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Shifting the Burden of Losses in the Securities Markets: The Role of Civil RICO in Securities Litigation

Arthur F. Mathews*

I. Introduction

For over fifty-five years the federal courts have been developing a body of jurisprudence delineating under what circumstances and in what manner a private party plaintiff injured in a securities transaction may recover damages or obtain other relief from various classes of defendants including issuers, underwriters, broker-dealers and professional advisers such as attorneys, accountants and bankers. Federal securities law jurisprudence has been developed primarily by courts interpreting and applying two principal federal statutes: the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act").

As courts have shaped the contours of both express and implied causes of action under the 1933 and 1934 Acts and have determined the application in federal securities litigation of such derivative liability theories as aiding and abetting, conspiracy, respondeat superior and controlling person liability, private party plaintiffs have struggled to find the easiest route to recover maximum damages from "deep pocket" defendants. Such defendants are often persons and entities that are "outsiders" with respect to the particular securities transactions consummated by plaintiff.

* Mr. Mathews, a partner at Wilmer, Cutler & Pickering, Washington, D.C., was Chairman of the Ad Hoc Civil RICO Task Force of the American Bar Association's Section of Corporation, Banking and Business Law. That ABA Task Force published an extensive report on Civil RICO in 1985. James L. O'Hara, a law clerk at Wilmer, Cutler & Pickering and a law student at Georgetown Law Center, assisted in the preparation of this paper. This article is an expansion of remarks delivered by Mr. Mathews at Notre Dame Law School on February 8, 1990 at a symposium--Law and the Continuing Enterprise: Perspectives on RICO. Some of Mr. Mathews' remarks were also covered in a speech at the Cato Institute in Washington, D.C. on October 18, 1989, at a symposium--RICO, Rights, and the Constitution, which will be published, as expanded and edited, as Mathews, RICO's Jurisprudential Dilemma: Curtailing Civil RICO Abuse Without Corrupting the Statute's Primary Goal of Eradicating Racketeering from Legitimate Business, -- CATO J. -- (1990).


4 See, e.g., Branson, Collateral Participant Liability Under the Securities Laws--Charting the Proper Course, 65 OR. L. REV. 327 (1986); Bromberg & Lowenfels, Aiding and Abetting Securities Fraud: A Critical Examination, 52 ALB. L. REV. 637 (1988); Ferrara & Sanger, Derivative Liability In Securities Law:
Plaintiffs' counsel began to search for new remedies in other federal statutes to vindicate their clients' damage claims, as courts have gradually increased the burdens of plaintiffs in pursuing the 1933 and 1934 Acts' express and implied private damages causes of actions in the 1970s and 1980s. Civil RICO has become one of the statutes of choice for pursuing an alternative route to recovery in federal securities litigation, as


§ 1964. Civil Remedies . . . . (c) Any person injured in his business or property by reason of a violation of Section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.


9 See AMENDING THE RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT, S. REP. No. 262, 101st Cong., 2d Sess. 2 (1990): "RICO introduced several new concepts and broad remedies into the law. Twenty years later, however, the meaning of many of these concepts and remedies is still unclear. Furthermore, the orderly development of the law has been interrupted by the filing of inappropriate actions by private parties under Civil RICO."


insider-trading allegations, routine broker-dealer disputes, and other ordinary corporate/federal securities law matters.

However, this new body of civil RICO jurisprudence has come under persistent attack for the past few years. The overuse or abuse of the civil RICO treble damages cause of action in securities and other commercial litigation was noted and criticized in 1985 in both the ABA Task Force Report and in the Supreme Court’s Sedima opinions (particularly in Mr. Justice Marshall’s dissent) and has been the subject of continued


17 See Civil RICO Task Force Report, supra note 7, at 1-5, 20-41, 55-69, 427-34.

18 See Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479 (1985). In Mr. Justice White’s majority opinion in Sedima, the Court acknowledged the concern of the Second Circuit that civil RICO was being put to “extraordinary, if not outrageous” uses and has become “a tool for everyday fraud cases brought against ‘respected and legitimate “enterprises’”, as well as “mobsters and organized criminals.” However, the majority felt the problems with overuse of the statute had to be corrected by Congress, not by the courts:

It is true that private civil actions under the statute are being brought almost solely against . . . [legitimate business] defendants, rather than against the archetypal, intimidating mobster. Yet this defect—if defect it is—is inherent in the statute as written, and its correction must lie with Congress . . . .

We nonetheless recognize that, in its private civil version, RICO is evolving into something quite different from the original conception of its enactors. See generally ABA [Civil RICO Task Force] Report, at 55-69. Though sharing the doubts of the Court of Appeals about this increasing divergence, we cannot agree with either its diagnosis or its remedy. The ‘extraordinary’ uses to which civil RICO has been put appear to be primarily the result of the breadth of the predicate offenses, in particular the inclusion of wire, mail and securities fraud, and the failure of Congress and the courts to develop a meaningful concept of ‘pattern.’

473 U.S. at 499-500 (footnote omitted).

19 Mr. Justice Marshall, in his stinging dissent in Sedima, pointed out in detail how civil RICO, through its mail and wire fraud predicates, was being overused or abused in all sorts of commercial litigation, including routine securities and commodities disputes:
debate in Congress since 1985. Academics and scholars have suggested a wide array of legislative reforms for civil RICO. Even Chief Justice Rehnquist has called for congressional action to cure any perceived abuse or overuse of the statute.

It is likely that Congress may soon succeed in amending the RICO statute to narrow the scope of the 18 U.S.C. § 1964(c) civil treble damages remedy, thereby curtailing abusive use of civil RICO. It is unlikely, however, that any legislative amendments will eliminate or narrow the commercial fraud predicate offenses, i.e., mail, wire and securities fraud. Consequently, it seems clear that the plaintiff’s bar will continue...
to pursue civil RICO remedies in a broad range of corporate/securities cases in the decade of the 1990s, despite Mr. Justice Marshall's observations in his *Sedima* dissent that it would be jurisprudentially inadvisable to allow civil RICO to disrupt and displace over a half century of judicial development of civil remedies under the federal securities laws:

In addition to altering fundamentally the federal-state balance in civil remedies, the broad reading of the civil RICO provision also displaces important areas of federal law. For example, one predicate offense under RICO is 'fraud in the sale of securities.' 18 U.S.C. § 1961(1) (1988). By alleging two instances of such fraud, a plaintiff might be able to bring a case within the scope of the civil RICO provision. It does not take great legal insight to realize that such a plaintiff would pursue his case under RICO rather than do so solely under the Securities Act of 1933 or the Securities Exchange Act of 1934, which provide both express and implied causes of action for violations of the federal securities laws. Indeed, the federal securities laws contemplate only compensatory damages and ordinarily do not authorize recovery of attorney's fees. By invoking RICO, in contrast, a successful plaintiff will recover both treble damages and attorney's fees.

More importantly, under the Court's interpretation, the civil RICO provision does far more than just increase the available damages. In fact, it virtually eliminates decades of legislative and judicial development of civil remedies under the federal securities laws. Over the years, courts have paid close attention to matters such as standing, culpability, causation, reliance and materiality, as well as the definitions of "securities" and "fraud." See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). All of this law is now an endangered species because plaintiffs can avoid the limitations of the securities laws merely by alleging violations of other predicate acts. For example, even in cases in which the investment instrument is not a "security" covered by the federal securities laws, RICO will provide a treble damage remedy to a plaintiff who can prove the required pattern of mail or wire fraud. *Cf Crocker National Bank v. Rockwell International Corp.*, 555 F. Supp. 47 (N.D. Cal. 1982). Before RICO, of course, the plaintiff could not have recovered under federal law for the mail or wire fraud violation.

Similarly, a customer who refrains from selling a security during a period in which its market value was declining could allege that, on two occasions, his broker recommended by telephone, as part of a scheme to defraud, that the customer not sell the security. The customer might thereby prevail under civil RICO, even though, as neither a purchaser nor a seller, he would not have had standing to bring an action under the federal securities laws. *See also 741 F.2d 482, 499 (1984) (two misstatements in a proxy solicitation could subject any director in any national corporation to 'racketeering' charges and the threat of treble damages and attorneys fees).*

24 473 U.S. 479, 504-6 (1985). Mr. Justice Marshall added:

The effect of civil RICO on federal remedial schemes is not limited to securities laws. For example, even though commodities fraud is not a predicate offense listed in § 1961, the
To appreciate the significance of Mr. Justice Marshall's comments about the untoward effects civil RICO is having on the jurisprudence of federal securities litigation, it is helpful to briefly review the available express and implied private damages remedies in the 1933 and 1934 Acts. Thus, Part II of this article provides a brief overview of the requirements and judicial development of the principal private plaintiff causes of action under the federal securities laws. Part III discusses the legislative history of the inclusion of the commercial fraud predicate offenses (mail, wire and securities fraud) in the RICO statute and their expansive use in securities litigation and related corporate/commercial litigation in the 1980s. Part IV considers the various advantages to a plaintiff in pursuing a cause of action under civil RICO, as opposed to or in addition to asserting traditional federal securities laws claims, and the complexities and confusion that RICO presents in securities cases. The article concludes in Part V with the proposition that the proper jurisprudential solution to civil RICO's circumvention of the federal securities laws and related or comparable federal statutes or regulatory schemes, lies in the legislative deletion from the RICO statute of the private civil damage cause of action based on commercial fraud predicate offenses. In its place, Congress should enact a modern federal commercial fraud statute containing an express private damage cause of action.

II. Private Plaintiff Causes of Action Under the Federal Securities Laws

Most suits by private plaintiffs for damages resulting from securities transactions are filed under one or more of four principal provisions of the 1933 and 1934 Acts, namely sections 11, 12(1) and 12(2) of the 1933 Act and section 10(b) of the 1934 Act as fleshed out by rule 10b-5 thereunder. The 1933 Act provisions—sections 11, 12(1) and 12(2)—pro-
vide express remedies for injured purchasers of securities in fraudulent or


defective sales transactions. Section 11 imposes civil damages liability


It is unclear whether there exist implied private damages causes of action for violations of the ownership reporting and tender offer filing provisions of §§ 13(d), 13(e), and 14(d) of the 1934 Act, although injunctive relief may be an available private party implied remedy pursuant to these provisions. See cases cited and related commentary in 1 T. HAZEN, supra note 1, § 11.18, at 735-39 nn.22-36. However, false filings under these provisions will trigger an express private party damages cause of action under § 18 of the 1934 Act, 15 U.S.C. § 78r. (1988); cf. Frankel, Implied Rights of Action, 67 VA. L. REV. 553 (1981); Hazen, The Supreme Court and the Securities Laws: Has the Pendulum Slowed? 30 EMORY L.J. 5 (1981); Hazen, Implied Private Remedies Under Federal Statutes: Neither a Death Knell Nor a Moratorium—Civil Rights, Securities Regulation, and Beyond, 33 VAND. L. REV. 1333 (1980); Steinberg, The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws, 67 CORNELL L. REV. 557 (1982).


Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1988) provides an express remedy for issuers to recover illegal short-swing profits from certain statutes. This section applies to any purchaser or seller of a security who relied on a material misstatement in a filing under the 1934 Act that affected the price of the security in question. See Wachovia Bank & Trust Co., N.A. v. National Student Mktg. Corp., 650 F.2d 342 (D.C. Cir. 1980); Ross v. A.H. Robins, 607 F.2d 545 (2d Cir. 1979).
upon a specifically defined class of persons who prepare and sign misleading 1933 Act registration statements filed with the SEC to cover public offerings of securities. Section 12(1) imposes rescission or damages liability upon anyone who offers or sells a security in violation of the registration provisions of section 5 of the 1933 Act. Section 12(2) imposes similar rescission or damages liability upon anyone who offers or sells a security by means of material misrepresentations or omissions of material fact, regardless of whether the registration requirements apply to the sales transaction. Section 10(b) of the 1934 Act, and rule 10b-5 thereunder, contain general anti-fraud and anti-manipulation proscriptions in connection with the purchase or sale of any security. Section 10(b) contains no express private damages or rescission remedy; however, courts have implied a private damages cause of action under rule 10b-5 in favor of any purchaser or seller who is injured as a result of fraudulent or ma-

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(b) Limitations on Liability.—

(1) Contemporaneous Trading Actions Limited to Profit Gained or Loss Avoided.—The total amount of damages imposed under subsection (a) shall not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation.

(2) Offsetting Disgorgements Against Liability.—The total amount of damages imposed against any person under subsection (a) shall be diminished by the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title relating to the same transaction or transactions.

(3) Controlling Person Liability.—No person shall be liable under this section solely by reason of employing another person who is liable under this section, but the liability of a controlling person under this section shall be subject to section 20(a) of this title.

(4) Statute of Limitations.—No action may be brought under this section more than 5 years after the date of the last transaction that is the subject of the violation.

Tippers have joint and several liability with tippees who effectuate the illegal trading. See § 20A(c) (1988). The § 20A(c) remedy is not exclusive. Section 20A(d) provides that plaintiffs, in addition to a § 20A claim, retain the right to take advantage of “the availability of any cause of action implied from a provision of this title [the 1934 Act].”

nipulative activity in connection with a securities purchase or sale transaction.

The language of these statutory provisions and this rule, coupled with over fifty-five years of extensive judicial development and construction, provide both private plaintiffs and defendants with a substantial degree of clarity and specificity as to when a private damages cause of action does or does not lie under the federal securities laws. To date, neither the language of the RICO statute nor judicial exposition thereof provides concomitant clarity or specificity as to when a civil RICO treble damages cause of action will, or will not, be available in a federal securities case.

A. Section 11 of the 1933 Act

Section 11 of the 1933 Act creates an express cause of action for damages for purchasers of securities in an SEC-registered public offering when the relevant registration statement contains false or misleading statements of material fact or omissions of material fact. Materiality under the securities laws is either a question of fact, or a mixed question
of fact and law, and must be pleaded and proved by the plaintiff.\textsuperscript{30} Any person acquiring a security under the defective registration statement can bring a damages action unless it can be demonstrated that the purchaser knew of the misstatement or omission at the time of the purchase.\textsuperscript{31} Reliance on the material misstatement or omission is presumed.\textsuperscript{32} But the purchaser must demonstrate that the securities are traceable directly to the particular offering covered by the registration statement in question.\textsuperscript{33} An action must be brought within one year of the discovery of the misstatement or omission but not more than three years after the security was bona fide offered to the public.\textsuperscript{34} It may be brought in either state or federal court.\textsuperscript{35}

The permissible class of defendants in a section 11 case is quite narrow, since the statutory provision on its face is expressly limited to the issuer, directors (including those persons "about to become" directors), signers of the registration statement, underwriters and certain experts.\textsuperscript{36} Thus, common law aiding and abetting principles may not be used to expand or extend section 11 liability to such outsiders as attorneys or bankers who have not signed the registration statement or rendered an expert opinion on a portion thereof.\textsuperscript{37} However, liability can be expanded under section 15 to cover all controlling persons who can not establish a good faith defense.\textsuperscript{38} 'Defendants' liability under section 11 is


\textsuperscript{32} See, e.g., Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967).


\textsuperscript{35} 15 U.S.C. § 77v(a) (1988). This section provides in part that federal and state courts possess concurrent jurisdiction over any violations of the 1933 Act or the rules and regulations promulgated thereunder. See Hazen, supra note 28.

\textsuperscript{36} The experts specified in § 11 include every accountant, engineer, or appraiser, or any person whose profession gives authority to statements made by him, who has with consent been named in the registration statement as having prepared or certified any part of the filing, or any report or evaluation used in connection with the registration statement. It is significant that attorneys are not expressly named in § 11. Thus, an attorney does not have § 11 liability merely by reason of preparing a registration statement for an issuer. But an attorney may assume § 11 liability if he is a director, a signer, or if he renders an expert opinion included in the registration statement or otherwise consents to "expertise" a portion thereof. See Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 554 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).


\textsuperscript{38} 15 U.S.C. § 77o (1988). Whether respondeat superior or other common law agency principles can help a plaintiff circumvent a controlling person's good faith defense under § 15 is unclear. Cf. Commerford v. Olson, 794 F.2d 1319 (8th Cir. 1986); Hatrock v. Edward D. Jones & Co., 750 F.2d 767 (9th Cir. 1984); Henricksen v. Henricksen, 640 F.2d 880 (7th Cir. 1981); Marbury Inc. v. Kohn, 629 F.2d 705 (2d Cir. 1980); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980), reh'g denied, 634 F.2d 1355 (5th Cir. 1980); Carpenter v. Harris, Upham & Co., 594 F.2d 388 (4th Cir. 1979); Holloway v. Howerd, 536 F.2d 690 (6th Cir. 1976); Rochez Bros., Inc. v.
joint and several, with a right to contribution from other permissible defendants.\textsuperscript{39}

Persons such as lawyers who prepare or render advice in the preparation of a registration statement, but do not sign it or give an expert opinion on a portion thereof, can not be liable under section 11. Accountants and attorneys only become liable for the specific content of the registration statement by signing the statement, performing an audit, or rendering an expert opinion.\textsuperscript{40} All defendants except the issuer, who remains strictly liable, also possess certain statutory “due diligence” defenses which protect them from liability.\textsuperscript{41}

Successful plaintiffs are entitled to compensatory damages unless the defendant can demonstrate that the decline in value is not attributable to the misstatement or omission in the registration statement.\textsuperscript{42} A


\textsuperscript{41} Section 11(b)(3), 15 U.S.C. § 77k(b)(3) (1988). Section 11(b)(3) requires that the defendant perform a “reasonable investigation,” possess reasonable ground to believe, and believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make statements therein not misleading, with regard to information in the registration statement purported to be made with the defendant’s authority. It further requires that the defendant have no reasonable ground to believe, and not believe, at the time such part of the registration statement became effective, that the statements made therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, with regard to any part of the registration statement made by another. See 17 C.F.R. § 230.176 (1990). See also Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

Section 11(b)(1) and (2), 15 U.S.C. § 77k(b)(1) and (2), also contain certain “whistle blowing” defenses. See 1 T. Hazen, supra note 1, at 295-96. However, such whistle blowing might cause serious ethical or professional problems for an attorney involved in preparing the registration statement. Id. at 296 n.5. See also Meyerhofer v. Empire Fire & Marine Ins. Co., 497 F.2d 1190 (2d Cir.), cert. denied, 419 U.S. 998 (1974).

