Ala. 1982) (Secretary of Labor has standing to bring action under ERISA against trustees and against a nonfiduciary who was the legal counsel of the plan).

78 Arguably, the Secretary should be able to sue nonfiduciaries even if fiduciaries are not involved in the suit. See *infra* note 121 for further discussion of this issue.

79 *Bryans*, 566 F. Supp. at 1264. ERISA states that the Secretary may take action "to enjoin any act or practice which violates any provision of this subchapter" or "to obtain other appropriate equitable relief." 29 U.S.C. § 1132(a)(5) (1985). See *infra* notes 270-87 and accompanying text for discussion of the equitable remedy of injunction which would freeze the assets of the defendant.

80 See *Donovan v. National Bank of Alaska*, 696 F.2d 678, 681-82 (9th Cir. 1983) (tracing the evolution of the Secretary's broad power to delegate authority) (in the context of an investigation of a bank fiduciary the Secretary has authority to delegate investigatory powers to bank officials).

81 ERISA provides:

(a) In any case in which a single-employer plan is terminated in a distress termination under section 1341(c) of this title or a termination otherwise instituted by the corporation [the PBGC] under section 1342 of this title, any person who is, on the termination date, a contributing sponsor of the plan or a member of such a contributing sponsor's controlled group shall incur liability under this section. The liability under this section of all such persons shall be joint and several. The liability under this section consists of—

(1) liability to the corporation [the PBGC], to the extent provided in subsection (b) of this section, . . . .

(b) . . . the liability to the corporation of a person described in subsection (a) of this section shall be the total amount of the unfunded benefit liabilities (as of the termination date) to all participants and beneficiaries under the plan, together with interest (at a reasonable rate) calculated from the termination date . . . .

29 U.S.C. § 1362 (Supp. 1989). Prior to a recent amendment, the PBGC's recovery was limited to 30% of the collective net worth of the plan sponsors. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 4062, 88 Stat. 829, 1029. The amendment was passed in 1987 and the relaxed limitation applies to proceedings instituted by the PBGC after December 17, 1987. Pension Protection Act, Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 9312(d)(1)(B), 101 Stat. 1330, 1330-364.

Although the PBGC has an express cause of action under ERISA against the plan sponsor and members of the sponsor's control group, the PBGC may have other causes of action. To illustrate, in certain circumstances, the PBGC or the plan administrator, or the PBGC in conjunction with the plan administrator, can cause a trustee to be appointed to oversee a distressed plan. 29 U.S.C. § 1342(b)(2) (1985). In many cases, the PBGC will be the appointed trustee. As trustee, the PBGC has the power "to commence, prosecute, or defend on behalf of the plan any suit or proceeding involving the plan." *Id.* § 1342(d)(1)(B)(iv).

employer's liability under ERISA is incurred upon termination of the plan and runs directly to the PBGC.<sup>82</sup> The members of the control group are jointly and severally liable to the PBGC.<sup>83</sup> The PBGC's claim against the plan's sponsor and members of the sponsor's control group reaches any entity responsible for decision making about the plan and, in appropriate circumstances, includes a predecessor corporation.<sup>84</sup>

Thus, under ERISA, the Secretary of Labor, through the PWBA, can sue on behalf of the plan for damages suffered by the plan while the PBGC can sue the plan sponsors to recover for any amount the PBGC was forced to pay to plan beneficiaries. Many factors influence which agency should bring suit. Among these factors, consider that since the PWBA can sue on behalf of the plan, the PWBA can proceed against any party who injured the plan—including the trustees, the accountants, the attorneys, or any investment advisors. In contrast, the PBGC can only proceed against the plan sponsor or members of the sponsor's control group. In addition, while the PWBA can sue to recover for the plan's entire loss, the PBGC's recovery cannot exceed the amount the PBGC paid out as benefits. Since the PBGC is not always obligated to pay workers the same amount of benefits as the failed plan, the plan itself may incur a greater loss than the PBGC.<sup>85</sup>

82 *In re International Harvester's Disposition of Wis. Steel Litig.*, 681 F. Supp. 512, 516 (N.D. Ill. 1988).

83 *In re Tenn-Ero Corp.*, 14 Bankr. 884, 890 (D. Mass. 1981), *cert. denied*, 464 U.S. 961 (1983). This express provision of ERISA will override state law, which may or may not allow for joint and several liability. The provision may be unnecessary, as the rule is one of joint and several liability unless Congress provides otherwise. See *Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 634-40 (1981) (joint and several liability; no right to contribution among antitrust wrongdoers where Congress neither expressly nor implicitly intended to create such a right). For the rule under RICO, see *Fleischhauer v. Feltner*, 879 F.2d 1290, 1301 (6th Cir. 1989) (joint and several); *Miller v. Affiliated Fin. Corp.*, 624 F. Supp. 1003, 1004 (N.D. Ill. 1985) (joint and several; neither indemnification nor contribution under RICO). But see *County of Cook v. Lynch*, 620 F. Supp. 1256, 1259 (N.D. Ill. 1985) (proper measure of damages under RICO is entire amount of loss where it is not possible to apportion damages amongst all defendants, but burden of proof is on the perpetrators).

84 *In re International Harvester*, 681 F. Supp. at 519 (predecessor liability allowed if dissolution and sale of business turns out to be a sham to avoid liability for pension benefits).

85 ERISA limits the amount the PBGC must pay out to each covered employee. The statute states:

(3) The amount of monthly benefits described in subsection (a) of this section provided by a plan, which are guaranteed under this section with respect to a participant, shall not have an actuarial value which exceeds the actuarial value of a monthly benefit in the form of a life annuity commencing at age 65 equal to the lesser of—

(A) his average monthly gross income from his employer during the 5 consecutive calendar year period (or, if less, during the number of calendar years in such period in which he actively participates in the plan) during which his gross income from that employer was greater than during any other such period with that employer determined by dividing 1/12 of the sum of all such gross income by the number of such calendar years in which he had such gross income, or

(B) \$750 multiplied by a fraction, the numerator of which is the contribution and benefit base (determined under section 430 of Title 42) in effect at the time the plan terminates and the denominator of which is such contribution and benefit base in effect in calendar year 1974.

29 U.S.C. § 1322(b)(3) (1985). In other words, the statute limits guaranteed benefits to a worker's average monthly salary over his best five consecutive years with the employer or \$750 adjusted for cost of living, whichever is lower. See *Nachman Corp. v. Pension Benefit Guar. Corp.*, 446 U.S. 359, 375 n.23 (1980) (interpreting the dollar limitations of PBGC coverage). See also 29 C.F.R. § 2621.3 (1987). As of 1987, the \$750 limit on the maximum guaranteeable monthly benefit had been adjusted to \$1,857.95. *Id.* § 2621 app. A. Although the PBGC's obligation is limited, the corporation

In addition, who will sue depends on why the plan incurred a loss.<sup>86</sup> The PWBA is concerned with wrongdoing. Consequently, if a plan incurred a loss for purely economic reasons, the PWBA would not have a cause of action because there was no wrongdoing. On the other hand, the PBGC is concerned with its obligation to pay out benefits to insured workers of troubled plans. Thus, so long as the plan failed, the reason for the failure—whether for economic reasons or because of wrongdoing—is not important to the PBGC. Accordingly, when there is wrongdoing but no plan failure, the PWBA and only the PWBA will sue. When there is plan failure, but no wrongdoing, the PBGC and only the PBGC will sue. When there is wrongdoing and plan failure, both the PWBA and the PBGC can sue, but the PWBA will usually be in a better position to recover for the total loss to the plan.

In assessing liability, the legal duty of the party must be analyzed. Since ERISA imposes special duties upon fiduciaries, the extent of the duty initially depends on whether the person is a "fiduciary" of the plan. A person is a fiduciary under ERISA to the extent he or she exercises discretion over the management of plan assets, renders investment advice for a fee, or exercises discretionary control over the administration of the plan.<sup>87</sup> Certain individuals automatically become fiduciaries by virtue of their relationship to the fund. For example, plan administrators,<sup>88</sup> plan trustees,<sup>89</sup> and any "named fiduciaries"<sup>90</sup> are always fiduciaries. On the other hand, directors and officers of the employer, the plan accountants, and the plan attorneys may or may not be fiduciaries.

Generally, an attorney rendering legal advice or an accountant providing accounting services (other than investment advice) to a pension plan is not considered to be a fiduciary solely by performing such serv-

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is authorized to guarantee the payment of other amounts "as it determines to be appropriate." 29 U.S.C. § 1322(d) (Supp. 1989).

86 Consider three general cases. First, a plan fails for purely economic reasons. In this situation, the PWBA would not have a cause of action while the PBGC would have a claim to recover the benefits it was forced to pay out to insured workers. Second, although a plan incurs losses due to wrongdoing, the plan itself does not fail. Here, the PWBA can sue on behalf of the plan to recover from the wrongdoers but since the plan did not fail and the PBGC did not have to pay out any benefits, the PBGC does not have a cause of action. Third, the plan fails because of wrongdoing. In this situation, both the PWBA and the PBGC have claims. The PWBA can sue on behalf of the plan to recover from the wrongdoers while the PBGC can sue to recover for the benefits it was forced to pay out.

87 *Thornton v. Evans*, 692 F.2d 1064, 1077 (7th Cir. 1982). ERISA defines a person to be a plan fiduciary to the extent:

(i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

29 U.S.C. § 1002(21)(A) (Supp. 1989).

88 See *Donovan v. Mercer*, 747 F.2d 304, 308 (5th Cir. 1984); *Shaw v. International Ass'n of Machinists & Aerospace Workers Pension Plan*, 563 F. Supp. 653, 657 (C.D. Cal. 1983), *aff'd*, 750 F.2d 1458 (9th Cir.), *cert. denied*, 471 U.S. 1137 (1985); *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 635 (W.D. Wis. 1979).

89 *NLRB v. AMAX Coal Co.*, 453 U.S. 322, 334, *reh'g denied*, 453 U.S. 950 (1981).

90 *Czyz v. General Pension Bd., Bethlehem Steel Corp.*, 578 F. Supp. 126, 129 (W.D. Pa. 1983).

ices.<sup>91</sup> Likewise, officers, principal employees, and board members are fiduciaries only to the extent their duties conform to ERISA's definition of a fiduciary.<sup>92</sup> Although a person who performs purely ministerial functions is not a fiduciary,<sup>93</sup> a person may be a fiduciary for some purposes and not for others.<sup>94</sup> Despite these exclusions, the concept of fiduciary duty under ERISA is broadly construed,<sup>95</sup> and in appropriate instances, corporate officers and directors,<sup>96</sup> accountants,<sup>97</sup> and attorneys<sup>98</sup> have been found to be fiduciaries under ERISA.

### A. *Fiduciary Liability*

Plan administrators, trustees, and named fiduciaries are subject to the fiduciary obligations of ERISA. The consequences of being a fiduciary are significant in two respects. First, a fiduciary must comply with the legal duties of a fiduciary as specifically set forth in ERISA. Second, a fiduciary who violates his duties under ERISA is subject to the sanctions set out in the statute.<sup>99</sup>

Once a party is a fiduciary, ERISA defines his duties. The individual must act for the exclusive purpose of providing benefits to participants and beneficiaries while defraying reasonable expenses of plan adminis-

91 29 C.F.R. § 2509.75-5, Question D-1 (1987).

92 *Id.* § 2509.75-8, Question D-4.

93 *Robbins v. First Am. Bank of Va.*, 514 F. Supp. 1183, 1189 (N.D. Ill. 1981). *See also* 29 C.F.R. § 2509.75-8, Question D-2 (1987).

94 *Leigh v. Engle*, 727 F.2d 113, 133 (7th Cir. 1984) ("ERISA recognizes that a person may be a fiduciary for some purposes and not others. . . . The key language in the statutory definition is that a person is a fiduciary 'to the extent' he or she exercises control or authority over the plan."), *cert. denied*, 109 S. Ct. 1528 (1989). *See United Indep. Flight Officers, Inc. v. United Air Lines, Inc.*, 756 F.2d 1262, 1268 (7th Cir. 1985) (union not a fiduciary by virtue of negotiating terms and conditions of future pension benefits).

95 *Donovan v. Mercer*, 747 F.2d 304, 308 (5th Cir. 1984).

96 In certain cases, corporate officers and directors are held to the fiduciary standards of ERISA. ERISA contemplates a situation where a corporate officer wears two hats. When acting as an employee of the corporation, the officer owes a duty to act on behalf of the corporation. On the other hand, when the officer acts as a fiduciary of a pension plan, the officer owes a duty to act in the best interests of the plan's beneficiaries. *Local Union 2134, United Mine Workers of Am. v. Powhatan Fuel, Inc.*, 828 F.2d 710, 713 (11th Cir. 1987). To illustrate, the Seventh Circuit, in *Engle*, 727 F.2d at 134-35, held a management supervisor to be a fiduciary when the manager supervised the trust managers. Similarly, corporate officers and directors are fiduciaries when they select plan trustees. *Shaw v. International Ass'n of Machinists & Aerospace Workers Pension Plan*, 563 F. Supp. 653, 657 (C.D. Cal. 1983), *aff'd*, 750 F.2d 1458 (9th Cir.), *cert. denied*, 471 U.S. 1137 (1985). In addition, the Tenth Circuit held the defendant, who was both a director and an officer of a corporation, liable as a fiduciary because he assisted in "recommending, designing and implementing" an amendment to the pension plan. *Eaves v. Penn.*, 587 F.2d 453, 459 (10th Cir. 1978).

97 An accountant who has the requisite "authority and responsibility" over pension plan matters is a fiduciary under ERISA. *Wright v. Nimmons*, 641 F. Supp. 1391, 1402 (S.D. Tex. 1986) (holding the accountant of a closely-held corporation to the fiduciary obligations of ERISA). Specifically, an accountant who keeps the books, compiles employee data, calculates employer contributions, prepares the required governmental reports and financial statements, and prepares annual reports, can be an ERISA-defined fiduciary. *Id.* at 1393-94.

98 In certain instances, corporate counsel is a fiduciary under ERISA. In the leading case of *Donovan v. Daugherty*, 550 F. Supp. 390, 410-11 (S.D. Ala. 1982), the court found the corporation's general counsel, a nonfiduciary, was liable as a fiduciary because he advised other fiduciaries about the extension of improper plan benefits to himself and the plan trustees.

99 Although ERISA preempts state common law causes of action, the fiduciary is subject to suits under federal law. *See infra* notes 113-19 and accompanying text for a discussion of preemption under ERISA.

tration.<sup>100</sup> A fiduciary is bound by the prudent person rule,<sup>101</sup> obligated to diversify pension plan investments,<sup>102</sup> and must conduct the plan in accordance with the plan documents (and the basic standards of ERISA).<sup>103</sup> A fiduciary is also subject to liability when a co-fiduciary breaches his own fiduciary obligations.<sup>104</sup> When a fiduciary breaches his statutory duty, good faith is not a defense.<sup>105</sup> Further, the law prohibits a fiduciary from engaging, directly or indirectly, in certain prohibited transactions when the fiduciary knew or should have known the transaction was prohibited.<sup>106</sup>

100 29 U.S.C. § 1104(a)(1)(A) (1985).

101 The fiduciary must discharge his duties: "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." *Id.* § 1104(a)(1)(B).

102 *Id.* § 1104(a)(1)(C).

103 *Id.* § 1104(a)(1)(D).

104 More specifically, a fiduciary is liable for a breach by a co-fiduciary in the following circumstances:

- (1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;
- (2) if, by his failure to comply with section 1104(a)(1) of this title [governing the general duties of a fiduciary] in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or
- (3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

*Id.* § 1105(a). This standard for imposing liability upon a co-fiduciary for the actions of another fiduciary is higher than the common law standard for negligence. The standard may also be less than the common law standard for aiding and abetting and conspiracy for criminal purposes, which is the standard for civil liability under RICO. *See United States v. Local 560, Int'l Bhd. of Teamsters*, 581 F. Supp. 279, 332 n.30, 332 (D.N.J. 1984), *aff'd*, 780 F.2d 267, 284 (3d Cir. 1985), *cert. denied*, 476 U.S. 1140 (1986). Under common law, courts are split as to whether the aider and abettor or co-conspirator had to act merely with "knowledge" of the illegal conduct or with "intent" to facilitate it. *See Civil Action*, *supra* note 9, at 290 n. 151 (for a detailed discussion of the split regarding the requisite state of mind for aiding and abetting). Since RICO reflects criminal conduct, the criminal code's express provision on aiding and abetting applies to suits under RICO. *See* 18 U.S.C. § 2 (1969). *See generally* Note, *Innocence by Association: Entities and the Person-Enterprise Rule Under RICO*, 63 NOTRE DAME L. REV. 179 (1988) [hereinafter *Innocence by Association*].

105 *Donovan v. Daugherty*, 550 F. Supp. 390, 403 (S.D. Ala. 1982); *Marshall v. Glass/Metal Ass'n & Glassworkers Pension Plan*, 507 F. Supp. 378, 384 (D. Haw. 1980) (sincerity of trustees' beliefs is "essentially irrelevant to a determination of the prudence of their conduct"). While good faith is not a defense to ERISA, good faith is a defense to mail fraud and wire fraud. This is significant because mail fraud and wire fraud can be integral parts of a pension plan scheme. Mail fraud and wire fraud can also constitute predicate acts under RICO. *See infra* notes 176-78 and accompanying text for a discussion of the good faith defense to mail fraud in the context of a RICO claim.

106 29 U.S.C. § 1106(a)(1) (1985). The prohibited transactions include:

- (A) sale or exchange, or leasing, of any property between the plan and a party in interest;
- (B) lending of money or other extension of credit between the plan and a party in interest;
- (C) furnishing of goods, services, or facilities between the plan and a party in interest;
- (D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan;
- or
- (E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 1107(a) of this title [governing the acquisition and holding of employer securities and employer real property].

*Id.*

If a fiduciary breaches<sup>107</sup> his duties, ERISA imposes personal liability upon the fiduciary to make up the losses.<sup>108</sup> The employer or plan administrator cannot relieve the fiduciary of his responsibilities<sup>109</sup> because such action would be against public policy.<sup>110</sup> Although the fiduciary can purchase liability insurance for his own account, the plan is prohibited from purchasing insurance for the fiduciary unless the policy allows the insurer recourse against the fiduciary.<sup>111</sup> In addition to liability insurance, every fiduciary must be bonded for an amount not less than ten percent of the amount of funds the fiduciary handles.<sup>112</sup>

ERISA preempts most state causes of action.<sup>113</sup> Specifically, the statute "supercede[s] any and all State laws insofar as they may now or hereafter relate to any employee benefit plan."<sup>114</sup> ERISA's preemption in the "area of pensions and other employee benefit programs is virtually total."<sup>115</sup> Accordingly, courts hold that ERISA preempts all common law and state-created civil causes of action,<sup>116</sup> including common law actions for breach of fiduciary duty.<sup>117</sup> ERISA preemption does not, however, apply to state criminal law,<sup>118</sup> nor to any federal law providing civil or criminal sanctions.<sup>119</sup>

107 Despite the fact that good faith is not a defense to a breach of fiduciary duty, *see supra* note 105, at least one court holds that ERISA fiduciary duties are only violated by "arbitrary and capricious" or bad faith behavior. *Fentron Indus., Inc. v. National Shopmen Pension Fund*, 674 F.2d 1300, 1307 (9th Cir. 1982). Other courts disagree with this proposition. *See, e.g., Leigh v. Engle*, 727 F.2d 113, 124 (7th Cir. 1984), *cert. denied*, 109 S. Ct. 1528 (1989).

108 The law provides:

Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

29 U.S.C. § 1109(a) (1985).

109 *Id.* § 1110(a).

110 *Id.*

111 *Id.* § 1110(b).

112 *Id.* § 1112(a).

113 *See generally Mackey v. Lanier Collections Agency & Serv., Inc.*, 486 U.S. 825 (1988) (the most recent Supreme Court case dealing with preemption under ERISA).

114 29 U.S.C. § 1144(a) (1985).

115 *Bell v. Employee Sec. Ben. Ass'n*, 437 F. Supp. 382, 387 (D. Kan. 1977).

116 *Blue Cross v. Peacock's Apothecary, Inc.*, 567 F. Supp. 1258, 1272-76 (N.D. Ala. 1983).

117 *Metzner v. D.H. Blair & Co., Inc.*, 663 F. Supp. 716, 722 (S.D.N.Y. 1987) ("Plaintiffs' cause of action under the common law for a breach of a fiduciary is preempted under ERISA.").

118 29 U.S.C. § 1144(b)(4) (1985). The statute provides: "Subsection (a) of this section [the preemption provision] shall not apply to any generally applicable criminal law of a State." *Id.*

This provision is increasingly significant given that more and more states are enacting racketeering statutes similar to the powerful federal Racketeer Influenced and Corrupt Organizations Act. *See, e.g., FLA. STAT. ANN.* §§ 895.01-.09 (West Supp. 1989). For a chart outlining the key provisions of federal RICO and the RICO laws of all 27 states that had such laws as of 1987, see Blakey & Cessar, *Equitable Relief Under Civil RICO: Reflections on Religious Technology Center v. Wollersheim: Will Civil RICO Be Effective Only Against White-Collar Crime?*, 62 NOTRE DAME L. REV. 526, 596-618 (1987) [hereinafter *Equitable Relief*]. Since 1987, the legislatures in Minnesota and Oklahoma have also enacted RICO statutes. *See Crimes—Racketeering, Concealing Criminal Proceeds*, ch. 286, H.F. No. 837, 1989 Minn. Sess. Law Serv. 1074-81 (to be codified at MINN. STAT. §§ 609.901-.912) and OKLA. STAT. ANN. tit. 22, §§ 1401-1419 (West Supp. 1989).

119 The statute provides:

Nothing in this subchapter shall be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States (except as provided in sections 1031 [relating to the



## B. *Nonfiduciary Liability*

In contrast to the extensive duties ERISA imposes upon fiduciaries, ERISA is silent with regard to the duties of a nonfiduciary. However, in certain circumstances, courts find nonfiduciaries liable under ERISA. Even though courts reason that nonfiduciaries are liable "under ERISA," it is not clear what provisions of ERISA apply to nonfiduciaries. For example, one court held a nonfiduciary liable "under ERISA" but emphasized that *ERISA's fiduciary standards* are not enforceable in civil damage actions against nonfiduciaries.<sup>120</sup> Another court found that a plaintiff could sue a nonfiduciary under state common law even though the nonfiduciary was not liable under ERISA.<sup>121</sup> Thus, these cases reveal that two

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repeal and amendment of the Welfare and Pensions Plans Disclosure Act] and 1137(b) of this title [relating to administrative procedure]) or any rule or regulation issued under any such law.

29 U.S.C. § 1144(d) (1985). No supersession provisions also apply to the federal RICO statute and the federal securities laws. The provision governing RICO provides: "Nothing in this title shall supersede any provision of Federal, State, or other law imposing criminal penalties or affording civil remedies in addition to those provided for in this title." Organized Crime Control Act of 1970, Pub. L. No. 91-452, § 904(b), 84 Stat. 922, 947. The provision governing the securities laws provides: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 78bb(a) (Supp. 1989).

120 *Thornton v. Evans*, 692 F.2d 1064, 1077 (7th Cir. 1982) (the fiduciary standards imposed by ERISA are enforceable in civil damage actions only against parties who are *fiduciaries* under the ERISA statute).

121 *McLaughlin v. Biasucci*, 688 F. Supp. 965, 968 (S.D.N.Y. 1988) (complaint does not state a claim against nonfiduciary attorney as a knowing participant but does state a state law claim against attorney for malpractice and negligence).

Generally, before a party can recover he must have standing to sue and must prove the elements of the offense. Even though a party may not have standing under common law, Congress can grant standing to sue. Accordingly, § 1132 of ERISA permits a civil suit to be brought by "the Secretary, or by a participant, beneficiary or fiduciary for appropriate relief under section 1109 of this title [relating to fiduciary liability]." 29 U.S.C. § 1132(a)(2) (1985). In addition to these parties, the PBGC can sue the plan sponsor or any member of the sponsor's control group—under ERISA—to recover any amount the PBGC was forced to pay to employees. See *supra* note 81 for the text of this provision of ERISA. Thus, under ERISA's express provisions, the PWBA (representing the Secretary), a participant in the plan, a beneficiary of the plan, or a plan fiduciary can bring a cause of action—under ERISA—against any fiduciary who breached his duties to the plan. Further, although not expressly addressed in ERISA, the PWBA has standing to bring suit on behalf of the plan against nonfiduciaries who knowingly participate in a breach by a fiduciary. *Donovan v. Schmuttey*, 592 F. Supp. 1361, 1390 (D. Nev. 1984) (Secretary is authorized to bring civil action under ERISA on behalf of the pension trust against certain of its trustees and against nonfiduciaries who received or benefitted from transfers of trust assets); *Donovan v. Daugherty*, 550 F. Supp. 390, 403 (S.D. Ala. 1982) (Secretary of Labor has standing to bring action under ERISA against trustees and against a nonfiduciary who was the legal counsel of the plan). While ERISA grants these parties a cause of action—under ERISA—at the same time, ERISA preempts any common law actions the plaintiffs would have against these same parties. See *supra* notes 113-19 for discussion of ERISA's preemption provision. In addition, the PBGC can sue the plan sponsor and related parties—under ERISA—to recover any amount the agency was forced to pay out.

In addition to these suits—under ERISA—an injured party could have other causes of action. For example, the plan could sue certain nonfiduciaries like its accountants (or attorneys or actuaries) for malpractice or for breach of contract. This type of suit would not be under ERISA, yet the plan has standing because it contracted with the accounting firm. Thus, if the party has standing, the party can have numerous causes of action—outside of ERISA—against parties who are nonfiduciaries.

It is not clear, however, whether the PWBA can bring suit against a nonfiduciary who is not a knowing participant in a breach by a fiduciary (the PWBA can sue a nonfiduciary who is a knowing participant; this suit would be under ERISA). The problem is that the PWBA lacks standing to bring the suit because the nonfiduciary's wrongdoing injured the plan and not the PWBA. Arguably, the PWBA should have standing against all nonfiduciaries. It is problematic that the PWBA can sue a

of ERISA's key provisions—the Act's fiduciary duty standards and its preemption provision—may not apply to nonfiduciaries.

In any case, nonfiduciaries may be accountable, under ERISA, for breaches of fiduciary duty that they help promote.<sup>122</sup> To find such liability, the nonfiduciary must act to further the breach, while possessing actual or constructive knowledge of the breach of trust.<sup>123</sup> In the leading case of *Freund v. Marshall & Illsey Bank*,<sup>124</sup> a Wisconsin district court held certain nonfiduciary relatives of the plan's trustees liable to the plan's beneficiaries. The court declared that "non-fiduciaries who knowingly participate, either directly or through an agent, in a breach of trust" could be held liable.<sup>125</sup>

Although the nonfiduciary in *Freund* had actual knowledge of the breach of trust, courts later held that constructive knowledge—or negligence by the nonfiduciary—was enough.<sup>126</sup> For example, in *Donovan v. Schmouley*,<sup>127</sup> the defendant was held liable when he and companies controlled by him acted as middlemen in an imprudent loan scheme. In imposing liability, the court found the defendants were knowing participants in the scheme. Knowing participation means the defendant committed: (1) an act or omission that furthered or completed the breach; and (2) that the defendant had either actual or constructive knowledge of the fiduciaries' breach of trust.<sup>128</sup> Constructive knowledge

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nonfiduciary who aids a fiduciary but cannot sue the same nonfiduciary who harms a plan but does so independent of the plan's fiduciaries.

Standing requirements also cloud the issue of whether the PBGC can sue nonfiduciaries. Generally, an insurer does not have standing to sue a party who injures the insured. See *United States v. Tilleraas*, 709 F.2d 1088, 1091 (6th Cir. 1983) ("[W]hen the contract is formed all legal rights and obligations flow between the insurer and the insured. At this initial stage, there is no legal obligation owing from the third party to the insurer."); *Harris v. Illinois—California Express, Inc.*, 687 F.2d 1361, 1374 (10th Cir. 1982) ("an insurer is not subrogated to a claim of its insured unless there exists an express agreement"). Thus, the PBGC, as insurer, does not generally have standing to sue a nonfiduciary whose wrongful conduct causes the insured pension plan to incur a loss. However, in certain circumstances, the PBGC can be appointed as the trustee who oversees a distressed plan. 29 U.S.C. § 1342(b)(2) (1985). As trustee, the PBGC has the power "to commence, prosecute, or defend on behalf of the plan any suit or proceeding involving the plan." *Id.* § 1342(d)(1)(B)(iv).

122 See, e.g., *Lowen v. Tower Asset Mgmt., Inc.*, 829 F.2d 1209, 1220 (2d Cir. 1987) (fact that defendant is not alleged to be a fiduciary is irrelevant because parties "who knowingly participate in fiduciary breaches may be liable under ERISA"); *Biasucci*, 688 F. Supp. at 967 (Secretary may bring claim against a nonfiduciary who knowingly participates in a fiduciary's breach); *Donovan v. Daugherty*, 550 F. Supp. 390, 411 (S.D. Ala. 1982) ("Nonfiduciaries are accountable for breaches of fiduciary duty which they help promote.").

