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Civil RICO and Proximate Cause

The U.S. Supreme Court has decided again to provide further definition to the reach of the expansive Racketeer Influenced and Corrupt Organizations Act (RICO) by agreeing in late 2005 to review two civil RICO decisions.¹

To provide judicial guidance on the issue of what defines “proximate cause” in the RICO context, the Supreme Court on Nov. 28, 2005 granted cert. in *Anza v. Ideal Steel Supply Corp.*²

The question presented is whether a competitor that is injured in its business or property has standing to pursue a RICO claim even though the alleged predicate acts of racketeering activity were mail and wire fraud against a state government (essentially tax evasion) and the RICO plaintiff did not rely on the alleged fraudulent behavior. Two weeks later, the Court agreed to review another case, *Mohawk Industries, Inc. v. Williams*,³ where the definition of “enterprise” in the civil RICO context will be addressed.

In drafting the RICO statute in 1970, Congress left the door open for broad interpretations by declaring that “[a]ny person injured in his business or property by reason of a violation of



section 1962 of [RICO] may sue...in any appropriate United States district court and shall recover threefold the

The issue: Whether an injured competitor has standing for a RICO claim though alleged acts of racketeering were mail and wire fraud against a state government and plaintiff did not rely on the fraud.

damages he sustains....”

While the Supreme Court has generally ruled for the government in criminal RICO cases, the Court has time and again narrowed the scope of civil RICO. Federal courts at all levels have found a number of ways to prevent garden-variety business fraud claims from being brought as racketeering suits. Circuit courts have been faced with the difficult challenge of maintaining consistency when deciding whether to allow standing for RICO

plaintiffs who alleged to have suffered injuries from RICO predicate acts even though such plaintiffs were not directly harmed and (in the case of fraud predicates) did not rely on defendant’s misrepresentations.

As the Supreme Court noted in its last RICO proximate cause case, *Holmes v. Securities Investor Protection Corp.*, “the infinite variety of claims that may arise make it virtually impossible to announce a blackletter rule that will dictate the result in every case.”⁴

The Ideal Facts and Decisions

Plaintiff Ideal Steel Supply Corp. and defendant National Steel Supply Inc. distribute and sell steel mill products. Both businesses have two store outlets: one in the Bronx and another in Queens. The two companies sell substantially the same commodity products to essentially the same customer base—ironworkers, small steel fabricators, and do-it-yourself homeowners in the same market: the New York metropolitan area.

Ideal sued National, citing RICO violations pursuant to 18 USC §§1962 (a) and (c) and a state breach-of-contract claim. Ideal alleged that National, since 1998, had used a “cash, no tax” scheme to undersell Ideal. National’s mail and electronic filing of fraudulent sales tax returns with the New York State Department of Taxation and Finance gave rise to the allegations of mail and wire fraud. Ideal claimed that National and Ideal split the market for the comprehensive array of steel mill goods

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they sell, and that because the two companies competed primarily on the basis of price, National's artificial lowering of its prices through its tax evasion scheme directly cut into Ideal's sales. National's elimination of its sales tax allegedly caused Ideal's injury in the form of lost profits.

The district court granted National's motion to dismiss pursuant to FedRCivP 12(b)(6) for Ideal's failure to state a claim. The Court found that Ideal lacked standing to bring a RICO claim because in "complaints predicated on mail or wire fraud, a plaintiff must plead 'loss causation,' meaning that the misrepresentation must be both an actual and a proximate source of the loss that the plaintiff suffer, and 'transaction causation,' which requires a plaintiff to demonstrate that plaintiff relied on defendants' misrepresentation."⁵ The Court decided that Ideal failed to plead transaction causation and the action was dismissed, because Ideal did not and could not allege that it relied on the sales tax returns that National mailed or wired to the New York State Department of Taxation and Finance.