\textsuperscript{42} Section 11(e), 15 U.S.C. § 77k(e) (1988), provides in part that a plaintiff is entitled to damages which represent, the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration state-
general market decline resulting from various economic and political factors can be sufficient evidence to preclude recovery.\textsuperscript{45} In addition, under section 11(e) a court may require the posting of a bond and the payment of costs, including reasonable attorneys' fees, if it finds that "the suit or the defense was without merit."\textsuperscript{44} This provision also applies to section 12(1) and 12(2) actions.\textsuperscript{45}

B. \textit{Section 12 of the 1933 Act}\textsuperscript{46}

Section 12(1) of the 1933 Act provides that anyone who offers or sells a security in violation of the registration requirements of section 5\textsuperscript{47} is liable for rescission or damages to persons purchasing such security from the violator. Section 12(2) creates an express private right of action for rescission or damages in favor of the purchaser of a security when material misstatements or omissions have been made in the offer or sale of such security regardless of the registration requirements.\textsuperscript{48} Since the

\begin{itemize}
\item[44] Section 11(e), 15 U.S.C. § 77k(e)(1988), states in part: In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fee, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit . . .
\item[45] Id. See also text and notes at 1 T. HAZEN, supra note 1, § 7.4.2, at 810-13 nn.1-24.
\begin{enumerate}
\item[(1)] offers or sells a security in violation of section 77e [Section 5] of this title, or
\item[(2)] offers or sells a security (whether or not exempted by the provisions of section 77c [Section 3] of this title, other than paragraph (2) of subsection (a) of said subsection, by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction to recover the consideration paid for such security with interest thereon, less
plaintiff must be a purchaser of the security in question, a private cause of action under section 12 arises only when a securities sale is involved.49

A section 12(1) claim must be brought within one year of the violation upon which it is based but not more than three years after the security was bona fide offered to the public.50 A 12(2) claim must be brought within one year of the discovery of the misstatement or omission but not more than three years after the sale in question.51 If the plaintiff still owns the security, he must tender it to the defendant upon filing his complaint, in both a section 12(1) and a section 12(2) claim.52

Section 12 requires a defendant to be a "seller" of the security. The statutory language expressly applies to "any person who offers or sells"; it does not contain rule 10b-5's broad, elastic "in connection with" a purchase or sale language. Nevertheless, over the years, courts have held that in addition to the actual seller, section 12 encompasses any person "whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place"—potentially embracing attorneys, accountants, bankers and other "outsiders."53 However, in 1988 in Pinter v. Dahl,54 the Supreme Court abruptly narrowed the scope of "seller" under section 12 by rejecting any "substantial-factor" test. Thus, any precedent on this issue prior to the Pinter decision may be

the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.


53 Several Fifth Circuit cases illustrate this holding. See Dahl v. Pinter, 787 F.2d 985 (5th Cir. 1986), rev'd, 486 U.S. 622 (1988); Pharo v. Smith, 621 F.2d 656, 667 (5th Cir. 1980).


invalid. *Pinter* was a section 12(1) case, but it has an a fortiori application to section 12(2). The *Pinter* Court squarely held that permissible defendants under section 12 must have *directly and actively participated in the sale in question*. Assistance in the preparation of offering material is not sufficient by itself to establish liability. In addition, the defendant must be motivated at least in part by a desire to further his own financial interests or those of the owner of the securities.

Professor Hazen notes:

Many of the cases imposing liability on accountants, attorneys, and underwriters were decided prior to *Pinter v. Dahl* and applied an expansive definition of 'seller' using the 'substantial factor' test. The Supreme Court has since rejected that test in *Pinter v. Dahl*, in favor of one which requires that a defendant is a section 12 'seller' only when acting to further its own or the securities owner's financial interest from the sale. By shifting the focus from the defendant's relationship with the transaction to the defendant's relationship with the plaintiff, the Court has nullified much of the previous case law. Thus, the Court may have practically eliminated advisers such as accountants and lawyers from section 12 liability, since in most cases they will not have the requisite financial interest in the sale. The language of *Pinter*, which is sympathetic towards accountants and lawyers, supports this conclusion.

Like section 11, liability under section 12 may be expanded to include controlling persons as provided by section 15. However, in light of the restrictive nature of the *Pinter v. Dahl* holding and the specific limiting language of section 12, it is likely that liability based on aiding and abetting principles will be denied. Prior to *Pinter*, some courts had accepted "aiding and abetting" liability in section 12 cases based on a rule of *aiding and abetting* analogy. However, the better view is that

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56 Id. at 648-54. The Court relied on traditional statutory interpretation principles and held that broad or remedial goals of the Securities Act are insufficient justification for expansion of liability beyond the scope which the specific language and statutory scheme reasonably permit. *See also*, I T. HAZEN, supra note 1, at 285-86 (footnotes omitted):

The Court in *Pinter* indicated that a Section 12 defendant must have been both an immediate and direct seller of the securities to the plaintiff. The Court stressed that Section 12 liability depends on the defendant having been more than a remote participant in the sale. Thus, merely participating in the preparation of the registration statement does not satisfy the active participation requirement so as to render such participants in privity with a purchaser. Even substantial involvement in the preparation of registration and offering materials will not create liability unless there is also active involvement in the negotiations leading to the sale in question.


58 *Pinter*, 486 U.S. at 647. In the words of Mr. Justice Blackmun in his *Pinter* opinion, Section 12(1) "contemplates a buyer-seller relationship not unlike traditional contractual privity." True, its scope is not "limited to persons who pass title." Since "solicitation is the stage at which an investor is most likely to be injured," a Section 12(1) seller must include the person "who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the security owner." *Id.* at 645-47. *See also* Capri v. Murphy, 856 F.2d 473 (2d Cir. 1988); Harelson v. Miller Fin. Corp., 854 F.2d 1141 (9th Cir. 1988).

59 See I T. HAZEN, supra note 1, at 324-25.

60 See supra note 35 and accompanying text.

aiding and abetting claims cannot be maintained under section [12(1) and] 12(2).”

There is a recent trend whereby lower courts have held that the section 12(2) remedy is limited to investors purchasing in initial public offerings, and is not available to investors purchasing in the secondary trading markets. Courts so holding rationalize that the legislative history of the 1933 Act is relatively clear that “the Act was designed to 'affect' only new offerings of securities . . . [and] does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering . . .” Other courts reject this approach, relying on the fact that the Supreme Court, in United States v. Naftalin, held that section 17(a) of the 1933 Act—the anti-fraud provision applicable to SEC civil injunctive actions and criminal prosecutions—applies to secondary market transfers, as well as initial public offerings.

Section 12(1) imposes virtual strict liability upon the seller of securities who violates section 5. A plaintiff under section 12(2), however, must plead with sufficient particularity and prove that defendant knew or should have known about the misstatements or omissions. A defendant in a section 12(2) case may escape liability by demonstrating reasonable inquiries into possible fraud by the issuer or other seller or that the exercise of reasonable care would not have discovered any wrongdoing.


67 713 F. Supp. at 750, n.17.

68 However, the Supreme Court did hold that the in pari delicto (equal fault) defense is available to a § 12(1) defendant if the plaintiff is at least equally responsible for actions that render the sale of unregistered securities illegal, and the plaintiff's role in the offering or sale of unregistered securities is more as a promoter than investor. Such a determination is dependent on the facts of the particular case. Pinter v. Dahl, 486 U.S. 622, 635-39 (1988). Cf. Berner v. Lazzaro, 472 U.S. 299 (1985).

i.e., by establishing, in effect, a "reasonable care" or a "due care" defense.\textsuperscript{70}

Once a material omission or misrepresentation is proven, reliance is presumed in a section 12(2) case.\textsuperscript{71}

A plaintiff who still owns the securities in question in a section 12(1) or section 12(2) case is entitled to rescission of the sale with return of the consideration given, plus interest, upon tender of the securities.\textsuperscript{72} A plaintiff who no longer owns the securities is entitled to damages equal to the purchase price of the securities minus the sale price.\textsuperscript{73} Under section 11(e), costs and attorneys’ fees can be directed by the court upon a finding that the suit or defense was "without merit."\textsuperscript{74} There is no express attorneys’ fee provision in section 12.

\textsuperscript{70} Section 12(2) states, in part, that the seller will be liable if the seller "shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." \textit{See supra} note 48. The "reasonable care" or "due care" defense under § 12(2) differs to some degree from the "due diligence" defense under § 11. For example, the "expertising" defense of § 11 is not available under § 12(2). \textit{See, e.g.,} R. JENNINGS & H. MARSH, \textit{The ‘Due Diligence’ Defense Under Section 11; The ‘Due Care’ Defense Under Section 12(2)}, in \textit{SECURITIES REGULATION} 931-36, particularly at 934 (6th ed. 1987). There is a fair amount of uncertainty in this area as a result of the Supreme Court’s vacation and remand of the Seventh Circuit opinion in Sanders v. John Nuveen & Co., 524 F.2d 1064 (7th Cir. 1975), \textit{vacated and remanded}, 425 U.S. 928 (1976). The Supreme Court remanded Sanders to be considered in light of its then recent rule 10b-5 opinion in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). After a new Seventh Circuit opinion on remand, Justices Powell and Rehnquist dissented from a denial of certiorari. \textit{See} Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980), \textit{cert. denied}, 450 U.S. 1005 (1981). Professor Hazen comments:

The imposition of a ‘reasonable care’ standard [under § 12(2)] is different language than the ‘due diligence’ rubric of § 11. It is clear that § 12(2)’s requirement of ‘reasonable care’ imparts some sort of negligence standard and that it is not necessary for the purchaser to show any type of scienter on the seller’s part. Although there is not a \textit{per se} affirmative investigation requirement, it has been held that the § 12(2) standard of reasonable care may impose a duty to investigate depending on the circumstances. Reasonable care imparts a sliding scale of standard of conduct and has been held to impose a duty of \textit{continuing investigation} in the case of the exclusive dealer of the security in question. On the other hand, two justices of the Supreme Court have taken the position that any imposition of an affirmative investigation requirement is a misapplication of the ‘reasonable care’ standard since the investigation language of § 11 is said to call for a greater undertaking than the ‘care’ requirement of § 12(2).


\textsuperscript{73} \textit{See, e.g.,} Randall v. Loftsgaarden, 478 U.S. 647 (1986); Hill York Corp. v. American Int’l Franchises, Inc., 448 F.2d 680, 697 (5th Cir. 1971); In re Baldwin-United Corp., 607 F. Supp. 3132 (S.D.N.Y. 1985) (Punitive damages are not recoverable under § 12); Adair v. Hunt Int’l Resources Corp., 526 F. Supp. 736, 748 (N.D. Ill. 1981) (Tax benefits received by plaintiff as a result of his securities purchase, need not be deducted from his damages).

Like all other 1933 Act private party suits, there is concurrent jurisdiction in both state and federal courts for private civil damages or rescission actions pursuant to section 12(1) and section 12(2).⁷⁵

C. Rule 10b-5 Under the 1934 Act⁷⁶

Rule 10b-5 under section 10(b) of the 1934 Act⁷⁷ is a general anti-fraud and anti-manipulative provision which creates an implied right of action in favor of anyone injured as a result of fraudulent activity in connection with the purchase or sale of a security.⁷⁸ The elastic scope of rule 10b-5 enables it to be employed in a broad range of cases where sections 11 and 12 of the 1933 Act do not apply.

Unlike sections 11 and 12, rule 10b-5 places no limitations on the permissible class of defendants in a case brought under the rule. Any person, including both controlling persons⁷⁹ and aiders and abettors⁸⁰ may be held liable under rule 10b-5. Liability attaches to perpetrators


⁷⁷ 17 C.F.R. § 240.10b-5 (1989). Rule 10b-5 states:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


⁷⁹ The controlling person provision of the 1934 Act is § 20(a), 15 U.S.C. § 78l(a) (1988). Under § 20(a), a controlling person of anyone liable under "any provision of this title or of any rule or regulation thereunder" is jointly and severally liable to the same extent as such controlled person
of, or participants in, fraudulent activity "in connection with the purchase or sale of any security."\textsuperscript{81}

1. In Connection With\textsuperscript{82}

Defendants themselves need not have purchased or sold any securities so long as their fraudulent activity occurred "in connection with" a purchase or sale by the plaintiff.\textsuperscript{83} Thus, if a defendant issuer or person associated with an issuer disseminates false or misleading statements into the market by press release or otherwise, in a manner reasonably calculated to affect investors who are buying and selling the issuer's securities in the open trading markets, the defendant will have rule 10b-5 liability exposure.\textsuperscript{84}

\textsuperscript{81} Unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.\textsuperscript{Id}

The common law doctrine of respondeat superior provides for liability without fault; it does not embrace a good faith defense such as those provided by § 15 of the 1933 Act and § 20(a) of the 1934 Act—the controlling persons provisions. See, e.g., In re Atl. Fin. Management, Inc., 784 F.2d 29, 30 (1st Cir. 1986); Note, Rule 10b-5—The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a)—Imposing a Benefit Requirement on Apparent Authority, 55 VAND. L. REV. 1383 (1982). The majority of courts have held that § 20(a) controlling person liability is not exclusive and may be expanded by respondent superior and other common law agency principles. See, e.g., In re Atl. Fin. Management, Inc., 784 F.2d 29 (1st Cir. 1986); Henricksen v. Henricksen, 640 F.2d 880, 887 (7th Cir.), cert. denied sub nom, 454 U.S. 1079 (1981); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), cert. denied sub nom, 449 U.S. 1011 (1980); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980); Holloway v. Howerd, 536 F.2d 690, 696 (6th Cir. 1976); Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975); Krebs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974). However, the Third Circuit has held that § 20(a) may not be circumvented by agency or respondeat superior principles. See Sharp v. Cooper & Lybrand, 649 F.2d 175 (3d Cir.), cert. denied, 455 U.S. 998 (1982); Roche Bros., Inc. v. Rhoades, 527 F.2d 880 (3d Cir. 1975).

Nevertheless, the only en banc holding to date affirmed the majority rule. In Hollinger v. Titan Capital Corp., 1990 U.S. App. LEXIS 17054, Fed. Sec. L. Rep. (CCH) 95,500 (9th Cir. 1990) (en banc), the Ninth Circuit overruled its prior precedent as espoused in Zweig v. Hearst Corp., 521 U.S. 1111 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), cert. denied sub nom, 449 U.S. 1011 (1980); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111 (5th Cir. 1980); Holloway v. Howerd, 536 F.2d 690, 696 (6th Cir. 1976); Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975); Krebs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974). However, the Third Circuit has held that § 20(a) may not be circumvented by agency or respondeat superior principles. See Sharp v. Cooper & Lybrand, 649 F.2d 175 (3d Cir.), cert. denied, 455 U.S. 998 (1982); Roche Bros., Inc. v. Rhoades, 527 F.2d 880 (3d Cir. 1975).

80 Courts apply a three-prong test for aiding and abetting in rule 10b-5 claims. A plaintiff must demonstrate: (1) a securities law violation by the primary party; (2) knowledge of the violation by the aider and abettor; and (3) substantial assistance by the aider and abettor in the primary violation. See, e.g., Zoelsch v. Arthur Andersen & Co., 824 F.2d 27 (D.C. Cir. 1987); Metge v. Baehler, 762 F.2d 621 (8th Cir. 1985), cert. denied, 474 U.S. 1057 (1986); Bloor v. Carro, Spanbock, London, Rodman & Fass, 754 F.2d 57, 62 (2d Cir. 1985); Stokes v. Lokken, 644 F.2d 779, 782-83 (8th Cir. 1981); ITT v. Cornfield, 619 F.2d 909, 922 (2d Cir. 1980); Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 485 n.5 (2d Cir. 1979), cert. denied, 444 U.S. 1045 (1980); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47-48 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); Landy v. FDIC, 486 F.2d 159, 162-63 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974). For an important "aiding and abetting" decision focusing on what degree of scienter must be proven to hold lawyers and accountants liable for aiding and abetting federal securities violations of an issuer, see Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986). For an excellent in-depth recent study of aiding and abetting in securities cases, see Bromberg & Lowenfels, Aiding and Abetting Securities Fraud: A Critical Examination, 52 ALB. L. REV. 637 (1988).


The "in connection with" language requires a not insignificant nexus between the defendant's wrongdoing and plaintiff's purchase or sale of securities.\(^{85}\) It is true that rule 10b-5 is not limited solely to fraud relating to the merits or value of the securities purchased or sold. It can relate to a general course of dealing in securities transactions.\(^{86}\) But rule 10b-5 does not reach, for example, the tortious conversion or outright theft of securities.\(^{87}\) Nevertheless, rule 10b-5's broad "in connection with" language has an elastic nature that stretches the coverage of the rule far beyond the scope of sections 11 and 12 of the 1933 Act. For example, section 11 applies only to registered public offerings, not to after-market trading. Some courts have so limited section 12, holding that section 12(2) cannot apply to after-market trading. However, rule 10b-5 is not so limited. It applies to both registered public offerings (including initial public offerings) as well as to after-market trading.\(^{98}\)

2. Standing to Sue: Purchaser-Seller Requirement\(^{89}\)

In 1975, in Blue Chip Stamps v. Manor Drug Stores,\(^{90}\) the Supreme Court reaffirmed the rule laid down by the Second Circuit in 1952 in Birnbaum v. Newport Steel Corp.,\(^{91}\) that an implied private damages remedy is available under rule 10b-5 only to purchasers or sellers of securities in the transaction in question. Failure to plead compliance with the purchaser/seller standing requirement will result in dismissal of a rule 10b-5 private damages claim.\(^{92}\)

The Blue Chip decision clearly bars a mere holder of securities from pursuing a rule 10b-5 damages claim for the alleged diminution of the

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\(^{91}\) 421 U.S. 723, reh'g denied, 425 U.S. 884 (1975).