123 In addition to imposing liability upon nonfiduciaries based on their actual or constructive knowledge of a breach of trust, courts have imposed liability on nonfiduciaries on a conspiracy theory. In *Thornton*, 692 F.2d at 1078, the Seventh Circuit announced that even though the defendant was not a fiduciary under ERISA, the plaintiff could still state a claim "on the theory that the defendants conspired with parties who are fiduciaries to breach the duties imposed by ERISA." The court concluded nonfiduciary liability was a "necessary development of the law of ERISA." *Id.* at 1079.

124 485 F. Supp. 629 (W.D. Wis. 1979).

125 *Id.* at 642.

126 This state of mind requirement—actual or constructive knowledge—is broader than the state of mind required to commit predicate acts under RICO. Predicate acts under RICO generally require that the defendant act recklessly or with actual knowledge. See *infra* notes 176-84 and accompanying text for an analysis of the state of mind required to commit a predicate act of mail or wire fraud.

127 592 F. Supp. 1361 (D. Nev. 1984).

128 *Id.* at 1396 ("no element of intent" need be proved; must show "actual or constructive knowledge").

existed because the nonfiduciary knew of the pension plan's precarious position.<sup>129</sup> In another case, a nonfiduciary was held liable when he assisted a fiduciary because the nonfiduciary should have known that the fiduciary had a duty not to profit personally from the transaction.<sup>130</sup>

Thus, determining that a party is a fiduciary is important in developing a litigation strategy for at least two reasons. First, a fiduciary is subject to the duties outlined in ERISA. These duties impose a higher standard of care upon the fiduciary than the common law duties imposed upon a nonfiduciary. Second, ERISA preempts the use of state common law remedies against the fiduciary. Thus, while the duty of a fiduciary is higher, the causes of action may be more limited.<sup>131</sup>

### C. Causation

Although the structure of a pension plan identifies the individuals likely to be responsible for pension plan failure, to be liable, the actions of the party must cause the plan to fail or lose money. Despite the causation requirement, it is axiomatic to state that the fraud or negligence of officers, directors, accountants, and attorneys actually cause pension plans to fail.<sup>132</sup> As the Seventh Circuit observed: "this case . . . traces a pattern which seems distressingly prevalent today: the savings of working men and women are pilfered, embezzled, parlayed, mismanaged and outright stolen by unscrupulous persons occupying positions of trust and confidence."<sup>133</sup>

129 *Id.* at 1398-99. As further evidence that the nonfiduciary had actual or constructive knowledge of the breach of trust, the court noted that the nonfiduciary's own financial position was precarious, the nonfiduciary knew the loan proceeds were being misapplied, the nonfiduciary made misrepresentations to the plan, and that the nonfiduciary knew the collateral securing the loans was insufficient. *Id.*

The court found these facts demonstrated "actual or constructive knowledge." Actual knowledge imparts a state of mind of intent or knowledge while constructive knowledge imparts a state of mind of negligence. These facts might also justify a finding that the defendant acted recklessly. See *infra* note 146 for a discussion of the different standards of state of mind.

130 *Brock v. Hendershott*, 840 F.2d 339, 342 (6th Cir. 1988) (nonfiduciary "knew or clearly should have known Hendershott [a fiduciary] had a duty not to profit personally through use of his union influence").

131 Even though the number of causes of action is more limited, the power of nonpreempted federal claims such as RICO can make recovery against fiduciaries as attractive as recovery against nonfiduciaries.

132 There is little data on the specific causes of pension plan failure. As part of a study on the growth in the PBGC's deficit, the General Accounting Office (GAO) reviewed 33 plans that caused 90% of the PBGC claims during fiscal years 1983-85. Generally, the GAO concluded that 70% of the claims resulted from insufficient minimum contributions to pay for the plans' rising unfunded benefits and that 30% of the claims resulted from minimum contributions not being paid at plan termination. UNITED STATES GENERAL ACCOUNTING OFFICE, PUB. NO. HRD-87-42, GOVERNMENT INSURANCE PROGRAM THREATENED BY ITS GROWING DEFICIT 12 (1987). The GAO was able to "identify several factors contributing to the increased underfunding" but was "not able to quantify the dollar effect of all of the factors." *Id.* However, the GAO concluded that each factor "contributed significantly to the underfunding of the 33 plans." *Id.* In contrast to the lack of data on the specific causes of pension plan failure, the causes for the failure of other financial institutions have been better documented. See *Insider Abuse*, *supra* note 12, at 225-29 (study by Office of Comptroller of the Currency found insider abuse was a significant factor in 35% of bank failures and fraud was a factor in 11% of such failures) (GAO study found 64% of failed banks that were examined showed evidence of insider abuse and 38% of these failed banks revealed insider fraud).

133 *Thornton v. Evans*, 692 F.2d 1064, 1065 (7th Cir. 1982).

The fraud or negligence of corporate officers and directors<sup>134</sup> are often cited as the cause of financial institution—and pension plan—fail-

134 Any attempt to hold corporate officers and directors liable raises the issue of corporate accountability. This issue must be addressed before one can decide if the entity should also be liable for the acts of its agents and corporate employees. Although high corporate officials would seem likely targets, they are often unaware of what goes on in the corporation. Related to this is the concept of "willful blindness." Willful blindness occurs when a corporate official willfully shields himself from the activities of his employees in order to protect himself from accountability for their illegal acts.

The events surrounding the E.F. Hutton brokerage firm in the 1980's is a vivid example of the seriousness and complexity of this issue. On February 10, 1982, government officials informed Hutton that it had discovered evidence that Hutton had engaged in "pinwheeling," a process whereby a company shifts uncleared bank funds from one account to another to create artificial balances. Three months later Hutton received a grand jury subpoena ordering the firm to deliver sensitive corporate documents. Eventually, Hutton struck a plea bargain and agreed to pay \$2 million in fines to the government. Because the maximum penalty for mail and wire fraud was \$1,000, Hutton in effect admitted to 2,000 counts of fraud. In an attempt to stem negative publicity, Hutton hired former Attorney General Griffin Bell to prepare an investigative report on the matter. The report exonerated Robert Fomon, Hutton's Chairman and Chief Executive Officer and George Ball, Hutton's President.

To understand the consequences of this case one must examine how Fomon and Ball ran Hutton. Griffin Bell reported it this way:

The peculiar management structure of Hutton placed no responsibility on Ball as president for finance, accounting, operations, or legal and compliance, nor did the vice-presidents of these divisions report to him. He was in effect an executive sales manager . . .

As a sales manager, he constantly exhorted the regional vice-presidents and branch managers to earn more through sales and through better interest earnings. His goal was to promote interest earning by chastising those who were below the average and thus seeing to it that the average was being constantly raised. This added to the Hutton overdraft culture. We do not find that Ball had operational responsibility to control interest improprieties or to create and supervise internal audit controls over them. Ball did have the responsibility as a senior corporate officer to report improprieties in overdrafting or gaps in accounting controls once he was put on notice. There is no substantial evidence that he was put on notice as to any gaps or lapses in accounting controls. The overdraft interest data showing aberrations did not constitute sufficient notice of overdrafting problems.

G. Bell, *The Hutton Report — A Special Investigation into the Conduct of E.F. Hutton & Company Inc. that Gave Rise to the Plea of Guilty Entered on May 2, 1985 94-95* (1985) [hereinafter *Bell Report*], reprinted in M. STEVENS, *SUDDEN DEATH: THE RISE AND FALL OF E.F. HUTTON* 199 (1989) [hereinafter *SUDDEN DEATH*].

Likewise, the Bell Report declared:

We do not hold Fomon, Chairman and Chief Executive Officer, responsible for failing to detect and terminate the improper overdrafting and other abusive practices which occurred at Hutton. Our justification is a matter of proper corporate governance. A corporate officer is, in the performance of his duty and functions, entitled to rely on the decisions, judgments, and performance of other officers and employees of the company if the officer believes that such decisions, judgments, or performance are within the professional or other competence of such officer or employee.

Bell Report, *supra*, at 171, reprinted in *SUDDEN DEATH*, *supra*, at 196. In exonerating Hutton's highest corporate officials, Bell's analysis sounded much like the leading court cases on the issue.

The leading Supreme Court case on corporate responsibility, *Briggs v. Spaulding*, 141 U.S. 132 (1891), was handed down at the end of the 19th century. Of course, this was the era of laissez-faire capitalism and caveat emptor. In *Briggs*, bank shareholders claimed that the bank's directors were liable for losses from bad loans made during the director's tenure. The Court rejected the plaintiffs arguments and outlined the duty of a director:

They [the directors] are not insurers of the fidelity of the agents whom they have appointed . . . they cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents, unless the loss is a consequence of their own neglect of duty, either for failure to supervise the business with attention or in neglecting to use proper care in the appointment of agents.

*Id.* at 147. Further, the Court ruled that directors did not have a duty to look for wrongdoing but only to act once the wrongdoing was brought to their attention. The Court stated:

If nothing has come to their knowledge, to awaken suspicion of the fidelity of the president and cashier, ordinary attention to the affairs of the institution is sufficient. If they become

acquainted with any fact calculated to put prudent men on their guard, a degree of care commensurate with the evil to be avoided is required, and a want of that care certainly makes them responsible.

*Id.* at 148. In ruling for the directors, the Court stated, "[t]he directors generally cannot know, and have not the ability or knowledge requisite to learn, by their own efforts, the true condition of the affairs of the company." *Id.* at 162-63.

The other leading case arose out of a 1961 price fixing scheme involving General Electric and 29 other contractors who together controlled 95% of the relevant electronics market. Although several middle-level managers were criminally convicted, the company presidents escaped charges by claiming that they were unaware of the practice. The presidents' word was accepted even though the middle level managers contended that price fixing in the industry was standard practice. After the criminal trials, several civil suits were brought against senior executives. In *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. 78, 82, 188 A.2d 125, 129 (1963), the court did not find senior executives liable because the plaintiffs failed to show the executives knew of the activity and failed to act. Likewise, the court concluded that management had no duty to establish a program to uncover wrongdoing unless the executives had a reason to suspect that wrongdoing was taking place. *Id.* at 85, 188 A.2d at 130.

Although the Hutton case never went to trial, it is questionable whether Fomon and Ball could meet the *Allis-Chalmers* test. The work of an investigative reporter revealed startling management practices. One individual contrasted Hutton's management with that at Merrill Lynch, another leading brokerage house:

At Merrill Lynch, systems were king. . . . There was a way of doing things, a corporate bible, that everyone followed or *else*. There was structure, clear lines of authority, and committees, committees, committees. No one was bigger than the organization and everyone, even the senior officers, worshiped it. It was a consensus style of management: you made decisions as part of a team.

Well, if there was a polar opposite of that, a wild and wooly zoo where everyone had his own agenda, that was Hutton. What rules there were meant to be broken. The corporate structure—hell, it's a joke to call it that—was more like a free-for-all. And teamwork in the Hutton culture was considered sissy stuff. The guy in charge made the decisions, and he made them by himself or he wasn't in charge for long.

SUDDEN DEATH, *supra*, at 188-89. This lack of management oversight was prevalent even at the board of directors level. A former Senior vice president stated:

Hutton's 'board of directors' was a misnomer. . . . It should have been called a 'board of protectors.' That should come as no surprise when you consider that Bob [Fomon] stacked the board with a menagerie of old buddies, bootlickers, and assorted freeloaders who wouldn't think of challenging him because he held the key to their promotions, salaries, and expense accounts. . . . Fomon's modus operandi was to work behind the scenes, cornering people in their offices, twisting their arms or whatever it took to get their support. When the board met, he would present his latest scheme as a fait accompli. No discussions. No votes.

*Id.* at 118.

In the Senate hearings on the Hutton case, Senator Biden pursued the willful blindness issue with both Ball and Bell. When Biden asked Ball if he should have known about the interest scam, Ball responded:

I do not believe so. . . . The control mechanisms were in parts of the firm that did not report to me. Now, I am not trying to lay the fault or the blame off on somebody else, but the oversights . . . did not report to me directly or indirectly. So other than by finding a needle randomly in a haystack, I do not know how I could have.

*White Collar Crime (E.F. Hutton): Hearings Before the Comm. on the Judiciary United States Senate*, 99th Cong., 2d Sess. 173 (1986) [hereinafter *Hutton Hearings*]. Senator Biden described the situation this way:

[Management] says that, hey, we are going to base you, the branch manager's income on your ability to increase profits. We do not care how you do it; do not let me know. Basically that is the message. . . . [Then] you have the plausible denial defense that is one which, in my view, does more to undermine the legal system and the confidence of the American people in their Government and their major institutions.

*Id.* at 174. Biden later confronted Bell with the text of the "willful blindness" instruction: "[t]he element of knowledge may be satisfied by inferences drawn from proof that a defendant deliberately closed his eyes to what would have otherwise have been obvious to him." *Id.* at 316-17. Willful blindness is like the piano player in the house of prostitution saying he did not understand what was going on upstairs. *Id.* at 317. Or like the manager who told his employees they had to meet targets

that the manager had reason to know they could not possibly meet without engaging in excessive illegal overdrafts. *Id.*

The law of "willful blindness" is well established. Where knowledge of an element of an offense is required, "such knowledge is established if a person is aware of a high probability of its existence, unless he actually believes that it does not exist." *Turner v. United States*, 396 U.S. 398, 416 n.29 (1970). Consequently, no one is "entitled" to "practice a studied ignorance." *Id.* at 417 (citing *Griego v. United States*, 298 F.2d 845, 849 (10th Cir. 1962) (citing *Spurr v. United States*, 174 U.S. 728, 735 (1899) ("evil design" may be inferred if one "purposely keeps himself in ignorance" or is "grossly indifferent to his duty in respect to the ascertainment of [the] fact")); *United States v. Glick*, 710 F.2d 639, 642 (10th Cir. 1983) (willful ignorance sufficient for responsibility in fraudulent scheme) ("either knew it or deliberately avoided acquiring positive knowledge"), *cert. denied*, 465 U.S. 1005 (1984). *See also* *United States v. Reed*, 790 F.2d 208, 211 (2d Cir.) (conscious avoidance instruction proper for international aspect of conspiracy), *cert. denied*, 479 U.S. 954 (1986); *United States v. Nicholson*, 677 F.2d 706, 710-11 (9th Cir. 1982) (conscious avoidance instruction proper for case investor with high return in "business" that was a drug conspiracy) ("defendant was aware of a high probability that his money would be used to further illegal activities and . . . he deliberately avoided finding out the facts").

However, the courts of appeals are split in determining the weight to be given to evidence of willful blindness. The majority hold that either knowledge or deliberate avoidance must be shown. *See Second Circuit:* *United States v. Aulet*, 618 F.2d 182, 190-91 (2d Cir. 1980); *United States v. Dozier*, 522 F.2d 224, 226-27 (2d Cir.), *cert. denied*, 423 U.S. 1021 (1975); *Third Circuit:* *United States v. General Motors Corp.*, 226 F.2d 745, 749 (3d Cir. 1955); *United States v. Erie R. Co.*, 222 F.444, 450 (D.N.J. 1915); *Fifth Circuit:* *United States v. Restrepo-Granda*, 575 F.2d 524, 528-29 (5th Cir.), *cert. denied*, 439 U.S. 935 (1978); *Sixth Circuit:* *United States v. Thomas*, 484 F.2d 909, 912-14 (6th Cir.), *cert. denied*, 414 U.S. 912 (1973); *Seventh Circuit:* *United States v. Kehm*, 799 F.2d 354, 362 (7th Cir. 1986); *United States v. Josefik*, 753 F.2d 585, 589 (7th Cir.), *cert. denied*, 471 U.S. 1055 (1985); *Ninth Circuit:* *United States v. Eaglin*, 571 F.2d 1069, 1074-75 (9th Cir. 1977), *cert. denied*, 435 U.S. 906 (1978); *United States v. Murrieta-Bejarano*, 552 F.2d 1323, 1324-25 (9th Cir. 1977); *United States v. Jewell*, 532 F.2d 697, 700-04 (9th Cir.), *cert. denied*, 426 U.S. 951 (1976); *Tenth Circuit:* *United States v. Glick*, 710 F.2d 639 (10th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984); *Eleventh Circuit:* *United States v. Gold*, 743 F.2d 800, 821-22 (11th Cir. 1984), *cert. denied*, 469 U.S. 1217 (1985). *But see* *United States v. Knight*, 705 F.2d 432, 434 (11th Cir. 1983) (though citing Ninth Circuit cases as general support, court states that knowledge "can only be inferred by referring to that defendant's subjective views of what was obvious to him had he not closed his eyes. . .").

A minority of courts hold that willful blindness is merely circumstantial evidence of knowledge. *See Fourth Circuit:* *United States v. Biggs*, 761 F.2d 184, 188 (4th Cir. 1985); *Eighth Circuit:* *United States v. Massa*, 740 F.2d 629, 642-43 (8th Cir. 1984), *cert. denied*, 471 U.S. 1115 (1985); *United States v. Graham*, 739 F.2d 351, 352-53 (8th Cir. 1984); *United States v. Kershman*, 555 F.2d 198, 200-01 (8th Cir.), *cert. denied*, 434 U.S. 892 (1977). Although the Eighth Circuit follows the minority rule, each of these decisions from the Eighth Circuit cites as persuasive authority cases following the majority rule. Apparently, the court does not feel the distinction between the minority and majority rules is of great significance. *District of Columbia Circuit:* *United States v. Gallo*, 543 F.2d 361, 367 (D.C. Cir. 1976) (evidence of willful ignorance may be considered as part of the proof of requisite knowledge). *See also* *Royal Netherlands Steamship Co. v. Federal Maritime Bd.*, 304 F.2d 938, 942 (D.C. Cir. 1962) (evidence insufficient to warrant finding that defendant willfully avoided discovery of facts). The First Circuit is on both sides of the fence. *Compare* *United States v. Cincotta*, 689 F.2d 238, 243 n.2 (1st Cir.) ("Evidence of conscious avoidance is merely circumstantial evidence of knowledge. . ."), *cert. denied*, 459 U.S. 991 (1982) with *United States v. Brien*, 617 F.2d 299, 312 (1st Cir.) ("[C]onscious avoidance is merely a subset of specific intent. . . . If by such conduct one participates in a scheme to defraud, that person is as guilty of violating the mail fraud statutes as a person who is conscious of the nature of his statements."), *cert. denied*, 446 U.S. 919 (1980). *See also* *United States v. Krown*, 809 F.2d 144, 150 (1st Cir. 1987) ("proving knowledge by means of willful blindness").

Given the numerous instances of fraud and misconduct in corporate America today, it is difficult to justify a continuation of the rationale advanced in *Briggs* and *Allis Chalmers*. As Senator Biden remarked:

We can learn from the past if only we will take the time to reflect on it. Recent white collar crime investigations and prosecutions by the Department of Justice have involved such major corporations as General Electric, E.F. Hutton and Company, General Dynamics, G.T.E., Rockwell International, Eli Lilly and Company, and Smith/Kline Beckmann Corporation. Whatever else we may conclude about the problem of white collar crime . . . that list of corporate superstars leaves no room to doubt that white collar crime is a problem that urgently demands our attention, a problem that will challenge our capacity for reflection and our willingness to act.

ure.<sup>135</sup> However, recent evidence increasingly points to accountants and attorneys as causes of pension fund losses.<sup>136</sup> For example, the General

Biden, *The Challenge of Institutional Responsibility*, 23 AM. CRIM. L. REV. 243, 243 (1986). Long ago, Saint Thomas Aquinas recognized that proper governance demands that all laws and rules flow from the direction and command of the first mover:

[L]aw denotes a kind of plan directing acts towards an end. Now wherever there are movers ordained to one another, the power of the second mover must needs be derived from the power of the first mover; since the second mover does not move except in so far as it is moved by the first. Wherefore we observe the same in all those who govern, so that the plan of government is derived by secondary governors from the governor in chief: thus the plan of what is to be done in a state flows from the king's command to his inferior administrators; and again in things of art the plan of whatever is to be done by art flows from the chief craftsman to the undercraftsmen who work with their hands.

T. AQUINAS, *TREATISE ON LAW (Summa Theologica, Questions 90-97)* 43-44 (Gateway ed. 1988).

In addition to the fact that white collar crime is prevalent in corporate America, corporations now have the means to detect such misconduct through internal control systems. See Anderson & Stier, *What You Don't Know Can Hurt You: The Case for 'Special Counsel' Investigations*, 29 CAL. MGMT. REV. 77 (1987); R. ELLIOTT & J. WILLINGHAM, *MANAGEMENT FRAUD: DETECTION AND DETERRENCE* 47-57 (1980) (outlining controls top management can use to detect and deter management fraud). One commentator stated the issue this way: "Business people . . . cannot deny that today's diet of corruption stories is corroding the public's respect for business—and probably business' own self-respect. The business community must start to project a more rigorous ethic." Editorial, *BUS. WK.* 84 (July 29, 1985). Just as police departments have internal affairs departments to investigate misconduct among police officers, it is time for corporations as well as pension and other funds to institute programs to look for fraud and misconduct within their businesses or other spheres of activity. The George Balls and Robert Fomons of the world should no longer be able to sit back and assume that their corporation or related funds and their employees are immune from the temptations that have so often resulted in insider misconduct and fraud.

135 See *supra* note 132.

136 Traditionally, the role of the independent public accountant in society has not been well-defined. Simply stated, the uncertainty has been whether accountants should merely count numbers or actively look for fraud.

Early on the auditor's concern with fraud was clearly expressed. In Dicksee's book on auditing, which was published in 1898, the object of an audit was said to be the detection of fraud, the detection of technical errors, and the detection of errors of principle. L. DICKSEE, *AUDITING: A PRACTICAL MANUAL FOR AUDITORS* 8 (3d ed., rev. and enl. 1898). However, since the nineteenth century, "[t]he straightforward recognition . . . of the detection of fraud as an object of an audit has been steadily eroded." THE COMMISSION ON AUDITORS' RESPONSIBILITIES: REPORT, CONCLUSIONS, AND RECOMMENDATIONS 33 (1978) (M. Cohen, Chairman) [hereinafter COHEN REPORT]. To illustrate, according to the American Institute of Certified Public Accountants (AICPA):

The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.

CODIFICATION OF ACCOUNTING STANDARDS & PROCEDURES, Statement on Auditing Standards No. 1, § 110.01 (Am. Inst. of Certified Pub. Accountants 1972). Notably absent from this standard is any discussion of fraud. Despite efforts by auditors to downgrade the importance of fraud detection, all segments of the public consider the detection of fraud as a necessary and important objective of an audit. COHEN REPORT, *supra*, at 2. Users expect the auditor to be concerned with the possibility of both fraud and illegal behavior by management. *Id.* One commentator reasoned:

The problem is, most of the users of financial statements—the investing public—have been led to believe that the auditor's signature on an annual report means the books are a totally accurate reflection of the corporation's financial status. At the very least, they are confident that a Big Eight stamp of approval means the company has been investigated for fraud and that it has been found free of any trace of wrongdoing. How shocked the 'little old widow' would be to find that auditors point to fraud as one of the factors they provide little insurance against.

M. STEVENS, *THE BIG EIGHT* 98 (1981).

As a result of increased pressure by financial statement users and within the profession itself, by the 1960's auditing literature was modified to acknowledge that an auditor must be aware of the possibility that fraud may exist. REPORT OF THE NAT'L COMM'N ON FRAUDULENT FIN. REPORTING 46 (Exposure Draft 1987) [hereinafter NATIONAL COMMISSION REPORT]. However, even within this acknowledgement, auditing literature made clear that the auditor's responsibility for fraud detection

## Accounting Office found that one in five pension plans examined by the Department of Labor or the Internal Revenue Service are cited for viola-

was quite limited and that financial statement users should not rely on the audit for assurance of detection. *Id.*

With the advent of the Cohen Commission Report, which was published in 1978, the accounting industry faced increased pressure to focus on fraud. The Commission unequivocally concluded that "the independent auditor should be expected to detect those illegal or questionable acts that the exercise of professional skill and care would normally uncover." COHEN REPORT, *supra*, at 47. A Congressional Committee studying auditor accountability reached similar conclusions: "[T]he subcommittee believes it is timely for the public and the accounting profession to reassess the role which independent auditors should play in making the Nation's economic system function effectively." *Improving the Accountability of Publicly Owned Corporations and Their Auditors: Report of the Subcomm. on Reports, Accounting and Management of the Comm. on Governmental Affairs United States Senate*, 95th Cong., 1st Sess. 5 (1977) [hereinafter *Senate Report*]. The Senate analogized the role of the auditor to that of a sports umpire:

Like the umpire, an auditor must perform his or her responsibilities in a manner which assures all interested parties that the opinion given is competent and unbiased. The independent auditor provides that assurance by applying standards established fairly, by forming an opinion using professional expertise and judgment, and by strictly maintaining his or her independence.

*Id.* at 7. The Senate concluded that "potential legal liability for negligence is the most effective mechanism for assuring that independent auditors perform their public responsibilities competently and diligently." *Id.* at 19.

The clamor for increasing the auditor's responsibility for detecting fraud reached new heights in the 1980's. In his report on the E.F. Hutton scandal, see *supra* note 134 for a discussion of this scandal, Griffin Bell recommended that "Hutton employ its independent accountants to review the adequacy of Hutton's system of internal accounting controls." *Hutton Hearings*, *supra* note 134, at 287. In response to this finding, the Senate's analysis of the Bell Report concluded that: "This kind of review is supposed to be at the essence of any thorough financial audit. It is remarkable that Arthur Andersen has not conducted such reviews in the past, or at least required that Hutton's internal audit department do so before AA signed off on the financial statements." *Id.* Despite the outrage expressed in the Senate's analysis, Arthur Andersen had told Bell that such a review was not part of their financial audit because they were not required under general auditing standards to conduct such a review. *Id.*

The National Commission on Fraudulent Financial Reporting concluded that: Generally Accepted Auditing Standards (GAAS) should be changed first to recognize better the independent public accountant's responsibility for detecting fraudulent financial reporting. The standards should restate this responsibility to require the independent public accountant to take affirmative steps to assess the potential for fraudulent financial reporting and design tests to provide reasonable assurance of detection.

NATIONAL COMMISSION REPORT, *supra*, at 8-9. Clearly, accountants have the ability to detect fraud. See R. ELLIOTT & J. WILLINGHAM, *MANAGEMENT FRAUD: DETECTION AND DETERRENCE* 35-46 (1980) (outlining new audit methods to detect and deter management fraud).

In addition to the Hutton matter, poor accounting audits have been cited as a catalyst for the savings and loan crisis. See Berton, *Spotlight on Arthur Young Is Likely To Intensify as Lincoln Hearings Resume*, Wall St. J., at A18, col. 1 (Congress to focus on Arthur Young accounting firm in investigation of the \$2.5 billion failure of the Lincoln Savings & Loan Association); Wayne, *Where Were the Accountants?*, N.Y. Times, Mar. 12, 1989, § 3 (Business), at 1, col. 2 (reporting that accountants have come under attack as the search for culprits in the savings and loan crisis widens); Wayne, *Showdown At 'Gunsbelt' Savings*, N.Y. Times, Mar. 12, 1989, § 3 (Business), at 1, col. 2 (reporting that after a huge bailout of the Sunbelt Savings Association, the government is pointing the finger at auditor Grant Thornton). The General Accounting Office concluded that "[p]roperly performed audits play a key role in the S&L industry" and that "[i]ndependent audits are an integral part of the system of controls designed to identify and report problems in S&Ls." UNITED STATES GENERAL ACCOUNTING OFFICE, PUB. NO. AFMD-89-45, *CPA AUDIT QUALITY: FAILURES OF CPA AUDITS TO IDENTIFY AND REPORT SIGNIFICANT SAVINGS AND LOAN PROBLEMS* 2 (1989). The Assistant Comptroller General reported that "[w]hile audit problems do not cause S&L failures, audits do play an important role in the regulatory and oversight process." UNITED STATES GENERAL ACCOUNTING OFFICE, PUB. NO. AFMD-89-2, *THE NEED TO IMPROVE AUDITING IN THE SAVINGS AND LOAN INDUSTRY* 2 (1989).

Despite the recognized importance of S&L audits, the GAO revealed five major reporting problems. First, in some cases the auditors did not report that their S&L clients had materially misstated their income. *Id.* at 5. Second, the auditors failed to report serious regulatory violations. *Id.* at 6. Third, extensive amounts in loans to shareholders or other insiders went undisclosed. *Id.*



tions.<sup>137</sup> Most of these plans are assailed for prohibited or imprudent transactions.<sup>138</sup> Congressman Conyers of Michigan finds auditors "too often [are] not fulfilling their duties" under ERISA's mandatory reporting system.<sup>139</sup> The auditors "all too often, do not perform the necessary testing" and many reports "fail to contain one or more of the [required] disclosures."<sup>140</sup> In a suit by the PWBA on behalf of the plan, the PWBA can establish proximate cause by demonstrating that the plan relied on the accountant's work product and suffered injury as a result.<sup>141</sup> The

Fourth, the inherent risk of high concentrations of loan activity in certain areas were not fully disclosed. *Id.* Finally, auditors often did not report material internal control problems even though the auditors were aware that they existed. *Id.* at 6-7.