The district court's decision suggests the application of a common-law concept—requiring pleading with particularity when fraud is alleged—in the RICO context. The Second Circuit rejected this attempt and reversed, finding that Ideal has standing to press its RICO claim against National. Ideal's lost profits were found to be proximately caused by National's fraudulent behavior within the RICO definition of racketeering activity. The Second Circuit stated that the complaint adequately pleaded that the alleged activity was intended to and did give the defendant a competitive advantage over the plaintiff. The transactional causation test was held to be "merely shorthand for part of the normal causation analysis."⁶ The Second Circuit concluded that Ideal was a direct competitor of National, and even though Ideal had not relied on National's fraudulent tax returns, Ideal was nevertheless "an entity

directly targeted for injury by National's racketeering activity."⁷

'Holmes' and Inconsistency

In the *Ideal* case, the Supreme Court may expand or narrow its holding in *Holmes*, in which the Court held that the statutory requirement "by reason of" can be satisfied only by a showing of proximate cause. The Supreme Court further identified three factors as requirements of proximate cause in the civil RICO context: (1) the directness of the injury; (2) the difficulty of apportioning damages among potential plaintiffs; and (3) the possibility of other plaintiffs vindicating the goals of RICO. Specifically on the directness of injury, the Supreme Court explained that "the less direct an injury, the more difficult it becomes to ascertain the amount of a plaintiff's damages attributable to the violation, as distinct from other, independent, factors."⁸

The Second Circuit in *Ideal* strained *Holmes'* concept of directness. The injury allegedly suffered by Ideal is far from being "direct" as defined in *Holmes*. First, the party directly injured by the alleged predicate act is the government of the state of New York and its taxpayers. New York State—not Ideal Supply Corp.—is the intended beneficiary of New York's sales tax legislation. Ideal's alleged injury is further removed from National's conduct in that the injury flowed from the buying decisions of the two companies' shared customer base. The sales tax evasion itself did not hurt Ideal. Second, as stated by the District Court, Ideal cannot allege that it reasonably relied on National's fraudulent sales tax filings.

The two key issues in the Second Circuit's decision in *Ideal* were: (1) whether allegations of fraud should trigger a higher standard of pleading for civil RICO plaintiffs in order to establish direct injury; and (2) whether such injured parties should be required to have relied upon the fraudulent acts themselves in order to bring a claim. The Second Circuit panel decided both issues in Ideal's favor.

A leading 2001 Second Circuit precedent provided the Court with guidance in deciding the first question. In *Commercial Cleaning Services, L.L.C. v. Colin Service Systems, Inc.*,⁹ the Second Circuit held that a direct proximate relationship was adequately stated by the plaintiff in its allegations that defendant competitor had employed illegal workers as a scheme to lower its contract bids and caused direct injury to the plaintiffs in the form of lost contracts. On the second element, the *Ideal* Court acknowledged that in *County of Suffolk v. Long Island Lighting Co.*, where defendant company committed mail fraud to induce a state commission to grant an unwarranted and excessive rate increase, the Second Circuit had "plainly accepted the principle that a RICO claim based on mail fraud may be proven where the misrepresentations were relied on by a third person, rather than by the plaintiff."¹⁰

In overturning the district court's decision in *Ideal*, the Second Circuit also reversed its own decision in *Bank of China v. NBM LLC*. In *Bank of China*, plaintiff bank alleged that defendants used false and misleading misrepresentations, in many cases fraudulent documents, to borrow funds from the bank. The jury found that the defendants violated §1962(d) of RICO and awarded \$132 million in compensatory and punitive damages to Bank of China. In its decision, the Second Circuit announced that "in order to prevail in a civil RICO action predicated on any type of fraud, including bank fraud, the plaintiff must establish 'reasonable reliance' on the defendant's purported misrepresentation or omissions."¹¹ The Supreme Court had decided to hear *Bank of China* to deal with the question of whether RICO plaintiffs alleging mail and wire fraud are required to establish "reasonable reliance." However, a stipulation between the parties has removed the case from further judicial review.

Another way of framing the issue before the Court in *Ideal* is to determine whether the proximate cause analysis must be applied to each RICO predicate act based

on mail and wire fraud—in which case plaintiffs must show transaction causation and loss causation (as the district court held in *Ideal*)—or rather whether the proximate cause analysis is applied only to the pattern of racketeering activity—in which case plaintiffs need to show only a reasonably direct impact of the pattern on a competitor (as the Second Circuit held in *Ideal*). The former approach suggests a special rule to be applied only to those acts of racketeering that allege some sort of fraud.