\(^{92}\) See, e.g., International Data Bank, Ltd. v. Zepkin, 812 F.2d 149 (4th Cir. 1987).
securities' value, allegedly caused by defendant's rule 10b-5 violation. However, whether there exist exceptions to the Blue Chip purchaser/seller standing rule that would allow "forced" sellers, "aborted" sellers, "frustrated" sellers, or "would be" sellers, to pursue rule 10b-5 damage claims, or whether a nonselling shareholder can bring a rule 10b-5 injunctive claim for a defendant's market manipulative conduct, remain unsettled areas of rule 10b-5 law.\textsuperscript{93} So too remains unsettled the question whether a purchaser or seller of an option can pursue a rule 10b-5 claim based upon fraud involving the underlying security.\textsuperscript{94}

3. **Scienter**\textsuperscript{95}

Proof of scienter, i.e., actual or constructive guilty knowledge, on the part of the defendant, is a necessary element of a rule 10b-5 cause of action. The Supreme Court squarely held so in Ernst \& Ernst v. Hochfelder, rejecting all claims that negligence could ever be a sufficient basis to support a rule 10b-5 action.\textsuperscript{96} The Supreme Court, however, left open the question whether recklessness could ever constitute constructive scienter for rule 10b-5 purposes.\textsuperscript{97} Most circuit courts have since held that some degree of recklessness—whether highly, gross, or simple, but in any event more than negligence—will satisfy rule 10b-5's scienter requirement, at least in cases where defendant owes plaintiff a fiduciary duty in connection with the securities transaction at issue.\textsuperscript{98}

In Hollinger v. Titan Capital Corp.,\textsuperscript{99} the Ninth Circuit recently reviewed en banc the various "recklessness" tests that might accommodate rule 10b-5 litigation, and adopted the fairly stringent Seventh Circuit test previously articulated in the Sunstrand\textsuperscript{100} case:

[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but

\textsuperscript{93} See 2 T. HAZEN, supra note 1, at 71-77.
\textsuperscript{96} 425 U.S. 185, reh'g. denied, 425 U.S. 986 (1976). In a subsequent case, Aaron v. SEC, 446 U.S. 680 (1980), on remand, 669 F.2d 5 (2d Cir. 1981), the Supreme Court held that in fraud cases brought under \S 17(a) of the 1933 Act, that is, SEC civil injunctive actions, proof of scienter is required under subsection 17(a)(1), but that negligence would be sufficient to support SEC claims for injunctive relief pursuant to subsections 17(a)(2) and (3).
\textsuperscript{97} 425 U.S. at 193-94 n.12. See also Aaron v. SEC, 446 U.S. at 690-91.
\textsuperscript{99} 1990 WL 139583 (9th Cir. 1990) (en banc).
\textsuperscript{100} Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1977).
an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.101

In adopting this stringent "recklessness test," the Ninth Circuit overruled the "flexible duty" rule 10b-5 test that has been applied in the Ninth Circuit for over fifteen years.102 The en banc Hollinger court acknowledged that the "flexible duty" test allowed for negligence liability in some circumstances in rule 10b-5 cases, thereby violating the Supreme Court's proscription in Hochfelder that mere negligence could never support a rule 10b-5 violation.103 The Hollinger court rejected the request of amicus curiae SEC that the Ninth Circuit adopt as the correct "recklessness" test the common law fraud standard of "conscious indifference."104

4. Reliance105

A plaintiff must rely on defendant's fraudulent conduct; a rule 10b-5 private damages cause of action will not be available to a plaintiff who was fully aware of the false, misleading or deceptive nature of defendant's conduct. Reliance, however, is difficult to demonstrate in nondisclosure situations. Therefore, the Supreme Court has held that there is a presumption of reliance in nondisclosure or "omissions" cases; i.e., the requisite reliance may be inferred from the demonstrated materiality of the omission.106

Since the Affiliated Ute Supreme Court decision in 1971, there has been an important issue in federal securities jurisprudence as to whether reliance can be indirect rather than direct; that is, will it be sufficient that plaintiff relied on the efficacy of the price in the open market when he bought his security, even if plaintiff was unaware that the price was affected by defendant's material misrepresentation or omission?107 This

102 Hollinger, 1990 WL 139583, *4 nn.9-10 and accompanying text. See also, Kidwell ex rel. Penfold v. Meikle, 597 F.2d 1273, 1294 (9th Cir. 1979); Crocker-Citizens Nat. Bank v. Control Metals Corp., 566 F.2d 631, 636 n.2 (9th Cir. 1977); Zweig v. Hearst Corp., 594 F.2d 1261, 1268 n.13 (9th Cir. 1975); White v. Abrams, 495 F.2d 724, 735-36 (9th Cir. 1974).
so-called "fraud on the market" theory of rule 10b-5 liability was recently approved by the Supreme Court in Basic, Inc. v. Levinson. The theory assumes that an efficient market's valuation of a security reflects all information available to the public; therefore, a purchaser's reliance on the market's valuation is equivalent to reliance on the underlying fraudulent activity that affects the market price.

5. Materiality

To successfully pursue a rule 10b-5 claim, a plaintiff must prove that defendant's misstatement, omission, or other fraudulent or deceptive conduct was "material." The Supreme Court, in 1976, in a rule 14a-9 proxy case—TSC Industries, Inc. v. Northway, Inc.—held that "the issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts."

In setting the legal standard of materiality in the proxy fraud context, the Northway Court held that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." This test requires a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of a reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having altered the "total mix" of information made available.

Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having altered the 'total mix' of information made available. Nevertheless, materiality issues...
6. Causation

A plaintiff in a rule 10b-5 damages action must prove "causation"—i.e., that there exists a sufficient causal connection between his injury and defendant's unlawful conduct that violates rule 10b-5. Causation in tort law ordinarily embraces both causation in fact, and legal cause which is sometimes framed in terms of "foreseeability" or "proximate cause." In rule 10b-5 cases, courts require proof of both "transaction causation" and "loss causation." Transaction causation is "but for" causation that is akin to reliance; i.e., the transaction would not have occurred "but for" the illegal conduct, or that the terms of the transaction that would have occurred in any event, were influenced by the material misrepresentation or omission. Loss causation requires that plaintiff's injury (i.e., his loss of money, or diminution of value of his security) is directly attributable to defendant's wrongful conduct. Sometimes courts lump both aspects of the required causation—i.e., "transaction" and "loss"—under time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. See, e.g., United States v. Matthews, 787 F.2d 38 (2d Cir. 1986) (issues concerning "qualitative" materiality and integrity theories of materiality); Branch & Rubright, Integrity of Management Disclosures Under the Federal Securities Laws, 37 Bus. Law. 1447 (1982); Ferrara, Starr & Steinberg, Disclosure of Information Bearing on Management Integrity and Competency, 76 Nw. U.L. Rev. 555 (1981); Fedders, Speech, Failure to Disclose Illegal Conduct, 14 Sec. Reg. & L. Rep. (BNA) 2057 (Nov. 26, 1982).


See, e.g., Rankow v. First Chicago Corp., 870 F.2d 356 (7th Cir. 1989) (market fluctuations are intervening cause between defendant's misconduct and plaintiff's loss, but not every intervening cause will defeat plaintiff's necessary showing of loss causation); Wilson v. Rufka & Hanover, P.C., 844 F.2d 81 (2d Cir. 1988), vacated sub nom. Wilson v. Saintine Exploration and Drilling Corp., 872 F.2d 1121 (1989); Rowe v. Maremont Corp., 890 F.2d 1226, 1233 (7th Cir. 1989); Harris v. Union Elec. Co., 787 F.2d 355, 366 (8th Cir.), cert. denied, 479 U.S. 823 (1986); Merritt, A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Remedy to the Wrong, 66 Tex. L. Rev. 469 (1988).
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the more traditional common law label of "proximate cause." For example, the Fifth Circuit in the Huddleston case stated:

The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation requirement is satisfied in a rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied upon by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the rule is not permitted. 121


Section 10(b) and rule 10b-5 prohibit "manipulation" or "deception" in connection with securities purchases and sales, and are commonly understood to proscribe securities fraud. After the Supreme Court's 1971 decision in Superintendent of Insurance v. Bankers Life & Casualty Co., 123 many courts, as well as legal commentators, believed that mere corporate mismanagement, at least if it constituted a corporate official's breach of fiduciary duty to the corporation or its shareholders, sufficiently constituted "fraud" for the purposes of triggering a rule 10b-5 damages cause of action. 124

But in 1977, in Santa Fe Industries, Inc. v. Green, 125 the Supreme Court slammed the door on the possibility of pursuing corporate mismanagement/breach of fiduciary duty cases through the guise of rule 10b-5


fraud. Unless a plaintiff can show "deception," the Santa Fe court held that a breach of fiduciary duty did not violate rule 10b-5. Even though a short form "squeeze out" merger with no valid corporate purpose caused the plaintiff minority shareholders in Santa Fe to receive a low cash-out price for their shares, there was no rule 10b-5 violation because the parent corporation had complied fully with applicable Delaware state law and had made all the disclosures that state law mandated. Since there was full disclosure, there was no "deception," and, a fortiori, no rule 10b-5 violation. Although Professor Hazen cites five post-Santa Fe court of appeals decisions reading the Supreme Court's Santa Fe opinion narrowly, and continuing to expansively construe the reach of rule 10b-5, he concludes, nevertheless, that it remains clear that a claim that states merely a breach of fiduciary duty will not be sufficient under rule 10b-5.

Mr. Justice White emphasized for the majority in Santa Fe, that the Court chose not to federalize all corporate breach of fiduciary duty cases by converting them into rule 10b-5 "fraud" cases: "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." The "deception" requirement of rule 10b-5 fraud was indirectly reinforced by the Supreme Court's decision in Schreiber v. Burlington Northern, Inc. Schreiber was a section 14(e) tender offer anti-fraud case, in which the Supreme Court held that fully disclosed, allegedly "manipulative" conduct does not violate section 14(e) because the conduct is not "deceptive." Section 14(e), like rule 10b-5, prohibits "fraudulent, deceptive or manipulative acts." As Professor Hazen observes: "The Schreiber decision reinforces the fact that attempting to characterize a breach of fiduciary duty as manipulative will not elevate it to a rule 10b-5 violation absent the type of deception required in the Santa Fe Industries case."

127 2 T. Hazen, supra note 1, at 171.
131 2 T. Hazen, supra note 1, at 172.
8. Damages

Punitive damages are not recoverable in a rule 10b-5 implied private damages cause of action. Section 28(a) of the 1934 Act expressly limits damages to "actual damages on account of the act complained of." However, punitive damages may be recoverable in a pendent state common law fraud claim that is adjudicated as a part of the rule 10b-5 case. Plaintiff must both affirmatively plead, and prove actual damages in a rule 10b-5 case; otherwise, the case will be dismissed. The case law is unclear on precisely what the appropriate measure of damages should be, i.e., "out-of-pocket," "benefit of the bargain," "rescission," or "disgorgement." Particularly in insider-trading cases, appropriate measurement of damages can be the most difficult aspect of a rule 10b-5 case. The issues of whether plaintiff's damages in a rule 10b-5 case may be increased by plaintiff's anticipated but unrealized tax benefits, or must be reduced by the amount of plaintiff's favorable tax benefits already recognized as a result of the contested securities transactions, are unresolved.


137 See cases and articles cited in 2 T. HAZEN, supra note 1, at 110-19.


9. Costs and Attorneys' Fees

Unlike section 11(e) of the 1933 Act, the 1934 Act contains no express provision mandating the award of costs or attorneys' fees in frivolous litigation or otherwise. Therefore, in rule 10b-5 cases, general federal law governs. "Costs shall be awarded to the prevailing party unless the court directs otherwise. . . ." But the "American rule" dictates that attorneys' fees are not generally recoverable in the absence of express statutory authority.

10. Statute of Limitations

There is no express statute of limitations governing the implied rule 10b-5 private damage cause of action. And the courts have not developed any uniform federal rule to resolve the statute of limitations issue in rule 10b-5 cases. There appear to be at least five alternatives: (i) apply by analogy the express limitations periods governing claims under sections 9, 16, 18, or 29(b), of the 1934 Act; (ii) apply by analogy the express limitations period governing the newly created insider-trading cause of action contained in section 20A of the 1934 Act; (iii) apply by analogy section 13 of the 1933 Act which expressly governs private remedies under sections 11 and 12 of that Act; (iv) apply by analogy the forum state's common law fraud limitations period; or (v) apply by analogy the forum state's blue sky securities fraud limitations period.

The recent, but not yet uniform, trend is to apply the analogous express 1934 Act limitations periods applicable to sections 9, 16, 18, and 29(b) of that Act, thereby providing a one-year/three-year limitations period for rule 10b-5 actions. The Third Circuit began this approach in In
The Data Access court, in formulating this approach, relied upon the Supreme Court's adoption of a uniform federal four-year statute of limitations for all civil RICO claims in *Agency Holding Corporation v. Malley-Duff & Associates.* The Supreme Court in October 1990 granted certiorari in *Lampf Pleva Lipkind Prupis & Petrigrow v. Gilbertson* to finally determine the question of what statute of limitations is appropriate for implied private damage causes of action under rule 10b-5.

11. Insider-Trading: The Misappropriation Theory

As a result of the Wall Street scandals of the 1980s, many rule 10b-5 private damage claims now involve illegal insider-trading allegations. Newly-amended section 20A of the 1934 Act provides an express damages cause of action to contemporaneous traders against illegal insider-traders. However, the damages limitations and the defenses of this new provision will likely cause private plaintiffs to continue to pursue an implied rule 10b-5 damage cause of action in insider-trading cases. An important issue remains to be resolved in the application of rule 10b-5 to insider-trading cases: Does the so-called "misappropriation" theory of insider-trading constitute a rule 10b-5 fraud?

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151 483 U.S. 143 (1987). For a listing of cases following the Data Access rule, as well as cases specifically rejecting it, see T. Hazen, supra note 1, at 131-32 n.25.
152 For a discussion of whether state or federal "equitable tolling" principles may extend the otherwise applicable rule 10b-5 statute of limitations, see id. at 134-37 nn.41-60.
155 See, e.g., Sperber v. Boesky, 849 F.2d 60 (2d Cir. 1988).
156 See supra note 26.
157 For example, the total recovery of a class of plaintiffs cannot exceed "the profit gained or loss avoided in the [violative] transaction" by the defendant. § 20A(b)(1), 15 U.S.C.A. § 78t-1 (Supp. 1990). Even that amount must be reduced by any disgorgement the defendant has made in a parallel SEC insider-trading enforcement action. § 20A(b)(2). However, § 20A(d) preserves a plaintiff's right to bring an implied private damages cause of action under rule 10b-5, as well as pursue a § 20A claim. See supra note 26.
Section 20A was specifically intended by the Congress to validate the misappropriation theory, at least for the purposes of the express remedy contained therein:

[T]he codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory. See, e.g., Moss v. Morgan Stanley, 719 F.2d 5 (2d Cir. 1983). The Committee believes that this result is inconsistent with the remedial purposes of the Exchange Act, and that the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful. . . .

But the Supreme Court has split 4 to 4 on the issue of whether the misappropriation theory of rule 10b-5 liability is valid. Until the Supreme Court resolves this sticky issue, the role of rule 10b-5 in major private damages class actions based upon allegedly illegal insider-trading remains in doubt.

12. Exclusive Federal Jurisdiction

Federal courts have exclusive jurisdiction over all rule 10b-5 damages cases. Section 27 of the 1934 Act provides that federal courts have "exclusive jurisdiction of violations of this title or the rules or regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title [1934 Act] or the rules and regulations thereunder." This differs from 1933 Act private remedies which may be pursued concurrently in state or federal court.

* * *

There is no doubt that the express private damages or rescission causes of action provided by sections 11 and 12 of the 1933 Act are fairly narrow in scope and that the expansive rule 10b-5 implied private party damages remedy of the 1960s has been narrowed significantly by the courts in the 1970s and 1980s. At the same time, use of civil RICO in securities litigation is expanding.

III. The Legislative History and Development of RICO as Applied to Securities Violations

Civil RICO's expansive development may be attributed in part to the statute's unduly broad and facially clear language, a lack of precise...
definition for RICO’s key elements of pattern and enterprise and the widespread use of the so-called “commercial fraud” predicate offenses—mail, wire and securities fraud—as the basis for civil RICO claims.

A. Legislative History—Securities Fraud Predicate Offense

There is little recorded legislative history on the inclusion of mail and wire fraud as predicate offenses. However, there is brief mention in the legislative history on the inclusion of securities fraud in the statute. The American Bar Association, the Securities and Exchange Commission, and a number of interested federal agencies were then concerned with a growing infiltration of organized crime into the securities

racketeering activity; (C) conduct the affairs of an enterprise engaged in interstate commerce through a pattern of racketeering activity; or (D) conspire to commit (A), (B), or (C). 18 U.S.C. § 1962 (1988). “Racketeering activity” is defined as a violation of any of the acts listed in § 1961(1). 18 U.S.C. § 1961(1) (1988). Such underlying violations are referred to as “predicate acts” or “predicate offenses.”


165 See Rehnquist, supra note 22, at 9: “Why does the statute work this way? In part, because it creates a civil counterpart for criminal wire fraud and mail fraud prosecutions. . . . Whether it is a good idea to have a civil counterpart to wire fraud and mail fraud is at least open to question, it seems to me, quite apart from the question whether treble damages should be awarded.” Professor Abrams, a moderator for a part of this Symposium, noted:

Most private civil RICO cases allege as predicate crimes fraud-type offenses—usually either mail or securities fraud. . . . The technical breadth of fraud-type offenses has been used by private RICO plaintiffs to their advantage. Thus, the reason that it is possible in so many ordinary business disputes to generate a superficially plausible private civil RICO claim is that it is so easy to make out a case of criminal fraud under applicable federal doctrines. Looking only to the general offense definitions, the law of criminal fraud seems to make almost any kind of asserted dishonest behavior in the course of business deal which is tied to the use of the mails or involves securities a basis for a criminal claim.


166 For my role in the events that led to the inclusion of securities fraud as a predicate offense, see Civil RICO Task Force Report, supra note 7, at 99-100 n.130.
markets. Racketeering activity was being used to manipulate stock prices—particularly on the American Stock Exchange, and to reap substantial illegal profits for securities swindlers through securities theft, counterfeiting, and other illicit practices. The Association of the Bar of the City of New York and the New York County Lawyers Association, however, issued strong statements in opposition to the inclusion of securities fraud in the proposed statute:

Against the background of expanding securities regulation this definition could include the various officers, directors and employees of corporations and underwriters of securities who have been found guilty of fraud in the sale of securities in some of the recent 10b-5 cases. Fraud in the sale of securities is simply not synonymous with racketeering activity.

The groups and agencies that favored inclusion of the commercial fraud offenses did so at a time prior to the inclusion of the private civil treble damages remedy, solely because they sought to assist governmental agencies in effectively pursuing criminal prosecutions and related governmental civil enforcement remedies against ongoing criminal organizations which conduct their activities through illegal means.

Professor G. Robert Blakey—Notre Dame's eminent RICO scholar, and several other academicians have applauded and encouraged the use of civil RICO as a substitute federal commercial fraud statute in securities and corporate matters, as well as in a broad array of general business litigation. They have argued, and indeed the courts...
have concurred, that RICO was not intended to be limited solely to "organized crime" in the traditional sense, and that other individuals or groups engaged in ongoing criminal activity fall within the ambit of the statute's plain language.

Nevertheless, it is clear that the primary legislative goal of RICO was the eradication of organized crime from legitimate business and labor unions. In addition to enhanced criminal penalties, Congress intended to bring creative, flexible remedies that had been successful in the antitrust field into the war against organized crime. These included a potpourri of new civil remedies available to the Department of Justice, and a private attorney general treble damages cause of action patterned on the Clayton Act on behalf of persons and entities injured in their business or property by patterns of racketeering activity. The legislative history of the statute demonstrates that Congress intended that the illegal activity that triggers the civil RICO remedy must constitute a criminal RICO violation. That is, the illegal activity must constitute a pattern of predicate offenses that embrace the types of criminal activities Congress envisioned the mob using in order to infiltrate legitimate business entities.