Similar problems plague audits of pension plans. In a recent report, the Department of Labor declared that "[l]imited scope reviews, under ERISA, although classified as audits, do not adequately test the employee benefit plan assets." OIG REPORT, *supra* note 1, at 1. The report cited four reasons why the audit reports "are not useful for enforcement purposes:"

1. ERISA violations are rarely identified;
2. Known ERISA violations are inadequately disclosed;
3. IPA-prepared reports cannot be relied upon to meet ERISA requirements and AICPA guidelines; and
4. The IPA prepared reports are too untimely to be useful because they are provided to the DOL about 2 years after the end of the plan year.

*Id.* at 2. In light of these deficiencies the study concluded that "[the reports] are of little value and give no assurance of asset integrity to benefit plan participants." *Id.* at 1.

Perhaps in response to these criticisms, the AICPA recently clarified and expanded the auditor's duty to detect mistakes and wrongdoing. The new standards apply to audits beginning on or after January 1, 1989. These standards classify mistakes and wrongdoing into three categories: (1) the term "errors" which refers to "unintentional misstatements or omissions of amounts or disclosures in financial statements," (2) the term "irregularities" which refers to "intentional misstatements or omissions of amounts or disclosures in financial statements," and (3) the term "illegal acts" which refers to "violations of laws or governmental regulations." CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, Statement on Auditing Standards No. 53, § 316 (Am. Inst. of Certified Pub. Accountants 1989) and *id.* No. 54, § 317.

With respect to errors and irregularities, the auditor "should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements." *Id.* No. 53, § 316. In addition, the auditor should exercise "the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected." *Id.* The exercise of professional skepticism requires that: "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, the auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine whether the financial statements are free of material misstatement." *Id.* With respect to illegal acts:

The auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

*Id.* No. 54, § 317. These changes more clearly define the auditor's duty to detect mistakes and wrongdoing. Although the changes do not represent a return to the stringent standards of the 19th century, the new standards do represent a reversal of the recent trend and are a step towards increasing the auditor's duty to detect fraud.

Not everyone agrees that the increased focus on auditor accountability is an efficient way to allocate risk. For a discussion of why auditors may be one of "the worst conceivable candidates for the role of risk-spreader," see Lawson & Olson, *Caveat Auditor: The Rise of Accountants' Liability*, CIV. JUSTICE MEMO No. 16 (July 10, 1989).

<sup>137</sup> UNITED STATES GENERAL ACCOUNTING OFFICE, PUB. NO. HRD-89-32, LABOR AND IRS ENFORCEMENT OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT 10 (1989).

<sup>138</sup> *Id.* at 11.

<sup>139</sup> 134 CONG. REC. H1072 (daily ed. Mar. 22, 1988) (statement of Rep. Conyers).

<sup>140</sup> *Id.* at H1073.

<sup>141</sup> In contrast to the PWBA's suit which would be on behalf of the plan, the PBGC's cause of action would be in its own right to recover for the benefits it was forced to pay out. Although ERISA

expressly permits the PBGC to sue the plan sponsors, the PBGC may have been injured by other parties such as the accountants, who audited the plan, or the attorneys, who set up the plan. To recover in these cases, the PBGC would have to show that it relied on the work of the accountant or attorney. In addition to proving reliance, the PBGC would have a problem with privity of contract, because it was the plan—and not the PBGC—who employed the accountant or attorney. Privity is a problem because although the accountant is liable to his corporate client, courts have historically refused to allow third parties to sue accountants for negligence. In these cases, the third party's cause of action is limited to fraud.

Often described as the "seminal" case on accountant liability, *see, e.g., Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 545, 483 N.E.2d 110, 114, 493 N.Y.S.2d 435, 439 (1985), *Ultramares Corp. v. Touche*, 255 N.Y. 170, 189, 174 N.E. 441, 448 (1931), held that "the ensuing liability for [an accountant's] negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made." In refusing to allow a third party who relied on allegedly negligently-prepared financial statements to sue the accountants for negligence, the court was concerned such suits could "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminable class." *Id.* at 179, 174 N.E. at 444. The court found the "hazards of a business conducted on these terms" would be "extreme." *Id.* at 179-80, 174 N.E. at 444.

Although courts in New York, *see Credit Alliance*, 65 N.Y.2d at 553, 483 N.E.2d at 119, 493 N.Y.S.2d at 444 (referring to *Ultramares* and approving of cases "consonant with the principles reaffirmed in this decision"), and Indiana, *see Toro Co. v. Krouse, Kern & Co., Inc.*, 644 F. Supp. 986, 994 (N.D. Ind. 1986) ("This court holds that Indiana would continue to adhere to the 'privity or near-privity' standard as set forth in *Ultramares*."), *aff'd*, 827 F.2d 155 (7th Cir. 1987), have recently affirmed adherence to *Ultramares*, a California court announced that "*Ultramares* is no longer viable, for the role of the accountant in our modern society has changed." *International Mortgage Co. v. John P. Butler Accountancy*, 177 Cal. App. 3d 806, 819-20, 223 Cal. Rptr. 218, 226 (Cal. Ct. App. 1986). In further rebuking *Ultramares*, this court declared, "accounting firms should no longer be permitted to hide within the citadel of privity and avoid liability for their malpractice." *Id.* at 819, 223 Cal. Rptr. at 226.

The driving force behind reform in the privity rule is that such change "may cause accounting firms to engage in more thorough reviews . . . setting up stricter standards and applying closer supervision, which should tend to reduce the number of instances in which liability would ensue." *Rosenblum v. Adler*, 93 N.J. 324, 350, 461 A.2d 138, 152 (1983).

The jurisdictions no longer following *Ultramares* focus on foreseeability not privity. *See Bradford Sec. Processing Servs., Inc. v. Plaza Bank & Trust*, 653 P.2d 188, 190-91 (Okla. 1982) ("[W]e hold that while the apprehensions expressed in *Ultramares* may or may not be a telling argument as to whether the harm to a particular plaintiff was *foreseeable* to the defendant, their significance is relegated to foreseeability as it relates to proximate cause and must be considered only in that light."); *Rosenblum*, 93 N.J. at 352, 461 A.2d at 153 (The independent auditor "has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes."). These courts impose one of two standards. One alternative is the rule set out in § 552 of the *Restatement (Second) of Torts*. The *Restatement* provides:

- (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
- (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered
  - (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
  - (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.
- (3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.

RESTATEMENT (SECOND) OF TORTS § 552 (1977). This standard extends the duty of an accountant to those the accountant "intends" or "knows" will receive the information. Under this test, "if the auditor knows that the report is to be prepared for bank borrowings, then his duty would run to the bank to whom the company delivered the opinion." *Rosenblum*, 93 N.J. at 333, 461 A.2d at 142. The

other alternative holds that "an independent auditor owes a duty of care to reasonably foreseeable plaintiffs who rely on negligently prepared and issued unqualified audited financial statements." *International Mortgage Co.*, 177 Cal. App. 3d at 820, 223 Cal. Rptr. at 227. See also *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361, 362 (1983) ("We conclude that an accountant may be held liable to a third party not in privity for the negligent preparation of an audit report."). Thus, one alternative requires that the accountant "actually foresee" the third party use while the other alternative merely requires that the use be "reasonably foreseeable."

Under either of these two theories, the PBGC could have a cause of action against the accountants who audited a failed pension plan. Since ERISA requires every employer to hire an accountant to audit the plan in accord with a prescribed format, the PBGC can establish the accountant "knew" the PBGC would rely upon the statements to assess the health of the pension plan. To illustrate, in the context of an examination by a state insurance commissioner, the accountant's "actual knowledge that the commissioner was relying on these representations renders them liable for their negligence in making them." *Bonhiver v. Graff*, 311 Minn. 111, 121, 248 N.W.2d 291, 298 (1976). At a minimum, it would be reasonably foreseeable for the accountant to expect the PBGC to rely on a financial statement that is prepared specifically for pension plan regulators.

In contrast to negligence suits, lack of privity has never barred suits alleging fraudulent misrepresentation or reckless misstatements by accountants. Even in *Ultramares*, Judge Cardozo declared "[o]ur holding does not emancipate accountants from the consequences of fraud." *Ultramares*, 255 N.Y. at 189, 174 N.E. at 448. Thus, accountants are liable to third parties for their fraud. For example, in *Merit Ins. Co. v. Colao*, 603 F.2d 654 (7th Cir. 1979), cert. denied, 445 U.S. 929 (1980), a senior accountant presented three drafts of financial statements to the company president. Each time the president expressed dissatisfaction with the figures. In response, the senior accountant revised the figures. *Id.* at 657. Although the accountants also discovered a variety of other irregularities, including the existence of two sets of books, the firm produced statements reflecting a substantial net worth and high operating income. *Id.* at 658. On these facts, the court found that the company had successfully set out a prima facie case of fraudulent misrepresentation. *Id.*

Like accountants, attorneys have traditionally benefitted from the privity rule. Long ago, the Supreme Court declared: "[b]eyond all doubt, the general rule is that the obligation of an attorney is to his client and not to a third party." *Savings Bank v. Ward*, 100 U.S. 195, 200 (1879). See *Clagett v. Dacy*, 47 Md. App. 23, 420 A.2d 1285 (Md. Ct. Spec. App. 1980) (refusing to hold attorneys liable to buyers when seller's attorneys failed to follow proper procedures forcing buyer's purchase to be set aside).

Due to the special nature of the attorney-client relationship, the privity requirement for attorney negligence has held up better than for accountant negligence. One commentator proclaimed: "A review of cases decided during the 1980s demonstrates that it [the privity requirement] is not only alive but very well and will be enforced in many situations." O'Neill, *Privity Defense in Legal Malpractice Cases: The Citadel Still Stands*, 54 DEF. COUNS. J. 511, 511 (1987). To the contrary, another scholar observed:

There is an abundance of authority for the proposition that, generally, only the client can sue the attorney for a negligent act or omission, and its corollary, that the attorney owes no duty to a person other than the client. Relying upon annotations and commentators, some courts have stated that a strict privity requirement is the majority rule. Such comments may reflect the holdings and dictum of the majority of the decisions under particular facts, but do not accurately characterize the state of the law in the United States.

R. MALLEN & J. SMITH, *LEGAL MALPRACTICE* § 7.10 (3d ed. 1989).

In requiring strict privity in a securities case, the California Supreme Court explained its rationale:

To make an attorney liable for negligent confidential advice not only to the client who enters into a transaction in reliance upon the advice but also to the other parties to the transaction with whom the client deals at arm's length would inject undesirable self-protective reservations into the attorney's counselling role. The attorney's preoccupation or concern with the possibility of claims based on mere negligence (as distinct from fraud or malice) by any with whom his client might deal 'would prevent him from devoting his entire energies to his client's interests.' The result would be both 'an undue burden on the profession' and a diminution in the quality of the legal services received by the client.

*Goodman v. Kennedy*, 18 Cal. 3d 335, 344, 556 P.2d 737, 743, 134 Cal Rptr. 375, 381 (1976) (denying liability because the defendant had no relationship to plaintiffs that would give rise to his owing plaintiffs any duty of care).

The degree of survival of the privity rule varies from state to state. See Note, *Extending Legal Malpractice Liability to Nonclients: The Washington Supreme Court Considers the Privity Requirement*—Bowman v. John Doe Two, 104 Wn. 2d 181, 704 P.2d 140 (1985), 61 WASH. L. REV. 761, 761-65 (1986) (detailing caselaw from states that have extended attorney liability to third parties on a variety of

government need not prove the accountant's negligence was the sole factor in causing the harm, but only that it was a substantial factor.<sup>142</sup>

theories). Although the general rule is that an attorney is not liable to third parties, the "rule is not without exceptions." *Auric v. Continental Casualty Co.*, 111 Wis. 2d 507, 331 N.W.2d 325, 328 (1983) (holding an attorney liable to a will beneficiary not in privity for the attorney's negligence in supervising the execution of a will). Most of the cases dispensing with privity hold attorneys liable to beneficiaries of negligently-prepared wills. The leading case in this area is *Lucas v. Hamm*, 56 Cal. 2d 583, 588-89, 364 P.2d 685, 687-88, 15 Cal. Rptr. 821, 823-24 (1961) (denying liability but indicating that the rule announced in *Biakanja* would be applied to attorneys), *cert. denied*, 368 U.S. 987 (1962). See also *Biakanja v. Irving*, 49 Cal. 2d 647, 651, 320 P.2d 16, 19 (1958) (holding notary public acting as an attorney liable to third party for negligence in preparing a will); *Licata v. Spector*, 26 Conn. Supp. 378, 383, 225 A.2d 28, 31 (Conn. Super. Ct. 1966); *Auric*, 331 N.W.2d at 327 ("We conclude that the beneficiary of a will may maintain an action against an attorney who negligently drafted or supervised the execution of the will even though the beneficiary is not in privity with that attorney.").

Since the California Supreme Court decided *Lucas* in 1961, many courts in other jurisdictions have followed *Lucas* and dispensed with the privity requirement. See, e.g., *Rathblott v. Levin*, 697 F. Supp. 817, 820 (D.N.J. 1988); *Wisdom v. Neal*, 568 F. Supp. 4, 8 (D.N.M. 1982); *Fickett v. Superior Court*, 27 Ariz. App. 793, 558 P.2d 988, 990 (Ariz. Ct. App. 1976); *Stowe v. Smith*, 184 Conn. 194, 196-97, 441 A.2d 81, 82-83 (1981) (contract cause of action; intended beneficiary); *Licata*, 26 Conn. Supp. at 383, 225 A.2d at 31; *Needham v. Hamilton*, 459 A.2d 1060, 1062 (D.C. 1983) (contract cause of action; intended beneficiary); *Lorraine v. Grover, Ciment, Weinstein & Stauber, P.A.*, 467 So. 2d 315, 317 (Fla. Dist. Ct. App. 1985); *McAbee v. Edwards*, 340 So. 2d 1167, 1168-70 (Fla. Dist. Ct. App. 1976); *McLane v. Russell*, 159 Ill. App. 3d 429, 432-33, 512 N.E.2d 366, 369 (1987), *aff'd*, 1989 WL 110884 (1989); *Ogle v. Fuiten*, 112 Ill. App. 3d 1048, 1053, 445 N.E.2d 1344, 1346 (1983), *aff'd*, 102 Ill. 2d 356, 466 N.E.2d 224 (1984); *Walker v. Lawson*, 526 N.E.2d 968, 968 (Ind. 1988) ("action will lie by a beneficiary under a will against the attorney" because the "beneficiary is a known third party"); *Succession of Killingsworth*, 292 So. 2d 536, 541-42 (La. 1973); *Flaherty v. Weinberg*, 303 Md. 115, 492 A.2d 618, 625 (1985); *Jenkins v. Wheeler*, 69 N.C. App. 140, 143, 316 S.E.2d 354, 356-57 ("North Carolina now recognizes a cause of action in tort by non-client third parties for attorney malpractice"), *reh'g denied*, 311 N.C. 758, 321 S.E.2d 136 (1984); *Albright v. Burns*, 206 N.J. Super. 625, 633, 503 A.2d 386, 389 (N.J. Super. Ct. App. Div. 1986) ("privity should not be required between the attorney and one harmed by his breach of duty where the attorney had reason to foresee the specific harm which occurred"); *Stewart v. Sbarro*, 142 N.J. Super. 581, 593, 362 A.2d 581, 588 (N.J. Super. Ct. App. Div. 1976); *Jaramillo v. Hood*, 93 N.M. 433, 601 P.2d 66, 67 (1979); *Hale v. Groce*, 304 Or. 281, 744 P.2d 1289, 1292 (1987); *Guy v. Liederbach*, 501 Pa. 47, 51, 459 A.2d 744, 746 (1983); *Persche v. Jones*, 387 N.W.2d 32, 36 (S.D. 1986) (suit against bank and bank president who drafted will for customer); *Ward v. Arnold*, 52 Wash. 2d 581, 328 P.2d 164, 166 (1958).

The only states continuing to follow the privity rule are Nebraska, see *Lilyhorn v. Dier*, 214 Neb. 728, 335 N.W.2d 554, 555 (1983); *St. Mary's Church of Schuyler v. Tomek*, 212 Neb. 728, 325 N.W.2d 164, 165 (1982), New York, see *Victor v. Goldman*, 74 Misc. 2d 685, 685, 344 N.Y.S.2d 672, 674 (N.Y. Sup. Ct. 1973), *aff'd*, 43 A.D.2d 1021, 351 N.Y.S.2d 956 (N.Y. App. Div. 1974), Ohio, see *Simon v. Zipperstein*, 32 Ohio St. 3d 74, 512 N.E.2d 636, 638 (1987) (except for cases involving fraud, collusion, malice, or bad faith), and Texas, see *Berry v. Dodson, Nunley & Taylor, P.C.*, 717 S.W.2d 716, 718 (Tex. Ct. App. 1986), *set aside*, 729 S.W.2d 690 (1987).

Several of the cases that dispense with privity actions allow suit in either tort or contract. See, e.g., *Wisdom*, 568 F. Supp. at 7-8; *Lorraine*, 467 So. 2d at 317; *Ogle*, 112 Ill. App. 3d at 1052-53, 445 N.E.2d at 1347-48; *Flaherty*, 492 A.2d at 625; *Hale*, 744 P.2d at 1292; *Auric*, 331 N.W.2d at 327, 330. In these cases, courts recognize that the attorney's services were intended to benefit the legatees. The rationale for loosening the reins of privity is to "make attorneys more careful in the execution of their responsibilities to their clients." *Id.* at 328.

The negatives of expanding attorney malpractice cases include: insurance rate increases, limits on coverage, and instances in which lawyers are unable to obtain malpractice coverage. See *Moss, Going Bare*, 73 A.B.A.J. 82 (Dec. 1, 1987); *Lynch, The Insurance Panic for Lawyers*, 72 A.B.A.J. 43 (July 1, 1986); *Stern, Reducing Your Malpractice Risk*, 72 A.B.A.J. 52 (June 1, 1986); *Marcotte, Suing Lawyers*, 72 A.B.A.J. 25 (Apr. 1, 1986) (citing statistics on malpractice cases).

As with accountant malpractice, even courts that adhere to the strict privity requirement hold that such a limitation does not apply to an attorney's liability for fraud. See, e.g., *Goodman*, 18 Cal. 3d at 346, 556 P.2d at 745, 134 Cal Rptr. at 383 ("The limitations upon liability for negligence based upon the scope of an attorney's duty of care do not apply to liability for fraud").

142 134 CONG. REC. H1073 (daily ed. Mar. 22, 1988) (statement of Rep. Conyers).

Attorneys too are facing charges of professional negligence for their role in counseling failed institutions.<sup>143</sup> Even before the recent surge in negligence cases, attorneys were among those embezzling pension assets.<sup>144</sup>

### III. Causes of Action Other Than ERISA

Although ERISA preempts the use of state common law against fiduciaries, the PWBA can sue fiduciaries under federal laws other than ERISA. In addition, in appropriate cases, the plan itself or the PBGC, as trustee of a distressed plan, can bring suit against nonfiduciaries under state common law or under federal laws other than ERISA. The best cause of action to pursue under state or federal law depends on the state of mind of the actor and whether the actor committed an isolated wrong or was involved in a pattern of activity, among other factors.<sup>145</sup>

#### A. *State of Mind of the Actor*

The most effective cause of action to bring against an officer or director of the employer or the employer's accountant or attorney will depend on the state of mind of the actor—that is, did the individual act negligently, recklessly, or with intent to do wrong.<sup>146</sup> In civil cases that

<sup>143</sup> See Green, *Alleging Negligence, The FSLIC Is Suing Many of the Attorneys for Failed Thrifts*, Wall St. J., Mar. 16, 1989, at B1, col. 3.

<sup>144</sup> See, e.g., *United States v. Andreen*, 628 F.2d 1236, 1245-49 (9th Cir. 1980) (upholding the conviction of an attorney who helped embezzle over \$5,000,000 from pension trust funds).

<sup>145</sup> The other factors include an evaluation of what can be recovered under each cause of action and what limitations apply to each cause of action. See *infra* notes 243-87 and accompanying text discussing what can be recovered and see *infra* notes 288-380 and accompanying text discussing what limitations apply.

The choice of a cause of action will affect whether the suit will be heard in federal or state court. When the PWBA or the PBGC sues under ERISA, the federal courts have exclusive jurisdiction. 29 U.S.C. § 1132(e)(1) (1985) (except for actions by a participant or a beneficiary to recover benefits due to him, "the district courts of the United States shall have exclusive jurisdiction of civil actions under this subchapter"). In contrast, suits under federal RICO can be heard in either state or federal court. *Tafflin v. Levitt*, 110 S. Ct. 792, 799 (1990) ("we hold that state courts have concurrent jurisdiction to consider civil claims arising under RICO").

<sup>146</sup> For an excellent framework interpreting state of mind requirements for federal statutes, see S. 1722, 96th Cong., 1st Sess. §§ 301-303 (1979).

Generally, this bill recognizes four states of mind: intentional, knowing, reckless, and negligent. The framework delineates each element of a statute as either conduct, surrounding circumstance, or result. In the absence of explicit statutory language as to state of mind, the bill requires the following: conduct must be knowing, surrounding circumstances must be reckless, and a result is reckless. In addition, the statute does not require state of mind as to matters that are solely a basis for federal jurisdiction, venue, grading, or questions of law.

At the time the bill was introduced, the legislature thought it was codifying existing caselaw. Cf. COMMITTEE ON THE JUDICIARY, UNITED STATES SENATE, CRIMINAL CODE REFORM ACT OF 1979, S. REP. NO. 553, 96th Cong., 2d Sess., at 59-61 (1980). See *United States v. Bailey*, 444 U.S. 394, 403-06 (1980) (rejecting common law classifications of general and specific intent crimes and declaring that there is a hierarchy of culpable states of mind consisting of purpose, knowledge, recklessness, and negligence); *United States v. Feola*, 420 U.S. 671, 696 (1975) (no state of mind requirement as to jurisdictional element). Unfortunately, subsequent Supreme Court decisions backed away from the framework of the bill and further confused the state of mind issue. See *Liparota v. United States*, 471 U.S. 419, 433 (1985) (requiring state of mind as to a question of law, namely the illegality of the act); *United States v. Yermian*, 468 U.S. 63, 75 (1984) (reversing the Ninth Circuit and upholding a trial court instruction that required a state of mind of knowledge or negligence as to a jurisdictional element). The relevant portion of the bill reads:

§ 301. State of Mind Generally

(a) **STATE OF MIND DEFINED.**—As used in this title, 'state of mind' means the mental state required to be proved with respect to conduct, an existing circumstance, or a result set forth in a section describing an offense.

(b) **TERMS USED TO DESCRIBE STATES OF MIND.**—The terms used to describe the different states of mind are 'intentional', 'knowing', 'reckless', and 'negligent', and variants thereof.

(c) **STATES OF MIND APPLICABLE TO CONDUCT, AN EXISTING CIRCUMSTANCE, AND A RESULT.**—The states of mind that may be specified as applicable to

(1) conduct are either 'intentional' or 'knowing';

(2) an existing circumstance are either 'knowing', 'reckless', or 'negligent'; and

(3) a result are either 'intentional', 'knowing', 'reckless', or 'negligent'.

#### § 302. 'Intentional', 'Knowing', 'Reckless', and 'Negligent' States of Mind

The following definitions apply with respect to an offense set forth in this title:

(a) **'INTENTIONAL.'**—A person's state of mind is intentional with respect to—

(1) his conduct if it is his conscious objective or desire to engage in the conduct; or

(2) a result of his conduct if it is his conscious objective or desire to cause the result.

(b) **'KNOWING.'**—A person's state of mind is knowing with respect to—

(1) his conduct if he is aware of the nature of his conduct;

(2) an existing circumstance if he is aware or believes that the circumstance exists; or

(3) a result of his conduct if he is aware or believes that his conduct is substantially certain to cause the result.

(c) **'RECKLESS.'**—A person's state of mind is reckless with respect to—

(1) an existing circumstance if he is aware of a substantial risk that the circumstance exists but disregards the risk; or

(2) a result of his conduct if he is aware of a substantial risk that the result will occur but disregards the risk;

except that awareness of the risk is not required if its absence is due to self-induced intoxication. A substantial risk means a risk that is of such a nature and degree that to disregard it constitutes a gross deviation from the standard of care that a reasonable person would exercise in such a situation.

(d) **'NEGLIGENT.'**—A person's state of mind is negligent with respect to—

(1) an existing circumstance if he ought to be aware of a substantial risk that the circumstance exists; or

(2) a result of his conduct if he ought to be aware of a substantial risk that the result will occur.

A substantial risk means a risk that is of such a nature and degree that to fail to perceive it constitutes a gross deviation from the standard of care that a reasonable person would exercise in such a situation.

#### § 303. Proof of State of Mind

Except as otherwise expressly provided, the following provisions apply to an offense under any federal statute:

(a) **REQUIRED PROOF OF STATE OF MIND.**—A state of mind must be proved with respect to each element of an offense, except that—

(1) no state of mind must be proved with respect to a particular element of an offense if that element is specified in the description of the offense as existing or occurring 'in fact'; and

(2) the state of mind, if any, to be proved with respect to any element of an offense described in a statute outside this title, or described in this title as a violation of a statute outside this title, or described in a regulation or rule issued pursuant to such a statute, shall be determined by the provisions of that statute.

(b) **REQUIRED STATE OF MIND FOR AN ELEMENT OF AN OFFENSE IF NOT SPECIFIED.**—Except as provided in subsection (a), if an element of an offense is described without specifying the required state of mind, the particular state of mind that must be proved with respect to—

(1) conduct is 'knowing';

(2) an existing circumstance is 'reckless'; and

(3) a result is 'reckless'.

(c) **SATISFACTION OF STATE OF MIND REQUIREMENT BY PROOF OF OTHER STATE OF MIND.**—If the state of mind required to be proved with respect to an element of an offense is—

(1) 'knowing', this requirement can be satisfied alternatively by proof of an 'intentional' state of mind;

(2) 'reckless', this requirement can be satisfied alternatively by proof of an 'intentional' or 'knowing' state of mind; or

(3) 'negligent', this requirement can be satisfied alternatively by proof of an 'intentional', 'knowing', or 'reckless' state of mind.

do not involve a pattern of activity, the suit will usually involve negligent misrepresentation or fraud.<sup>147</sup>

## 1. Officers and Directors

A cause of action for negligent misrepresentation or professional malpractice requires proof of four elements: duty, breach, causation, and damages.<sup>148</sup> State corporate law defines the duty of an officer or director. Generally, the officer or director must carry out his duties with the care that an "ordinarily prudent person in a like position would exercise under similar circumstances."<sup>149</sup> Some courts hold officers to a higher

### (d) MATTERS OF LAW REQUIRING NO PROOF OF STATE OF MIND.—

(1) EXISTENCE OF OFFENSE.—Proof of knowledge or other state of mind is not required with respect to—

(A) the fact that particular conduct constitutes an offense, or that conduct or another element of an offense is pursuant to, or required by, or violates, a statute or a regulation, rule, or order issued pursuant thereto;

(B) the fact that particular conduct is described in a section of this title; or

(C) the existence, meaning, or application of the law determining the elements of an offense.

(2) JURISDICTION, VENUE, AND GRADING MATTERS.—Proof of state of mind is not required with respect to any matter that is solely a basis for federal jurisdiction, for venue, or for grading.

(3) MATTERS DESIGNATED A QUESTION OF LAW.—Proof of state of mind is not required with respect to any matter that is designated as a question of law.

(e) MATTERS PERTAINING TO BARS OR DEFENSES REQUIRING NO PROOF OF STATE OF MIND.—Proof of state of mind is not required with respect to an element of a bar to prosecution, defense, or affirmative defense.

*Id.*

147 Since ERISA grants the PWBA standing to sue on behalf of the plan, the agency does not have to contend with privity of contract problems that otherwise hinder suits against third parties such as accountants and attorneys. However, privity could be an issue when the PBGC seeks to recover from the plan's accountants and attorneys. See *supra* note 141 for a discussion of this issue.

148 Prosser set forth the traditional negligence formula as follows:

1. A duty, or obligation, recognized by the law, requiring the person to conform to a certain standard of conduct, for the protection of others against unreasonable risks.

2. A failure on the person's part to conform to the standard required: a breach of the duty. These two elements go to make up what the courts usually have called negligence; but the term quite frequently is applied to the second alone. Thus it may be said that the defendant was negligent, but is not liable because he was under no duty to the plaintiff not to be.