B. Overuse of Civil RICO in Securities Cases

However, the use of the civil RICO private attorney general treble damages provision has been pushed far beyond what Congress actually envisioned for 18 U.S.C. section 1964(c). In actual practice in the decade of the 1980s, civil RICO was overused or abused in a floodgate of cases having nothing to do with driving organized crime out of legitimate business. Many of these cases were traditional federal securities cases involving reputable business defendants. The courts have been relatively unsuccessful in narrowing civil RICO's scope through judicial construction, due to the breadth of the plain wording of the statute.
sequence, in the 1990s there continue to be too many civil RICO cases litigated in which reputable businesses and business persons, as well as their legal, accounting and other professional advisers, who were intended to be the beneficiaries of the statute, are named as defendants and branded as racketeers.

The ABA Ad Hoc Civil RICO Task Force reported in 1985 "that approximately 90 percent of the civil RICO cases in which there has been a published judicial decision rely upon the use of mail, wire, or securities fraud as predicate offenses."\footnote{Civil RICO Task Force Report, supra note 7, at 243. Although there has not been a comprehensive survey of civil RICO cases since the publication of the ABA Task Force Report, there is reason to believe the figures have remained substantially the same.} Thirty-five percent relied solely or primarily on allegations of securities fraud.\footnote{Id. at 57.} \footnote{Id. at 56.} The ABA Task Force found that only nine percent of the civil RICO cases surveyed in its study involved allegations of traditional Mafia-type organized criminal activity.\footnote{473 U.S. at 499-500 (footnote omitted).}

The Supreme Court addressed the growing expansion of civil RICO through commercial fraud offenses in \textit{Sedima}, but felt constrained by the statute's plain language and breadth from affirmatively curtailing overuse of the statute's civil treble damages remedy. In a dissenting opinion, Justice Marshall agreed with the majority's observations about the extraordinary uses of civil RICO in ordinary commercial cases, but he disagreed vigorously with the majority's "hands-off" solution.\footnote{Justice Marshall was particularly concerned with the private litigant's inability to use the civil RICO statute with caution, in the manner that federal prosecutors use the statute in criminal prosecutions pursuant to the DOJ Guidelines:}

\begin{quote}
Unlike the Government, private litigants have no reason to avoid displacing state common-law remedies. Quite to the contrary, such litigants, lured by the prospect of treble damages and attorney's fees, have a strong incentive to invoke RICO's provisions whenever they can allege in good faith two instances of mail or wire fraud.\footnote{Chief Justice Rehnquist recently echoed this criticism of overuse or abuse of civil RICO:}

Chief Justice Rehnquist recently echoed this criticism of overuse or abuse of civil RICO:

\begin{quote}
Virtually everyone who has addressed the question agrees that civil RICO is now being used in ways that Congress never intended when it enacted the statute in 1970. Most of the civil suits filed under the statute have nothing to do with organized crime. They are garden variety civil fraud cases of the type traditionally litigated in state courts.\footnote{473 U.S. at 504. See Bridges, supra note 16, at 50 n.43. See also United States Attorneys' Manual, tit. 9-110.200 (1984); 10 Department of Justice Manual, tit. 110-200 (Prentice Hall 1988); U.S. Department of Justice, Racketeer Influenced and Corrupt Organizations (RICO): A Manual for Federal Prosecutors (1988); Pedowitz & Bookin, Department of Justice RICO Guidelines and Their Applicability to Civil Cases, in Civil RICO 295 (Hynes ed. P.L.I. 1984); Dennis, Current RICO Policies of the Department of Justice, 43 Vand. L. Rev. 651 (1990).}
\end{quote}
It is clear that judicial interpretation and legislative inaction have allowed plaintiffs to stretch the confines of civil RICO to apply to "a broad range of commercial disputes far beyond any matters considered by Congress in enacting the statute."183 The mails and the telephone bring virtually all commercial transactions facially within the scope of the statute—even though there has never been an express or implied federal private damages cause of action for mail fraud or wire fraud.

Abuses of civil RICO also result from what the statute does not say. Nowhere in the language of RICO are the terms "pattern" and "enterprise" precisely defined. For a number of years, some courts seemed to accept as the required "pattern" virtually any two predicate offenses, despite the disparate circumstances of the two offenses and the absence of on-going criminal behavior.184 Other courts accepted as an adequate "enterprise" the mere sum of the alleged predicate offenses, without any additional structural or organizational attributes.185

C. Pattern

The "pattern" element of the statute is ambiguous. In footnote 14 in Sedima, the Court stated:

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."186

The Court pointed out that pattern "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,"187 but did nothing in the way of explicitly addressing what a pattern is.

The Supreme Court directly considered the question of what constitutes a "pattern" in H.J. Inc. v. Northwestern Bell Telephone Co.188 There, the Court reversed the Eighth Circuit's unique requirement that a showing be made that the RICO defendant committed acts in furtherance of

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184 See, e.g., R.A.G.S. Couture, Inc. v. Hyatt, 774 F.2d 1350 (5th Cir. 1985).
185 See, e.g., Moss v. Morgan Stanley, Inc., 719 F.2d 85 (2d Cir. 1983); United States v. Mazzei, 700 F.2d 85 (2d Cir. 1983); United States v. Errico, 635 F.2d 152 (2d Cir. 1980).
187 Id. (quoting 18 U.S.C. § 3575(c) (1982)). Much of what the Sedima court said about "pattern" had previously been espoused in the Civil RICO Task Force Report, supra note 7, at 193-208.
two or more discrete criminal schemes. The Court also invalidated the approach of the Fifth Circuit, which had required only the commission of any two related predicate acts.

The majority stated that “there is something to a RICO pattern beyond simply the number of predicate acts involved.” That something is that “the racketeering predicates are related, and that they amount to or pose a threat of continued criminal activity.” This judicial definition requiring both relatedness and continuity is somewhat more helpful than Sedima, but is still very broad. Indeed, despite H.J. Inc., the circuit courts and district courts are continuing to struggle with the pattern concept. And the fact that in H.J. Inc. Justice Scalia raised the question whether confusion and ambiguity endemic to the pattern concept makes RICO unconstitutionally vague suggests that pattern issues will continue to be at the forefront of both civil and criminal RICO litigation.

D. Enterprise

The “enterprise” element is also ambiguous. Section 1961(4) broadly states that 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.” However, section 1961(4) is not a limiting definition.

In United States v. Turkette, the Court pointed out that there may be two types of enterprises under the statute—those that are “legal entities” and those that are “associations in fact.” The Court held that wholly illegitimate organizations or groups of criminals, like an organized crime

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189 Id. at 2901.
190 Id. at 2899-2900 (invalidating R.A.G.S. Couture, Inc. v. Hyatt, 774 F.2d 1550 (5th Cir. 1985)).
191 Id. at 2900.
192 Id.
194 See, e.g., Yellow Bus Lines v. Local 639, 883 F.2d 132 (D.C. Cir. 1989); see also, Fleet Credit Corp. v. Sion, 893 F.2d 441 (1st Cir. 1990); Dana Corp. v. Blue Cross & Blue Shield Mutual of N. Ohio, Nos. 89-3442, 89-3474 (6th Cir. Apr. 26, 1990) (LEXIS, Genfed library, U.S.App. file); Beauford v. Helmsley, 865 F.2d 1386 (2d Cir. 1989) (en banc); Jacobson v. Cooper, 882 F.2d 717 (2d Cir. 1989); Swistock v. Jones, 884 F.2d 755 (3d Cir. 1989); Menasco, Inc. v. Wasserman, 886 F.2d 287 (4th Cir. 1989); Combs v. Baker, 886 F.2d 673 (4th Cir. 1989); Parcol Corp. v. NOWSCO Well Service Ltd., 887 F.2d 502 (4th Cir. 1989); Morley v. Cohen, 888 F.2d 1006 (4th Cir. 1989); Walk v. B&O Railroad, 847 F.2d 1100 (4th Cir. 1989); Newmyer v. Philatelic Leasing, Ltd., 888 F.2d 385 (6th Cir. 1989); Management Computer Servs., Inc. v. Hawkins, Ash, Baptie & Co., 883 F.2d 48 (7th Cir. 1989); Sutherland v. O’Malley, 882 F.2d 1196 (7th Cir. 1989); Atlas Pile Driving Co. v. DiCon Fin. Co., 886 F.2d 986 (8th Cir. 1989); Phelps v. The Wichita Eagle-Beacon, 886 F.2d 1262 (10th Cir. 1989).
198 “[I]n Section 1961(4),] Congress defined the enterprise with a non-exclusive term, ‘includes.’ A variety of RICO enterprises not listed in the definition may exist.” Note, RICO Enterprise, supra note 163, at 654-55 (footnotes omitted).
syndicate, a narcotics distribution gang, or an illegal gambling operation, can constitute an "association in fact" enterprise.200

The *Turkette* Court also found that "pattern" and "enterprise" are separate and distinct elements of a RICO claim, even though each may be established by common or similar evidence.201 At the very least, *Turkette* stands for the proposition that in some circumstances the government (or a private party plaintiff) may be able to establish the elements of both pattern and enterprise through the same facts.202 However, different circuit courts have relied on identical language in *Turkette* to justify vastly different enterprise tests.203

E. Suggested Limitations on Pattern and Enterprise

Without substantial limitations to the broad scope of pattern and enterprise,204 civil RICO will continue to be the darling of the plaintiff's

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200 When United States v. *Turkette* was *sub judice* before the U. S. Supreme Court, and the law of the First Circuit was that RICO did not apply to wholly illegitimate enterprises (i.e., the statute applied only to the infiltration of legitimate businesses or labor unions by racketeers), a Mafia chief and his lieutenant had the following conversation (as actually recorded surreptitiously by the FBI):

Mr. Angiulo: "Our argument is we're illegitimate business."
Mr. Zannino: "We're a shaylock."
Mr. Angiulo: "We are a bookmaker. We're selling marijuana. We are illegal here, illegal there, arsonists. We are everything."
Mr. Zannino: "Pimps."
Mr. Angiulo: "So what?"
Mr. Zannino: "Prostitutes."
Mr. Angiulo: "The law does not cover us, is that right?"
Mr. Zannino: "That's the argument."
Mr. Angiulo: "They can stick RICO . . . I wouldn't be in a legitimate business for all the [expletive] money in the world."

*See Doherty, On FBI Tape At Trial, Angiulo Swears Off 'Legitimate Business',* Boston Globe, Aug. 24, 1985, at 17, col. 1; *Butterfield, Jury Hears Tape on Gang Wars in Boston Trial,* N.Y. Times, Sept. 8, 1985, at 26, col. 1; President Ronald Reagan, *Declaring Wars on Organized Crime,* N.Y. Times, Jan. 12, 1986 (Magazine) at 26. *See also* United States v. Angiulo, 847 F.2d 956 (1st Cir. 1988) and 897 F.2d 1169 (1st Cir. 1990); United States v. Zannino, 798 F.2d 544 (1st Cir. 1986).

201 The enterprise is an entity, for present purposes a group of persons associated together for a common purpose of engaging in a course of conduct. The pattern of racketeering activity is, on the other hand, a series of criminal acts as defined by the statute. The [enterprise] is proved by evidence of an ongoing organization, formal or informal, and by evidence that the various associates function as a continuing unit. The [pattern] is proved by evidence of the requisite number of acts of racketeering committed by the participants in the enterprise.

*Turkette*, 452 U.S. at 583 (footnotes and citations omitted).

202 The Court acknowledged that it may be possible in some circumstances for proof of the commission of a pattern of racketeering activity to be sufficient to prove the existence of an enterprise. "While the proof used to establish these separate elements may in particular cases coalesce, proof of one does not necessarily establish the other. The 'enterprise' is not the 'pattern of racketeering activity;' it is an entity separate and apart from the pattern of activity in which it engages." *Turkette*, 452 U.S. at 453. *See also* id. at n.5. *See generally Note, Of Racketeers, RICO, the Enterprise—Pattern Separateness Issue and Chicken Little: What's Really Falling?,* 17 Sw. U. L. Rev. 565, 583 (1988) (discussing whether *Turkette* opinion hints at possibility that proof of pattern could equal proof of enterprise); *see also Note, RICO Enterprise, supra* note 164, at 707-10.


204 The definition of "enterprise" offers one opportunity to limit RICO's broad scope. A frequent "enterprise" issue in civil RICO litigation is whether each defendant "participated in the con-
bar in securities litigation as well as other federal commercial litigation. The Department of Justice

duct of the enterprise's affairs." See e.g., Alcorn County, Miss. v. U.S. Interstate Supplies, Inc., 731 F.2d 1160, 1167 (5th Cir. 1984); cf., United States v. Phillips, 664 F.2d 971, 1011 (5th Cir. 1981). This "participation" element bears on the required "nexus" between "pattern" and the "enterprise." See analysis of cases in Mathews & Weissman, Civil RICO Outline, in A. Mathews, Sixth Annual RICO Litigation Update, at 18, 109-124 (1990).

In its recent en banc decision in Yellow Bus Lines, Inc. v. Drivers Local 639, 1990 U.S. App. LEXIS 15547, No. 86-5135 (D.C. Cir. Sept. 4, 1990), the D.C. Circuit held that mere participation in committing the predicate offenses is not sufficient, and that RICO requires participation in either the "operation" or "management" of the enterprise. This is a fairly strict test for a plaintiff to establish—particularly with respect to such "outsiders" as attorneys, accountants and other professional advisors. The D.C. Circuit specifically rejected the more liberal "participation in the conduct" tests of the Second Circuit (e.g., United States v. Scotto, 641 F.2d 47, 54 (2d Cir. 1980)), the Fifth Circuit (e.g., United States v. Cauble, 706 F.2d 1322 (5th Cir. 1983), cert. denied, 465 U.S. 1005 (1984)), the Ninth Circuit (e.g., United States v. Yarbrough, 852 F.2d 1522, 1544 (9th Cir. 1988)), and the Eleventh Circuit (e.g., Bank of America v. Touche Ross & Co., 782 F.2d 966, 970 (11th Cir. 1986)).

Instead, in Yellow Bus, the D.C. Circuit adopted the test previously articulated by the Eighth Circuit in Bennett v. Berg, 710 F.2d 1361 (8th Cir.) (en banc), cert. denied sub nom. Prudential Ins. Co. v. Bennett, 464 U.S. 1008 (1983):

Mere participation in the predicate offenses listed in RICO, even in conjunction with a RICO enterprise, may be insufficient to support a RICO cause of action. A defendant's participation must be in the affairs of the RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself. Yellow Bus, 1990 U.S. App. LEXIS 15347 at *14 (quoting Bennett, 710 F.2d at 1364) (emphasis in original).

In Yellow Bus, the D.C. Circuit stressed that "conducting" connotes more than "participating in" affairs, and that § 1962(c) applies only "when a defendant, through a pattern of racketeering activity, exercises significant control over or within an enterprise, participating not merely in the enterprise's affairs, but in the conduct of the enterprise's affairs." Yellow Bus at *18, slip op. at 12. The D.C. Court added: "Most often the participation requirement will be satisfied when a defendant either participates in directing the enterprise toward its pre-existing goals or participates in exercising control over an enterprise so as to reset its goals. As the Eighth Circuit observed [in Bennett v. Berg], most of the time this requirement will only be satisfied when the defendant, either directly or indirectly, exercises control over the management or operation of the enterprise." Id., slip op. at 12. The D.C. Circuit noted that "outsiders" as well as "insiders" could be valid defendants under its new rule, since 18 U.S.C. § 1962(c) covers indirect as well as direct participation: "[N]othing in our interpretation of the participation requirement precludes liability on the part of outsiders. The crucial question is not whether a person is an insider or an outsider, but whether and to what extent that person controls the course of the enterprise's business." Id. at *19, slip op. at 12. The Yellow Bus holding found that a union, committing predicate offenses in picketing a business enterprise during a recognition strike, was not participating in the conduct of the enterprise's affairs. See id. at *25-*29, slip op. at 15-17. See also, Yellow Bus Lines, Inc. v. Local 639, 839 F.2d 782 (D.C. Cir. 1988), vacated, 109 S. Ct. 3235 (1989).

In future federal securities litigation containing civil RICO claims against "outside" professionals like attorneys, accountants, and bankers, the Yellow Bus en banc opinion may be the vehicle by which such "outsiders" find a way to extricate themselves from treble damages exposure by way of motions to dismiss or for summary judgment.


206 See, e.g., Mathews, RICO's Jurisprudential Dilemma: Curtaining Civil RICO Abuse Without Corrupting the Statute's Primary Goal of Eradicating Racketeering from Legitimate Business, — CATO J. — (1990); Weissman, Look to the Criminal, Not the Victim, in Denising Standards for RICO's Pattern Requirement, 4 Civ. RICO Rep. (BNA) No. 32, at 3-4 (Jan. 17, 1989); see also, Mathews & Weissman, New Cottage Industry: Interpreting RICO's 'Pattern' Requirement, 1 INSIDE LITIG., March, 1987, at 17; Civil RICO Task Force Report, supra note 7, at 8:

The 'pattern' concept in § 1961(5) should be accorded greater meaning by using it to focus upon criminal activity of a nature that tends to characterize the perpetrator as a person who regularly uses crime as a means of achieving his desired ends. At a minimum, this requires
has already incorporated this requirement in its RICO Guidelines.\textsuperscript{207} Likewise, the DOJ has adopted a narrow definition of enterprise which Congress should incorporate into the statute itself.\textsuperscript{208} That definition reads:

No RICO count of an indictment shall charge the enterprise as a group associated in fact, unless the association in fact had an ascertainable structure which exists for the purpose of maintaining operations directed toward an economical goal, that has an existence that can be defined apart from the commission of the predicate acts constituting the patterns of racketeering activity.\textsuperscript{209}

These more restrictive definitions would add substance to any serious movement to narrow the reach of civil RICO.

The expansion of RICO into unintended waters can clearly be recognized when concepts of "pattern" and "enterprise" which appear sound in a federal criminal prosecution of La Cosa Nostra murders committed in furtherance of illicit gambling, loan-sharking and narcotics trafficking\textsuperscript{210} are later applied in a private securities damage action. Application of civil RICO to two or three mailings or telephone calls by a registered representative who fails to state a material fact when selling a security to a customer/investor (or other comparable conduct), in pursuit of a reputable brokerage firm's nationwide securities business is much more draconian than application of criminal RICO to Cosa Nostra murderers.\textsuperscript{211} However, since civil RICO provides plaintiffs significant litigation advantages, it is likely that use of the statute will continue to proliferate in federal securities litigation.

\textsuperscript{207} See Civil RICO Task Force Report, supra note 7, at 206-07 (DOJ Guidelines reject view that single criminal episode is encompassed by RICO). The Department of Justice has expressed its interest in "prevent[ing] a pattern of racketeering activity being charged which lacks the attributes which Congress had in mind but which is literally within the language of the statute." CRIMINAL DIV., U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEY'S MANUAL § 9-110.341, reprinted in Civil RICO Task Force Report, supra note 7, at Appendix D.

\textsuperscript{208} See Civil RICO Task Force Report, supra note 7, at 8-9:

The "enterprise" concept introduced at § 1961(4) should be given meaning independent of the pattern of racketeering requirement where associations-in-fact formed to perform criminal acts are alleged. The positions articulated by the Third and Eighth Circuits, as well as the Guidelines adopted by the Department of Justice, which requires that an association-in-fact have a structural continuity distinct from any single set of criminal acts, should be adopted.

\textsuperscript{209} Id. at Appendix D, at 14.

\textsuperscript{210} Cf. United States v. Indelicato, 865 F.2d 1370 (2d Cir.) (en banc) (murder of three members of Bonanno crime family in one incident in assassination plot directed by "Commission" of La Cosa Nostra in an effort to realign the leadership of Bonanno crime family, constituted adequate RICO "pattern"), cert. denied, 110 S. Ct. 56 (1989). See also United States v. Watchmaker, 761 F.2d 1459 (11th Cir.) (three predicate offenses of attempted murder arising from a single incident between defendant motorcycle gang members and police constituted adequate RICO "pattern" since motorcycle gang was ongoing criminal enterprise), cert. denied, 474 U.S. 110 (1985).

\textsuperscript{211} Cf. the cases involving broker-dealers cited supra note 15.
IV. Plaintiff’s Potential Advantages in Pursuing a Federal Securities Action Under Civil RICO and the Problems RICO Presents to Such Actions

A private plaintiff possesses numerous potential advantages in pursuing a cause of action under civil RICO in a federal securities law case. However, RICO creates certain problems when applied to securities violations. This section will analyze the potential advantages to the plaintiff of pursuing a civil RICO claim in federal securities litigation, and the major problems which RICO presents to such litigation.

A. Plaintiff’s Advantages in Pursuing a Civil RICO Cause of Action

A plaintiff injured in a securities transaction is faced with the limitations in scope, and the requirements of pleading and proof of the federal securities laws, i.e., the express causes of action under sections 11 and 12 of the 1933 Act and the implied remedy under rule 10b-5 of the 1934 Act.212 As a result, the plaintiff often joins a civil RICO claim, so long as the initial pleading standards of RICO may be met. Through use of civil RICO, the plaintiff receives advantages with regard to the liberal construction clause, permissible defendants, forum choice, statute of limitations, damages, costs and attorneys’ fees, and discovery. In addition, a civil RICO claim may be available in cases involving investment transactions where no remedy exists under the federal securities laws. A plaintiff may avoid rule 10b-5 requirements of materiality and reliance through civil RICO, as well as avoid the Blue Chip purchaser/seller standing requirement. Cases of internal corporate mismanagement or breaches of fiduciary duty not actionable under rule 10b-5 may potentially be pursued under civil RICO. In addition, the “in terrorem” effect of potential treble damages under civil RICO might induce a defendant to settle a securities violation at one hundred cents on the dollar, rather than at a fraction of the damage claim which is more common in ordinary securities litigation.

1. Liberal Construction Clause

Nowhere is the advantage in using civil RICO more visible than in RICO’s liberal construction clause which states, “[t]he provisions of this title shall be liberally construed to effectuate its remedial purposes.”213 The elasticity of several of RICO’s key requirements including “pattern” and “enterprise,” combined with this liberal directive, support a broad

212 See supra notes 28-161 and accompanying text.
application of the statute in favor of private party plaintiffs. In effect, the clause abrogates the usual federal "rule of lenity" which requires that criminal statutes be interpreted narrowly in favor of defendants. The Supreme Court noted in Sedima, "if Congress' liberal-construction mandate is to be applied anywhere, it is in § 1964, where RICO's remedial purposes are most evident." 

2. Scope of Potential Defendants: Aiding and Abetting

Liability under sections 11 and 12 of the 1933 Act is limited to certain classes of defendants, i.e., those classes of defendants specified in section 11(a). Section 12 defendants are limited by Pinter v. Dahl to the actual sellers or those who directly and actively participated in the sale in question. Section 11 defendants who did not sign the registration statement but are deemed experts due to their relationship to information in the registration statement possess a statutory due diligence defense. Outside professionals, who may have been involved in the sale or preparation of offering materials but do not meet the standard set forth in Pinter v. Dahl are not liable under section 12. In addition, section 12 defendants possess a reasonable care defense. All these classes of persons may have potential liability under civil RICO. Indeed, it is often these types of professional defendants upon whose "deep pockets" civil RICO plaintiffs focus.

Even though "aiding and abetting" derivative liability is not available in cases brought under sections 11 and 12 of the 1933 Act, it is clearly available in RICO litigation. After all, the RICO statute is found in title 18—the Federal Criminal Code—and in that same title 18 is found the principal federal "aiding and abetting" provision, 18 U.S.C. § 2.

3. Concurrent Jurisdiction

Rule 10b-5 cases and other 1934 Act remedies must be pursued exclusively in the federal courts. However, in Tafflin v. Levitt, the Supreme Court squarely determined that state courts possess concurrent jurisdiction with federal courts over all civil RICO private treble damage

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216 See supra notes 36-41 and accompanying text.

217 See supra notes 53-59 and accompanying text.

218 See supra note 41 and accompanying text.

219 See supra note 70 and accompanying text.

220 See supra notes 61-62 and accompanying text.

221 See supra notes 160-61 and accompanying text.

222 See, e.g., Petro-Tech, Inc. v. Western Co. of North America, 824 F.2d 1349, 1358 (3d Cir. 1987); Armco Industrial Credit Corp. v. SLT Warehouse Co., 782 F.2d 475 (5th Cir. 1986). Aiding and abetting is embraced in the RESTATEMENT (SECOND) OF TORTS § 876(b) (1976), and is often applied in civil cases, see, e.g., Halberstam v. Welch, 705 F.2d 472, 481-86 (D.C. Cir. 1983).

223 See supra notes 160-61 and accompanying text.

In so holding, the Court found no indication that Congress intended exclusive federal jurisdiction, and further found that no "clear incompatibility" existed between state court jurisdiction and federal interests as reflected in the RICO statute. In addition, the Supreme Court held that concurrent state jurisdiction would further the remedial purposes as called for in RICO's liberal construction clause.\(^2\)

Cases brought under sections 11 and 12 of the 1933 Act have always been susceptible to litigation in either state or federal courts, while rule 10b-5 cases must necessarily be filed solely in federal court. However, as a result of \textit{Tafflin}, a plaintiff can now bring a civil RICO case based on rule 10b-5 securities fraud predicate offenses \textit{in state court}. This may increase the use of state courts in securities litigation, and concomitantly increase the use of civil RICO therein.\(^2\)

\section*{4. Statute of Limitations}

In \textit{Agency Holding Corporation v. Malley-Duff & Associates},\(^2\) the Supreme Court established a uniform statute of limitations for civil RICO actions. The Court held that the similarities in purpose and structure between RICO and the Clayton Act, and the legislative intent to pattern RICO's civil provision on the Clayton Act, favored adoption of the Clayton Act's uniform four-year statute of limitations in civil RICO claims.\(^2\) The designation of the appropriate time for the accrual of a civil RICO claim was expressly reserved by the Court.\(^2\)

As a result of \textit{Malley-Duff}, a civil RICO plaintiff may be given more time to commence a damages action than the applicable 1933 and 1934 Acts provisions allow. Section 13 of the 1933 Act establishes a one- to three-year statute of limitations for sections 11 and 12 actions.\(^2\) In some circuits, rule 10b-5 claims will be governed by a forum state's common law fraud limitations period or a blue sky securities fraud limitations period that is as short as two or three years. In other circuits, rule 10b-5 claims may be covered by the analogous one year/three year section 13

\(^{225}\) Following its decision in \\textit{Gulf Offshore Co. v. Mobil Oil Corp.}, 453 U.S. 473 (1981), the Court looked for explicit legislative intent to make jurisdiction exclusive or for clear incompatibility between state and federal jurisdiction. \textit{Tafflin}, 110 S. Ct. at 795. Of course, the federal courts have exclusive jurisdiction over federal anti-trust treble damage claims, and the Court has often relied on an antitrust analogy in construing RICO. \textit{See}, e.g., \textit{Agency Holding Corp. v. Malley-Duff & Assocs.}, 483 U.S. 143 (1987). The Court in \textit{Tafflin}, nevertheless, held that its \textit{Gulf Offshore} precedent precluded it from deciding the concurrent exclusive jurisdiction issue solely on the Clayton Act analogy. 110 S. Ct. at 796-97.

\(^{226}\) \textit{Tafflin}, 110 S. Ct. at 797-99.

\(^{227}\) Some commentators have suggested that there may be a resistance by many local attorneys to litigate in federal court. \textit{See}, e.g., \textit{Poker}, supra note 8, at 523: (In the past... many attorneys may have been reluctant to file a suit under RICO because they wished to avoid federal court. Consequently, the attorneys only filed a suit under state law. Attorneys may have based their decision to avoid federal court on the fact that they were more familiar with state courts than with federal courts, or because the federal courts were an inconvenient forum. \textit{Id.} at 146.

\(^{228}\) 483 U.S. 143 (1987).

\(^{229}\) \textit{Id.} at 156-57. For a detailed exploration of the thorny issue of accrual in a civil RICO case, see Note, "\textit{Mother of Mercy, Is This the Beginning of RICO?}": The Proper Point of Accrual of a Private Civil RICO Action, 65 N.Y.U. L. REV. 172 (1990).

\(^{230}\) \textit{See supra} notes 34, 50-51 and accompanying text.
limitations period. Yet, civil RICO will now always provide these claims with a uniform four-year limitations period if they are pleaded as securities, mail or wire fraud predicate offenses.

5. Damages, Costs and Attorneys' Fees

A successful plaintiff under civil RICO is awarded treble damages, costs and attorneys' fees in every case. A successful plaintiff in a 1933 or 1934 Act federal securities law case receives only actual damages. There is no certainty of recovery of costs or attorneys' fees in 1933 and 1934 Act cases. The "in terrorem" effect of potential treble damages, and automatic imposition of costs and attorneys' fees often enable plaintiffs to extract favorable settlements even if their civil RICO claims are weak. The limitations on damages in the 1933 and 1934 Acts help insure that only proper claims are brought and reduce the incentive for a large settlement unless plaintiff's case is substantial. On the other hand, such damages limitations also discourage many plaintiffs who possess small claims from seeking redress under the 1933 and 1934 Acts; civil RICO treble damages provide them with an incentive to do so.

6. Discovery

Since a "pattern" of racketeering activity may stretch over a substantial period of time, a plaintiff in a civil RICO case undoubtedly will be able to engage in more far-ranging discovery than would be available solely on a substantive 1933 or 1934 Act claim. However, district courts are likely to control discovery through the courts' discretionary powers in civil RICO cases to prevent significant discovery abuses.

7. Using Mail and Wire Fraud Predicate Offenses to Fill the Holes in a Securities Fraud Claim

The federal mail fraud statute, 18 U.S.C. § 1341, has for many years been one of the most widely used prosecutorial tools in federal "white collar" criminal cases. Mail fraud, along with its companion wire

232 See supra notes 139-45 and accompanying text. To date, no circuit has yet adopted for rule 10b-5 suits the analogous five-year limitations period included in newly enacted § 20A of the 1934 Act. See supra note 141 and accompanying text.
234 See supra notes 72-73, 132-39 and accompanying text.
235 See supra notes 44-45, 140-43 and accompanying text.
236 See, e.g., Senate Comm. on the Judiciary, Amending the Racketeer Influenced and Corrupt Organizations Act, S. Rep. No. 269, 101st Cong., 2d Sess. 2 (1990), where Congress specifically noted that civil RICO actions often "include imaginative attempts to use RICO's treble damages remedy to leverage more favorable settlements in ordinary civil, even familial, disputes."
239 See Coffee, From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics, 19 AM. CRIM. L. REV. 117, 126 (1981) ("Among prosecutors, a well-known maxim says 'when in doubt, charge mail fraud.'"); Rakoff, The Federal Mail Fraud Statute (Part I), 18 DUQ. L. REV. 771 (1980) ("To federal prosecutors of white collar crime, the mail fraud statute is our Stradivarius, our Colt .45, our Louisville Slugger, our Cuisinart—and our true love. We may flirt with RICO, show off with 10b-5, and call the conspiracy law 'darling,' but we always
fraud statute, 18 U.S.C. § 1343, are widely used RICO "predicate offenses." Indeed, mail, wire and securities fraud—the so-called "commercial fraud" predicate offenses—predominate in civil RICO cases. It is important to note that neither the mail nor wire fraud statutes expressly provide for a private party civil damages remedy. Furthermore, the federal courts have consistently refused to find an implied federal private damages cause of action based upon criminal mail or wire fraud violations. Nevertheless, through civil RICO, a victim of a "pattern"
of mail or wire fraud violations committed with the requisite nexus to an “enterprise” can pursue an express cause of action for treble damages, costs and attorneys’ fees.

More importantly, a securities law plaintiff can use mail fraud predicate offenses (or wire fraud predicates) to elevate certain defective securities fraud claims into wholly valid civil RICO treble damage claims. A plaintiff pursuing a damages claim under the federal securities laws must demonstrate that the transaction or investment arrangement in question involves a “security” within the coverage of the appropriate federal securities statute. A civil RICO plaintiff who is incapable of satisfying this “security” requirement may bypass this securities law requirement by framing the civil RICO charge in terms of mail or wire fraud.

Even though commodities fraud is not a predicate offense in the RICO statutes, commodities fraud cases may be converted into civil RICO cases through use of mail and wire fraud predicate offenses. Whenever a plaintiff has any doubt whether a particular instrument is a “security” covered by the 1933 and 1934 Acts—i.e., various options or futures instruments or hybrids thereof—mail fraud and wire fraud predicates provide the vehicle to frame a damages case under civil RICO.

8. Internal Corporate Mismanagement and Fiduciary Breaches: The “McNally Amendment” to Mail and Wire Fraud

The Supreme Court held in the Santa Fe case that a mere breach of fiduciary duty, in the absence of “deception,” will not support an implied damages cause of action under rule 10b-5. Such internal corporate mismanagement must be pursued under appropriate state law. It will not constitute federal securities “fraud” under rule 10b-5.

However, Congress recently enacted an amendment to the mail and wire fraud statutes which provides “[f]or the purposes of this chapter, the term ‘scheme or artifice to defraud’ includes a scheme or artifice to deprive another of the intangible right of honest services.” The new law was passed in direct response to the Supreme Court’s invalidation of the

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250 See supra note 122-81 and accompanying text.
251 Santa Fe, 430 U.S. at 478.
so-called "intangible rights" doctrine of mail and wire fraud in *McNally v. United States*.253

The *McNally* decision upset an entire body of criminal mail fraud law which had been developed through judicial interpretation in the 1960s, 1970s, and 1980s and had extended the reach of the mail fraud statute to cover schemes involving the deprivation of "intangible rights" and breaches of fiduciary duty, as well as those involving the loss of money or property.254 Swift congressional action aimed at reversing the *McNally* holding led to the passage of section 1346.255 This formal expansion of the definition of "scheme or artifice to defraud" to include "intangible rights" will trigger an expansion of the scope of both criminal and civil RICO.256

Since mail and wire fraud now reach intangible rights as opposed to merely intangible property, mere breaches of fiduciary duty—at least those in connection with which there is a right to "honest services"—may well become predicate offenses in a wide range of new civil RICO claims.257 If so, although the *Santa Fe* doctrine will preclude rule 10b-5

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253 483 U.S. 550 (1987). In *McNally*, the Supreme Court held that the mail fraud statute is "limited in scope to the protection of property rights," id. at 360, and "does not refer to the intangible right of the citizenry to good government." Id. at 356. *McNally* involved the conviction of a government official and a private citizen for mail fraud in connection with the selection of insurance agencies for the state of Kentucky. The prosecution argued that "petitioners' participation in a self-dealing patronage scheme defrauded the citizens and government of Kentucky of certain 'intangible rights,' such as the right to have the Commonwealth's affairs conducted honestly." Id. at 352. The Supreme Court held that the language of the mail fraud statute prohibited prosecution unless there was a showing that the defendant's conduct resulted in the loss of money or property. Since the government alleged only the loss of an intangible right, the defendants' convictions were reversed. Id. at 361. See Rakoff, *Intangible Rights and Wrongs: The McNally Case*, 6 RICO L. REP. 254 (1987); Note, *McNally* v. United States and Its Effect on the Federal Mail Fraud Statute, 39 MERCER L. REV. 697 (1988). Cf. Dreeben, *Insider Trading and Intangible Rights: The Redefinition of the Mail Fraud Statute*, 26 AM. CRIM. L. REV. 181 (1988).


255 See Rakoff, *Congressional Macho*, 8 RICO L. REP. 860 (1988) (discussing impact of § 1346 on RICO). See also United States v. Berg, 710 F. Supp. 438 (E.D.N.Y. 1989) (Section 1346 "may be viewed as restoring the law to its state prior to the *McNally* decision.").

256 Civil RICO provides an express private party cause of action for treble damages as long as the plaintiff can prove that the defendant engaged in at least two predicate acts of mail or wire fraud as part of a pattern of racketeering activity that has a requisite connection to an enterprise. See Montesano v. Seafirst Commercial Corp., 818 F.2d 423, 424 (9th Cir. 1987) ("An imaginative plaintiff could take virtually any illegal occurrence and point to acts preparatory to the occurrence, usually the use of the telephone or mails, as meeting the requirement of pattern."). If a plaintiff can show that the defendant has engaged in activity amounting to a pattern of indictable offenses under either the mail or wire fraud statute, then civil RICO's private party treble damage remedy will facially be available. This is true despite the fact that due to the borderline nature of any particular case a federal prosecutor, exercising prosecutorial discretion pursuant to the Department of Justice Criminal RICO Guidelines and the general Principles of Federal Prosecution, may decline to pursue a criminal prosecution for either a RICO offense or for an underlying substantive mail or wire fraud offense. See U.S. ATTORNEYS' MANUAL, §§ 9-27.000 - 9-27.760. For the prosecutorial guidelines specifically applicable to mail fraud, see U.S. ATTORNEYS' MANUAL, § 9-43.120. See also the concurring opinion of Ninth Circuit Judge (now Supreme Court Justice) Kennedy in Schreiber Distrb. Co. v. Serv-Well Furniture Co., 806 F.2d 1993, 1402 (9th Cir. 1986).