3. A reasonably close causal connection between the conduct and the resulting injury. This is what is commonly known as 'legal cause,' or 'proximate cause,' and which includes the notion of cause in fact.

4. Actual loss or damage resulting to the interests of another.

W. PROSSER & W. KEETON, *THE LAW OF TORTS* § 30 (5th ed. 1984) [hereinafter PROSSER].

149 REVISED MODEL BUSINESS CORPORATION ACT § 8.30(a)(2) (As approved June, 1984). The Revised Model Business Corporation Act outlines the general duty of a director:

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

(b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

standard than directors because officers are more involved with the day to day activities of the company.<sup>150</sup>

Although either a director or an officer is entitled to rely on financial statements prepared by others,<sup>151</sup> the review of the statements may give rise to a duty to inquire further into matters revealed by the statements.<sup>152</sup> Directors are under a "continuing obligation" and may not "shut their eyes to corporate matters and then claim that because they did not see the misconduct, they did not have a duty to look."<sup>153</sup>

Common law fraud requires proof of the following: false representation or omission, scienter, intent to induce reliance, justifiable reliance, and injury to the plaintiff.<sup>154</sup> Any fraudulent misrepresentation claim must, of course, satisfy all of these elements.

Negligent misrepresentation and fraud actions have long been used in suits against officers and directors. Specifically, the PWBA has recov-

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(3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.

*Id.* § 8.30. Similarly, the Revised Model Business Corporation Act describes the duty of an officer:

(a) An officer with discretionary authority shall discharge his duties under that authority:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

(b) In discharging his duties an officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the officer reasonably believes to be reliable and competent in the matters presented; or

(2) legal counsel, public accountants, or other persons as to matters the officer reasonably believes are within the person's professional or expert competence.

(c) An officer is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) An officer is not liable for any action taken as an officer, or any failure to take any action, if he performed the duties of his office in compliance with this section.

*Id.* § 8.42. See generally Note, *The Duty of Care and the Duty of Loyalty in the Revised Model Business Corporation Act*, 40 VAND. L. REV. 663 (1987).

Note that the Model Act protects officers and directors who "reasonably rely" on reports prepared by others. The Act protects these officials unless they have "knowledge" of matters that make reliance on others unwarranted. Significantly, the Act does not impose any duty on officers or directors to actively look for wrongdoing or to institute an internal control system. Given the numerous instances of fraud and misconduct that are so pervasive in institutional America, officers and directors should be obligated to institute internal control programs to ferret out wrongdoing within the corporation. See *supra* note 134 for further discussion of this issue.

150 See, e.g., *Bates v. Dresser*, 251 U.S. 524, 529-31 (1920) (concluding that the president would be held to a greater degree of care because he controlled the bank's business affairs, and holding the director, who had less involvement with the daily business operations, not liable); *Raines v. Toney*, 228 Ark. 1170, 1178, 313 S.W.2d 802, 808 (1958) (the law imposes a high standard of conduct upon an officer or director of a corporation but imposes an even higher standard on one who is a vice president, director or manager).

151 REVISED MODEL BUSINESS CORPORATION ACT §§ 8.30(b), 8.42(b) (As approved June, 1984).

152 *Francis v. United Jersey Bank*, 87 N.J. 15, 33, 432 A.2d 814, 823 (1981).

153 *Id.* at 31, 432 A.2d at 822. Such conduct by an officer or director raises the issue of willful blindness. See *supra* note 134 for discussion of willful blindness.

154 Prosser set forth the elements of a tort action for deceit as follows:

1. A false representation made by the defendant. In the ordinary sense, this representation must be one of fact.



ered millions of dollars from officers and directors whose improper actions have cheated workers.<sup>155</sup>

## 2. Accountants and Attorneys

The nature of the accountant-client relationship<sup>156</sup> and the contract for professional services imply that the accountant will exercise the degree of skill and competency reasonably expected of persons in his profession in the community.<sup>157</sup> In the exercise of his normal professional skill and care, the independent auditor is expected to "detect illegal or improper acts," to determine whether there are "suspicious circumstances," and to verify the data underlying the client's financial statements.<sup>158</sup>

Negligent misrepresentation of a pension fund's financial condition may result from a variety of accounting failures. An accountant might fail to conduct an independent or thorough investigation to verify the data used in preparing an audit report, or the accountant might fail to disclose that the firm did not look for or could not find evidence to support the data used.<sup>159</sup>

An attorney's liability for malpractice does not depend solely on the existence of a duty, but on whether or not the duty has been breached.

2. Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not made a sufficient basis of information to make it. This element often is given the technical name of 'scienter.'

3. An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.

4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.

5. Damage to the plaintiff, resulting from such reliance.

PROSSER, *supra* note 148, at § 105.

155 See EMPLOYEE RETIREMENT INCOME SECURITY ACT, 1986 REP. TO CONGRESS 2-11; OIG REPORT, *supra* note 1, at 29-33 (for a description of the significant cases filed during the year).

156 Chief Justice Burger summarized the unique role of the independent auditor:

An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

United States v. Arthur Young & Co., 465 U.S. 805, 817-18, *cert. denied*, 466 U.S. 936 (1984). The role of the public accountant as described by Justice Burger hardly comports with the legal duty actually imposed upon accountants. See *supra* note 136 for discussion of the role of the accountant in detecting fraud.

157 Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 453 (7th Cir.) (tort of negligence in context of auditing is a failure to use professional care and skill in carrying out an audit), *cert. denied*, 459 U.S. 880 (1982); Bancroft v. Indemnity Ins. Co. of N. Am., 203 F. Supp. 49, 53 (W.D. La.), *aff'd*, 309 F.2d 959 (5th Cir. 1962).

158 Rosenblum v. Adler, 93 N.J. 324, 344, 461 A.2d 138, 148-49 (1983).

159 For example, in Stanley L. Bloch, Inc. v. Klein, 45 Misc. 2d 1054, 1057, 258 N.Y.S.2d 501, 505 (1965), the accountant breached the duty to use reasonable care when he violated professional standards requiring an accountant to either independently verify inventory figures or to state on the financial statement that such verification was not performed.

The scope of the attorney's duty depends on why the attorney was retained,<sup>160</sup> and the attorney can limit his duty by agreement.<sup>161</sup>

### B. *Pattern of Activity*

In many instances, the failure of a pension plan will not be the result of a single isolated act of fraud or negligence. Instead, culpable parties may engage in a pattern of wrongful activity over a period of time. In these cases, the PWBA or the PBGC may be able to proceed against the individual, or the entities for which he works, under the Racketeer-Influenced Corrupt Organizations Act (RICO).<sup>162</sup>

RICO prohibits the use of income derived from a "pattern of racketeering activity" to acquire an interest in or establish an enterprise en-

160 See *Maillard v. Dowdell*, 528 So. 2d 512, 515 (Fla. Dist. Ct. App. 1988) (lawyer handling purchase of condominium had no duty to discover details regarding litigation involving the condominium association); *York v. Stiefel*, 99 Ill. 2d 312, 320-21, 458 N.E.2d 488, 492-93 (1983) (attorney retained to incorporate business owed no duty to plaintiffs' wives). But see *Practical Offset, Inc. v. Davis*, 83 Ill. App. 3d 566, 571, 404 N.E.2d 516, 520 (Ill. App. Ct. 1980) (attorney hired to document sale of assets had duty to file security agreement).

161 See *Warmbrodt v. Blanchard*, 692 P.2d 1282, 1285 (Nev. 1984) (contract between attorneys and client did not hold attorneys accountable for timely filing of papers).

162 18 U.S.C. §§ 1961-1968 (1984). See generally *H.J. Inc. v. Northwestern Bell Telephone Co.*, 109 S. Ct. 2893 (1989); *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479 (1985). At the time this Note was written, efforts were underway in Congress to amend RICO. For a critique of the proposed changes, see Blakey, *Possible Amendments to "The RICO Reform Act of 1989" (HR 1046)*, 5 Civ. RICO REP. (BNA) No. 11, Part 2 (Aug. 8, 1989). If Congress were to pass this amendment in its present form, the changes would affect: who could sue under civil RICO, the measure of damages that could be recovered, the burden of proof, and the statute of limitations. In addition, the changes to the statute may be made retroactive such that they would affect suits filed prior to passage of the amendment.

Some argue that Congress enacted the RICO statute solely to combat organized crime. For example, the Second Circuit expressed distress at the "extraordinary, if not outrageous" uses to which civil RICO has been put. *Sedima, S.P.R.L. v. Imrex Co.*, 741 F.2d 482, 487 (2d Cir.), *rev'd*, 473 U.S. 479 (1984). The circuit court complained that instead of being used against mobsters and organized criminals, civil RICO has become a tool for everyday fraud cases brought against "respected and legitimate 'enterprises.'" *Id.* Members of the Supreme Court have also expressed dismay at the scope of civil RICO:

The Court's interpretation of the civil RICO statute quite simply revolutionizes private litigation; it validates the federalization of broad areas of state common law of frauds, and it approves the displacement of well-established federal remedial provisions. We do not lightly infer a congressional intent to effect such fundamental changes. To infer such intent here would be untenable, for there is no indication that Congress ever considered, much less approved, the scheme that the Court today defines.

*Sedima*, 473 U.S. at 501 (Marshall, J., dissenting).

Recently, Chief Justice William Rehnquist expressed his concern over the expanded use of civil RICO. See *Wermiel, Rehnquist Urges Curbs on Suits To Aid Overloaded Federal Courts*, Wall St. J., Feb. 7, 1989, at B1, col. 1. Despite the concern over the increase in civil RICO cases, the Supreme Court has noted that litigation itself is not an "evil." *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 643 (1985). "Over the course of centuries, our society has settled upon civil litigation as a means for redressing grievances, resolving disputes, and vindicating rights when other means fail. . . . That our citizens have access to their civil courts is not an evil to be regretted; rather, it is an attribute of our system of justice in which we ought to take pride." *Id.*

In addition, Justice Scalia suggests that RICO's pattern requirement is unconstitutionally vague. *H.J. Inc.*, 109 S. Ct. at 2908-09 (Scalia, J., dissenting). For a recent analysis of the vagueness issue, see Blakey, *Is 'Pattern' Void for Vagueness?* 5 Civ. RICO REP. (BNA) No. 28, (Dec. 12, 1989).

Despite the critics, the language of the statute is broad enough to be used against white collar pension scams. In fact, RICO has been used successfully in the context of pension plan fraud. See, e.g., *Crawford v. La Boucherie Bernard Ltd.*, No. 83-0780 (D.D.C. Aug. 15, 1984) (participants can sue fiduciaries on behalf of plan under RICO for fraudulent conversion of plan assets), *aff'd*, 815 F.2d 117 (D.C. Cir.), *cert. denied*, 484 U.S. 943 (1987).

gaged in or affecting interstate commerce; the acquisition or maintenance of any interest in an enterprise "through" a pattern of racketeering activity; conducting or participating in the conduct of an enterprise through a pattern of racketeering activity; and conspiring to violate any of these provisions.<sup>163</sup> The necessary elements of a civil RICO action are: (1) that a person; (2) participate in a "pattern" of "racketeering activity;" (3) directly or indirectly invest in, maintain an interest in, or participate in an "enterprise;" (4) the activities of which affect interstate or foreign commerce; and, (5) injure the plaintiff in his business or property by reason of the defendant's activity.<sup>164</sup>

A review of these five elements reveals that the PWBA or the PBGC can use RICO against officers, directors, accountants, and attorneys, who defraud pension plans. First, under RICO's definition of a person,<sup>165</sup> any player in a pension plan fraud is a potential defendant under the statute. The definition is broad enough to include any officer or director, an accountant or an accounting firm, or an attorney or a law firm involved with the plan.<sup>166</sup>

Second, the defendant must have participated in a "pattern of racketeering activity."<sup>167</sup> This element of RICO involves two issues: (1) defin-

163 *H.J. Inc.*, 109 S. Ct. at 2897; *Sedima*, 473 U.S. at 482-83. The statute itself provides:

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt . . . to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce. . . .

(b) It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

(d) It shall be unlawful for any person to conspire to violate any of the provisions of subsection (a), (b), or (c) of this section.

18 U.S.C. § 1962 (1984 & Supp. 1989).

164 *See Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 17 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

165 A person is "any individual or entity capable of holding a legal or beneficial interest in property." 18 U.S.C. § 1961(3) (1984).

166 For a discussion of vicarious liability under RICO, see *Innocence by Association*, *supra* note 104.

167 These terms are defined by the statute:

(1) 'racketeering activity' means (A) any act or threat involving murder, kidnapping, gambling, arson, robbery, bribery, extortion, dealing in obscene matter, or dealing in narcotic or other dangerous drugs, which is chargeable under State law and punishable by imprisonment for more than one year; (B) any act which is indictable under any of the following provisions of title 18, United States Code: Section 201 (relating to bribery), section 224 (relating to sports bribery), sections 471, 472, and 473 (relating to counterfeiting), section 659 (relating to theft from interstate shipment) if the act indictable under section 659 is felonious, section 664 (relating to embezzlement from pension and welfare funds), sections 891-894 (relating to extortionate credit transactions), section 1029 (relative to fraud and related activity in connection with access devices), section 1084 (relating to the transmission of gambling information), section 1341 (relating to mail fraud), section 1343 (relating to wire fraud), sections 1461-1465 (relating to obscene matter), section 1503 (relating to obstruction of justice), section 1510 (relating to obstruction of criminal investigations), section 1511 (relating to the obstruction of State or local law enforcement), section 1512

ing what acts count as "racketeering activity" and (2) determining how these acts must be related in order to qualify as a "pattern of activity."

Although other statutes may be implicated,<sup>168</sup> in the context of pen-

(relating to tampering with a witness, victim, or an informant), section 1513 (relating to retaliating against a witness, victim, or an informant), section 1951 (relating to interference with commerce, robbery, or extortion), section 1952 (relating to racketeering), section 1953 (relating to interstate transportation of wagering paraphernalia), section 1954 (relating to unlawful welfare fund payments), section 1955 (relating to the prohibition of illegal gambling businesses), section 1956 (relating to the laundering of monetary instruments), section 1957 (relating to engaging in monetary transactions in property derived from specified unlawful activity), section 1958 (relating to use of interstate commerce facilities in the commission of murder-for-hire), sections 2251-2252 (relating to sexual exploitation of children), sections 2312 and 2313 (relating to interstate transportation of stolen motor vehicles), sections 2314 and 2315 (relating to interstate transportation of stolen property), section 2321 (relating to trafficking in certain motor vehicles or motor vehicle parts), sections 2341-2346 (relating to trafficking in contraband cigarettes), sections 2421-24 (relating to white slave traffic), (C) any act which is indictable under title 29, United States Code, section 186 (dealing with restrictions on payments and loans to labor organizations) or section 501(c) (relating to embezzlement from union funds), (D) any offense involving fraud connected with a case under title 11, fraud in the sale of securities, or the felonious manufacture, importation, receiving, concealment, buying, selling, or otherwise dealing in narcotic or other dangerous drugs, punishable under any law of the United States, or (E) any act which is indictable under the Currency and Foreign Transactions Reporting Act.

....

(5) 'pattern of racketeering activity' requires at least two acts of racketeering activity, one of which occurred after the effective date of this chapter [October 15, 1970] and the last of which occurred within ten years (excluding any period of imprisonment) after the commission of a prior act of racketeering activity.

18 U.S.C. § 1961 (1984 & Supp. 1989).

168 In the pension plan fraud context, racketeering activity may also involve violations of statutes relating to: (1) embezzlement from pension and welfare funds, (2) unlawful welfare fund payments, and (3) interstate transportation and stolen property. The embezzlement statute reads:

Any person who embezzles, steals, or unlawfully and willfully abstracts or converts to his own use or to the use of another, any of the moneys, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or of any fund connected therewith, shall be fined not more than \$10,000, or imprisoned not more than five years, or both.

As used in this section, the term 'any employee welfare benefit plan or employee pension benefit plan' means any employee benefit plan subject to any provision of title I of the Employee Retirement Income Security Act of 1974.

18 U.S.C. § 664 (1976).

The welfare fund payment statute provides:

Whoever being—

- (1) an administrator, officer, trustee, custodian, counsel, agent, or employee of any employee welfare benefit plan or employee pension benefit plan; or
- (2) an officer, counsel, agent or employee of an employer or an employer any of whose employees are covered by such plan; or
- (3) an officer, counsel, agent, or employee of an employee organization any of whose members are covered by such plan; or
- (4) a person who, or an officer, counsel, agent, or employee of an organization which, provides benefit plan services to such plan

receives or agrees to receive or solicits any fee, kickback, commission, gift, loan, money, or thing of value because of or with intent to be influenced with respect to, any of his actions, decisions, or other duties relating to any question or matter concerning such plan or any person who directly or indirectly gives or offers, or promises to give or offer, any fee, kickback, commission, gift, loan, money, or thing of value prohibited by this section, shall be fined not more than \$10,000 or imprisoned not more than three years, or both: *Provided*, That this section shall not prohibit the payment to or acceptance by any person of bona fide salary, compensation, or other payments made for goods or facilities actually furnished or for services actually performed in the regular course of his duties as such person, adminis-

sion plan fraud, racketeering activity would likely involve mail fraud<sup>169</sup> or wire fraud.<sup>170</sup> The purpose of the mail and wire fraud statutes is to prevent the use of the Postal Service and interstate communication facilities

trator, officer, trustee, custodian, counsel, agent, or employee of such plan, employer, employee organization, or organization providing benefit plan services to such plan.

As used in this section, the term (a) 'any employee welfare benefit plan' or 'employee pension benefit plan' means any employee welfare benefit plan or employee pension benefit plan, respectively, subject to any provision of title I of the Employee Retirement Income Security Act of 1974, and (b) 'employee organization' and 'administrator' as defined respectively in sections 3(4) and (3)(16) of the Employee Retirement Income Security Act of 1974.

*Id.* § 1954 (1984).

Lastly, the statute prohibiting the interstate transportation of stolen property reads:

Whoever transports, transmits, or transfers in interstate or foreign commerce any goods, wares, merchandise, securities or money, of the value of \$5,000 or more, knowing the same to have been stolen, converted or taken by fraud; or

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transports or causes to be transported, or induces any person or persons to travel in, or to be transported in interstate commerce in the execution or concealment of a scheme or artifice to defraud that person or those persons of money or property having a value of \$5,000 or more; or

Whoever, with unlawful or fraudulent intent, transports in interstate or foreign commerce any falsely made, forged, altered, or counterfeited securities or tax stamps, knowing the same to have been falsely made, forged, altered, or counterfeited; or

Whoever, with unlawful or fraudulent intent, transports in interstate or foreign commerce any traveler's check bearing a forged countersignature; or

Whoever, with unlawful or fraudulent intent, transports in interstate or foreign commerce, any tool, implement, or thing used or fitted to be used in falsely making, forging, altering, or counterfeiting any security or tax stamps, or any part thereof—

Shall be fined not more than \$10,000 or imprisoned not more than ten years, or both.

This section shall not apply to any falsely made, forged, altered, counterfeited or spurious representation of an obligation or other security of the United States, or of an obligation, bond, certificate, security, treasury note, bill, promise to pay or bank note issued by any foreign government. This section also shall not apply to any falsely made, forged, altered, counterfeited, or spurious representation of any bank note or bill issued by a bank or corporation of any foreign country which is intended by the laws or usage of such country to circulate as money.

*Id.* § 2314 (Supp. 1989).

169 The code provision defining mail fraud provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than \$1,000 or imprisoned not more than five years, or both.

*Id.* § 1341 (1984).

170 The code provision defining wire fraud provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits, or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined not more than \$1,000 or imprisoned not more than five years, or both.

*Id.* § 1343.

to effect fraudulent schemes.<sup>171</sup> Since the two statutes are *in pari materia*, cases construing the mail fraud statute also apply to wire fraud.<sup>172</sup>

The mail and wire fraud statutes make it unlawful to use the mail, wire, radio, or television to further a scheme to defraud. With respect to mail fraud, the elements of the offense are (1) a scheme to defraud and (2) use of the mails.<sup>173</sup> To fulfill the scheme element, the accused must conduct a scheme with intent to defraud. There is no result requirement.<sup>174</sup> The concept of a scheme to defraud is broad and inclusive; any scheme involving trickery or deceit is within the statute.<sup>175</sup> Thus, the conduct requirement of the mail fraud and wire fraud statutes is broad enough to include any scheme to defraud a pension plan.

In addition to the conduct requirement, the defendant must act with specific intent to defraud.<sup>176</sup> This state of mind requirement has two parts. First, the accused must intend the result of the scheme.<sup>177</sup> It fol-

171 See *Parr v. United States*, 363 U.S. 370, 389 (1960); *Durland v. United States*, 161 U.S. 306, 314 (1896). See generally Rakoff, *The Federal Mail Fraud Statute (Part I)*, 18 Duq. L. Rev. 779 (1980) (general treatment of development of mail fraud).

172 *United States v. Soteris*, 770 F.2d 641, 645 n.5 (7th Cir. 1985) ("equally applicable"); *United States v. Lemire*, 720 F.2d 1327, 1334 n.6 (D.C. Cir. 1983) ("cases construing mail fraud apply to the wire fraud statute as well"), *cert. denied*, 467 U.S. 1226 (1984); *United States v. Tarnopol*, 561 F.2d 466, 475 (3d Cir. 1977); *United States v. Donahue*, 539 F.2d 1131, 1135 (8th Cir. 1976).

173 *United States v. Moss*, 591 F.2d 428, 435 (8th Cir. 1979); *Pereira v. United States*, 347 U.S. 1, 8 (1954).

174 Unlike most state fraud statutes, the federal mail fraud statute does not require the actual obtaining of property. Section 1341 requires that the schemer intend to execute a scheme or artifice to defraud, but it does not require that the scheme be completed or successfully carried out. *Blachly v. United States*, 380 F.2d 665, 673 (5th Cir. 1967) (success of scheme is not essential to completion of the offense). Since § 1341 is intended to prevent misuse of the Postal Service, the offense is complete when the mails are used. Because the completion or success of the scheme is not part of the offense, the prosecutor need not show actual damage or harm to the victim. *United States v. Strong*, 702 F.2d 97, 100 (6th Cir. 1983) (conviction of mail fraud does not require proof of actual injury); *United States v. Melton*, 689 F.2d 679, 684 (7th Cir. 1982) ("it is unnecessary that the victim of the scheme actually be defrauded or suffer loss"); *Blachly*, 380 F.2d at 673; *United States v. Andreadis*, 366 F.2d 423, 431 (2d Cir. 1966), *cert. denied*, 385 U.S. 1001 (1967).

175 The Eighth Circuit described the broad nature of fraud:

[W]e recognize that the forms of fraud are as multifarious as human ingenuity can devise; that courts consider it difficult, if not impossible, to formulate an exact, definite and all-inclusive definition thereof; and that each case must be determined on its own facts. In general, and in its generic sense, fraud comprises all acts, conduct, omissions and concealment involving breach of a legal or equitable duty and resulting in damage to another.

*Isaacs v. United States*, 301 F.2d 706, 713 (8th Cir.), *cert. denied*, 371 U.S. 818 (1962). There is recent evidence that courts still adhere to this standard. See, e.g., *Atlas Pile Driving Co. v. DiCon Fin. Co.*, 886 F.2d 986, 991 (8th Cir. 1989) ("nontechnical standard, condemning conduct which fails to conform to standards of moral uprightness, fundamental honesty, and fair play") (citing *United States v. Bishop*, 825 F.2d 1278, 1280 (8th Cir. 1987)). However, some courts have started to back away from this broad standard. See *Reynolds v. East Dyer Dev. Co.*, 882 F.2d 1249, 1251-53 (7th Cir. 1989) ("broad language . . . cannot have been intended, and must not be taken literally") (citing *United States v. Holzer*, 816 F.2d 304, 309 (7th Cir.), *vacated on other grounds*, 108 S. Ct. 53 (1987), *cert. denied*, 108 S. Ct. 2022 (1988)).

176 *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 49 (2d Cir. 1987) (mail and wire fraud statutes require showing of intentional fraud), *cert. denied*, 484 U.S. 1005 (1988). See *United States v. Washita Constr. Co.*, 789 F.2d 809, 817 (10th Cir. 1986); *Haroco v. American Nat'l Bank & Trust Co.*, 747 F.2d 384, 403 (7th Cir. 1984), *aff'd*, 473 U.S. 606 (1985); *United States v. Condo*, 741 F.2d 238, 240 (9th Cir. 1984), *cert. denied*, 469 U.S. 1164 (1985); *United States v. Fowler*, 735 F.2d 823, 828 (5th Cir. 1984); *United States v. Bronston*, 658 F.2d 920, 927 (2d Cir. 1981), *cert. denied*, 456 U.S. 915 (1982).

177 Where a breach of private fiduciary relations is the basis for mail fraud, detriment to the victim is required. *United States v. Connor*, 752 F.2d 566, 573 (11th Cir.), *cert. denied*, 474 U.S. 821 (1985).

lows that good faith is a complete defense to mail fraud, since good faith negates intent.<sup>178</sup> However, when the scheme involves depriving someone of money or property, the requisite intent is evident.

The second part of proving state of mind under the mail fraud statute requires that the defendant must be reckless as to the truth or falsity of the representations made in the course of the scheme.<sup>179</sup> The accused need not know that his representations are false; recklessness in failing to investigate the matter or to otherwise acquire the knowledge is sufficient. Accordingly, mere negligence in failing to investigate is not enough. State of mind can be proven by circumstantial evidence.<sup>180</sup> To illustrate, intent to harm another or to benefit oneself may be inferred from evidence that a harm actually occurred or that a benefit was gained.<sup>181</sup> In the context of a pension plan scam, the prosecution could establish state of mind by demonstrating that the plan suffered unusual losses and that the defendant—a corrupt officer, for example—enjoyed an unreasonably large income. Furthermore, a court may imply intent to defraud if the defendant acted with a reckless disregard for the truth of the communication.<sup>182</sup> Recklessness may be established by the facts and circumstances surrounding the transaction. If the schemer is put on notice of the possibility that certain information is false, and yet continues to use the infor-

178 *Durland v. United States*, 161 U.S. 306, 314 (1896) (if evidence had shown that defendant acted in good faith, "no conviction could be sustained"). In contrast, good faith is not a defense to a violation of the fiduciary provisions of ERISA. See *supra* note 105 and accompanying text for a discussion of good faith under ERISA.

179 *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1249 (3d Cir. 1989) ("mail fraud can be premised upon a reckless disregard for the truth"); *United States v. Dick*, 744 F.2d 546, 551 (7th Cir. 1984) ("[r]eckless disregard for truth or falsity is sufficient"); *United States v. Schaflander*, 719 F.2d 1024, 1027 (9th Cir. 1983) (same), *cert. denied*, 467 U.S. 1216 (1984); *United States v. Boyer*, 694 F.2d 58, 60 (3d Cir. 1982) (charge of "reckless disregard" was not improper); *United States v. Pearlstein*, 576 F.2d 531, 537 (3d Cir. 1978); *United States v. Henderson*, 446 F.2d 960, 966 (8th Cir.), *cert. denied*, 404 U.S. 991 (1971).

180 *United States v. Themy*, 624 F.2d 963, 965 (10th Cir. 1980) (direct proof not necessary); *United States v. Toliver*, 541 F.2d 958, 966 (2d Cir. 1976) ("use of the mails may be established . . . by circumstantial evidence"); *Aiken v. United States*, 108 F.2d 182 (4th Cir. 1939). The court explained:

Fraudulent intent . . . is too often difficult to prove by direct and convincing evidence. In many cases it must be inferred from a series of seemingly isolated acts and instances which have been rather aptly designated as badges of fraud. When these are sufficiently numerous they may in their totality properly justify an inference of fraudulent intent.

*Id.* at 183. There are limits to the use of circumstantial evidence. For example, evidence of misrepresentations about unimportant or extraneous matters does not suffice. See *Pearlstein*, 576 F.2d at 544.

181 *United States v. Meyer*, 359 F.2d 837, 839-40 (7th Cir.), *cert. denied*, 385 U.S. 837 (1966).

182 See *United States v. Dick*, 744 F.2d 546, 551 (7th Cir. 1984) (attorney who mailed fictitious bids to insurance companies guilty of "reckless mishandling of information"); *United States v. Johnson*, 622 F.2d 507, 511 (10th Cir. 1980) (attorney involved in organization of health insurance organization where no reserve was established for the payment of claims showed a reckless indifference for the promises of the organization), *cert. denied*, 449 U.S. 953 (1980); *United States v. Frick*, 588 F.2d 531, 536 (5th Cir.) (attorney acting as escrow agent for fraudulent loan showed reckless indifference towards worthless loan commitment.), *cert. denied*, 441 U.S. 913 (1979).

See generally the following cases holding that a violation of the mail or wire fraud statute requires at least a reckless disregard for the truth of the communication: *Phillips Petroleum*, 881 F.2d at 1249 (RICO case); *United States v. Sawyer*, 799 F.2d 1494, 1502 (11th Cir. 1986), *cert. denied sub nom. Leavitt v. United States*, 479 U.S. 1069 (1987); *United States v. Hathaway*, 798 F.2d 902, 908 (6th Cir. 1986); *Schaflander*, 719 F.2d at 1027; *Boyer*, 694 F.2d at 59; *United States v. Habel*, 613 F.2d 1321, 1328 (5th Cir.), *cert. denied sub nom. Carcaise v. United States*, 447 U.S. 925 (1980); *United States v. Amrep Corp.*, 560 F.2d 539, 543 (2d Cir. 1977), *cert. denied*, 434 U.S. 1015 (1978); *United States v. MacKay*, 491 F.2d 616, 623 (10th Cir. 1973), *cert. denied*, 416 U.S. 972 (1974).

mation, a jury may infer that the individual acted with a reckless disregard for the truth of the data.<sup>183</sup> Similarly, an individual's failure to inquire into the accuracy of suspect data may give rise to an inference that he is indifferent to the truth.<sup>184</sup>

The second element of mail fraud is use of the mails. Each use of the mails is a separate offense.<sup>185</sup> If the defendant himself, or his agent<sup>186</sup> sends or receives material through the mail, he is chargeable under the mail fraud statute. The defendant need only "cause" the use of the mails and need not be a perpetrator of the scheme.<sup>187</sup> The defendant's use of the mails must be in execution or in furtherance of the scheme to defraud. The sequence of events and the closeness of the relationship between the mailing and the scheme determine whether this requirement is satisfied. Thus, if the mailing occurs before the conception<sup>188</sup> or after completion of the scheme,<sup>189</sup> the use of the mails is not in furtherance of the scheme.

The second component of the "in furtherance" requirement mandates that the mailing be "sufficiently closely related" to the scheme.<sup>190</sup> This component is fulfilled when the mailing is "incident to an essential part of the scheme."<sup>191</sup> Significantly, this component has been narrowly construed.<sup>192</sup> As a result, the use of the mails must be in furtherance of the scheme, not merely incidental or collateral to it.

The prosecution need only establish that the accused knowingly "caused" the use of the mails. Where use of the mails can reasonably be foreseen, even though not actually intended, the defendant "causes" the mails to be used.<sup>193</sup>

This analysis of the mail fraud statute reveals why mail or wire fraud is a likely predicate act for a pension plan fraud. Close consideration of the statute shows that if an accountant or attorney helps prepare the financial statements of a failed pension plan with a reckless disregard for

183 *United States v. Press*, 336 F.2d 1003, 1011 (2d Cir. 1964), *cert. denied*, 379 U.S. 965 (1965).

184 *Pearlstein*, 576 F.2d at 537 (reckless disregard for validity of revenue projections); *Irwin v. United States*, 338 F.2d 770, 774 (9th Cir. 1964) (reckless disregard as to the truth of representations that mail order franchises would be profitable), *cert. denied*, 381 U.S. 911 (1965).

185 *Badders v. United States*, 240 U.S. 391, 394 (1916) ("no doubt" each putting of a letter in the mail is a separate offense).

186 *United States v. Kenofsky*, 243 U.S. 440, 443 (1917).

187 *See, e.g., Pereira v. United States*, 347 U.S. 1, 12 (1954) (finding of mail fraud when the sender and receiver were two banks, neither of which was a perpetrator of the scheme).

188 *United States v. Cina*, 699 F.2d 853, 861 (7th Cir.) (mailing which occurred prior to actual fraud will not support jurisdiction), *cert. denied*, 464 U.S. 991 (1983); *United States v. Beall*, 126 F. Supp. 363, 365 (N.D. Cal. 1954).

189 *Cina*, 699 F.2d at 861 (allegation of mailing which occurred after the actual fraud will not support jurisdiction); *United States v. Maze*, 414 U.S. 395, 402 (1974); *Parr v. United States*, 363 U.S. 370, 393 (1960); *Kann v. United States*, 323 U.S. 88, 94 (1944).

190 *Maze*, 414 U.S. at 399.

191 *Pereira*, 347 U.S. at 8 (mailing of a check from one bank to another incident to obtaining the money); *United States v. Flemino*, 691 F.2d 1263, 1265 (8th Cir. 1982); *United States v. Clark*, 649 F.2d 534, 540 (7th Cir. 1981).

192 *See United States v. LaFerriere*, 546 F.2d 182, 186 (5th Cir. 1977). The court in *LaFerriere* interpreted *Pereira* this way: "[t]he court's language does not mean . . . that a mailing somehow related to an aspect of the scheme brings the scheme within the scope of the mail fraud statute." *Id.*

193 *Pereira*, 347 U.S. at 8-9.



the truth of the statements, and these statements are mailed to the DOL, the individual has committed at least one predicate act of mail fraud.<sup>194</sup>

To constitute a pattern of activity, the plaintiff must establish that the defendant committed at least two acts of racketeering within a ten year period.<sup>195</sup> The accused need not have been criminally convicted of the acts.<sup>196</sup> While the racketeering acts must be related,<sup>197</sup> until 1989, courts failed to establish a workable framework for interpreting the extent of this pattern relationship.<sup>198</sup>

The pattern concept can best be understood in the context of its evolution. The concept of a RICO pattern has evolved in three stages: (1) cases decided prior to the Court's decision in *Sedima, S.P.R.L. v. Imrex Co.*;<sup>199</sup> (2) cases decided after *Sedima* but before *H.J. Inc. v. Northwestern Bell Telephone Co.*; and, (3) the Court's recent decision in *H.J. Inc.*

### 1. Pre-*Sedima*

Prior to *Sedima*, two main issues were raised concerning the pattern requirement. First, it was argued that the predicate acts could not occur during the same criminal episode. Despite dicta to the contrary,<sup>200</sup> most

194 This concept has been used in RICO suits against accountants. See, e.g., *Bank of Am. v. Touche Ross & Co.*, 782 F.2d 966, 971 (11th Cir. 1986) (allegation that on seven occasions accountants prepared false financial statements that accountants knew would be mailed to banks was sufficient to state a RICO pattern). This same theory has also been used extensively in RICO claims for securities fraud. See, e.g., *Odesser v. Continental Bank*, 676 F. Supp. 1305, 1309 (E.D. Pa. 1987) (RICO pattern consisted of fraudulent representations made in the negotiation of a loan agreement which took place during several interstate telephone calls); *Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 660 F. Supp. 1362, 1369 (D. Conn. 1987) (allegations of securities fraud against a law firm sufficiently stated a pattern); *In re Energy Sys. Equip. Leasing Sec. Litig.*, 642 F. Supp. 718, 741 (E.D.N.Y. 1986) (pattern consisting of numerous mailings and phone calls to investors); *Penturelli v. Spector Cohen Gaden & Rosen*, 640 F. Supp. 868, 873 (E.D. Pa. 1986) (pattern consisting of securities fraud and mail fraud); *In re National Mortgage Equity Corp. Mortgage Pool Certificates Sec. Litig.*, 636 F. Supp. 1138, 1157-59 (C.D. Cal. 1986) (pattern consisted of solicitations by the law firm using the mail and phone). But see *Corcoran v. American Plan Corp.*, 886 F.2d 16, 20-21 (2d Cir. 1989) (finding no predicate acts of mail fraud to support RICO claim by state insurance agency superintendent on grounds that alleged mail fraud deprived the superintendent of money or property in the agency's capacity as liquidator while the mail fraud allegedly deceived the superintendent in the agency's capacity as regulator).

195 See *H.J. Inc. v. Northwestern Bell Telephone Co.*, 109 S. Ct. 2893, 2897 (1989).

196 *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 493 (1984) (finding no support for a requirement that a civil RICO action can proceed only against a defendant who has already been criminally convicted).

197 *H.J. Inc.*, 109 S. Ct. at 2900. Even prior to *H.J. Inc.*, courts recognized that the acts had to be related. In this era, judicial interpretations found a "pattern" if the racketeering acts were connected by a "common scheme, plan or motive." *United States v. Stofsky*, 409 F. Supp. 609, 614 (S.D.N.Y. 1973), *aff'd*, 527 F.2d 237 (2d Cir. 1975), *cert. denied*, 429 U.S. 819 (1976). It was not enough that the racketeering acts were a mere series of unconnected acts. *Id.* at 614. They could also be not related to each other by a common scheme or plan, but within the affairs of the same enterprise. *United States v. Elliott*, 571 F.2d 880, 899 (5th Cir.), *cert. denied*, 439 U.S. 953 (1978).

198 For a description of the pre-*H.J. Inc.* split in the cases attempting to construe a RICO pattern, see Goldsmith, *RICO and 'Pattern': The Search for 'Continuity Plus Relationship'*, 73 CORNELL L. REV. 971 (1988). The Supreme Court resolved this conflict in *H.J. Inc.* See *infra* notes 218-30 and accompanying text for an analysis of the Court's holding in *H.J. Inc.*

199 473 U.S. 479 (1985).

200 See *United States v. Moeller*, 402 F. Supp. 49 (D. Conn. 1975), *cert. denied sub nom. Napoli v. United States*, 429 U.S. 1039 (1977). In this case, the court found that burning a warehouse and kidnapping three warehouse employees during the same day constituted a RICO pattern. *Id.* at 58. Despite its holding, the court reasoned in dicta that pattern "implies acts occurring in different criminal episodes." *Id.* at 57.

courts adopted the position that several acts occurring within a single criminal episode could constitute a pattern.<sup>201</sup> Second, it was argued that a pattern required the presence of a common scheme.<sup>202</sup> Most courts held, however, that even absent a common scheme, a RICO pattern could exist.<sup>203</sup>

## 2. Post-*Sedima*

The Supreme Court first confronted the pattern issue in *Sedima, S.P.R.L. v. Imrex Co.*<sup>204</sup> In a footnote, Justice White addressed the pattern requirement and reasoned "that while two acts are necessary, they may not be sufficient."<sup>205</sup> He then concluded that it was the "factor of *continuity plus relationship* which combines to produce a pattern."<sup>206</sup> Despite the Court's guidance, lower courts began to interpret the pattern requirement in different ways. In the post-*Sedima* era, courts took two basic approaches to pattern analysis. Some courts merely required that the predicate acts be related to each other in the course of a single scheme.<sup>207</sup> Other courts required a close analysis of the predicate acts to determine if they were related and constituted a continuous scheme.

201 See, e.g., *United States v. Watchmaker*, 761 F.2d 1459, 1475 (11th Cir. 1985) (holding that the shooting of three police officers constituted a pattern), *cert. denied*, 474 U.S. 1100 (1986); *United States v. Starnes*, 644 F.2d 673, 678 (7th Cir.) (holding that committing arson with intent to defraud insurer constituted a pattern), *cert. denied*, 454 U.S. 826 (1981).

202 See, e.g., *Stofsky*, 409 F. Supp. at 614 (pattern requires that "the racketeering acts must have been connected with each other by some common scheme, plan or motive").

203 See, e.g., *United States v. Elliott*, 571 F.2d 880, 899 (5th Cir.), *cert. denied*, 439 U.S. 953 (1978) (finding a RICO pattern even though the defendants were involved in diversified and unrelated criminal activities).

204 473 U.S. 479 (1985) (addressing the necessity of prior criminal conviction for racketeering acts and the racketeering injury requirement).

205 *Id.* at 496 n.14. The footnote reads:

As many commentators have pointed out, the definition of a 'pattern of racketeering activity' differs from the other provisions in § 1961 in that it states that a pattern 'requires at least two acts of racketeering activity,' § 1961(5) (emphasis added), not that it 'means' two such acts. The implication is that while two acts are necessary, they may not be sufficient. Indeed, in common parlance two of anything do not generally form a 'pattern.' The legislative history supports the view that two isolated acts of racketeering activity do not constitute a pattern. As the Senate Report explained: 'The target of [RICO] is thus not sporadic activity. The infiltration of legitimate business normally requires more than one "racketeering activity" and the threat of continuing activity to be effective. It is this factor of *continuity plus relationship* which combines to produce a pattern.' S. Rep. No. 91-617, p. 158 (1969) (emphasis added). Similarly, the sponsor of the Senate bill, after quoting this portion of the Report, pointed out to his colleagues that '[t]he term "pattern" itself requires the showing of a relationship . . . . So, therefore, proof of two acts of racketeering activity, without more, does not establish a pattern . . . .' 116 Cong. Rec. 18,940 (1970) (statement of Sen. McClellan). See also *id.*, at 35,193 (statement of Rep. Poff) (RICO 'not aimed at the isolated offender'); House Hearings, at 665. Significantly, in defining 'pattern' in a later provision of the same bill, Congress was more enlightening: '[C]riminal conduct forms a pattern if it embraces criminal acts that have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events.' 18 U.S.C. § 3575(e). This language may be useful in interpreting other sections of the Act. Cf. *Iannelli v. United States*, 420 U.S. 770, 789 (1975).

*Id.*

206 *Id.*

207 *Barticheck v. Fidelity Union Bank*, 832 F.2d 36, 39 (3d Cir. 1987); *R.A.G.S. Couture, Inc. v. Hyatt*, 774 F.2d 1350, 1354 (5th Cir. 1985) (pattern found where two predicate acts were related to each other in the course of a single scheme).

As a result, in the context of accountant fraud,<sup>208</sup> similar fact patterns yielded divergent results. Some courts held that a single fraudulent audit was too compressed in time and scope to constitute a "pattern" regardless of how many mailings, wirings, or fraudulent acts contributed to the audit. To illustrate, in *Professional Assets Management, Inc. v. Penn Square Bank*,<sup>209</sup> the plaintiff brought a RICO action against the defendant's accounting firm alleging that the firm conducted a fraudulent audit of Penn Square Bank. The plaintiff alleged the defendant's pattern of activity consisted of several acts of mail and wire fraud.<sup>210</sup> The court disagreed and noted all of the predicate acts were part of a unified single transaction—the preparation of a single audit report. The court concluded that several mailings in furtherance of a single scheme did not constitute a pattern under RICO.<sup>211</sup> Other courts took the view that multiple mailings in conjunction with a single bad audit could constitute a pattern. Thus, one court concluded that thirty fraudulent audit letters mailed in connection with a single audit were sufficient to constitute a RICO pattern.<sup>212</sup>

Despite the courts' focus on "schemes," the RICO statute itself refers to "acts," two or more of which must be "related" and in "continuity" to constitute a "pattern."<sup>213</sup> Neither RICO nor its legislative history refers to a "pattern" in terms of a "scheme."<sup>214</sup> A court relying

208 Similar concerns surrounded the use of RICO against attorneys. In the context of attorney misconduct, RICO has been used against attorneys who acted in concert with corporate officers to enable a fraudulent sale of securities to occur. *Robertson v. White*, 633 F. Supp. 954, 977 (W.D. Ark. 1986). In another securities case, the fact that a law firm prepared offering memoranda was enough to allege direct or indirect participation in the affairs of an enterprise. *In re National Mortgage Equity Corp. Mortgage Pool Certificates Sec. Litig.*, 636 F. Supp. 1138, 1170 (C.D. Cal. 1986). See also *Crocker Nat'l Bank v. Rockwell Int'l Corp.*, 555 F. Supp. 47, 49 (N.D. Cal. 1982).

209 616 F. Supp. 1418 (W.D. Okla. 1985). Beyond its relevance in this context, the failure of Penn Square Bank had major ramifications on America's financial institutions. For a description of the circumstances leading to the Penn Square Bank failure, see M. SINGER, *FUNNY MONEY* (1985) and P. ZWEIG, *BELLY UP* (1985).

210 *Penn Square Bank*, 616 F. Supp. at 1420-21.

211 Other cases holding multiple predicate acts do not constitute a "pattern" include: *Lipin Enter. Inc. v. Lee*, 803 F.2d 322, 323 (7th Cir. 1986) (12 predicate acts are not enough); *Superior Oil Co. v. Fulmer*, 785 F.2d 252, 257 (8th Cir. 1986) (defendant's actions were in pursuit of a single plan to steal gas); *Norman v. Brown, Todd, & Heyburn*, 693 F. Supp. 1259, 1264 (D. Mass. 1988) (no pattern because fraudulent information was provided solely in connection with one limited partnership); *Singh v. Curry*, 667 F. Supp. 603, 608 (N.D. Ill. 1987) (attorney defendants); *Buran Equip. Co., Inc. v. Hydro Elec. Constructors, Inc.*, 656 F. Supp. 864, 866 (N.D. Cal. 1987) (no pattern where offenses all relate to one commercial transaction that involved a single injury and a single victim).

212 *Alexander Grant & Co. v. Tiffany Indus., Inc.*, 770 F.2d 717, 718 n.1 (8th Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986). See *United States v. Ianniello*, 808 F.2d 184, 192 (2d Cir. 1986), *cert. denied*, 483 U.S. 1006 (1987) (rejecting any requirement of multiple criminal episodes and holding that the elements of relatedness and continuity are satisfied when a person commits at least two acts that have the common purpose of furthering a continuing criminal enterprise with which the person is associated); *Bank of Am. Nat'l Trust & Sav. Ass'n v. Touche Ross & Co.*, 782 F.2d 966, 971 (11th Cir. 1986) (holding that nine mailings of fraudulent financial statements over a period of three years was sufficient to constitute a pattern even though the fraud was the same as to each statement); *Schacht v. Brown*, 711 F.2d 1343, 1351 (7th Cir.) (allowing pattern which consisted of mailing fraudulent financial statements of insurer), *cert. denied*, 464 U.S. 1002 (1983). See also *R.A.G.S. Couture, Inc. v. Hyatt*, 774 F.2d 1350, 1354 (5th Cir. 1985) (finding that the mailing of false invoices on two occasions is enough to constitute a pattern).

213 *Federal Deposit Ins. Corp. v. Kerr*, 637 F. Supp. 828, 835 (W.D.N.C. 1986).

214 *Id.*

on this reading of RICO found that a series of loans and asset transfers constituted a pattern although the activity comprised but one "scheme."<sup>215</sup> In the context of the predicate acts for a pension plan scam, in and of itself, a multiplicity of mailings does not necessarily translate directly into a "pattern."<sup>216</sup> However, some courts were more likely to find a pattern when the fraud affected a large group of plaintiffs.<sup>217</sup> Thus, in the post-*Sedima* era, it was not clear if one fraudulent pension plan audit could ever constitute a RICO pattern.

### 3. *H.J. Inc.*

In contrast to *Sedima*, which dealt with pattern only as a collateral matter, the Court directly addressed the pattern issue in *H.J. Inc. v. Northwestern Bell Telephone Co.*<sup>218</sup> The Court rejected notions—espoused by the Eight Circuit—that a pattern of activity required separate schemes: "We find no support . . . for the proposition . . . that predicate acts of racketeering activity may form a pattern only when they are part of separate illegal schemes."<sup>219</sup> Also rejected was the notion that the mere existence of two predicate acts constituted a pattern: "Nor can we agree . . . that a pattern is established merely by proving two predicate acts."<sup>220</sup> Instead, the Court propounded that the predicate acts themselves must "amount to, or . . . otherwise constitute a threat of, *continuing* racketeering activity."<sup>221</sup> Consequently, "[p]redicate acts extending over a few weeks or months and threatening no future criminal conduct do not satisfy this [the pattern] requirement."<sup>222</sup> The acts must involve a "distinct threat of long-term racketeering activity, either implicit or explicit."<sup>223</sup>

After deciding *H.J. Inc.*, the Court cleared its docket of fifteen pending certiorari petitions dealing with the RICO pattern requirement. The treatment of these cases is further evidence of what a RICO pattern may look like after *H.J. Inc.* The Court remanded ten cases. Arguably, these cases were inconsistent with *H.J. Inc.* because they failed properly to consider continuity,<sup>224</sup> overly relied on the lack of a future threat,<sup>225</sup> or im-

<sup>215</sup> *Id.*

<sup>216</sup> *Elliott v. Chicago Motor Club Ins.*, 809 F.2d 347, 350 (7th Cir. 1986). *See also* *Louisiana Power & Light Co. v. United Gas Pipe Line Co.*, 642 F. Supp. 781, 809 (E.D. La. 1986) (pattern ought not be found where one fraud, but repeated mailings).

<sup>217</sup> *See, e.g., In re Energy Sys. Equip. Leasing Sec. Litig.*, 642 F. Supp. 718, 741 (E.D.N.Y. 1986) ("nor do plaintiffs merely allege the existence of a single fraudulent scheme or transaction that defrauded a single individual plaintiff").

<sup>218</sup> 109 S. Ct. 2893 (1989).

<sup>219</sup> *Id.* at 2899.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* at 2901.

<sup>222</sup> *Id.* at 2902.

<sup>223</sup> *Id.*

<sup>224</sup> First, the Court remanded *United States v. Hobson*, 825 F.2d 364 (11th Cir. 1987) (this case also held that there could be two predicate offenses in the same criminal act), *vacated*, 109 S. Ct. 3233 (1989). In *Hobson*, the Eleventh Circuit reasoned that *Sedima* did not change the Circuit's rule that two separate crimes clearly constituted two separate acts for RICO purposes. *Id.* at 366 n.2. Since the court did not consider continuity in its analysis, this case does not comport with *H.J. Inc.*

Second, in *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988), *vacated*, 109 S. Ct. 3236 (1989), the Fifth Circuit held that "RICO requires only that the predicate acts alleged be related, *not* that they arise from separate schemes or incidents." *Id.* at 1129. In doing so, the court determined

properly evaluated a single incident of activity.<sup>226</sup> In addition, the Court remanded an Eighth Circuit case that followed the two scheme approach.<sup>227</sup> On the other hand, the Court declined to review five decisions. Two of these explicitly rejected the two scheme approach in their

that each fraudulent use of the mails to accomplish the same scheme is a separate predicate act. However, in its analysis the court failed to examine the relatedness or the continuity of the acts.

Next, the Court remanded *Hospital Employees' Local 79 v. Mercy-Memorial Hosp. Corp.*, 862 F.2d 606 (6th Cir. 1988), *vacated*, 109 S. Ct. 3236 (1989), a case from the Sixth Circuit. In *Mercy Hospital*, the court held that the fact that the defendant had "one overall purpose" did not conflate all of its alleged wrongful acts into only one RICO event. *Id.* at 609. Importantly, however, the court did not even mention continuity or relatedness in its analysis.

The last in this series of cases remanded by the Court was *United States v. Alexander*, 850 F.2d 1500 (11th Cir. 1988), *vacated*, 109 S. Ct. 3236 (1989), from the Eleventh Circuit. In *Alexander*, the court reasoned that the prosecution need only prove that "each individual participated in two or more predicate acts or crimes." *Id.* at 1506. Absent from the analysis was any mention of "relatedness" or "continuity."

225 First, the Court remanded *Eastern Publishing & Advertising v. Chesapeake Publishing & Advertising*, 831 F.2d 488 (4th Cir. 1987), *vacated*, 109 S. Ct. 3234 (1989), a case in which the Fourth Circuit failed to find a RICO pattern. In this case, the court concluded that the alleged acts of mail and wire fraud "failed to charge the kind and degree of continuous engagement in criminal conduct required to constitute a RICO 'pattern'" because there was "no inference that the scheme embodies a threat of continuity like activity in the future." *Id.* at 492. *But see* *Menasco, Inc. v. Wasserman*, 886 F.2d 681, 684 (4th Cir. 1989) (failing to find a RICO pattern because allegations involved a "limited purpose," "one perpetrator," "one set of victims," and took place over the course of only one year).

Second, the Court remanded *Yellow Bus Lines, Inc. v. Drivers, Chauffeurs & Helpers Local Union 639*, 839 F.2d 782 (D.C. Cir. 1988), *vacated*, 109 S. Ct. 3235, *reaffirmed and remanded*, 883 F.2d 132, 145 (D.C. Cir. 1989) (district court to hear RICO claim). In *Yellow Bus Lines*, the District of Columbia Circuit determined that an accusation that the defendants engaged in four acts "during a specific time period in pursuit of a unitary goal" met the requirements for a pattern. *Id.* at 789. In this case, the RICO claim was also challenged because the defendant was alleged to be both the "person" and the RICO "enterprise." *Id.* at 789-92.

Finally, the Court remanded a Second Circuit case, *Beauford v. Helmsley*, 865 F.2d 1386 (2d Cir.), *vacated*, 109 S. Ct. 3236 (1989). In this case the court refused to impose a "multiple episode requirement" and concluded that "each individual racketeering act should be separately counted." *Id.* at 1391. The court also reasoned that the plaintiff need not allege that the criminal activity comprise an "ongoing scheme." *Id.*

226 First, the Court remanded a Third Circuit case, *Marshall-Silver Constr. Co., Inc. v. Mendel*, 835 F.2d 63 (3d Cir. 1987), *vacated*, 109 S. Ct. 3233 (1989). There, the court refused to find a RICO pattern because the cases involved "a single victim, a single injury, and a single, short-lived scheme with only two active perpetrators." *Id.* at 67. The *Mendel* court evaluated continuity, but failed to find that it existed.

Also, in *Walk v. Baltimore & O.R.R.*, 847 F.2d 1100 (4th Cir. 1988), *vacated*, 109 S. Ct. 3235 (1989), the Fourth Circuit had determined that "the objective of the related predicate acts is a factor to be considered in assessing the criminal dimension and degree." *Id.* at 1106. In doing so the court rejected a finding that predicate acts which perpetrate only a single fraud can constitute a pattern. *Id.* at 1104. Although the court disavowed the Eighth Circuit's two-scheme requirement, its holding had the similar effect of making a single fraud RICO claim all but impossible.

227 In *Terre Du Lac, Assoc., Inc. v. Terre Du Lac, Inc.*, 834 F.2d 148 (8th Cir. 1987), *vacated*, 109 S. Ct. 3234 (1989), the Eighth Circuit reaffirmed its view that "something more than a single scheme is required in order to establish a pattern of racketeering activity." *Id.* at 149. Of course, the double scheme requirement was specifically rejected by the Court in *H.J. Inc.* See *supra* note 219 and accompanying text.

analysis of continuity<sup>228</sup> while the other cases evaluated continuity along the lines of *H.J. Inc.*<sup>229</sup>

The Court's holding in *H.J. Inc.* and its treatment of the other pattern cases on its docket demonstrate that the two scheme requirement is dead. These decisions also eliminate ambiguity as to whether a single fraudulent audit or pension plan report could ever result in a RICO pattern: they could.<sup>230</sup> Accordingly, *H.J. Inc.* presents an opportunity for the PWBA and the PBGC to pursue pension plan fraud more aggressively under the RICO statute.

The third requirement for a RICO violation is that the person participate in an "enterprise."<sup>231</sup> This element demands (1) the existence of an enterprise and (2) that the defendant participate in the enterprise. An enterprise is, among other things, "a group of persons associated together for a common purpose of engaging in a course of conduct."<sup>232</sup> More specifically, enterprise "includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity."<sup>233</sup> Most courts tend to give a broad and literal meaning to the requirement that the defendant "directly or indirectly" participate in the enterprise.<sup>234</sup> How-

228 First, the Court refused to review a Seventh Circuit case, *Liquid Air Corp. v. Rogers*, 834 F.2d 1297 (7th Cir. 1987), cert. denied, 109 S. Ct. 3241 (1989). In *Rogers*, the court found that the repeated infliction of economic injury on a single victim, pursuant to a single scheme was sufficient to constitute a RICO pattern. *Id.* at 1305. In its analysis, the court rejected the two scheme requirement. *Id.* at 1304. The court also held that "continuity" could be found even though there was no continuing threat of criminal activity. *Id.* at 1308.

Second, the Court refused to review *Medallion Television Enter. v. SelecTV of Cal.*, 833 F.2d 1360 (9th Cir. 1987), cert. denied, 109 S. Ct. 3241 (1989), from the Ninth Circuit. In *SelecTV*, the court rejected any requirement of "more than one 'scheme' or 'criminal episode.'" *Id.* at 1363. Instead, the court held that the case "must suggest that the predicate acts are indicative of a threat of continuing [sic] activity." *Id.* This analysis, of course, echoes the Court's decision in *H.J. Inc.*

229 First, the Court declined to review *Creative Bath Prods. v. Connecticut Gen. Life Ins. Co.*, 837 F.2d 561 (2d Cir. 1988), cert. denied, 109 S. Ct. 3241 (1989), a case decided by the Second Circuit. In *Creative Bath*, the court evaluated *Sedima's* "continuity plus relationship" factor as "requiring that the plaintiff establish the existence of an enterprise whose illicit activities or unlawful goals are continuing ones." *Id.* at 564. Again, this analysis parallels the Court's reasoning in *H.J. Inc.*

Next, the Court refused to review *Cory v. Lang*, 843 F.2d 1386 (4th Cir. 1988) (table opinion) (text in WESTLAW), cert. denied, 109 S. Ct. 3241 (1989), in which the court propounded that a RICO complaint had to allege "continuous engagement in criminal conduct" in order to permit the finding of a RICO pattern. *Id.* at WESTLAW p. 3 of 3.