257 The question is whether the intangible rights/breach of fiduciary duty theories of criminal mail and wire fraud violations pursued in cases like the following will now spawn a new generation of
securities law claims, a whole new range of state law internal corporate mismanagement claims may be turned into civil RICO treble damages claims. Thus, although Congress ostensibly acted solely to preserve what had been the status quo of criminal mail fraud law before the Supreme Court’s action in *McNally*, it inadvertently may have created a potpourri of new interpretive problems in future civil RICO cases.

9. Insider Trading: Misappropriation Theory

Although the Supreme Court split 4 to 4 in *United States v. Carpenter*, as to whether the “misappropriation theory” will support rule 10b-5 liability, it unanimously and squarely held in *Carpenter* that the mail fraud statute is violated by “misappropriation” of money, property or information through breach of a fiduciary duty, such as a duty to render honest services. The “*McNally* amendment” to the mail and wire fraud statutes, coupled with the *Carpenter* mail fraud holding, indicates that a broad range of “misappropriation theory” insider-trading cases that are questionable under rule 10b-5 clearly could be pursued as civil RICO “breach of duty” mail fraud cases.

10. Materiality and Reliance


*260 Id. at 22. See also Louderman*, 576 F.2d 1383, 1388.


*262 See supra* notes 48, 70 and accompanying text.

*263 See supra* note 71 and accompanying text; *see also supra* notes 99-103 and accompanying text.

*264 J. Rakoff & H. Goldstein, RICO: CIVIL AND CRIMINAL LAW AND STRATEGY § 2.02[1] (1990):* Probably none of the predicate acts which can form the basis for a civil RICO claim are broader than the federal mail and wire fraud statutes. These statutes simply prohibit any use of the mails or of interstate telephone calls in furtherance of any fraudulent scheme. Unlike many other predicate acts, the mail and wire fraud statutes do not require pleading
predicates in a civil RICO claim might circumvent the materiality and reliance requirements of rule 10b-5 securities fraud.265

B. Complexities and Unresolved Issues in Utilizing Civil RICO in Federal Securities Litigation

Since it is likely that civil RICO will continue to be extensively applied in securities cases, several important issues must be litigated in the 1990s. These issues include the scope of the securities fraud predicate offenses, whether the Blue Chip purchaser/seller standing limitation is superimposed on civil RICO securities cases, the proper scienter standard, injury/causation distinctions, the availability of equitable relief, and the application of respondeat superior, as well as the further definition of "pattern" and "enterprise."

1. Scope of the Securities Fraud Predicate Offense: Are Both Purchases and Sales Covered?

Unlike the mail and wire fraud predicates—which are designated in the statute by specific reference to sections 1341 and 1343 of title 18—the securities fraud predicate offense in the RICO statute is not designated by any reference whatsoever to any particular title or section of the United States Code or any of the federal securities statutes. Rather, the definition of "racketeering activity" in section 1961(1) of the RICO statute includes "any offense involving ... fraud in the sale of securities ... punishable under any law of the United States."266

Substantial disagreement exists in case law precedent as to the intended scope or breadth of the securities fraud predicate offense. RICO's legislative history does not reveal whether Congress had one or more particular provisions of the federal securities laws in mind when it crafted this particular predicate offense.267 District courts have disagreed about which fraud provisions in the 1933 and 1934 Acts are sub-

of misrepresentation, reliance or injury stemming directly from the conduct at issue, i.e., the mail or wire communication. The communication need only be in furtherance of a scheme which itself intentionally or recklessly causes the harm. [footnotes omitted.]

265 Professor Blakey criticizes two Eighth Circuit opinions that have superimposed the common law fraud elements of materiality and reliance upon civil RICO claims pursued with allegations of mail or wire fraud predicate offenses—i.e. Flowers v. Continental Grain Co., 775 F.2d 1051 (8th Cir. 1985) and Horn v. Ray. E. Friedman Co., 776 F.2d 777, 780-82 (8th Cir. 1985). See Blakey, RICO Litigation Update in Mathews, Sixth Annual RICO Litigation Update 378-80 (1990). Professor Blakey cites McLendon v. Continental Group, Inc., 602 F. Supp. 1492 (D.N.J. 1985), as the proper rule as to the materiality issue since McLendon is in accord with general mail fraud jurisprudence and makes no requirement for a showing of material misrepresentation or omission for the predicate act of mail fraud in a civil RICO complaint. Id. at 379. Professor Blakey cites the following cases to refute the Eighth Circuit Horn and Flowers requirement of reliance in a civil RICO mail or wire fraud case: Armco Industrial Credit Corp. v. SLT Warehouse Co., 782 F.2d 475, 481-83 (5th Cir. 1986) and Abell v. Potomac Ins. Co., 858 F.2d 1104, 1129-30 (5th Cir. 1988). Id. at 379-80. However, Professor Blakey concedes that while "reliance" may not be necessary for proof of mail or wire "fraud," it may be necessary for proof of requisite "causation." Id. at 380 (citing Brandenberg v. Seidel, 859 F.2d 1179, 1187, 1188 n.10 (4th Cir. 1988)).


267 See generally Glanz, supra note 7.
sumed by the RICO securities fraud predicate, and appellate courts have not yet squarely faced the issue.268

The two principal anti-fraud provisions in the federal securities statutes are section 17(a) of the 1933 Act,269 and section 10(b) of the 1934 Act as fleshed out by rule 10b-5.270 These are the anti-fraud provisions that are most commonly utilized in criminal securities fraud prosecutions271 and in SEC civil injunction enforcement actions.272 Section 17(a) fraud embraces a much more narrow range of conduct than rule 10b-5 fraud. Section 17(a) prohibits fraud solely in the offer or sale of a security. However, section 10(b) and rule 10b-5 prohibit fraud in connection with the purchase or sale of a security. Rule 10b-5 has a much broader sphere of coverage than section 17(a), as a result of including "purchases" as well as sales, and by virtue of its elastic "in connection with" nexus element.

Although RICO's language in 18 U.S.C. § 1961(1)(D) more closely resembles section 17(a) than it does rule 10b-5—the RICO provision does not specifically mention "purchase," and refers to fraud in the sale, not in connection with the sale—many courts have accepted rule 10b-5 claims, even though they embrace fraud in a securities purchase, as valid civil RICO predicate offenses.273 For example, in In Re Catanella and E. F. Hutton & Company Securities Litigation,274 in a broker-dealer "churning" case brought under both rule 10b-5 and civil RICO, the court stated that in securities fraud cases "the reach of RICO should extend to both purchases and sales."275 In addition, a number of courts have allowed section 13(d) claims—i.e. violations of the "Williams Act" amendments


Although RICO provides that "fraud in the sale of securities" may constitute "racketeering activity," it supplies neither a definition of "fraud" nor a reference to other federal laws contemplated in drafting this "predicate offense."

The district court did not define "RICO fraud" when it dismissed plaintiff's complaint. Similarly, we need not decide this complex and far-reaching question ... [As] neither common law fraud nor traditional securities fraud underpins plaintiff's RICO claim, we need not delineate RICO's definition of "fraud in the sale of securities."


275 Id. at 1425 n.56.
to the 1934 Act—embracing nondisclosure of purchasing over five percent of an issuer's securities, to constitute valid RICO predicate offenses.\textsuperscript{276} For example, in \textit{Spencer Companies, Inc. v. Agency Rent-a-Car, Inc.},\textsuperscript{277} the district court held that section 13(d) claims may be valid civil RICO securities fraud predicate offenses, stating: "The remedial purpose of the [RICO] statute would appear to encompass fraud committed by the purchaser of securities, as well as by the seller."\textsuperscript{278}

Only recently have the courts begun to construe the precise language of RICO's securities fraud predicate offense more narrowly.\textsuperscript{279} For example, in \textit{First Pacific Bancorp v. Bro},\textsuperscript{280} the Ninth Circuit held that violations of sections 13(d) and 14(e) of the 1934 Act cannot be RICO securities fraud predicate offenses because neither of these provisions embrace fraud "in the sale" of a security. The District Court in \textit{In re Par Pharmaceutical, Inc. Securities Litigation}\textsuperscript{281} refused to apply civil RICO to facts involving alleged fraud in connection with the purchase of securities in a rule 10b-5 securities case. The court noted that in \textit{Moss v. Morgan Stanley Inc.},\textsuperscript{282} the Second Circuit had determined not to address the "complex and far-reaching question" whether RICO's securities fraud predicate offense covers all securities fraud embraced by rule 10b-5.\textsuperscript{283} After analyzing the plain wording of section 1961(1)(D) pertaining to "fraud in the sale of securities," and the sparse legislative history, the \textit{Par} court held that "securities fraud is only a [RICO] predicate offense if the fraud occurs in the actual sale of a security"\textsuperscript{284} and that "only fraud that occurs as part of the actual securities [sale] transaction is a predicate act."\textsuperscript{285}

The \textit{Par} court built upon dicta of the Fourth Circuit in \textit{International Data Bank, Ltd. v. Zepkin},\textsuperscript{286} as well as the views of several commenta-

\textsuperscript{278} \textit{Id.} at 92,215. The Court specifically relied upon RICO's liberal construction clause. \textit{Id.}
\textsuperscript{279} \textit{See} First Pac. Bancorp v. Bro, 847 F.2d 542 (9th Cir. 1988) (violations of §§ 13(d) and 14(e) of the 1934 Act cannot be RICO securities fraud predicate offenses because neither of these provisions embrace fraud "in the sale" of a security).
\textsuperscript{280} 847 F.2d 542 (9th Cir. 1988).
\textsuperscript{283} \textit{Id.} at 683 (emphasis added).
\textsuperscript{284} \textit{Id.} at 684 (emphasis added). "[G]iving § 1961(1)(D) its plain meaning, RICO does not incorporate all violations of § 10(b) and Rule 10b-5, but rather is limited to those fraudulent acts that occur in an actual sale transaction." \textit{Id.} at 683.
\textsuperscript{285} 812 F.2d 149, 152 (4th Cir. 1987) ("The statutory language describing the [securities fraud] predicate offense. . . is, however, narrow and suggests the pivotal role of the actual sales transaction.")
In my view, other courts should pay heed to the Par Pharmaceutical court's rationale. 288

2. Blue Chip Purchaser/Seller Standing Issue

A private party plaintiff must satisfy the Blue Chip purchaser/seller standing requirement to pursue a rule 10b-5 damages claim. 289 Similarly, plaintiffs in a section 11 or section 12 case must have purchased the security at issue. But the courts are in disagreement as to whether a securities fraud plaintiff needs to satisfy the Blue Chip standing requirement to pursue a civil RICO claim based upon either securities fraud predicate offenses, or mail or wire fraud predicate offenses. Both the Eleventh and the Ninth Circuits have squarely held that there is no "purchase or sale" standing requirement in a civil RICO securities fraud case. 290 Both circuits hold that so long as a plaintiff is injured directly, rather than derivatively, by reason of defendant's RICO violation, standing exists for a civil RICO treble damage claim.

The Eleventh Circuit in Securities Investor Protection Corporation v. Vigman placed great emphasis on the fact that private plaintiff actions under rule 10b-5 are implied while Congress expressly provided for civil RICO suits. The "in connection with the purchase or sale" language of rule 10b-5 291 combined with the absence of an express right of action necessitates strict construction of the 1934 Act in rule 10b-5 cases. In contrast, the express language of section 1964(c) providing treble damages, combined with the broad language of the "fraud in the sale of securities" predicate offense in section 1962, as well as the RICO's liberal

287 See, e.g., Glanz, supra note 7, at 1542 ("Where the wrongful act alleged is a failure to properly disclose information, such violation... does not constitute a [securities fraud] predicate offense under RICO.").

288 It is reasonable to assume that Congress, had it wanted to make the RICO predicate acts coextensive with § 10(b), would have used the same or similar language in § 1961(1)(D) that it used in § 10(b). Had Congress intended RICO to be coextensive with § 10(b), it certainly knew how to do so. However, "fraud in the sale of securities" is quite limited in comparison to the broader language Congress used in § 10(b), which prohibits fraud "in connection with the purchase or sale of any security." The "in connection with" language provides standing only to plaintiffs who have either purchased or sold securities, but it does not limit liability to defendants who sold or bought from the plaintiffs. Thus, under the "in connection with" requirement, a defendant may be held liable even though he was not a party to a securities transaction. This concept arose directly out of the "in connection with" language. The language in § 1961(1)(D) - "fraud in the sale of securities" - is much less susceptible to such an interpretation, and to stretch the language so far in the absence of any evidence that Congress intended such a result would be an act of judicial legislation.

When one considers that Congress "enacted this legislation in 1970 against the developed backdrop of almost forty years of federal securities law," the fact that Congress opted not to use the language "in connection with the purchase or sale of any security," or something similar, must be considered significant and meaningful.

733 F. Supp. at 683-84 (footnotes and citations omitted). Practitioners should be wary of relying upon broad generalizations of commentators that do not yet reflect the recent judicial narrowing of the securities fraud predicate offense; e.g., J. Rakoff & H. Goldstein, RICO—Civil and Criminal Law and Strategy § 2.02(2) (1990) (the RICO securities fraud predicate offense "certainly reaches to both purchasers and sellers, as do the Federal Securities laws.").

289 See supra notes 87-97 and accompanying text.

290 Warner v. Alexander Grant & Co., 828 F.2d 1528, 1530 (11th Cir. 1987); Securities Inv. Protection Corp. v. Vigman, 908 F.2d 1461 (9th Cir. 1990).

291 See supra notes 81-86 and accompanying text.
construction clause, illustrate the need for an expansive interpretation.\textsuperscript{292}

Nevertheless, the Fourth and Eighth Circuits both apply the \textit{Blue Chip} purchaser/seller standing requirement to civil RICO securities law claims.\textsuperscript{293} In \textit{Zepkin}, the Fourth Circuit held that, once the underlying rule 10b-5 fraud claim is dismissed for lack of standing, the civil RICO claim also falls due to lack of standing. In other words, the standing requirements of the rule 10b-5 predicate offenses are superimposed onto the civil RICO claim. In \textit{Brannan}, the Eighth Circuit went even farther than \textit{Zepkin}. The \textit{Brannan} court dismissed the rule 10b-5 claim for lack of purchaser/seller standing\textsuperscript{294} and then dismissed the RICO claim, which was based upon both rule 10b-5 predicate acts and wire fraud predicate acts. Thus, \textit{Brannan} holds that when the securities fraud predicate offenses are dismissed for lack of standing under the \textit{Blue Chip} purchaser/seller requirement, that same conduct cannot be pleaded as wire fraud (or presumably mail fraud) predicate offenses in an effort to plug the standing "loophole" in the securities fraud claim.\textsuperscript{295} In \textit{Forkin v. Rooney Pace, Inc.},\textsuperscript{296} the Eighth Circuit held that once the securities fraud claims were dismissed based upon a lack of proof of the requisite "deception" to constitute Rule 10b-5 fraud, the civil RICO claim, embracing the same conduct but alleging securities, wire and mail fraud predicate offenses, was also dismissed.

The Second Circuit also appears to apply a standing rule somewhat like the \textit{Blue Chip} requirement to a securities fraud civil RICO claim.\textsuperscript{297} In \textit{Moss}, one of the defendants (Newman) had been criminally convicted for rule 10b-5 felonies for trading on misappropriated non-public information.\textsuperscript{298} \textit{Moss} held that the plaintiff’s rule 10b-5 claims were defective due to lack of standing—defendant Newman owed no duty to the plaintiff that would support an implied rule 10b-5 damage action \textit{on behalf of the

\textsuperscript{292} Other cases indicating that civil RICO has no purchaser/seller standing requirement include Smith v. Ayers, 845 F.2d 1360 (5th Cir. 1988) (rule 10b-5 claim dismissed for lack of reliance and because plaintiff also was not a purchaser or seller; but court looks for other ground to dismiss civil RICO claim and accepts as one valid predicate act the securities fraud—on another party as seller); Silverman v. Senft, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,543 (S.D.N.Y. 1986) (purchaser/seller requirement for securities fraud claim does not apply to civil RICO claim).


\textsuperscript{294} \textit{Brannan}, 804 F.2d at 1046-47.

\textsuperscript{295} [T]he directors allege securities fraud and wire fraud as the basis of racketeering activity. Since we have already found that the directors' state and federal securities fraud claims as well as the common law fraud claim were properly dismissed, the directors may not rely upon the same conduct as the basis of any securities fraud that may constitute racketeering activity. As to the remaining alleged predicate act, wire fraud requires a fraudulent scheme and use of the wire or telephone in furtherance of the scheme. \textit{See United States v. Andrade}, 787 F.2d 521, 527 (8th Cir. 1986). The fraudulent scheme alleged by the directors, however, consists solely of statements and omissions by Schroeder and Eisenstein in connection with the sales of securities. Since we have affirmed the dismissal of the securities fraud claims, the same conduct cannot constitute a fraudulent scheme giving rise to a wire fraud claim. Thus, wire fraud also fails as a basis for racketeering activity. . . . \textit{[T]he RICO claim must be dismissed.} (Emphasis added).

\textsuperscript{296} \textit{Moss v. Morgan Stanley Inc.}, 719 F.2d 5 (2d Cir. 1983).


Despite Newman's criminal convictions on rule 10b-5 charges, the Moss court held that plaintiff's lack of rule 10b-5 standing precluded a civil RICO claim by plaintiff on the same alleged securities violations. However, some "misappropriation" cases that may be defective as securities fraud claims because they lack "purchaser/seller" standing or fail to embrace the requisite injury causation requirements, may nevertheless be pursued as civil RICO claims based upon securities, mail or wire fraud embracing the same conduct. For example, in FMC Corporation v. Boesky, the district court dismissed all substantive securities law damage claims due to lack of "purchaser/seller" standing or lack of proper injury/causation requisites, but allowed all the civil RICO claims to proceed based upon securities fraud predicate offenses embracing the same conduct.

3. Scienter/Criminal Intent

While a rule 10b-5 implied civil damages cause of action requires proof of scienter, section 11 and section 12 claims do not. Indeed, even civil violations of sections 17(a)(2) and (3) of the 1933 Act require only proof of negligence. In contrast, it is clear that securities fraud civil RICO claims cannot be based on merely negligent conduct. A criminal intent or scienter requirement must be proven with regard to each alleged securities fraud predicate offense, as well as with regard to the overall RICO violation itself, which embraces "pattern" and "enterprise" as well as predicate offenses.