Last, the court refused to review another Seventh Circuit case, *SK Hand Tool Corp. v. Dresser Indus.*, 852 F.2d 936 (7th Cir. 1988), cert. denied, 109 S. Ct. 3241 (1989). In *Dresser*, the court concluded that several predicate acts which "defrauded only one victim . . . on only one occasion" did not constitute a pattern because "there has been no threat of continuing fraudulent activity." *Id.* at 940.

230 A single fraudulent audit could result in a RICO pattern if the audit was part of the accounting firm's "regular way of doing business." See *H.J. Inc. v. Northwestern Bell Telephone Co.*, 109 S. Ct. 2893, 2902 (1989). In *H.J. Inc.*, the Court declared, "the threat of continuity may be established by showing that the predicate acts or offenses are part of an ongoing entity's regular way of doing business." *Id.*

231 As defined by the statute: "'enterprise' includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity." 18 U.S.C. § 1961(4) (1984). For a comprehensive analysis of the enterprise concept, see Note, *Functions of the RICO Enterprise Concept*, 64 NOTRE DAME L. REV. 646 (1989).

232 *United States v. Turkette*, 452 U.S. 576, 583 (1981).

233 18 U.S.C. § 1961(4) (1984).

234 See, e.g., *Bank of Am. Nat'l Trust & Sav. Ass'n v. Touche Ross & Co.*, 782 F.2d 966, 970 (11th Cir. 1986) (rejecting lack of conduct defense by accounting firm since "'conduct' in § 1962(c) sim-

ever, some courts take a more narrow view of the conduct requirement reasoning that "[a] person who assists another in some unknown activity does not conduct the activity and is not a participant."<sup>235</sup> Since attorneys and accountants do not directly participate in the day to day operations of a pension fund, these professionals may challenge the "conduct" requirement of section 1962(c). In this context, courts have reached varied results. Some courts tend to find that outside accountants do not "conduct" the enterprise.<sup>236</sup> Other courts find it not necessary for the outside auditor to participate in management, concluding that "conduct" means performance of activity necessary or helpful to the enterprise.<sup>237</sup>

Fourth, to constitute a RICO violation, the activities of the enterprise must affect interstate commerce. A slight effect on interstate commerce is sufficient.<sup>238</sup>

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ply means the performance of activities necessary or helpful to the operation of the enterprise"); *Schacht v. Brown*, 711 F.2d 1343, 1360 (7th Cir.) (insurance companies and auditors who aided defendants in fraud satisfied conduct requirement), *cert. denied*, 464 U.S. 1002 (1983).

For a discussion of the history of the conduct requirement, see *Civil Action*, *supra* note 9, at 309 n.176. For a discussion of the conduct requirement in the context of *respondeat superior*, see *Equitable Relief*, *supra* note 118, at 584 n.236. Although some courts hold that the conduct must be by management level personnel, there is no consensus on the issue. Compare *Bennett v. Berg*, 710 F.2d 1361, 1364 (8th Cir.) ("ordinarily will require some participation in the operation or management of the enterprise"), *cert. denied*, 464 U.S. 1008 (1983) with *United States v. De Peri*, 778 F.2d 963, 983 (3d Cir. 1985) (RICO "draws no distinction between the foot soldier and the general"), *cert. denied*, 475 U.S. 1110 (1986).

235 *Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 660 F. Supp. 1362, 1371 (D. Conn. 1987) (requiring that the defendant law firm have "at least a general awareness or knowledge of the illegal activities of the [RICO] enterprise"). See also *Bennett*, 710 F.2d at 1364 ("[a] defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself"); *Lipin Enter., Inc. v. Lee*, 625 F. Supp. 1098, 1100 (N.D. Ill. 1985) (RICO claim against attorney dismissed since attorney had not "conducted or participated in the direction or management of the companies' affairs").

236 See, e.g., *Plains/Anadarko-P Ltd. v. Coopers & Lybrand*, 658 F. Supp. 238, 240 (S.D.N.Y. 1987).

237 See *supra* note 234.

238 See *United States v. Doherty*, 867 F.2d 47, 68 (1st Cir. 1989) ("RICO requires no more than a slight effect upon interstate commerce"), *cert. denied*, 109 S. Ct. 3243 (1989); *United States v. Robinson*, 763 F.2d 778, 781 (6th Cir. 1985) ("minimal impact"). See also *McLain v. Real Estate Bd. of New Orleans, Inc.*, 444 U.S. 232, 241-43 (1980) (antitrust case); *Hospital Bldg. Co. v. Trustees of Rex Hosp.*, 425 U.S. 738, 744 (1976) (antitrust case), *cert. denied*, 464 U.S. 890 (1983).

Fifth, the plaintiff must suffer an injury to business or property<sup>239</sup> and the RICO violation must have caused the injury.<sup>240</sup> If a party violates RICO, the civil<sup>241</sup> and criminal<sup>242</sup> sanctions are substantial.

#### IV. Available Remedies

The best cause of action to pursue also depends on the available remedies. A proper evaluation of remedies mandates consideration of the following: (1) the measure of damages—whether general or special, or treble; (2) the availability of punitive damages; and, (3) the ability to freeze the defendant's assets prior to trial.

##### A. Measure of Damages

Important to any recovery strategy is the measure of damages. There are two broad types of damages: general damages and special damages. General damages are damages that are usually associated with the particular wrong committed by the defendant while special damages are peculiar to the specific plaintiff and would not be expected to occur to other plaintiffs in similar circumstances.<sup>243</sup>

239 The statute authorizes "[a]ny person injured in his business or property" to bring a civil suit in federal court against the wrongdoers. 18 U.S.C. § 1964(c) (1984). See *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 493-500 (1985) (analyzing RICO's injury requirement). See also *Reiter v. Sonotone Corp.*, 442 U.S. 330, 338-39 (1979) (antitrust case); *McMurtry v. Brasfield*, 654 F. Supp. 1222, 1225 (E.D. Va. 1987) (injury must be to business or property and cannot be personal). The attorney general can also bring such a suit. 18 U.S.C. § 1964(b) (Supp. 1989).

The requirement of injury to business or property is the test for whether a plaintiff has standing to sue under RICO. See *Ocean Energy II, Inc. v. Alexander & Alexander, Inc.*, 868 F.2d 740, 743 (5th Cir. 1989). In addition to "RICO standing," there are non-RICO standing requirements that a plaintiff must satisfy. *Id.* at 744. Non-RICO standing requires that the plaintiff suffer a direct as opposed to indirect injury. *Id.* Under non-RICO standing, courts have held that shareholders may not bring a RICO action where the injury was to the corporation. *Id.* Likewise, union members do not have standing to assert a RICO claim when only the union itself suffered direct injury. *Id.* at 745. Finally, the rule means that in a bankruptcy case, only the trustee and not the individual creditors have standing to recover property belonging to the estate. *Id.*

In the context of pension plan fraud, the PWBA would sue on behalf of the plan for injury to the plan, while the injury to the PBGC would be the amount the agency was forced to pay to the employees of failed plans.

240 *Sedima*, 473 U.S. at 497 ("Any recoverable damages occurring by reason of a violation of § 1962(c) will flow from the commission of the predicate acts."); *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir.) (no recovery to those injured as a consequence of being used as a tool of the criminal enterprise), *cert. denied*, 459 U.S. 880 (1982).

241 See *infra* notes 254-57 and accompanying text for discussion of the remedies available under civil RICO.

242 For a criminal violation, the violator can be fined or imprisoned not more than 20 years, or both. 18 U.S.C. § 1963 (Supp. 1989). In addition to fine and imprisonment, the violator must forfeit to the United States any interest acquired as a result of the illegality and any interest in the enterprise that affords the violator a source of power over the enterprise involved. *Id.* § 1963(a). See *Russello v. United States*, 464 U.S. 16, 20-22 (1983). Once forfeited, the United States shall dispose of the property as soon as commercially feasible, making due provision for the rights of innocent persons. 18 U.S.C. § 1963(f) (Supp. 1989). As an additional sanction, a court may enter a restraining order to prevent transfer of the property threatened with forfeiture. *Id.* § 1963(d)(2). See *United States v. Regan*, 858 F.2d 115, 120-22 (2d Cir. 1988) (requirement of a monitor to measure compliance with restraints upon property potentially forfeitable under RICO was appropriate because parties had opportunity to dissipate assets of the enterprise). This provision of RICO has come under increasing attack from those opposed to the RICO statute. See, e.g., Adler, *Are RICO Seizures A Violation of Rights, As Critics Contend?*, Wall St. J., Feb. 15, 1989, at A1, col. 1.

243 D. DOBBS, LAW OF REMEDIES 138 (1973) [hereinafter DOBBS].



General damages are computed on the basis of either "actual damages" or the "benefit of the bargain." Damages under the "benefit of the bargain" approach usually consist of the value of the "profit" the nonbreaching party would have made on the agreement.<sup>244</sup> In contrast, the goal of "actual damages" is to put the nonbreaching party into the position he was in before the agreement.<sup>245</sup> Consequently, if the agreement was beneficial to the innocent party, the benefit of the bargain approach will result in a higher damage amount.<sup>246</sup> The choice of a cause of action should consider which method will be used.

In contrast to general damages, courts are often reluctant to award special damages.<sup>247</sup> Accordingly, courts limit recovery of special damages in two ways. First, special damages must be proven to a "reasonable certainty."<sup>248</sup> Second, special damages are not recoverable if they are "remote."<sup>249</sup> In addition, recovery of special damages depends on the nature of the cause of action.

With respect to general damages, the common law in most states provides for actual damages to be awarded in negligent misrepresentation claims.<sup>250</sup> With respect to fraud cases, some states allow recovery for the benefit of the bargain,<sup>251</sup> while others limit recovery to the out-of-pocket loss.<sup>252</sup> Although special damages can be awarded in fraud cases, they cannot be recovered for mere negligence.<sup>253</sup>

The measure of damages in a federal RICO suit is at least out-of-pocket losses, or the actual damages suffered by the plaintiff.<sup>254</sup> It is not clear, however, whether damages under federal RICO are compensatory

244 H. HUNTER, MODERN LAW OF CONTRACTS: BREACH AND REMEDIES ¶ 7.02 [2] (1986).

245 *Id.* ¶ 7.02 [4].

246 DOBBS, *supra* note 243, at 596.

247 *Id.* at 139.

248 *Id.*

249 *Id.* In tort actions, remoteness is expressed in terms of proximate cause. *Id.* Thus, if the defendant's act was not the proximate cause of the damage, then special damages cannot be recovered because the injury was too remote. In breach of contract actions, remoteness is defined in terms of the "contemplation of the parties when the contract was made." *Id.* Thus, damages are too remote if they were not contemplated by the parties to the contract.

250 See, e.g., Arizona Title Ins. & Trust Co. v. O'Malley Lumber Co., 14 Ariz. App. 486, 492, 484 P.2d 639, 645 (1971) ("under most authorities a false statement negligently made may be the basis of a recovery of damages for injury or loss sustained in consequence of reliance thereon"); Robinson v. Poudre Valley Fed. Credit Union, 654 P.2d 861, 863 (Colo. Ct. App. 1982) (damages equal difference between value received and purchase price plus other pecuniary loss suffered as a result of plaintiff's injury); Alice D. v. William M., 113 Misc. 2d 940, 949, 450 N.Y.S.2d 350, 356 (N.Y. Civ. Ct. 1982) ("remedy afforded an injured party in negligence is designed to place that party in the position he would have occupied but for the negligence of the defendant").

251 See, e.g., Steele v. Vanderslice, 90 Ariz. 277, 367 P.2d 636, 641 (1961) (en banc).

252 See, e.g., Zimmerman v. Loose, 162 Colo. 80, 91, 425 P.2d 803, 809 (1967) (damages equal actual loss suffered); Clearview Concrete Prods. Corp. v. S. Charles Gherardi, Inc., 88 A.D.2d 461, 467-68, 453 N.Y.S.2d 750, 755 (N.Y. App. Div. 1982) (standard is out of pocket rule plus consequential damages caused by reliance on misrepresentation).

253 DOBBS, *supra* note 243, at 598. Special damages can include consequential damages and attorney fees. *Id.* at 598-99. In an action for fraud, a plaintiff can recover—in addition to general damages—consequential damages for lost profits, expenses resulting from the fraud, and loss of good will suffered with customers. Lowrey v. Dingmann, 251 Minn. 124, 127, 86 N.W.2d 499, 502 (1957).

254 18 U.S.C. § 1964(c) (1984) ("shall recover . . . the damages he sustains"). Compare Fleischhauer v. Feltner, 879 F.2d 1290, 1300 (6th Cir. 1989) ("amounts actually invested;" no expectancy "in this case") with Liquid Air Corp. v. Rogers, 834 F.2d 1297, 1310 (7th Cir. 1987) (contract not fair market value is proper measure), *cert. denied*, 109 S. Ct. 3241 (1989).

or penal in nature. The cases in this area are inconsistent with some courts treating RICO damages as compensatory and others classifying the damages as punitive.<sup>255</sup> State RICO statutes usually adhere to the same measure of damages as federal RICO.<sup>256</sup> In contrast to actions under ERISA or under state common law, under civil RICO, a private plaintiff can recover treble damages.<sup>257</sup>

### B. Punitive Damages

The purpose of punitive damages is to punish the defendant and to deter others from similar behavior.<sup>258</sup> Accordingly, punitive damages do not compensate for injury.<sup>259</sup> Although there is no formula for computing punitive damages, the amount must be "reasonably related to actual damages"<sup>260</sup> and should not "destroy" the defendant's net worth.<sup>261</sup>

Given the nature of punitive damages, they cannot be recovered in all types of common law claims. Specifically, punitive damages cannot be recovered in breach of contract cases.<sup>262</sup> With respect to tort actions, the

255 The confusion in the courts is exemplified by *State Farm Fire & Casualty Co. v. Estate of Caton*, 540 F. Supp. 673 (N.D. Ind. 1982). In *Caton*, the court characterized RICO damages as compensatory in concluding that the RICO action survived the death of the defendant. *Id.* at 685. However, the continued vitality of *Caton* is uncertain because the Seventh Circuit subsequently held treble damages to be penal for statute of limitations purposes. *Tellis v. United States Fidelity & Guar. Co.*, 805 F.2d 741, 746 (7th Cir.), *vacated*, 483 U.S. 1015 (1986), *on remand*, 826 F.2d 477 (7th Cir. 1987). Based upon *Tellis*, the district court overruled *Caton* for statute of limitations purposes, in *Ashland Oil Co. v. Arnett*, 656 F. Supp. 950, 953 (N.D. Ind. 1987) ("Civil RICO claims . . . are now uniformly characterized as claims for statutory penalties"), *aff'd on other grounds*, 875 F.2d 1271 (7th Cir. 1989). *Tellis* in turn was vacated after the Court's ruling in *Agency Holding Corp. v. Malley-Duff Assocs., Inc.*, 483 U.S. 143 (1987). Arguably, *Ashland Oil's* reason for overruling *Caton* on a statute of limitations question has been rejected and the survival issue should be regarded as intact. See *Liquid Air Corp.*, 834 F.2d at 1310 n.8 (treble damages not punitive, but compensatory).

For a comprehensive discussion of how RICO damages should be characterized, see Note, *Treble Damages Under RICO: Characterization and Computation*, 61 NOTRE DAME L. REV. 526, 534-44 (1986) [hereinafter *Treble Damages*]. The characterization of damages is important for several reasons. First, while a claim for compensatory damages survives the death of the defendant, a claim for punitive damages does not. *Id.* at 535. Second, although a plaintiff can recover compensatory damages by summary judgment, punitive damages cannot be recovered on summary judgment because such an award is within the discretion of the jury. *Id.* at 537. Third, while compensatory damages are deductible under the Internal Revenue Code as a business expense, punitive damages are not deductible. *Id.* at 538. Fourth, while insurance covers compensatory damages, punitive damages are usually not insurable due to public policy concerns. *Id.* at 540.

256 See, e.g., *Vairo v. Clayden*, 153 Ariz. 13, 734 P.2d 110, 116 (Ariz. Ct. App. 1987) (actual losses out of pocket trebled to find damages); COLO. REV. STAT. § 18-17-106(7) (1986) ("actual damages sustained").

257 18 U.S.C. § 1964(c) (1984).

258 *Memphis Community School Dist. v. Stachura*, 477 U.S. 299, 306 n.9 (1986); *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 350 (1974) ("private fines levied by civil juries to punish reprehensible conduct and to deter it future occurrence"). See DOBBS, *supra* note 243, at 204.

259 *Gertz*, 418 U.S. at 350.

260 *Hudson v. Moore Business Forms, Inc.*, 836 F.2d 1156, 1163 (9th Cir. 1987). See DOBBS, *supra* note 243, at 210-11.

261 *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498, 1503 (11th Cir. 1985). The law in some states may deviate from these basic principles. For example, in Oklahoma, punitive damages need bear no relation to actual damages but "must bear some relation to the injuries inflicted." *Spaeth v. Union Oil Co. of Cal.*, 762 F.2d 865, 866 (10th Cir. 1985), *cert. denied*, 476 U.S. 1104 (1986).

262 *Tibbs v. Great Am. Ins. Co.*, 755 F.2d 1370, 1375 (9th Cir. 1985) (not recoverable for breach of contract "no matter how gross or willful"). See DOBBS, *supra* note 243, at 207, 818. But see *Hamed v. General Accident Ins. Co. of Am.*, 842 F.2d 170, 172 (7th Cir. 1988) (punitive damages can be

allowability of punitive damages depends on the type of tort. If the defendant is merely negligent, the plaintiff cannot generally recover punitive damages.<sup>263</sup> However, if the defendant is grossly negligent, punitive relief may be available.<sup>264</sup> Punitive damages can also be assessed if the defendant acted in a willful manner.<sup>265</sup> Although punitive damages can usually be assessed in actions for fraud,<sup>266</sup> some states require additional evidence of egregious action and disallow punitive recovery in cases of "mere fraud."<sup>267</sup>

With respect to statutory causes of action, it is generally agreed that a plaintiff cannot recover punitive damages in a civil RICO action.<sup>268</sup> Although ERISA does not specifically provide for punitive damages, courts are split as to whether a plaintiff can recover such damages.<sup>269</sup>

In summary, while a plaintiff cannot recover some multiple of actual damages in an action for negligence, he may be able to recover treble damages under RICO or punitive damages in an action for fraud. In some jurisdictions, a plaintiff can also recover punitive damages when a fiduciary breaches his duties under ERISA.

### C. *Freezing Assets*

In suits under common law, there are two primary methods for freezing assets prior to the outcome of the litigation: attachment and

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imposed for breach of contract where the conduct "constitutes an independent tort" or where "elements of fraud, malice, gross negligence or oppression mingle in the controversy").

263 *Creamer v. Porter*, 754 F.2d 1311, 1319 (5th Cir. 1985) ("must have been in reckless disregard for the rights of others, and not just merely negligent, before exemplary damages will be assessed"); *David by Berkeley v. Pueblo Supermarket*, 740 F.2d 230, 237 (3d Cir. 1984) ("existence of negligence alone is not sufficient to award punitive damages"); *Dukeminier v. K-Mart Corp.*, 651 F. Supp. 1322, 1324 (D. Colo. 1987) (no punitives for "simple negligence").

264 *Compare Stewart & Stevenson Servs., Inc. v. Pickard*, 749 F.2d 635, 650 (11th Cir. 1984) ("[e]ither gross negligence or intentional or reckless fraud will support an award of punitive damages") with *Raynor v. Richardson-Merrell, Inc.*, 643 F. Supp. 238, 245 (D.D.C. 1986) ("[w]anton and reckless disregard for the rights of others will support an award of punitive damages, but gross negligence will not").

265 *Raynor*, 643 F. Supp. at 245 ("[w]anton and reckless disregard for the rights of others will support an award of punitive damages"); *Martin v. Granite City Steel Corp.*, 596 F. Supp. 293, 296 (S.D. Ill. 1984) (punitives allowed where defendant "acted wilfully or with such extreme negligence as to indicate reckless disregard for the safety of others").

266 *See Computer Sys. Eng'g, Inc. v. Qantel Corp.*, 740 F.2d 59, 70 (1st Cir. 1984) (under California law punitives are allowed in fraud cases); *Tackett v. Kidder*, 616 F.2d 1050, 1053 (8th Cir. 1980) (Arkansas permits punitive damages for fraud).

267 *Wallach Marine Corp. v. Donzi Marine Corp.*, 675 F. Supp. 838, 842 (S.D.N.Y. 1987) ("mere fraud is insufficient to support a claim of punitive damages"); *Computer Sys. Eng'g*, 740 F.2d at 70 (no punitives for fraud under Massachusetts law).

268 *Moravian Dev. Corp. v. Dow Chem. Co.*, 651 F. Supp. 144, 149-50 (E.D. Pa. 1986) ("punitive damages are not appropriate in addition to the treble damages provided by RICO"). *See also Beneficial Standard Life Ins. Co. v. Madariaga*, 851 F.2d 271, 277 (9th Cir. 1988) (reserving question of whether RICO preempts punitive damage awards on pendent state claims based on the same underlying activity that gave rise to the RICO claim). For an argument that punitive damages should be allowed in addition to treble damages under RICO, see *Treble Damages*, *supra* note 255, at 547-48.

269 *Compare Winterrowd v. David Freedman & Co., Inc.*, 724 F.2d 823, 826 (9th Cir. 1984) ("a punitive award is appropriate where a fiduciary duty has been breached" under ERISA); *Schoenholtz v. Doniger*, 657 F. Supp. 899, 914 (S.D.N.Y. 1987) ("punitive damages are a form of 'equitable relief' within the meaning" of ERISA) with *Dependahl v. Falstaff Brewing Corp.*, 653 F.2d 1208, 1216 (8th Cir.) ("[w]e do not think punitive damages are provided for in ERISA"), *cert. denied*, 454 U.S. 968 (1981); *Bartucca v. Katy Indus., Inc.*, 668 F. Supp. 111, 114 (D. Conn. 1987) (examining the law of trusts and holding that "ERISA does not provide for punitive damages").

injunction.<sup>270</sup> Since neither ERISA nor federal civil RICO expressly allows a plaintiff to freeze assets, common law principles govern.

An injunction is a "judicial process operating in personam, and requiring [the] person to whom it is directed to do or refrain from doing a particular thing."<sup>271</sup> An attachment is a "remedy ancillary to an action by which plaintiff is enabled to acquire a lien upon property or effects of defendant for satisfaction of judgment which plaintiff may obtain."<sup>272</sup> An injunction is an equitable remedy while attachment is a remedy at law. While a freeze of assets pursuant to an injunction can have the effect of an attachment, an injunction is not an attachment.<sup>273</sup>

Since an injunction is an equitable remedy, it is governed by general common law principles of equity. To obtain a preliminary injunction, a plaintiff must show that (1) he has a substantial likelihood of prevailing on the merits, (2) he is likely to suffer irreparable injury if the injunction is not granted, (3) the threatened injury outweighs the threatened harm to the defendant from the injunction, and (4) granting the injunction will not disserve the public interest.<sup>274</sup> The general federal rule of equity is that a court may not reach a defendant's assets unrelated to the underlying litigation and freeze them to satisfy a potential monetary judgment.<sup>275</sup> Courts are divided on whether injunctive relief can be granted in conjunction with an attachment. For example, the Sixth Circuit relied on District of Columbia Circuit precedent and "long-standing theories of equity jurisdiction" in concluding that a preliminary injunction should not be granted unless the legal remedy provided by a state's attachment statute is inadequate.<sup>276</sup> However, in *Mishkin v. Kenney & Branisel, Inc.*,<sup>277</sup> a district court held that corporate trustees were entitled to an order of attachment as well as a preliminary injunction.

In contrast to injunctive relief, attachment is governed by principles of state law.<sup>278</sup> The Federal Rules of Civil Procedure provide that attachment is available "in the manner provided by the law of the state in which the district court is held."<sup>279</sup> In some states attachment can only be granted in connection with a contractual claim.<sup>280</sup> But, in contrast to in-

270 For a discussion of the remedies of attachment, the temporary restraining order, and the injunction in the context of civil RICO, see *Civil Action*, *supra* note 9, at 334 n.217. For a historical perspective on the English common law of injunctions, see *Equitable Relief*, *supra* note 118, at 559 n.166.

271 BLACK'S LAW DICTIONARY 705 (5th ed. 1979).

272 *Id.* at 115.

273 *Republic of the Philippines v. Marcos*, 862 F.2d 1355, 1361 (9th Cir. 1988), *cert. denied*, 109 S. Ct. 1933 (1989).

274 See *In re Fredeman Litig.*, 843 F.2d 821, 824 (5th Cir. 1988) (denying an injunction under state law claims and in a civil RICO case).

275 *Id.* at 824 (citing *De Beers Consolidated Mines v. United States*, 325 U.S. 212 (1945)).

276 *Ebsco Indus., Inc. v. Lilly*, 840 F.2d 333, 335-36 (6th Cir.) (affirming grant of injunction because attachment remedy was inadequate to protect the plaintiff) (citing *Dorfmann v. Boozer*, 414 F.2d 1168, 1171-72, 1174 (D.C. Cir. 1969)), *cert. denied*, 109 S. Ct. 73 (1988).

277 609 F. Supp. 1254, 1257 (S.D.N.Y.), *aff'd*, 779 F.2d 35 (2d Cir. 1985).

278 For a more detailed discussion of attachment in the context of civil RICO, see *Civil Action*, *supra* note 9, at 334 n.217.

279 FED. R. CIV. P. 64. See *Ebsco Indus.*, 840 F.2d at 335-36 (applying Ohio law); *Filmtrucks, Inc. v. Earls*, 635 F. Supp. 1158, 1161-62 (S.D.N.Y. 1986) (applying New York law).

280 See, e.g., *Republic of the Philippines v. Marcos*, 862 F.2d 1355, 1361 (9th Cir. 1988) (applying California law), *cert. denied*, 109 S. Ct. 1933 (1989).

junctive relief, an attachment can reach any property of the defendant and not just the property germane to the underlying litigation.

Injunctive relief has been upheld in the specific context of ERISA. In *Anthony v. Texaco*,<sup>281</sup> employees claiming benefits under an ERISA plan obtained a temporary restraining order prohibiting their employer from transferring certain assets. The court cited *Foltz v. U.S. News & World Report*<sup>282</sup> for the proposition that a prejudgment asset freeze was warranted under ERISA. Not allowing injunctive relief "would do violence to Congress' intent in carefully framing an arsenal of remedial legal weapons in this watershed statute not to preserve the *status quo* to the extent of keeping alive an otherwise viable, statutorily provided cause of action."<sup>283</sup>

Some state RICO statutes take a more liberal approach to injunctive relief than the federal rule. For example, under Florida RICO, the plaintiff does not need to show irreparable damage to obtain an injunction.<sup>284</sup> In addition to the possibility of freezing assets, under civil RICO a plaintiff can obtain equitable relief that includes forcing divestiture of an interest in an enterprise, restricting future activities or investments, and forcing dissolution or reorganization of the enterprise.<sup>285</sup> Unlike criminal RICO cases where injunctive relief is permitted by statute,<sup>286</sup> courts are divided on whether private plaintiffs can obtain injunctive relief.<sup>287</sup>

## V. Limitations on Causes of Action

Also important to the litigation strategy are the limitations of each cause of action. Such limitations include: (1) the required burden of

281 803 F.2d 593 (10th Cir. 1986).

282 760 F.2d 1300 (D.C. Cir. 1985).

283 *Texaco*, 803 F.2d at 597 (citing *Foltz*, 760 F.2d at 1309).

284 See *infra* note 287.

285 18 U.S.C. § 1964(a) (1984).

286 See *supra* note 242 for discussion of the injunctive relief available in criminal RICO cases.

287 Compare *Chambers Dev. Co. v. Browning-Ferris Indus.*, 590 F. Supp. 1528, 1540 (W.D. Pa. 1984) (equitable relief is available to private parties under RICO); *Aetna Casualty & Sur. Co. v. Liebowitz*, 570 F. Supp. 908, 910-11 (E.D.N.Y. 1983) (allowing injunctive relief), *aff'd*, 730 F.2d 905 (2d Cir. 1984) with *Religious Technology Center v. Wollersheim*, 796 F.2d 1076, 1084 (9th Cir. 1986) (denying injunctive relief), *cert. denied*, 479 U.S. 1103 (1987); *Dan River, Inc. v. Icahn*, 701 F.2d 278, 290 (4th Cir. 1983) (denying injunctive relief to a private plaintiff in RICO case predicated upon securities fraud). For a detailed analysis of equitable relief under civil RICO and of the arguments advanced in *Wollersheim*, see *Equitable Relief*, *supra* note 118.