Apart from whether RICO's securities fraud predicate offense is as elastic as rule 10b-5, or as rigidly narrow as section 17(a), one thing
should be crystal clear: civil RICO applies to only criminal violations of the anti-fraud provisions of the federal securities laws.\textsuperscript{308} Section 1961(1)(D) incorporates the securities fraud predicate by using the following language—"any offense involving ... fraud in the sale of securities ... punishable under any law of the United States." An offense punishable is a criminal violation. All violations of section 17(a) or rule 10b-5 are not criminal offenses. A section 17(a) violation is a securities fraud crime only if the "willfulness" requirement of the section 24 "Penalties" provision of the 1933 Act is satisfied.\textsuperscript{309} Similarly, a rule 10b-5 violation is a securities fraud crime only if the "willfulness" requirement of the section 32(a) "Penalties" provision of the 1934 Act is satisfied.\textsuperscript{310} Thus criminal

\textsuperscript{308} See, e.g., Bender v. Southland Corp., 749 F.2d 1205, 1216 (6th Cir. 1984) (holding that civil RICO mail fraud requires intent to defraud); Dan River, Inc. v. Icahn, 701 F.2d 278, 291 (4th Cir. 1983) ("criminal fraud is . . . necessary in either mail fraud or securities fraud" under civil RICO); Frota v. Prudential-Bache Sec. Inc., 639 F. Supp. 1186, 1192 (S.D.N.Y. 1986) (civil RICO covers predicate offenses that must be criminal); Pandick, Inc. v. Rooney, 632 F. Supp. 1450, 1434 (N.D. Ill. 1986) (civil RICO requires "willful" conduct). Professor Blakey suggests: "Because some confusion exists about whether RICO incorporates the 'civil' or the 'criminal' provisions of the securities statutes, Congress should clarify that RICO includes only the criminal provisions." [Footnote omitted.] Blakey & Perry, An Analysis of the Myths That Bolster Efforts to Rewire RICO and the Various Proposals for Reform: 'Mother of God—Is This the End of RICO?', 43 VAND. L. REV. 851, 928 (1990).


Requisite criminal intent to defraud, however, need not be proven by direct evidence; circumstantial evidence may be sufficient to sustain a criminal conviction. Thus, the requisite criminal scientist may be inferred solely from the conduct of the defendant. See, e.g., Swallow v. United States, 307 F.2d 81, 83 (10th Cir. 1963); United States v. Brown, 236 F.2d 403, 405 (2d Cir. 1956); United States v. Vasen, 222 F.2d 3, 7-8 (7th Cir. 1955); Wall v. United States, 384 F.2d 758 (10th Cir. 1967); Elbel v. United States, 364 F.2d 127 (10th Cir. 1966)."Indeed criminal convictions under § 17(a) have been consistently upheld when based upon statements made with a 'reckless indifference' to their truth or falsity, even though the government was unable to prove that a defendant had actual knowledge of the falsity of his statements." Mathews, Defense of Federal Securities Laws Criminal Prosecutions, in NAFTALIS, WHITE COLLAR CRIMES 131 (1980). See also United States v. Boyer, 694 F.2d 58, 60 (3d Cir. 1982); United States v. Benjamin, 328 F.2d 854 (2d Cir. 1964). In Benjamin, Judge Friendly stated: "We think that in the context of § 24 of the Securities Act as applied to § 17(a), the Government can meet its burden by proving that a defendant deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant." Id. at 862.

\textsuperscript{310} The § 17(a)/§ 24 criminal "willfulness" standard of the 1933 Act is also applied to the "willfulness" requirement of a criminal 1934 Act violation under rule 10b-5/§ 32(a). Thus, in United States v. Peltz, 433 F.2d 48, 54 (2d Cir. 1970), the Second Circuit held that to satisfy § 32(a) 'willfulness' requirement, there must exist "a realization on the defendant's part that he was doing a wrongful act . . . with the qualifications that the act be wrongful under the securities laws and that the knowingly wrongful act involve a significant risk of affecting the violation that has occurred." See also United States v. Dixon, 536 F.2d 1388, 1395 (2d Cir. 1976); United States v. Koenig, 388 F. Supp. 670, 712 (S.D.N.Y. 1974) ("[T]he Government must prove, in order to establish criminal intent, a defendant misrepresented or failed to disclose material facts, (a) knowing that the facts represented were false or (b) not knowing that the facts represented were false or that he failed to disclose material facts but acting with willful or reckless disregard for the truth or being under a duty to know of such falsity or failure to disclose."); Herlands, Criminal Law Aspects of the Securities Exchange Act of 1934, 21 VA. L. REV. 139, 149 (1934). But see United States v. Schwartz, 464 F.2d 499, 509 (2d Cir. 1972) ("Proof of a specific intent to violate the law is not necessary to uphold a conviction under
scienter, i.e., specific intent to defraud, must be proven to sustain a civil RICO securities fraud predicate offense.

It is true that a criminal case must be proven beyond a reasonable doubt, whereas a civil RICO claim need only be proven by a preponderance of the evidence.\(^{311}\) However, apart from the different standards by which the proof is measured (and the fact that injury causation must be established in a civil RICO claim), the essential elements of each part of a RICO claim—that is, pattern, enterprise, and the particular predicate offenses relied upon—are identical in both the civil and criminal contexts. Thus, it is a prerequisite for a civil RICO recovery that a plaintiff prove that crimes were committed by the defendants.\(^{312}\) Courts and commentators concur in this observation,\(^{313}\) although some plaintiffs’ lawyers refuse to acknowledge it.

Although the Supreme Court has not yet addressed the issue, virtually every court of appeals has held that some form of "recklessness" will satisfy the scienter requirement of an implied private civil damages remedy under rule 10b-5. It is unclear, however, what degree of recklessness, if any, will satisfy the criminal intent requirement of a civil RICO

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\(^{311}\) See, e.g., Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 491 (1985); Fleischhauer v. Feltner, 879 F.2d 1290, 1297 (6th Cir. 1989); Liquid Air Corp. v. Rogers, 834 F.2d 1297, 1303 (7th Cir. 1987); Wilcox v. First Interstate Bank of Or., 815 F.2d 522, 530-32 (9th Cir. 1986); Armco Indus. Credit Corp. v. SLT Warehouse Co., 782 F.2d 475 (5th Cir. 1986); United States v. Local 560, Intl’l Bhd. of Teamsters, 780 F.2d 267 (3d Cir. 1985), aff’g, 581 F. Supp. 279 (D.N.J. 1984); Alcorn County, Miss. v. U.S. Interstate Supplies, Inc., 731 F.2d 1160 (5th Cir. 1984); United States v. Cappetto, 502 F.2d 1351, 1357 (7th Cir. 1974); Note, Civil RICO: Prior Criminal Conviction and Burden of Proof, 60 NOTRE DAME L. REV. 566 (1985). But see Civil RICO Task Force Report, supra note 7, at 384 (Recommendng “that the RICO statute be amended to make it clear that the required predicate acts of ‘racketeering activity’ must be proven beyond a reasonable doubt as a prerequisite to recovery under Civil RICO”).

\(^{312}\) In this respect, RICO is significantly different than the antitrust laws, where it is possible to bring a civil treble damage claim even in the absence of criminal conduct. Civil RICO Task Force Report, supra note 7, at 381 n.621; Note, Organized Crime and the Infiltration of Legitimate Business: Civil Remedies for ‘Criminal Activity’, 124 U. PA. L. REV. 192, 208-09 (1975).

treble damages claim based upon securities, wire or mail fraud predicate offenses.314

The reason there is confusion over whether and when "recklessness" will be sufficient constructive criminal intent under civil RICO, and if so, what degree of recklessness is required, is that the underlying substantive criminal law relating to criminal intent is not precise. Some federal courts have held that proof of "reckless disregard" or "reckless indifference" is sufficient to satisfy the willfulness or criminal intent requirement of federal securities, mail or wire fraud crimes.315 However, the recent formulation by appellate courts of the proper test has been to require proof of a defendant's "conscious avoidance" or "willful blindness."316 The ABA Task Force commented that this newer test "appears to be a stricter test than the 'recklessly tolerated' test of the Model Penal Code." The problem with any criminal intent test that uses the word "reckless" is that juries may well confuse recklessness with mere negligence.317


315 See United States v. Benjamin, 328 F.2d 854, 862-63 (2d Cir. 1964) ("the Government can meet its burden by proving that a defendant deliberately closed his eyes to the facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant. . . ."); see also United States v. Natelli, 527 F.2d 311, 322 n.9 (2d Cir. 1975) ("reckless deliberate indifference to or disregard for truth"); United States v. Simon, 425 F.2d 796 (2d Cir. 1969).


To the requirement of actual knowledge there is one strictly limited exception . . . [the rule is that if a party has his suspicion aroused but then deliberately omits to make further inquiries, because he wishes to remain in ignorance, he is deemed to have knowledge. . . . The rule that willful blindness is equivalent to knowledge is essential, and is found throughout the criminal law.

See also R. PERKINS, CRIMINAL LAW 776 (2d ed. 1969) ("knowledge" includes circumstances where one "deliberately 'shut his eyes' to avoid knowing"); Edwards, The Criminal Degree of Knowledge, 17 MODERN L. REV. 294, 298, 302 (1954) ("wilful shutting of eyes," "wilful blindness," "purposely abstaining from ascertaining," and "wilfully abstaining from knowing").

317 See United States v. Hanlon, 548 F.2d 1096 (2d Cir. 1977), where the Second Circuit noted: We are troubled . . . by the repeated use of the term "reckless." This Court has previously had occasion to criticize the use of this "technical and confusing" term. . . . The distinction between recklessness and negligence is elusive enough for even the most respected legal scholars. See Prosser on Torts, 32, 184-86 (4th ed. 1972). It follows that to the layman on the jury, it might prove a significant source of confusion. It is thus preferable, in cases such as this, to omit the use of the term. It adds nothing to the "conscious avoidance" language which we have approved, and might tend to mislead the jury.

Id. at 1101-02 (citing at second ellipsis: United States v. Gentile, 530 F.2d 461, 470 (2d Cir.), cert. denied, 426 U.S. 936 (1976); United States v. Bright, 517 F.2d 584, 587-88 (2d Cir. 1975); United States v. Sarantonos, 455 F.2d 877 (2d Cir. 1972).
Courts in the 1990s will be forced to compare the criminal law constructive fraudulent intent test of "conscious avoidance" to the civil litigation rule 10b-5 test of scienter on a "recklessness" basis, to determine if the two tests are substantively differently. If so, courts will then be faced with the decision of which formulation should be used in civil RICO cases based upon commercial fraud predicate offenses.

4. Respondeat Superior

The doctrine of respondeat superior, i.e., the liability without fault of a principal/employer for the torts of an agent/employee—-is not mentioned in the RICO statute or its legislative history. Whether respondeat superior may apply in civil RICO cases is an important, unresolved issue.

RICO's "liberal construction clause" may indicate that general federal jurisprudence, including derivative or vicarious liability principles, should apply to civil RICO. If the court employs an antitrust analogy (as the Supreme Court did in Malley-Duff) then respondeat superior would apply across the board to civil RICO cases just as it does to federal antitrust private treble damages actions. However, early district court decisions reached opposite results in dealing with respondeat superior in the civil RICO context.

For example, in Bernstein v. IDT Corporation the court imposed respondeat superior civil RICO liability upon defendant General Dynamics for the criminal conduct of its top officers in circumstances where the crimes/torts of the employees/agents benefitted, and were intended to benefit, the corporation. The Bernstein court, relying on the recent Supreme Court antitrust analogy (American Society of Mechanical Engineers, Inc. v. Hydrolevel Corporation), observed that "the normal rules of

318 See supra note 4 and accompanying text. See also Civil Rico Task Force Report, supra note 7, at 342-65.
321 See American Soc'y of Mechanical Eng'rs, Inc. v. Hydrolevel Corp., 456 U.S. 556 (1982) (generally, an agent acting within the scope of his employment or apparent authority will render his principal liable to third parties for harm caused by the agent's antitrust violations). The Court stated:

Under an apparent authority theory, "[i]iability is based upon the fact that the agents' position facilitates the consummation of the fraud, in that from the point of view of the third person the transaction seems regular on its face and the agent appears to be acting in the ordinary course of business confided to him."... ASME's system of codes and interpretive advice would not be effective if the statements of its agents did not carry with them the assurances that persons in the affected industries could reasonably rely upon their apparent trustworthiness.

Id. at 566 (quoting RESTATEMENT (SECOND) OF AGENCY § 261, comment a (1957)).
322 582 F. Supp. 1079, 1083 (D. Del. 1982).
323 This is the federal criminal test for respondeat superior—requiring benefit to the principal. See generally K. BRICKLEY, CORPORATION CRIMINAL LIABILITY, ch. 3 (1984). Compare RESTATEMENT (SECOND) OF AGENCY §§ 228-37 (1958).
agency law apply in the absence of some indication that Congress had a contrary intent.”

The court found nothing in RICO’s language or legislative history suggesting that normal rules of agency do not apply. To the contrary, the court held that the application of the doctrines of apparent authority and respondeat superior will further the statutory goals of civil RICO.

In *Parnes v. Heinold Commodities, Inc.*, the court reached just the opposite conclusion in rejecting the application of respondeat superior to civil RICO. Low-level employees of a large brokerage house had defrauded a client. The court viewed the corporate employer as an “enterprise” that was the victim of the racketeering activity. The court reasoned that the goals of civil RICO would be distorted if a victim enterprise had treble damage liability for the torts which the agents had committed in order to infiltrate the enterprise.

As circuit courts have gradually wrestled with respondeat superior issues in civil RICO cases, a trend appears to be developing: respondeat superior liability is usually rejected as to section 1962(c) claims, but may well be sanctioned in section 1962(a) and (b) claims.

Vicarious liability issues are complicated by several considerations. First, the required distinction between “enterprise” and “person,” under section 1962(c), may form the basis for precluding derivative liability that circumvents that rule. Second, there is a distinction to be drawn, often not focused upon by the courts, between (i) direct civil RICO liability based upon derivative criminal liability for the predicate acts and (ii) derivative civil RICO liability based upon common law principles of agency and respondeat superior. The cases simply have not done a thorough job of parsing this difficult issue.

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325 582 F. Supp. at 1083.
327 548 F. Supp. 20 (N.D. Ill. 1982).
328 *Id.* at 23-24.
329 *See* Yellow Bus Lines, Inc. v. Drivers Local 639, 839 F.2d 782 (D.C. Cir. 1988) (no respondeat superior under § 1962(c)); S.L. Hand Tool Corp. v. Dresser Indus., Inc., 852 F.2d 996 (7th Cir. 1988) (no vicarious liability under § 1962(c)); Petro-Tech, Inc. v. Western Co. of N. Am., 824 F.2d 149 (3d Cir. 1987) (no vicarious liability under § 1962(c), but respondeat superior may apply to § 1962(a)); Liquid Air Corp. v. Rogers, 834 F.2d 1297 (7th Cir. 1987) (no respondeat superior under § 1962(c), but may lie for § 1962(a) and § 1962(b)); Luthi v. Tonka Corp., 815 F.2d 1229 (8th Cir. 1987) (no respondeat superior under § 1962(c)); Schofield v. First Commodity Corp., 793 F.2d 28 (1st Cir. 1986) (no respondeat superior in § 1962(c) claim). *See also* Landry v. Airline Pilots’ Assocs., 892 F.2d 1238 (5th Cir. 1990).
When, if ever, the Supreme Court addresses respondeat superior and other vicarious or derivative liability theories under civil RICO, it will be forced to focus upon a multitude of policy issues implicated by the various roles that a "corporation/enterprise" may play in a RICO case—i.e., perpetrator, passive instrument, victim or prize. Each role may require a different treatment for vicarious liability purposes.333

The Seventh Circuit commented in Haroco, Inc. v. American National Bank and Trust Co. of Chicago:335

At the policy level of the [person/enterprise] dispute, there are several significant competing arguments. The Eleventh Circuit argued in Hartley that where the defendant corporation is the central figure in a criminal scheme, as it was in that case, Congress could not have meant to let the central perpetrator escape RICO liability while subjecting only the sidekicks to RICO's severe penalties. Similarly, plaintiffs here argue that Congress intended to make a "deep pocket" (in the person of the corporation) liable where corporate agents engage in a pattern of racketeering activity redounding to the benefit of the corporation. In Parnes, Judge Shadur argued that it would make little sense to hold a corporation liable under RICO for the misconduct of lower level employees, at least where it appears that the corporation is a passive instrument or even a victim of the racketeering activity.

In our view, the RICO provisions have already taken into account these competing policies in different situations, and a careful parsing of section 1962 reveals a sensible balance among these policies. We find helpful here Professor Blakey's discussion in The RICO Civil Fraud Action in Context, 58 Notre Dame L. Rev. 237, 307-25. Blakey points out that under the subsections of section 1962, the enterprise may play the various roles of victim, prize, instrument or perpetrator. The RICO liability of the enterprise should depend on the role played. In our view, the plaintiffs here and the court in Hartley are correct when they argue that the corporate enterprise should be liable where it is the perpetrator, or the central figure in the criminal scheme. In that situation, the corporate deep pocket should certainly be subject to RICO liability. At the same time, the defendants here and Judge Shadur in Parnes are surely correct in saying that the corporation-enterprise should not be liable when the corporation is itself the victim or target, or merely the passive instrument for the wrongdoing of others.336

335 747 F.2d 384 (7th Cir. 1984), aff'd, 473 U.S. 606 (1985).
336 747 F.2d at 401 (citations omitted). In addition, the Haroco court stated:

In our view, the tensions between these policies may be resolved sensibly and in accord with the language of section 1962 by reading subsection (c) together with subsection (a). As we read subsection (c), the "enterprise" and the "person" must be distinct. However, a corporation-enterprise may be held liable under subsection (a) when the corporation is also a perpetrator. As we parse subsection (a), a "person" (such as a corporation-enterprise) acts unlawfully if it receives income derived directly or indirectly from a pattern of racketeering activity in which the person has participated as a principal within the meaning of 18 U.S.C. § 2, and if the person uses the income in the establishment or operation of an enterprise affecting commerce. Subsection (a) does not contain any of the language in subsection (c) which suggests that the liable person and the enterprise must be separate. Under subsec-
The First Circuit in *Schofield v. First Commodity Corporation of Boston*, rejected respondeat superior in a section 1964(c) case, because it felt application of vicarious liability principles to RICO would circumvent the person/enterprise rule. Other courts of appeals have been strongly influenced by, and have expressly adopted, the *Schofield* approach. But *Schofield* may not have given deep enough analysis to *Haroco*’s observations about the differing roles of a corporation/enterprise as victim, perpetrator, passive instrument or prize.

Neither the *Schofield* court nor any other appellate courts struggling with vicarious liability under civil RICO have discussed the ABA Civil RICO Task Force Report approach to this complex jurisprudential problem. Naturally, as Chairman of the ABA Task Force, I believe the report’s analysis of and recommendations on this issue are pertinent:

The Task Force recommends that the RICO provision should be amended to reflect that the respondeat superior or derivative liability test that should be applied in civil RICO cases for holding legitimate businesses liable for treble damages for the RICO violations of their low-level agents and employees should, with one exception, be patterned upon but slightly different from the lines of the strict Model Penal Code/State Law criminal respondeat superior or derivative liability test. Under this strict test, a corporation will not be liable for treble damages under civil RICO in instances where (i) there is not direct criminal involvement of either high-level managerial agents or top officers or directors, and (ii) high-level officials or managerial agents had no knowledge of the criminal activities (knowledge exists if there has been “conscious avoidance” or “willful blindness” of offending activities by such high-level officials or managerial agents). The one exception is that actual damage derivative or respondeat superior liability should exist in the limited circumstances where there exists a distinct RICO injury for which no compensation is available in claims based upon the individual criminal acts that constitute the predicate offenses.

5. Injunctive Relief

In some corporate/securities civil RICO cases, the appropriateness of allowing a plaintiff to seek injunctive relief, rather than damages, could be an important issue, e.g., in corporate takeover or tender offer
RICO IN SECURITIES LITIGATION

It is not clear whether private parties may obtain injunctive or other equitable relief in civil RICO lawsuits. The Ninth Circuit in Religious Technology Center v. Wollersheim held that injunctive relief is not available to private civil RICO claimants. After reviewing conflicting lower court precedent, statutory language and legislative history, as well as countervailing policy arguments, the Ninth Circuit concluded that "Congress did not intend to give private RICO plaintiffs any right to injunctive relief." However, the law in other circuits remains unsettled.

Professor Blakey strongly disagrees with the Wollersheim decision, and, indeed, has written a scholarly article criticizing it. No circuit court has yet credited Professor Blakey's view that traditional equitable relief, including injunctive relief, should be fully available to a private party plaintiff in civil RICO litigation. The ABA Civil RICO Task force favored granting limited equitable/injunctive relief to private party civil plaintiffs:

The Task Force recommends that Section 1964 be clarified to allow a private action for a limited, restrictive class of injunctive or other equitable relief as follows:

(1) To allow preliminary relieve in a private treble damage action to the extent needed to prevent the dissipation of assets; and
(2) To allow permanent injunctive relief to the extent needed to restrain future RICO violations by the defendant, but to exclude any of the broader injunctive or other equitable relief of the type available to the Government.

6. Injury/Causation

Section 1964(c), RICO's private party civil treble damages remedy, states in part that "any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue ... for treble

342 796 F.2d 1076 (9th Cir. 1986).
343 Id. at 1088.
347 Civil RICO Task Force Report, supra note 7, at 341 (emphasis in original).
Prior to Sedima, some lower courts had attempted to narrow civil RICO's scope by holding that only "competitive" injury in the antitrust sense was compensable under the statute. Other courts held that a special "racketeering enterprise" injury was required. However, in Sedima, and the companion Haroco case, the Supreme Court rejected both the competitive injury and racketeering enterprise injury limitations. The Court stated in Sedima that the language of the statute "belied" any need for a special injury requirement insofar as a section 1962(c) case is concerned.

Where the plaintiff alleges each element of the violation, the compensable injury necessarily is the harm caused by predicate acts sufficiently related to constitute a pattern, for the essence of the violation is the commission of those acts in connection with the conduct of an enterprise. Those acts are, when committed in the circumstances delineated in [the RICO statute], "an activity which RICO was designed to deter." In Haroco, the Supreme Court added that "[t]he submission that the injury must flow... from the fact that [the predicate acts] were performed as part of the conduct of an enterprise suffers from the same defects as the amorphous and unfounded restrictions on [] RICO... rejected in [Sedima]."

Thus, the "proximate cause" of Palsgraf v. Long Island Railroad Co. appears to be the principal injury/causation test for civil RICO's section 1962(c) cases. However, the ambiguity inherent in a proximate cause requirement remains as evident in RICO cases as in cases of negligence. In addition, injury/causation problems endure with respect to section 1962(a) and 1962(b) claims.
In *Sperber v. Boesky*, the Second Circuit discussed RICO's proximate causation requirement extensively. Investors in companies put "in play" by the defendant sued him because the revelation of his alleged insider trading schemes resulted in a drop in value of all the takeover stocks. Plaintiffs had not invested in any particular stocks in which the defendant had been trading. The *Sperber* court noted that although RICO is to be read broadly under *Sedima*, legal liability does not extend as far as "factual causation." The court stated, "[a]s a leading treatise explains, '[i]n a philosophical sense, the consequences of an act go forward to eternity,' and extending liability as far as factual causation therefore 'would result in infinite liability for all wrongful acts,' and would 'set society on edge and fill courts with endless litigation. . . ." But the majority in *Sedima* contemplated that some types of indirect injury are recoverable; i.e., the reference to "competitive injury" in footnote 15. Therefore, the court in *Sperber* rejected the notion that only direct injury is recoverable under RICO.

The leading case dealing with the "by reason of" language of RICO is *Sedima*, which held that damages caused directly by the predicate acts of a RICO violation are recoverable. It did not focus on the issue raised by this appeal: to what extent are damages caused only indirectly by the predicate acts recoverable? (By damages caused only "indirectly" we mean "racketeering" injury, "competitive" injury or injury caused by the total effect of the pattern of racketeering in the enterprise. . . .) *Sperber* emphasized that both direct and indirect injury must be proximately caused by defendant's acts. Plaintiffs did not meet this proximate cause requirement in *Sperber* because "plaintiffs here were neither the target of the racketeering enterprise nor the competitors nor the customers of the racketeer." The court also rejected the argument that foreseeability is the sole proximate causation test. This argument proves too much since many remote injuries are foreseeable.

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356 849 F.2d 60 (2d Cir. 1988).
357 Id. at 63.
359 *Sedima*, 473 U.S. at 497 n.15.
360 *Sperber*, 849 F.2d at 63 (citing Alexander Grant & Co. v. Tiffany Indus., 742 F.2d 408, 411 n.7 (8th Cir. 1984), vacated, 473 U.S. 922 (1985), adhered to in relevant part, 770 F.2d 717 (8th Cir. 1985), cert. denied, 474 U.S. 1058 (1986)).
361 *Sperber*, 849 F.2d at 65.
362 Id. at 65-66:

Plaintiffs argue that the scope of liability is determined only by the foreseeability of injury, that massive insider trading and self-promotion foreseeably lead to a rise in the market price for the relevant stocks, and that it was foreseeable that the price would fall when the illegal props that were holding it up were removed. This appealingly simple argument proves too much. It is foreseeable that as a result of the disclosure of Boesky's activities, his company would close and that some employees lose their jobs, that some of those employees would not be able to find new jobs and that their children would not be able to buy new clothes, injuring a clothing manufacturer. However, we have no doubt that the clothing manufacturer is too far from the racketeering to recover under RICO.
In a recent Seventh Circuit decision, *Bastian v. Petren Resources Corp.*, the court held that a rule 10b-5 claim was properly dismissed due to plaintiff's inability to establish required "loss causation," because the decline in value of the investment was not attributable to the alleged material misrepresentation. Similarly, if the plaintiffs would have lost money regardless of the RICO violation, they would have incurred no loss for which RICO provides a remedy, since RICO requires a loss "by reason of [the] violation."  

Another case growing out of Ivan Boesky's role in the Wall Street scandals of the 1980s demonstrates both the complexity of the causation of injury/damages issues in civil RICO cases involving federal securities laws claims, as well as the use of civil RICO to circumvent the deficiencies in underlying substantive securities fraud claims and other damage claims under related provisions of the federal securities laws.

In *FMC Corp. v. Boesky*, the plaintiff, a multi-billion dollar corporation, sued Boesky and a number of national investment banking firms (including Goldman, Sachs & Co., Shearson Lehman Bros., Inc., and Drexel Burnham Lambert, Inc.), claiming damages in excess of $235 million, caused by Boesky's allegedly illegal insider-trading activities. The district court initially dismissed the FMC complaint on lack of standing grounds because it found that FMC had not suffered any legally cognizable injury. The district court rejected FMC's claim that Boesky's conduct had caused it to set an unduly high exchange ratio for various securities it issued and redeemed in a complex corporate reorganization and restructuring plan. The Seventh Circuit reversed, finding that the district court had not adequately explained whether FMC had "constitutional standing" in the sense of "whether FMC was injured for the purpose of Article III's case or controversy requirement." The Seventh Circuit found that FMC's complaint contained sufficient allegations to satisfy Article III's injury requirement.

Although FMC's allegations of injury satisfied Article III's case or controversy requirement, the Seventh Circuit instructed the district court on remand "to determine whether FMC's federal claims fall within the zones of interests protected by the federal statutes under which FMC seeks relief." After remand, the district court pointed out that to recover on its securities fraud and civil RICO damages claims, FMC would...

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363 892 F.2d 680 (7th Cir. 1990).
364 Id. at 686. *See also* Brandenburg v. Seidel, 859 F.2d 1179 (4th Cir. 1988). *Brandenburg* was a class action against S&L and state insurance agency officials for misrepresentations that led to deposits in S&Ls which were later frozen in the Maryland S&L crisis and on which interest was lost. The court held that the plaintiffs did not adequately tie these losses to the misrepresentations alleged—i.e., those that induced savings deposits. Instead, the cause of the losses was more closely tied to the failure of the defendants to prevent unsound banking practices and self-dealing by bank officers. Such negligence, however, did not rise to the required level of fraud that would support civil RICO commercial fraud offenses, whether they be couched as mail, wire or securities fraud.
366 Id. at 251.
367 852 F.2d 981, 982 n.1.
368 Id. at 994.
369 Id.
be required to establish that it established "actual economic damage" as a consequence of defendants' illegal acts.\(^\text{370}\)

The district court held that both the securities fraud counts and the civil RICO counts required FMC to establish actual injury (i.e., damages) caused by the defendants' alleged statutory violations.\(^\text{371}\) However, what is important about the court's opinion is a distinction the court made concerning standing for substantive securities law claims, versus standing to support civil RICO treble damages claims. The court found plaintiff could not establish the required injury/cause/damages to provide standing under any of the substantive securities law claims pursued (section 17(a) and rule 10b-5 fraud, tender offer fraud under section 14(e)(3), market manipulation under section 9(a), and false schedule 13D filings with the SEC under section 18(a)).\(^\text{372}\) However, the court found plaintiff could establish standing by proving the required injury/cause/damages based on the same underlying conduct to support civil RICO treble damages claims under each of the four categories of RICO violations embraced by 18 U.S.C. § 1962(a), (b), (c), and (d).\(^\text{373}\)


\(^{371}\) As to the rule 10b-5 fraud claims, see Latigo Ventures v. Laventhal & Horvath, 876 F.2d 1322, 1325 (7th Cir. 1989); Pelletier v. Stuart-James Co., 863 F.2d 1550, 1557 (11th Cir. 1989); Harris Trust & Sav. Bank v. Ellis, 810 F.2d 700, 706 (7th Cir. 1987); Disher v. Information Resources, Inc., 691 F. Supp. 75, 79 (N.D. Ill.), aff'd, 873 F.2d 136 (7th Cir. 1989); and as to the civil RICO claims, see Kaiser Cement Corp. v. Fischbach & Moore, Inc., 793 F.2d 1100 (9th Cir.), cert. denied, 479 U.S. 949 (1986); Flaherty v. Torquato, 623 F. Supp. 55, 58 (W.D. Pa. 1985), aff'd without opinion, 800 F.2d 1133 (3d Cir. 1986).

\(^{372}\) With regard to the § 17(a) fraud claim, the court relied upon the holding of Schifke v. Seafirst Corp., 866 F.2d 935, 942-43 (7th Cir. 1989) that there is no implied private damages action under § 17(a). 727 F. Supp. at 1197. As to the rule 10b-5 claim, the court found that FMC did not suffer damages "in connection with" the purchase or sale of a security, relying upon Atchley v. Qonaar Corp., 704 F.2d 355, 358-59 (7th Cir. 1983); Tully v. Mott Supermarkts., Inc., 540 F.2d 187, 194 (3d Cir. 1976); Investors Funding Corp. Sec. Litig. v. Dansker, 523 F. Supp. 533, 539 (S.D.N.Y. 1980). See 727 F. Supp. at 1192. In addition, the court dismissed the § 9 and § 18 claims, as well as the rule 10b-5 claims, on the ground that in effectuating the recapitalization plan, FMC was not a "purchaser or seller" of securities, relying upon Richardson v. Shearson/Am. Express Co., 575 F. Supp. 133, 136 (S.D.N.Y. 1983) (as to § 9) and Rankow v. First Chicago Corp., 678 F. Supp. 202, 207 (N.D. Ill. 1988) (as to § 18). In addition, the court found that FMC could not recover under §§ 9(a) and (e) because it could not establish that it had been damaged in the sense of paying an "improper premium" by purchasing shares at a manipulated price, relying upon Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 46 (1977); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, 303 F.2d 527, 533 (10th Cir. 1962); Madigan, Inc. v. Goodman, 498 F.2d 233, 238-40 (7th Cir. 1974). With regard to the § 14(e) claim, the court found that FMC's recapitalization was not a tender offer, relying upon Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), aff'd, 682 F.2d 355 (2d Cir. 1982), cert. denied, 460 U.S. 1089 (1983); SEC v. Carter Howley Hale Stores, Inc., 760 F.2d 945 (9th Cir. 1985); Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 58 (1985). See 727 F. Supp. at 1198.

\(^{373}\) Despite dismissing all the substantive securities law claims, the court allowed the civil RICO claims to be pursued because it found that an employee of defendant Goldman Sachs "misappropriated" FMC's confidential information in violation of a contract with and duty owed to FMC, "passed it along through the illegal trading ring to Boesky" and thereby "destroyed whatever value it had in FMC's hands." 727 F. Supp. at 1192, (citing FMC II, 852 F.2d at 991 n.21). The district court added: "Whatever value the misappropriated property had to FMC, it stands to reason this information would have been worth at least what FMC paid to create it. Thus, FMC has adequately alleged a compensable injury to its property for the purposes of the RICO statute." Id. at 1192. Although the motion to dismiss the civil RICO counts was accordingly denied, the court explicitly commented: "The [RICO] injury does not, however, provide FMC with standing to pursue its securities law
V. A Jurisprudential Solution

I have previously articulated my views as to how the perceived abuse or overuse of civil RICO in general commercial litigation and, more specifically, in federal securities litigation, could be curtailed.\(^374\) Rather than tinkering with amending the existing civil RICO statutory provision, I have advocated that a sounder jurisprudential perspective is to focus instead upon the question whether it is time to legislate a general federal commercial/consumer fraud statute—wholly apart from RICO—that would provide victims of fraud or related commercial torts with an express private party damages remedy in the federal courts.\(^375\) Obviously, such consideration would implicate a very important issue of federalism: Whether federal courts are too busy to have forced upon them the adjudication of commercial/consumer fraud/tort claims that at present supposedly are relegated to state and local courts, pursuant to common law fraud and state law consumer protection provisions.\(^376\) In my view, reputable businesses would not be RICOed if injured plaintiffs had an across-the-board express federal commercial/consumer fraud damages reme-

claims. As will be explained below, the breaches of contract and fiduciary duty which led to the misappropriation of FMC’s property did not occur in connection with the purchase or sale of securities.” Id. at n.12.

374 I chaired the ABA Ad Hoc Civil RICO Task Force that in 1985 made ten principal recommendations concerning how civil RICO abuse could be lessened without diluting criminal RICO. Civil RICO Task Force Report, supra note 7, at 7-16. The various Supreme Court opinions in Sedima seemed to be affected somewhat by the ABA Task Force’s views; the ABA Report was cited 16 times in Sedima. Congress, on the other hand, has appeared to pay little attention to the ABA Report and its recommendations, as it has debated RICO reform during the past five years.

375 See Testimony and Prepared Statement of Arthur F. Mathews, on civil RICO before the Senate Judiciary Committee (July 29, 1985, Wash. D.C.) reprinted in Oversight on Civil RICO Suits: Hearings before the Sen. Comm. on the Judiciary, 99th Cong., 1st Sess. 562-85 (May 20, July 31 & Sept. 24, 1985) (Serial No. J-99-57). See also Mathews, RICO’s Jurisprudential Dilemma: Curtailing Civil RICO Abuse Without Corrupting the Statute’s Primary Goal of Eradicating Racketeering From Legitimate Business, — Cato J. — (1990): “Rather than trying to manipulate RICO with its specialized pattern and enterprise elements and its other arcane and ill-defined pleading requirements, to fit the types of civil commercial claims private plaintiffs are wont to make, perhaps it would make more sense to delete the commercial fraud offenses solely from civil RICO, i.e., from inclusion in the private treble damages remedy of 18 U.S.C. § 1964(c). Congress in a new noncriminal statute could then provide a federal forum for private civil claims arising out of mail, wire, bank, and other types of commercial frauds.”

376 Chief Justice Rehnquist touched upon this “federalism” issue in a recent speech advocating legislative consideration of civil RICO reform:

I take no position as to which of the reform proposals are acceptable or which is best, but I do think that the imposition of some limitations on Civil RICO actions is required so that federal courts are not required to duplicate the efforts of the state courts. No one doubts that the victim of a fraudulent scheme should be able to obtain redress in a court.


(II) It is also important to keep in mind the concern for federalism. One need not see an encroachment on federalism behind every bush before questioning the wisdom of the current statutory scheme. The list of predicate acts captures a great many areas normally thought to be exclusive domain of state law. The predicate acts include both overtly state law crimes and broad federal crimes, such as mail fraud and wire fraud, into which many state law violations can be shoehorned. Any rethinking of RICO should consider the appropriate division of authority between state and federal courts.
edy—albeit with whatever limitations or restrictions Congress chooses to impose regarding multiple/punitive damages, injury/causation, and standing, as well as any regulatory defenses that Congress deems appropriate. But whether Congress is ready to provide an express federal damages remedy for victims of mail and wire fraud (when courts have for many decades refused to sanction an implied private damages remedy for the victims of such crimes/torts) is uncertain.

It is clear to me that much commercial litigation, including vast amounts of federal securities litigation today, is being squeezed into the civil RICO rubric even though the substance of the underlying claims or disputes has no relationship to such special RICO concepts as "enterprise" and "pattern" in the context envisioned by the Congress in passing the RICO legislation in 1970. I continue to advocate that Congress should give sufficient attention to how civil RICO is being used, should make the public policy tradeoffs as to what, if any, limitations should be put on the statute's scope, and should balance all the competing interests of various segments of our society to reach an informed judgment as to whether it is sound jurisprudential policy to continue to adjudicate civil commercial/consumer fraud/tort disputes under a criminal racketeering statutory scheme. Until Congress chooses to change the present framework of how the civil RICO provision interacts with federal securities fraud claims through the inclusion of the commercial fraud predicate offenses in the RICO statute, section 1964(c)'s private treble damages remedy will remain a potential plaintiff's plea for treble damages, costs and attorneys' fees in a wide variety of federal securities cases.