Several states have enacted racketeering statutes similar to RICO. One advantage of some state racketeering statutes is that they specifically provide for injunctive relief, as well as treble damages and attorneys fees. See, e.g., COLO. REV. STAT. § 18-17-106 (1986); CONN. GEN. STAT. ANN. § 53-398 (West 1985); FLA. STAT. ANN. § 895-05 (West Supp. 1989); GA. CODE ANN. § 26-3406 (Harrison 1988). In addition, the requirements for obtaining injunctive relief under state RICO statutes may be less than the requirements for obtaining an injunction under common law. Compare *Finklestein v. Southeast Bank N.A.*, 490 So. 2d 976, 984 (Fla. Dist. Ct. App. 1986) (injunction order under Florida RICO reversed on common law grounds) with *Banco Industrial de Venezuela v. Mederos Suarez*, 541 So. 2d 1324, 1326 (Fla. Dist. Ct. App. 1989) (*Finklestein* rejected; Florida RICO statute obviates common law need to show irreparable damage to obtain injunction) and Note, *Criminal Law—Plaintiffs Under Florida RICO Must Meet Traditional Equity Requirements When Seeking Temporary Injunctions to Safeguard Assets—Finklestein v. Southeast Bank*, 490 So. 2d 976 (Fla. 4th DCA 1986), 14 FLA. ST. U.L. REV. 975 (1987) (*Finklestein* criticized). See also *FDIC v. Antonio*, 649 F. Supp. 1352, 1354-56 (D. Colo. 1986) (injunction granted under Colorado RICO extending to unrelated asset in bank fraud), *aff'd*, 843 F.2d 1311 (10th Cir. 1988).

proof; (2) the statute of limitations period; (3) federal common law considerations; and, (4) the applicability of insurance coverage.

### A. *Burden of Proof*

In any criminal action—including federal or state RICO—the state has the burden of proving its case “beyond a reasonable doubt.” With respect to civil actions, the standard depends on the cause of action. The general standard of proof in civil actions requires the plaintiff to prove its case by a preponderance of the evidence.<sup>288</sup> This standard applies to ERISA cases, and state law mandates this standard for negligent representation cases.<sup>289</sup>

For fraud cases, most states<sup>290</sup> mandate a higher burden—clear and convincing evidence—due to a fear that such claims could be fabricated.<sup>291</sup> Even in fraud cases, a few states still apply the general standard of preponderance.<sup>292</sup>

In addition, a handful of states require proof beyond a reasonable doubt in civil cases in order for the plaintiff to recover exemplary damages.<sup>293</sup> Also, some states provide for a shorter statute of limitations period when the plaintiff seeks a penal recovery. Thus, although the general limitations period for fraud or misrepresentation might be three years,<sup>294</sup> a one year statute may apply when the plaintiff seeks multi-damage relief classified as penal.<sup>295</sup>

Despite arguments for a higher burden, the standard of proof in a civil RICO action is the preponderance test.<sup>296</sup>

Thus, an evaluation of the burden of proof raises at least two strategy considerations. First, since different states demand different burdens for the same cause of action; choice of law becomes a key issue. Second, in choosing a cause of action, one must consider that all jurisdictions require the lowest burden—preponderance of the evidence—for suits under ERISA, for negligent misrepresentation, and for civil RICO.

288 See PROSSER, *supra* note 148, at 239-40, 269-70 (describing the burden of proof in civil cases).

289 See, e.g., COLO. REV. STAT. § 13-25-127(1) (1987) (preponderance test used in all civil actions); *Goelet v. F.W. Woolworth Co.*, 162 Misc. 735, 738, 294 N.Y.S. 542, 545 (N.Y. Civ. Ct. 1936).

290 See, e.g., *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 848 (E.D. Va. 1968); *General Accident Fire & Life Assurance Corp. v. Little*, 103 Ariz. 435, 443 P.2d 690, 698 (1968) (en banc); *National Republic Bank of Chicago v. National Homes Constr. Corp.*, 63 Ill. App. 3d 920, 924, 381 N.E.2d 15, 18 (1978).

291 *Liquid Air Corp. v. Rogers*, 834 F.2d 1297, 1303 (7th Cir. 1987), *cert. denied*, 109 S. Ct. 3241 (1989).

292 See, e.g., COLO. REV. STAT. § 13-25-127(1) (1987) (preponderance test used in all civil actions).

293 See, e.g., *id.* § 13-25-127(2).

294 See, e.g., *id.* § 13-80-101(1)(c).

295 See, e.g., *id.* § 13-80-103(1)(d). See *Sherwood v. Graco, Inc.*, 427 F. Supp. 155, 157 (D. Colo. 1977). See generally *Blakey & Walker, Emerging Issues Under the Colorado Organized Crime Control Act—Colorado's Little RICO*, 18 COLO. LAW. 2077, 2081-82 (1989) (detailed analysis of relevant statutes and caselaw materials on statute of limitations).

296 See *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479, 491 (1985) (“[N]o indication that Congress sought to depart from [preponderance standard in private civil actions].”); *Liquid Air Corp.*, 834 F.2d at 1302 (“Since *Sedima*, many lower courts have addressed the issue and have reached the conclusion that proof by a preponderance of the evidence is sufficient to establish a civil violation of section 1962.”).

## B. Statute of Limitations

In most cases, the statute of limitations<sup>297</sup> for an ERISA action is six years, although the limit is three years if the plaintiff had actual knowledge of the breach.<sup>298</sup> The limitations period for negligence suits alleging injury to personal property varies from state to state. Of the states with express statutory periods, the most common period is two years.<sup>299</sup> Several states provide for a period of as long as six years.<sup>300</sup>

The limitations period for suits alleging fraud also varies depending on the jurisdiction. Of the states with express statutory periods, the most common period is three years.<sup>301</sup> Several states provide for a period of as long as six years.<sup>302</sup>

With respect to a RICO action, different issues are implicated for criminal RICO and for civil RICO. Under the federal criminal law, the general statute of limitations period for non-capital offenses is five years.<sup>303</sup> Since RICO provides for criminal penalties,<sup>304</sup> its criminal sanctions are governed by the five year rule.<sup>305</sup> Further, since section 1962 is a continuing offense,<sup>306</sup> the statute begins to run from the last act of racketeering in the pattern.<sup>307</sup>

297 As Justice Rehnquist lamented, "[f]ew areas of the law stand in greater need of firmly defined, easily applied rules than does the subject of periods of limitations." *Chardon v. Fumero Soto*, 462 U.S. 650, 667 (1983) (Rehnquist, J., dissenting).

298 ERISA provides:

An action under this section may not be brought after the later of—

- (1) 6 years after the date on which the cause of action arose, or
- (2) 3 years after the earliest date on which the plaintiff acquired or should have acquired actual knowledge of the existence of such cause of action;

except that in the case of fraud or concealment, such action may be brought not later than 6 years after the date of discovery of the existence of such cause of action.

29 U.S.C. § 1451 (1985). The receipt by the PWBA of a pension plan's annual report could constitute actual knowledge of the cause of action for the purpose of triggering the three year limitations period. To begin the running of the three year period, the report need not detail every element of the ERISA violation so long as the PWBA could reasonably conclude from the report that ERISA had been violated. *Brock v. TIC Int'l Corp.*, 785 F.2d 168, 172 (7th Cir. 1986). However, the failure of the plan to file an annual report does not serve as notice to the PWBA that a fiduciary duty has been breached. *Brock v. Gillikin*, 677 F. Supp. 398, 402 (E.D.N.C. 1987).

299 See, e.g., CONN. GEN. STAT. ANN. § 52-584 (West Supp. 1989); DEL. CODE ANN. tit. 10, § 8107 (1975).

300 See, e.g., N.J. STAT. ANN. § 2A:14-1 (West 1987); N.D. CENT. CODE § 28-01-16(4) (1974).

301 See, e.g., CAL. CIV. PROC. CODE § 338(d) (West Supp. 1989); CONN. GEN. STAT. ANN. § 52-577 (West 1960).

302 See, e.g., IND. CODE ANN. § 34-1-2-1 (West 1983); N.D. CENT. CODE § 28-01-16(6) (1974).

303 18 U.S.C. § 3282 (1985). The statute provides: "Except as otherwise expressly provided by law, no person shall be prosecuted, tried, or punished for any offense, not capital, unless the indictment is found or the information is instituted within five years next after such offense shall have been committed." *Id.*

304 *Id.* § 1962 (1984).

305 See *United States v. Coia*, 719 F.2d 1120, 1124 (11th Cir. 1983), *cert. denied*, 466 U.S. 973 (1984); *United States v. Bethea*, 672 F.2d 407, 419 (5th Cir. 1982).

306 *United States v. Field*, 432 F. Supp. 55, 59 (S.D.N.Y. 1977) ("[section 1962 (c)] provides an example of a continuing offense for purposes of computing the time at which the statute of limitations begins to run"), *aff'd*, 578 F.2d 1371 (2d Cir.), *cert. dismissed*, 439 U.S. 801 (1978).

307 See *United States v. Forsythe*, 560 F.2d 1127, 1134 (3d Cir. 1977).

When multiple parties are involved, the statute runs from the last act of racketeering committed by one of the parties.<sup>308</sup> Where one act of a pattern of racketeering occurs within the limitations period, the entire pattern is subject to prosecution.<sup>309</sup> Also, once a pattern is established, an act occurring within the limitations period but after the defendant terminated his relationship with the enterprise is still subject to prosecution.<sup>310</sup>

Although civil RICO does not contain an express limitations period, the implied limitations period for a civil action is four years.<sup>311</sup> Some state RICO laws contain an express statute of limitations. These limits can be as long as seven years,<sup>312</sup> or as short as three years.<sup>313</sup> Most states that define an express limitations period use five years.<sup>314</sup>

Despite the four year rule for federal RICO, courts have failed to reach a consensus as to when the limitations period accrues. Most courts, at least initially, use the discovery rule.<sup>315</sup> Under the discovery rule, the limitations period begins to run when the plaintiff knows or has reason to know of the injury which is the basis of the action.<sup>316</sup>

As opposed to the simple discovery rule, some courts use the separate accrual rule or the last predicate act rule. The separate accrual rule provides that the cause of action accrues each time the plaintiff discovers or should have discovered a separate injury.<sup>317</sup> Each new injury creates a new limitations period. Thus, the plaintiff can bring his cause of action whenever the injury is discovered regardless of when the act that gave

308 *United States v. Kissel*, 218 U.S. 601, 608 (1910) ("A conspiracy is a partnership in criminal purposes. That as such it may have continuation in time is shown by the rule that an overt act of one partner may be the act of all without any new agreement.").

309 *Field*, 432 F. Supp. at 59 ("Although the five year limitations period clearly prohibits . . . charging . . . [of] separate violations . . . which were complete . . . it cannot . . . bar prosecution for engaging in a pattern . . . where . . . the separate violations . . . are simply elements of the [RICO] violation.").

310 *United States v. Forszt*, 655 F.2d 101, 103-04 (7th Cir. 1981) (RICO conviction upheld even though illegal payment was made after public official had left office because the court found it was the "final installment in a continuous course of criminal conduct.").

311 *Agency Holding Corp. v. Malley-Duff & Assocs., Inc.*, 483 U.S. 143, 152 (1987) (RICO period of limitations governed by the Clayton Act, 15 U.S.C. § 15b). See generally *Special Project, Time Bars in Specialized Federal Common Law: Federal Rights of Action and State Statutes of Limitations*, 65 CORNELL L. REV. 1011 (1980).

312 See, e.g., N.D. CENT. CODE § 12.1-06.1-05(7) (Supp. 1989).

313 See, e.g., WASH. REV. CODE ANN. § 9A.82.100(7) (1988).

314 See, e.g., DEL. CODE ANN. tit. 11, § 1505(f) (1987); FLA. STAT. ANN. § 895.05(10) (West Supp. 1989); OHIO REV. CODE ANN. § 2923.34(K) (Anderson 1987).

315 See *Riddell v. Riddell Wash. Corp.*, 866 F.2d 1480, 1491 (D.C. Cir. 1989); *Pocahontas Supreme Coal Co. v. Bethlehem Steel Corp.*, 828 F.2d 211, 218 (4th Cir. 1987); *Bowling v. Founders Title Co.*, 773 F.2d 1175, 1178 (11th Cir. 1985), cert. denied, 475 U.S. 1109 (1986); *Compton v. Ide*, 732 F.2d 1429, 1432 (9th Cir. 1984); *Alexander v. Perkin Elmer Corp.*, 729 F.2d 576, 577 (8th Cir. 1984).

316 *Compton*, 732 F.2d at 1433. Generally, a plaintiff cannot bring a cause of action until he knows three things. First, the plaintiff must know that a wrongful act has occurred. Second, the plaintiff must know he has been injured. Third, the plaintiff must know the identity of the wrongdoer. Thus, the statute of limitations should not begin until a plaintiff knows or has reason to know each of these items. For example, if a plaintiff knows he has been injured as a result of a wrongful act but cannot identify the wrongdoer, the statute should not begin to run.

317 *Bankers Trust Co. v. Rhoades*, 859 F.2d 1096, 1105 (2d Cir. 1988), cert. denied, 109 S. Ct. 1642 (1989).



rise to the injury was committed.<sup>318</sup> However, like the simple discovery rule, this rule does not allow a plaintiff to recover for injuries that occur outside of the limitations period even though they were part of the same pattern.<sup>319</sup>

Under the last predicate act rule, the RICO cause of action accrues on the date the plaintiff knew or should have known that the elements of a civil RICO action existed. This rule is more favorable to plaintiffs because it allows recovery for damages that occur outside of the limitations period provided that the complaint was filed within four years of the last predicate act.<sup>320</sup>

In contrast to the complexity of the RICO limitations period, most states provide that the statute of limitations for an accountant's negligence to a third party begins to run on the date the party receives the report.<sup>321</sup>

### C. Federal Common Law Considerations

Suits under federal law are complicated by uncertainties concerning the scope of the federal common law. When a suit is brought under a body of federal law such as ERISA or the laws governing the FDIC, a significant issue arises as to what law applies. For example, when Congress set up the FDIC, the statutory provision was viewed as a charge to the federal courts to develop a federal common law consistent with the policy goals of the Act.<sup>322</sup> When federal law applies to the rights and duties of a federal agency, whether state law should be applied to give content to that law requires a balancing of three factors: (1) whether the federal program was one which by its nature requires national uniformity, (2) whether adopting state law would frustrate the specific goals of the federal program, and (3) whether applying a federal rule would dis-

318 *Id.*

319 *Id.*

320 *Keystone Ins. Co. v. Houghton*, 863 F.2d 1125, 1130-31 (3d Cir. 1988) (if complaint filed within four years of last predicate act, plaintiff may recover for injuries caused by other predicate acts which occurred outside the limitations period but which are part of the same pattern); *County of Cook v. Berger*, 648 F. Supp. 433, 435 (N.D. Ill. 1986) ("it would be incongruous to bar . . . recovery for predicate acts taking place outside the limitations period and permitting recovery only for those within the limitations period").

Two other tests are used by a small number of courts. A few district courts in the Seventh Circuit use the conspiracy rule which holds that all acts that are part of the same pattern can be compensated so long as the last overt act is within the limitations period. *Id.* Although it is based on a different theory, this rule has the same effect as the last predicate act rule. The other test is the Clayton Act rule which means that "a cause of action accrues when new overt acts occur within the limitations period, even if a conspiracy was formed and other acts were committed outside the limitations period." *State Farm Mutual Auto. Ins. Co. v. Ammann*, 828 F.2d 4, 5 (9th Cir. 1987) (Kennedy, J., concurring). The results of this rule are similar to the results of the separate accrual rule in that the plaintiff can recover for acts committed within the limitations period but he cannot recover for acts outside of the limitations period even if these acts are part of the same pattern.

321 See, e.g., *Toro Co. v. Krouse, Kern & Co.*, 644 F. Supp. 986, 997 (N.D. Ind. 1986) (recognizing that the proper statute of limitations is the state statute covering injuries to personal property and noting that the statute is an accrual statute), *aff'd*, 827 F.2d 155 (7th Cir. 1987).

322 See, e.g., *Federal Deposit Ins. Corp. v. Braemoor Assocs.*, 686 F.2d 550, 553-54 (7th Cir. 1982), *cert. denied*, 461 U.S. 927 (1983); *Gunter v. Hutcheson*, 674 F.2d 862, 868-69 (11th Cir.) (citing *D'Oench, Duhme & Co. v. Federal Deposit Ins. Co.*, 315 U.S. 447 (1942)), *cert. denied*, 459 U.S. 826 (1982), *overruled on other grounds*, *Langley v. FDIC*, 108 S. Ct. 396 (1987).

rupt commercial relationships predicated on state law.<sup>323</sup> Under this reasoning, courts have refused to allow state laws to reduce the value of FDIC-acquired assets in a variety of contexts.<sup>324</sup> Despite these cases, the FDIC must still contend with state law in many situations.

One area in which state law interferes with the goals of a federal law is with respect to joint and several liability. To illustrate, in a recent suit brought by the FDIC in Colorado, a court refused to apply the general federal common law for joint and several liability.<sup>325</sup> This ruling was made in spite of the fact that the rule that two or more persons who cause a single indivisible harm are jointly and severally liable for that harm is found in most state jurisdictions and reflected in scholarly treatises and the Restatement.<sup>326</sup> However, in contrast, Colorado law does not provide for joint and several liability.<sup>327</sup> Since ERISA expressly provides for joint and several liability for fiduciaries,<sup>328</sup> ERISA would override state law in this area.

Nevertheless, the same issue could arise in the context of comparative versus contributory negligence and in the law of contribution. Although most states have adopted some form of comparative negligence,<sup>329</sup> several states,<sup>330</sup> still adhere to the doctrine of contributory

323 *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728-29 (1979); *Gunter*, 674 F.2d at 868; *In re Murdock Mach. & Eng'g Co. of Utah*, 620 F.2d 767, 771-73 (10th Cir. 1980).

324 See, e.g., *FDIC v. Leach*, 772 F.2d 1262, 1267 (6th Cir. 1985) (failure of consideration defense not available against FDIC); *FDIC v. Wood*, 758 F.2d 156, 160 (6th Cir.) (state usury statute does not limit FDIC's recovery of interest on note acquired in purchase and assumption transaction), *cert. denied*, 474 U.S. 944 (1985); *FDIC v. Gulf Life Ins. Co.*, 737 F.2d 1513, 1517 (11th Cir. 1984) (waiver, estoppel, and unjust enrichment defense not available against the FDIC); *Gunter*, 674 F.2d at 873 (fraud defense not available against the FDIC); *FDIC v. Ohlson*, 659 F. Supp. 490, 492 (N.D. Iowa 1987) (mental incapacity defense not available against the FDIC).

325 *Federal Deposit Ins. Corp. v. Glenn B. Clark*, No. 88-F-647 (D. Colo. Mar. 23, 1989) (order denying plaintiff's motion to strike defendants' designation of non-parties at fault) ("The need for national uniformity and the potential frustration of the national program do not present the compelling reasons for the development of federal common law in the context of joint and several liability.").

326 See, e.g., *Edmonds v. Compagnie Generale Transatlantique*, 443 U.S. 256, 260 & n.8 (1979) (the common law provides for joint and several liability); PROSSER, *supra* note 148, at 347-48; RESTATEMENT (SECOND) OF TORTS § 875 (1979).

327 COLO. REV. STAT. § 13-21-111.5 (1987). As one commentator noted "Colorado . . . has now abolished joint and several liability and created a role for nonparties by statute. The sheer novelty of the legislature's action will increase the normal uncertainty that inevitably follows any major change in the law." Benson, *New Role for Nonparties in Tort Actions—The Empty Chair*, 15 COLO. LAW. 1650, 1655 (1986).

328 Although fiduciaries are subject to joint and several liability, some courts limit nonfiduciary liability to the amount illegally obtained from the fund. The Seventh Circuit indicated nonfiduciary liability should be limited "to the extent the [non-fiduciary] profited from the breach." *Fremont v. McGraw-Edison Co.*, 606 F.2d 752, 759 (7th Cir. 1979), *cert. denied*, 445 U.S. 951 (1980). See also *Donovan v. Bryans*, 566 F. Supp. 1258, 1267 (E.D. Pa. 1983) (an ERISA action in which the court merely ordered the nonfiduciary to make "restitution to the Plan for the benefit received"). In contrast, common law principles dictate that nonfiduciaries should face joint and several liability. See G. BOGERT, TRUSTS AND TRUSTEES §§ 868, 901 (rev. 2d ed. 1981). See also *Olin Cemetery Ass'n v. Citizen's Sav. Bank*, 222 Iowa 1053, 1061-62, 270 N.W. 455, 459-60 (1936). To illustrate, in *Duckett v. National Mechanics' Bank of Baltimore*, 86 Md. 400, 409-10, 38 A. 983, 986-87 (1897), the court held a bank jointly and severally liable when it participated in a trustee's breach. Despite the common law rule, comparative negligence statutes in most states would limit the liability of a nonfiduciary to the amount the party was at fault.

329 See PROSSER, *supra* note 148, at § 67 (explaining comparative negligence).

330 See *id.* at 471 n.30 (listing states that still adhere to contributory negligence).

negligence.<sup>331</sup> With respect to contribution,<sup>332</sup> the common law rule and the federal rule,<sup>333</sup> is that there can be no contribution among joint tortfeasors.<sup>334</sup> However, statutes in most states now permit some form of contribution.<sup>335</sup> Thus, from a strategy standpoint, the PWBA or the PBGC should bring its cause of action in a state with favorable common law unless it is clear that the general federal common law rule will control.

#### D. Insurance Considerations

Even if the DOL is successful in any type of suit against a party responsible for pension plan fraud, actual recovery may depend on whether the individual or organization was insured. Consequently, the PWBA or the PBGC should evaluate insurance issues prior to filing suit. Since different policies apply, insurance covering directors and officers, accountants, and attorneys raise separate concerns.

##### 1. Directors and Officers

Two types of insurance cover corporate officers and directors: director and officer (D&O) liability policies and fidelity bonds. Generally, D&O policies insure negligent acts while fidelity bonds cover dishonest acts.

The standard D&O policy covers losses caused by the "wrongful acts" of directors and officers and is structured in two parts. One part insures officers and directors for damages and expenses for which the corporation does not indemnify the directors. The second part of the policy reimburses the corporation when the corporation indemnifies its directors and officers in accord with corporate by-laws or state law.<sup>336</sup> D&O insurance defines a wrongful act as any "actual or alleged error or misstatement or misleading statement or act or omission or breach of duty by directors or officers while acting in their individual or collective capacities; or any matter claimed against them solely by reason of their being directors or officers of the company."<sup>337</sup> In contrast to a fidelity bond, the D&O policy excludes losses resulting from "active and deliberate dishonesty committed . . . with actual dishonest purpose and intent."<sup>338</sup> The standard D&O policy covers only officers and directors

331 See *id.* at § 65 (explaining the effect of contributory negligence).

332 See *id.* at § 50 (explaining the doctrine of contribution).

333 See *Northwest Airlines, Inc. v. Transport Workers Union of Am.*, 451 U.S. 77, 86-95 (1981) (no federal statutory or federal common law right to contribution); *Treble Damages*, *supra* note 255, at 541-44 (discussing the development of the federal common law with respect to contribution and indemnity).

334 PROSSER, *supra* note 148, at § 50.

335 *Id.* at 338. See Note, *Adjusting Losses Among Joint Tortfeasors in Vehicular Collision Cases*, 68 YALE L.J. 964, 981-84 (1959) (surveying state law with respect to contribution).

336 See generally Note, *Protecting Corporate Directors and Officers: Indemnification*, 40 VAND. L. REV. 737 (1987). See also J. BISHOP, *THE LAW OF CORPORATE OFFICERS AND DIRECTORS* ¶ 8.03 (1981).

337 W. KNEPPER & D. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* 697 (4th ed. 1988) [hereinafter KNEPPER].

338 *Eglin Nat'l Bank v. Home Indem. Co.*, 583 F.2d 1281, 1284 (5th Cir. 1978). Other typical policies exclude claims "[a]rising from, brought about, or contributed to by the dishonest (and, in some newer forms, fraudulent or criminal) acts of the insureds." KNEPPER, *supra* note 337, at 719.

and not the corporation itself.<sup>339</sup> A director or officer is only covered while acting in his capacity as a director. Thus, in one case, a court denied coverage to a director who was sued individually and as a co-partner in an investment partnership.<sup>340</sup> Although the insurer may participate at its option, under D&O insurance, the insured must provide his own defense because the standard policy does not contain a duty to defend provision.<sup>341</sup>

D&O insurance is written on a claims-made basis.<sup>342</sup> For purposes of triggering coverage under a D&O policy and for applying the policy limits and deductibles, the standard policy provides that "all loss arising out of all interrelated wrongful acts of any insured shall be deemed one loss."<sup>343</sup> The concept of a "claim" affects how much an insured can recover under the policy.<sup>344</sup> For example, if a director commits more than one wrongful act over a period of time, his acts would seem to give rise

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In most policies, this exclusion is only effective upon adjudication of actual and deliberate dishonesty with actual dishonest purpose and intent. *Id.* See also *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1465 (W.D. Pa. 1986) (such exclusion may be unenforceable if language is vague and ambiguous), *aff'd*, 836 F.2d 789, 794 (3d Cir. 1987). Some newer policies contain no such adjudication requirement. KNEPPER, *supra* note 337, at 719.

If the policy requires adjudication, it must be made in the "underlying litigation." *Id.*; *Eglin Nat'l Bank*, 583 F.2d at 1287-88 (adverse adjudication required to trigger policy exclusion); *National Union Fire Ins. v. Seafirst Corp.*, 662 F. Supp. 36, 39 (W.D. Wash. 1986) (exception "cannot apply in this case because the former officers and directors have never been adjudged guilty of any conduct falling within [its] scope"); *Pepsico, Inc. v. Continental Casualty Co.*, 640 F. Supp. 656, 660 (S.D.N.Y. 1986) ("Here Continental was obligated to pay incurred defense costs unless a final judgment found 'material dishonesty' by the directors or officers."); *Stargatt v. Avenell*, 434 F. Supp. 234, 244 (D. Del. 1977) ("settlement itself is not sufficient proof that [plaintiff] engaged in dishonest acts").

339 See *Pepsico*, 640 F. Supp. at 666. See generally Comment, *Practical Aspects of Directors' and Officers' Liability Insurance—Allocating and Advancing Legal Fees and the Duty to Defend*, 32 UCLA L. REV. 690 (1985).

340 *Hack v. Standard Accident Ins. Co.*, 351 Mich. 319, 88 N.W.2d 424 (1958).

341 KNEPPER, *supra* note 337, at 705-06.

342 *Id.* at 687. A claims-made policy covers all claims made against the officer or director during the policy period. This means coverage only extends to claims that are first made during the policy period, regardless of when the director committed the wrongful act. Thus, if a claim is not made during the policy period, there is no coverage. These policies are different from "occurrence" policies which cover all acts causing loss during the policy period, regardless of the date of discovery or the filing of the claim. *Id.* at 691-92.

343 B. VANYO & E. YODOWITZ, *SECURITIES LITIGATION 1987 PROSECUTION & DEFENSE STRATEGIES* 267 [hereinafter *DEFENSE STRATEGIES*].

344 The same issue arises in the context of fidelity bonds. The standard fidelity bond defines a single loss:

Single loss means all covered loss, including court costs and attorneys' fees incurred by the Underwriter under General Agreement F, resulting from

(a) any one act or series of related acts of burglary, robbery or attempt threat, in which no Employee is implicated, or (b) any one act or series of related unintentional acts or omissions on the part of any person (whether an Employee or not) resulting in damage or to destruction or misplacement of Property, or (c) all acts or omissions other than those specified in (a) and (b) preceding, caused by any person (whether an Employee or not) or in which such person is implicated, or (d) any one casualty or event not specified in (a), (b), or (c) preceding.

Section 4, Limit on Liability, Standard Form No. 24, 1986 ed. Much litigation focuses on whether a specific factual situation qualifies as a single loss. See, e.g., *Business Interiors, Inc. v. Aetna Casualty & Sur. Co.*, 751 F.2d 361, 363 (10th Cir. 1984) (40 acts of forgery met the definition of a single loss).

to different claims.<sup>345</sup> However, a series of apparently unrelated acts can constitute "predicate offenses" under RICO. With RICO as the glue, the insurer can contend the unrelated acts constitute but one claim.<sup>346</sup>

The standard D&O policy also contains important exclusions.<sup>347</sup> Among the exclusions, D&O insurance does not cover claims resulting in unlawful advantage and personal profit for the insured or claims for the return of remuneration illegally paid to the insured.<sup>348</sup> Although coverage can be obtained in a separate policy or by endorsement, typical D&O insurance excludes coverage for any liability based on ERISA.<sup>349</sup> Now that officers and directors have increasingly become targets of civil RICO suits,<sup>350</sup> D&O coverage for civil RICO sanctions has become a significant issue. Since RICO provides redress for injuries to "business or property,"<sup>351</sup> D&O policies may seem well-suited to protect against such

345 The clause is especially significant when RICO is used against a director or an officer. See *infra* note 346 and accompanying text for discussion of whether "interrelated acts" as defined in a D&O policy corresponds to a "pattern of racketeering" under RICO.

346 Attempts have been made to define the concept of "interrelated acts":

For acts to be interrelated so that several claims would be aggregated into a single loss, it would appear that there must be an element of mutuality among the acts, namely, that those doing an act had knowledge or were conscious of the other acts. Without collusion or at least knowledge there would seem to be no interrelation.

KNEPPER, *supra* note 337, at 715. Compare this definition with the requirements of a RICO pattern. See, e.g., *Torwest DBC, Inc. v. Dick*, 810 F.2d 925, 928-29 (10th Cir. 1987) (RICO requires evidence showing scheme was "not an isolated occurrence").

Two federal courts have indicated that a series of negligent acts or a series of transactions will not constitute a single loss or occurrence for purposes of determining the limit of liability merely because they all contribute to a single result. See *North River Ins. Co. v. Huff*, 628 F. Supp. 1129, 1133-34 (D. Kan. 1985); *Okada v. MGIC Indem. Corp.*, 608 F. Supp. 383, 388 (D. Haw. 1985), *aff'd in part and rev'd in part*, 795 F.2d 1450 (9th Cir. 1986). Also see *Gregory v. Home Ins. Co.*, 876 F.2d 602, 604-06 (7th Cir. 1989) (investors' securities fraud, common law fraud, and RICO claims against law firm were a single claim because all the claims arose from the same conduct). Courts have been more amenable to aggregating related losses in determining the applicable retention. Also, if the multiple claims are found to be interrelated, multiple limits of liability may apply. KNEPPER, *supra* note 337, at 716.

347 Although D&O insurance does not specifically exclude coverage for punitive damages, such policies limit the definition of a "loss" as follows: "Loss does not include fines or penalties imposed by law or matters uninsurable under the law pursuant to which this policy is construed." DEFENSE STRATEGIES, *supra* note 343, at 291.

348 See KNEPPER, *supra* note 337, at 718-19.

349 *Id.* at 718.

350 See Ichel & Thompson, *Directors' and Officers' Insurance Coverage: An Overview and Current Issues*, in PRACTICING LAW INSTITUTE, SECURITIES LITIGATION 319-20 (1987) (citation omitted) [hereinafter Ichel & Thompson]. It has been observed that:

During the past few years, there have been a staggering number of lawsuits brought against corporation directors and officers under the civil remedy provisions of the federal Racketeer Influenced and Corrupt Organizations Act. . . . Enacted by Congress as part of the Organized Crime Control Act of 1970, and successfully employed by federal prosecutors for more than a decade in organized crime prosecutions, RICO has only recently been employed by civil plaintiffs with fraud-related claims.

RICO's attraction to civil plaintiffs is explained not only by its provisions for the recovery of treble damages together with the 'cost of suit including a reasonable attorney's fee,' 18 U.S.C. § 1964 (c), but also by the anticipated *in terrorem* effect a claim suggesting racketeering and organized crime will have upon persons and institutions named as defendants. Indeed, some commentators have predicted that RICO will become the next Rule 10b-5.

*Id.* Despite this concern, the anticipated flood of RICO litigation has not occurred. See *Equitable Relief*, *supra* note 118, at 534 n.29 (analyzing statistics on the number of RICO cases). In addition, there are indications that RICO has not had the anticipated *in terrorem* effect. See *id.* at 569 n.193 (pointing to evidence that businesses wrongfully accused of racketeering will not settle suits).

351 18 U.S.C. § 1964(c) (1984).

losses. However, liability under RICO demands that the target of the suit commit at least two predicate acts of criminal activity.<sup>352</sup> Thus, the D&O policy's "wrongful conduct" exclusion will preclude coverage for the predicate acts.<sup>353</sup> D&O coverage for RICO claims is also complicated by controversy surrounding the number and dates of occurrences and whether coverage applies to punitive damages. Since a RICO claim must be based on the prior occurrence of predicate acts, it is unclear when the claim occurs for purposes of triggering a claims-made policy.<sup>354</sup> Although the claim would seem to arise when the RICO suit is commenced, it can be argued that the RICO claim first arose when the predicate acts occurred.<sup>355</sup> Moreover, it is not certain whether the predicate acts and the RICO claim itself constitute one claim or more than one claim for the purposes of triggering policy limits and deductibles.<sup>356</sup>

While a D&O policy does not exclude coverage for punitive damages, fines, or penalties, recovery for these items is limited by the definition of a loss. A "[l]oss does not include fines or penalties imposed by law or matters uninsurable under the law pursuant to which this policy is construed."<sup>357</sup> Although this definition is easily applied in the context of

352 *Id.* § 1961(1), (5) (1984 & Supp. 1989).

353 In many situations the insured can recover for these criminal acts under its fidelity bond. However, the 1986 edition of the Financial Institution Bond specifically excludes coverage of most RICO damages. See Exclusion (z), Standard Form No. 24, 1986 ed. Courts have yet to interpret the breadth of this exclusion. Thus, it is not clear whether the exclusion precludes coverage of all RICO actions.

354 See, e.g., *Michigan Chem. Corp. v. American Home Assurance Co.*, 728 F.2d 374, 379-81 (6th Cir. 1984) (number of occurrences is determined by referring to cause or causes of damage and not to number of injuries or claims); *Schering Corp. v. Home Ins. Co.*, 712 F.2d 4, 9 (2d Cir. 1983) (summary judgment improper where party opposing summary judgment "propounds a reasonable conflicting interpretation of a material disputed fact" such as which occurrences an insurance policy covers); *Eagle-Picher Indus., Inc. v. Liberty Mut. Ins. Co.*, 682 F.2d 12, 19 (1st Cir. 1982) (in dispute regarding date of injury, policy was triggered by resulting injury, not exposure), *cert. denied*, 460 U.S. 1028 (1983); *Keene Corp. v. Insurance Co. of N. Am.*, 667 F.2d 1034, 1044 (D.C. Cir. 1981) (in a dispute regarding the date of occurrences, coverage was triggered by manifestation of asbestosis-related disease as well as by exposure), *cert. denied*, 455 U.S. 1007 (1982); *Insurance Co. of N. Am. v. Forty-Eight Insulations*, 633 F.2d 1212, 1218-19 (6th Cir. 1980) (in dispute regarding date of bodily injury, coverage was triggered by initial injury caused by exposure to asbestos rather than manifestation of asbestos-related disease), *cert. denied*, 454 U.S. 1109 (1981); *Champion Int'l Corp. v. Continental Casualty Co.*, 546 F.2d 502, 505-06 (2d Cir. 1976) ("per occurrence" policies measure coverage not on the basis of individual accidents but on the basis of underlying circumstances which resulted in the claim for damages), *cert. denied*, 434 U.S. 819 (1977); *Harbor Ins. Co. v. Arthur Andersen & Co.*, 149 Ill. App. 3d 235, 240, 500 N.E.2d 707, 711 (1986) (in a dispute regarding date of claim, insured's underlying actions need not occur during the policy period), *appeal denied*, 505 N.E.2d 353 (Ill. 1987).

355 *Ichel & Thompson, supra* note 350, at 334-35. Commentators have described this ambiguity:

It can be argued . . . that a RICO lawsuit first commenced against an insured in 1984 is not properly presented to a 'claims made' carrier for the 1984 policy year when, for example, the alleged predicate acts of 'racketeering activity' were the basis for two prior lawsuits against the insured in the years 1981 and 1983. In such case, not only is it unsettled *when* the RICO claim was first made—1981, 1983 or 1984—but it could be argued that up to three different claims are involved.

*Id.*

356 See *supra* note 346 and accompanying text.

357 *Ichel & Thompson, supra* note 350, at 291. The second portion of this definition leaves open the question of whether insurance coverage of punitive damages contravenes public policy. Most courts hold that insurance against "damages" includes insurance against punitive damages unless specifically excluded in the insurance agreement or by public policy. See, e.g., *Ridgway v. Gulf Life Ins. Co.* 578 F.2d 1026, 1029-30 (5th Cir. 1978) (no such exclusion in policy or under Texas law);

compensatory damages, uncertainty arises in the context of punitive damages. There is a difference of opinion as to whether treble damages under RICO are covered by a D&O policy.<sup>358</sup> Since some courts consider treble damages to be wholly punitive, this would preclude their recovery under D&O insurance.<sup>359</sup> Others reason that RICO treble damages are intended to liquidate uncertain actual damages.<sup>360</sup> In addi-

*Harrell v. Travelers Indem. Co.*, 279 Or. 199, 567 P.2d 1013, 1014 (1969) (no such exclusion in policy); *Lazenby v. Universal Underwriters Ins. Co.*, 214 Tenn. 639, 383 S.W.2d 1, 5 (1964) (no such exclusion in the policy or under Tennessee law for punitive damages imposed for negligence); *Hensley v. Erie Ins. Co.*, 283 S.E.2d 227, 230-31, 233-34 (W. Va. 1981) (no such exclusion in policy or under West Virginia law for punitive damages imposed for negligence). But see *Brown v. Western Casualty & Surety Co.*, 484 P.2d 1252, 1253 (Colo. Ct. App. 1971) (although exemplary damages were not specifically excluded, they are not included in policy obligating insurer to pay all damages arising from bodily injury, sickness, death or disease caused by accident); *Cavin's, Inc. v. Atlantic Mut. Ins. Co.*, 27 N.C. App. 698, 702, 220 S.E.2d 403, 406 (1975) (punitive damages are not awarded merely because of personal injury, so they cannot be covered by a policy which insures "only with respect to personal injury").

Despite this, courts are split as to the overall propriety of insuring punitive damages. Compare *Greenwood Cemetery, Inc. v. Travelers Indem. Co.*, 238 Ga. 313, 316, 232 S.E.2d 910, 913-14 (1977) and *Dairyland County Mutual Ins. Co. v. Wallgren*, 477 S.W.2d 341, 342 (Tex. Civ. App. 1972) (contracts insuring against punitive damages are not illegal as a matter of public policy) with *Ford Motor Co. v. Home Ins. Co.*, 116 Cal. App. 3d 374, 383, 172 Cal. Rptr. 59, 65 (1981) (punitive damages are uninsurable as a matter of public policy); *Beaver v. Country Mut. Ins. Co.*, 95 Ill. App. 3d 1122, 1124, 420 N.E.2d 1058, 1060 (1981) (punitive damages are uninsurable as a matter of public policy).

The outcome of the punitive damage coverage issue will most likely depend on which state law applies. See *Ichel & Thompson*, *supra* note 350, at 293. As *Ichel and Thompson* explain:

[T]he determination of which state's law will apply to construe a Directors and Officers policy can have an outcome determinative impact on coverage for punitive damages. Choice of law rules vary from state to state, and the following divergent rules have been applied to determine which state's law is applicable:

- (1) the place where the insurance policy was entered into (*e.g.*, where the last act necessary to make it a binding contract took place);
- (2) the place where the insurance policy is being performed (*e.g.*, the state where the punitive damage award has been rendered for which coverage is sought);
- (3) the state with the most significant contacts with the insurance relationship; and
- (4) the state with the greatest interest in having its public policy apply.

*Id.* See, *e.g.*, *Capitol Indem. Corp. v. St. Paul Fire & Marine Ins. Co.*, 357 F. Supp. 399, 411-12 (W.D. Wis. 1972) (applying the grouping-of-contacts approach; contacts include location of contracting, negotiations, performance, subject matter and parties); *Chrysler Corp. v. Insurance Co. of N. Am.*, 328 F. Supp. 445, 448 (E.D. Mich. 1971) (applying the law of the state in which the insurance contract was made); *Oakley v. National W. Life Ins. Co.*, 294 F. Supp. 504, 506-07 (S.D.N.Y. 1968) (applying the law of the state having most significant contacts with the case, especially the superior interest in having its policy or law applied); *Kemp v. Allstate Ins. Co.*, 183 Mont. 526, 601 P.2d 20, 24 (1979) (applying the law of the place of performance of the insurer's obligations).

358 See generally *Hellerstein & Mullins, The Likely Insurance Treatment of Treble Damage RICO Judgments*, 42 Bus. Law. 121 (1986); *Treble Damages*, *supra* note 255.

359 See, *e.g.*, *Summers v. FDIC*, 592 F. Supp. 1240, 1243 (W.D. Okla. 1984) (RICO treble damages are punitive and therefore plaintiff cannot recover them from the FDIC); *Tedesco v. Maryland Casualty Co.*, 127 Conn. 533, 537, 18 A.2d 357, 359 (1941) (because statutory multiple damages are awarded to punish the defendant, and not to compensate the plaintiff, they are uninsurable punitive damages). See also *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1140-41 (5th Cir. 1988) (damages in excess of actual are penal for purposes of calculation), *cert. denied*, 109 S. Ct. 3242 (1989).

The characterization of damages for purposes of federal RICO may not necessarily apply to damages under state RICO statutes. In fact, in some states precedent suggests that damages under state RICO laws should be classified as compensatory. See, *e.g.*, *Goff v. H.J.H. Co.*, 95 Idaho 837, 839-40, 521 P.2d 661, 663-64 (1974) (treble damages for wrongfully withheld wages are compensatory); *Aylsworth v. Curtis*, 19 R.I. 517, 34 A. 1109 (1896) (double damages are not penal).

360 See *State Farm Fire & Casualty Co. v. Estate of Caton*, 540 F. Supp. 673, 682 (N.D. Ind. 1982).

tion to the fines or penalties provision, the typical D&O policy excludes coverage for losses covered by any other policy, past or present.<sup>361</sup>

With respect to fidelity bonds, ERISA makes it unlawful for any person who handles pension plan assets not to be bonded.<sup>362</sup> Even though directors and officers may not "handle" pension funds, it is not unusual for a corporation to carry fidelity coverage on its officers and directors.<sup>363</sup> Although the standard fidelity policy contains an exclusion for directors,<sup>364</sup> the exclusion does not apply if the director is also a salaried, pensioned, or elected officer of the corporation.<sup>365</sup> In addition, the director is covered if he acts within the scope of the usual duties of an employee.<sup>366</sup> Thus, despite the director exclusion, a fidelity bond will normally protect both officers and directors.

Fidelity bonds cover losses caused by "any dishonest act of any of the Employees wherever committed, and whether committed directly or by collusion with others."<sup>367</sup> Under this definition, the bond covers acts short of criminal behavior,<sup>368</sup> so long as the actor exhibited a "reckless, willful, and wanton disregard for the interests of the employer."<sup>369</sup> The presence of reckless disregard enables the court to infer intent to deceive.<sup>370</sup> Although fidelity bonds cover reckless or willful acts, the bonds do not cover losses due to unintentional acts that were merely

361 KNEPPER, *supra* note 337, at 654.

362 ERISA mandates fidelity bond coverage in situations where the officer or director is a "fiduciary." 29 U.S.C. § 1112(a) (1985). See *supra* note 112 and accompanying text.

363 See *infra* notes 367-71 and accompanying text for discussion of fidelity bond coverage.

364 The standard policy excludes:

(d) loss resulting directly or indirectly from any acts of any director of the Insured other than one employed as a salaried, pensioned or elected official or an Employee of the Insured, except when performing acts coming within the scope of the usual duties of an Employee, or while acting as a member of any committee duly elected or appointed by resolution of the board of directors of the Insured to perform specific, as distinguished from general, directoral acts on behalf of the Insured.

Reprinted in ANNOTATED BANKERS BLANKET BOND 33 (F. Skillern ed. Supp. 1983).

365 See, e.g., *General Fin. Corp. v. Fidelity & Casualty Co. of N. Y.*, 439 F.2d 981, 984 (8th Cir. 1971) (director exclusion only excludes outside directors or trustees and not those who function as both a director and an officer); *Insurance Co. of N. Am. v. Greenberg*, 405 F.2d 330, 333 (10th Cir. 1969) (director exclusion was only intended to exclude outside directors).

366 See *FDIC v. Aetna Casualty & Sur. Co.*, 426 F.2d 729, 738 (5th Cir. 1970) (policy covered director's authorized actions in connection with the purchase of real estate notes since such action was held to be within the scope of usual employee duties).

367 Skillern, *Fidelity Coverage—What is Dishonesty?*, in *BANKERS & OTHER FINANCIAL INSTITUTION BLANKET BONDS* 23, 24 (1979) (quoting Standard Form No. 1).

368 See, e.g., *World Exchange Bank v. Commercial Casualty Ins. Co.*, 255 N.Y. 1, 5, 173 N.E. 902, 903 (N.Y. 1930) ("[D]ishonesty within such a contract may be something short of criminality. . . . The appeal is to the mores rather than to the statutes.").

369 *London & Lancashire Indem. Co. v. Peoples Nat'l Bank & Trust Co.*, 59 F.2d 149, 152 (7th Cir. 1932). See also *Fidelity & Deposit Co. of Md. v. Bates*, 76 F.2d 160, 171 (8th Cir. 1935) (fidelity bonds cover any acts done in breach of duty, but do not include acts of carelessness); *Maryland Casualty Co. v. Am. Trust Co.*, 71 F.2d 137, 138 (5th Cir.) (fidelity insurance guarantees that the officers will act with common honesty and an eye single to its interests), *cert. denied*, 293 U.S. 582 (1934).

370 *Miami Nat'l Bank v. Pennsylvania Ins. Co.*, 314 F. Supp. 858, 862 (S.D. Fla. 1970); *Arlington Trust Co. v. Hawkeye-Sec. Ins. Co.*, 301 F. Supp. 854, 858 (E.D. Va. 1969) (intent to deceive may be inferred from officer's reckless disregard).



negligent.<sup>371</sup> The failure of fidelity bonds to cover negligence is one reason most corporations<sup>372</sup> also purchase D&O liability policies.

## 2. Accountants

Liability insurance is also available to qualified accountants. Like D&O insurance, "errors and omissions" or professional liability policies are written on a claims-made basis.<sup>373</sup> The typical policy obligates the insurer to pay all sums which the insured may become legally obligated to pay on account of professional services rendered or which should have been rendered in the insured's capacity as an accountant.<sup>374</sup> Although the policy will exclude willful or intentional conduct, the coverage may include legal liability arising from dishonesty, misrepresentation, or fraud if committed in the ordinary course of the insured's business as an accountant.<sup>375</sup> Malpractice insurance protects an accountant even if the accountant's advice is of a legal nature.<sup>376</sup>

## 3. Attorneys

Attorney's professional liability insurance<sup>377</sup> is similar to the insurance available to accountants. As such, attorney liability insurance is usually written on a claims-made basis.<sup>378</sup> An important element of the attorney liability policy is that the policy defines its limits of liability in terms of "each claim." This limit is the total limit of the insurer's liability for all damages arising out of the same professional services, regardless of the number of claims or claimants.<sup>379</sup>

The D&O policy and the attorney's professional malpractice policy are intended to be mutually exclusive. The attorney's liability policy covers only liability arising out of the performance of professional services in the insured's capacity as a lawyer, while the D&O policy only covers the insured while acting in his capacity as a director or officer of the corporation.<sup>380</sup>

371 See, e.g., *Citizens' Acceptance Corp. v. New Amsterdam Casualty Co.*, 32 F.R.D. 600, 602 (D. Del. 1963); *Mortgage Corp. of N.J. v. Aetna Casualty & Sur. Co.*, 19 N.J. 30, 37, 115 A.2d 43, 46 (1955).

The broad coverage of fidelity policies and the increased number of claims have caused insurers to offer riders to reduce the scope of the policies. See generally Comment, *The Nature and Extent of Subrogation Rights of Fidelity Insurers Against Officers and Directors of Financial Institutions*, 47 U. PITT. L. REV. 727, 731-32 (1986).

372 A survey of 1,047 American and Canadian Corporations revealed that 96.8% of the companies listed on the New York Stock Exchange, 91.1% of the companies on the American Stock Exchange, and 87.4% of the companies trading on National Association of Securities Dealers system carried D&O insurance. *The 1987 Wyatt Company Director and Officers and Fiduciary Liability Survey* 52. Larger corporations are more likely to carry such insurance. To illustrate, only 32% of the businesses with assets under \$25 million carry D&O insurance. *Id.* at 49.

373 KNEPPER, *supra* note 337, at 651.

374 *Id.* at 652.

375 *Id.*

376 *Bancroft v. Indemnity Ins. Co. of N. Am.*, 203 F. Supp. 49, 56-57 (W.D. La.) (holding that the mixed legal and accounting nature of an accountant's opinion is not a valid defense to the accountant's insurer), *aff'd*, 309 F.2d 959 (5th Cir. 1962).

377 See generally, Annotation, *Lawyers' Professional Liability Insurance*, 84 A.L.R.3d 187 (1978).

378 KNEPPER, *supra* note 337, at 655.

379 *Id.* at 658.

380 *Id.* at 655.

## VI. Conclusion

The goal of the Department of Labor and its departments that deal with pension plans—the PWBA and the PBGC—is to maximize recovery against those whose conduct causes a loss of pension assets. The PWBA and the PBGC must use the facts of each case to achieve this end.<sup>381</sup>

In order to formulate their strategy, the PWBA and the PBGC must evaluate the situation and determine who should bring suit—the PWBA, the PBGC, or both the PWBA and the PBGC. Although the PBGC can reach a broad range of entities responsible for plan decisions, a suit by the PWBA requires an initial determination of whether the individual who committed the misconduct is a fund fiduciary. If the party is a fiduciary, the PWBA must proceed under ERISA or under other federal laws such as RICO. Consequently, state common law claims of negligent misrepresentation and fraud are preempted.<sup>382</sup> Although use of RICO raises complex issues such as what constitutes a “pattern” and whether the individual “participated” in the enterprise,<sup>383</sup> the RICO action offers significant advantages over a suit under ERISA. These advantages include a favorable statute of limitations provision and the ability to recover treble damages. In fact, in the context of pension plan fraud occurring over many years, RICO is the only cause of action that can reach crimes and torts committed during the early stages of the scam.

Also important to suits against fiduciaries and nonfiduciaries is insurance coverage. First, the standard D&O policy does not cover claims under ERISA. Consequently, unless the policy contains a special rider, the PWBA and the PBGC must look to the assets of the individual (or the individual’s company under indemnification) and not to the insurer. Despite the unavailability of D&O coverage, a fidelity bond would provide coverage so long as the individual acted dishonestly. The standard fidelity bond does not contain an ERISA or a RICO exclusion. In fact, the bond covers any violation of the federal criminal law—including RICO.

Nonfiduciary liability is an indispensable part of a comprehensive recovery strategy for two reasons. First, nonfiduciaries—such as account-

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381 To illustrate, if the PWBA only sues plan fiduciaries whose dishonest conduct cheated the plan, the fidelity insurer will treat the wrongdoing as a single claim with the maximum recovery subject to the policy limit. Since the fiduciary acted dishonestly, fidelity insurance may cover the loss but D&O insurance will not apply. However, even in the simplest case, it is the dishonest parties who perpetrate the fraud, while honest but inattentive—and thus negligent—officers and directors fail to catch them. In only the rarest of situations will a loss result solely from dishonesty. Consequently, the PWBA should sue the dishonest employees to maximize recovery under fidelity bonding in addition to suing negligent employees to maximize recovery under D&O liability insurance. The result also dictates that the PWBA will sue some parties as fiduciaries under ERISA and others as nonfiduciaries. This strategy may also enable the DOL to reach the most wrongdoers, while minimizing the number of cases it must battle.

In formulating this strategy, the PWBA must be mindful of collateral estoppel and of Rule 11. Collateral estoppel, or issue preclusion, prevents a party from taking inconsistent positions in two different actions. See generally F. JAMES & G. HAZARD, CIVIL PROCEDURE §§ 11.16-11.19 (2d ed. 1977). Recently, too, courts have used Rule 11 to sanction lawyers representing the FSLIC in that agency’s attempt to recover for losses to savings and loan institutions. See *Lavelle, FSLIC Lawyers Face Sanctions*, Nat’l L.J., June 5, 1989, at 3, col. 1.

382 See *supra* notes 113-19 and accompanying text for discussion of ERISA’s preemption provision.

383 See *supra* notes 162-242 for a discussion of the issues involved in a RICO suit.

ants and attorneys—are increasingly responsible for pension plan failure. Second, since accountants and attorneys tend to carry liability insurance coverage, the policies provide a ready source of recovery for actions covered by the policy.

Recovery against nonfiduciaries requires an initial determination of whether the nonfiduciary acted in connection with a fiduciary or whether the nonfiduciary acted independently. Nonfiduciary liability—under ERISA—must be premised on the fact that the nonfiduciary knowingly promoted a breach of trust by a fiduciary. Accordingly, if a nonfiduciary acted independently, he cannot be sued under ERISA. However, even if the nonfiduciary acted independently, the plan itself or the PBGC, as trustee of a distressed plan, could have a non-ERISA cause of action against the wrongdoer. Since such a suit is not an ERISA action, ERISA's broad preemption provision does not apply. Consequently, the common law causes of action, negligent misrepresentation and fraud, and state RICO, as well as federal statutory causes of action enter the recovery strategy. Significantly, in the tort law causes of action, the chain of causation lengthens as the level of culpability increases.<sup>384</sup> Thus, if the plan or the PBGC as trustee of the plan can prove fraud, as opposed to negligence, liability will reach farther and extend to all of those participating in the fraud. In addition, a fraud cause of action can result in a higher damage amount. Despite these factors, most states require a higher burden of proof for fraud than for mere negligence or even for civil RICO.

In addition to tort actions, the federal and state criminal laws can help the government recover from those who defraud pension plans. With its ability to shut down the fraudulent enterprise, freeze the assets of the defendants, and compensate victims with treble damages, RICO is a potent weapon that should be used by pension plan regulators.<sup>385</sup>

The use of RICO against accountants and attorneys raises important legal issues in an uncertain area of the law. Specifically, prior to the Court's decision in *H.J. Inc.*,<sup>386</sup> there was no consensus among the circuit courts as to what constituted a RICO "pattern." Some argue that *H.J. Inc.*'s requirement of "continuing" racketeering activity will do little to

384 PROSSER, *supra* note 148, at 37. Prosser's hornbook explains:

There is a definite tendency to impose greater responsibility upon a defendant whose conduct was intended to do harm, or was morally wrong. More liberal rules are applied as to the consequences for which the defendant will be held liable, the certainty of proof required, and the type of damage for which recovery is to be permitted, as well as the measure of compensation. The defendant's interests have been accorded substantially less weight in opposition to the plaintiff's claim to protection when moral inequity is thrown into the balance. Apparently the courts have more or less unconsciously worked out an irregular and poorly defined sliding scale, by which the defendant's liability is least where the conduct is merely inadvertent, greater for acts in disregard of consequences increasingly likely to follow, greater still for intentionally invading the rights of another under a mistaken belief of committing no wrong, and greatest of all where the motive is a malevolent desire to do harm.

*Id.* (footnotes omitted).

385 Of the four types of prohibited acts detailed in RICO's § 1962, § 1962(c) is the best cause of action to use in cases of pension plan fraud.

386 See *supra* notes 218-30 for a discussion of the impact of *H.J. Inc.*

remedy the confusion.<sup>387</sup> Still uncertain is whether accountants and attorneys can fulfill the "conduct" requirement. Despite these strategy challenges, the success of a RICO claim against accountants and attorneys will depend on how long the pension plan was on the brink of failure. If misrepresentations were made in only one or two financial reports over a short period of time, the action may not constitute "continuing racketeering activity"—thus precluding a RICO cause of action. However, if the pension plan was disguised from the regulators for several years and several false financial reports were filed, there is a better chance of recovering under RICO.

In summary, the most efficient use of scarce resources dictates that the PWBA and the PBGC formulate a comprehensive strategy to make sure that those who cause pension plans to fail are the ones who pay the bill. This strategy necessarily involves acting against pension fund fiduciaries under ERISA's enforcement provisions and under the criminal law. More importantly, the PWBA, the PBGC, and the plan itself must aggressively pursue nonfiduciaries—accountants, attorneys, and officers and directors not involved in the management of the plan—under both tort and criminal law. Oftentimes, the most potent cause of action against fiduciaries and nonfiduciaries will be the state and federal RICO laws. These causes of action are an indispensable weapon in the fight against pension scam artists.

*J. Robert Suffoletta, Jr.\**

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<sup>387</sup> Justice Scalia remarked that judicial confusion over the pattern requirement caused "the widest and most persistent circuit split on an issue of federal law in recent memory." *H.J. Inc. v. Northwestern Bell Telephone Co.*, 109 S. Ct. 2893, 2906-07 (1989) (Scalia, J., dissenting). Although the Supreme Court recently addressed the issue in *H.J. Inc.*, Scalia lamented that "[t]here is no reason to believe that the Courts of Appeals will be any more unified in the future, than they have in the past." *Id.* at 2908 (Scalia, J., dissenting).

\* In memory of Robert Joseph Neely, a life-long friend (June 17, 1961-Nov. 23, 1989).