The Third Circuit's Decisions

The U.S. Court of Appeals for the Third Circuit and its district courts have had the most experience in addressing analogous situations in which a competitor is suing for fraudulent activities carried out against a government entity.

In *RegScan, Inc. v. Brewer*, plaintiff alleged causation in their RICO claim by arguing that defendants, through fraudulent acts, were able to cut their costs and save expenses, and thus plaintiff, a competitor, suffered a loss in sales. The U.S. District Court for the Eastern District of Pennsylvania denied standing for the plaintiff because of the remoteness of injury. The court suggested that "...the injuries alleged by [p]laintiff may turn out not to be direct and proximate.... [A]lthough [p]laintiff adequately alleged that it and [defendant] are direct competitors, and [defendant] has achieved lower costs through its allegedly illegal activities, it is possible that [plaintiff] has higher costs than [defendant] for reasons completely unrelated to the alleged illegal activities of [d]efendant.... For example, [if] the facts showed that [p]laintiff paid higher salaries, or had higher lease expenses, or had an inefficient sales organization—all factors unrelated to the alleged RICO violation—then there would be no direct and proximate relationship between the alleged RICO violations and the loss of income by [p]laintiff."¹²

In *Callahan v. A.E.V., Inc.*, the Third Circuit denied standing to multiple beer

distributorship plaintiffs that brought RICO claims against competitor defendant by alleging injury in the form of lost profits as result of defendant's fraudulent representations made to the Pennsylvania Liquor Control Board (LCB) and a grand jury. The plaintiffs alleged that such fraudulent acts allowed the defendant to maintain illegal consolidated control of the defendant's beer business and was the proximate cause of their injury. The Third Circuit decided that the "causal connection between the defendants' racketeering activities—defrauding the LCB—is too remote as a matter of law from the plaintiffs' losses—lost business. [And] although the ultimate goal of [defendant] was presumably to woo customers away from the plaintiffs, the direct target of its alleged fraudulent scheme was the LCB, not customers [nor the plaintiffs]."¹³

Later, in *Bonavitacola Electric Contractor, Inc. v. Boro Developers, Inc.*,¹⁴ Bonavitacola brought civil RICO claims against competitor electric contractor, Boro, for submitting fraudulent bids to the government and obtaining contracts in public projects that otherwise should have gone to Bonavitacola as the second highest bidder. The Third Circuit decided that Bonavitacola's allegation of a loss of a bidding contract is not a direct injury required for standing under RICO.

Fifth Circuit Distinguished

In *P&G Co. v. Amway Corp.*, the Fifth Circuit decided that a target of fraud that did not rely on the alleged fraudulent acts may pursue a RICO claim when there are other elements of proximate cause present. Though at first glance this decision appears to be in line with the Second Circuit's decision in *Ideal*, *P&G* is distinguishable. In *P&G*, the defendant Amway allegedly started Satanism rumors about P&G to lure customers from P&G. The court declared that "if P&G's customers relied on the fraudulent rumor in making decisions to boycott P&G products, [such] reliance suffices to show proximate causation."¹⁵

Ideal cannot argue that customers had relied on the predicate acts of filing fraudulent sales tax records in making their purchase decision. *Ideal*'s injury in relation to National's pattern of racketeering activities is more remote than P&G's injury in relation to Amway's defaming rumors.

Conclusion

With *Ideal* up for judicial review, this is a crucial time for civil RICO litigants to receive instruction on what constitutes a "direct injury" and whether reliance is required in cases alleging civil RICO claims based on predicate acts of mail and wire fraud. In *Holmes*, the Supreme Court emphasized "the very unlikelihood that Congress meant to allow all factually injured plaintiffs to recover" and was therefore persuaded that "RICO should not get such an expansive reading."¹⁶

Proximate cause has never been an easy issue for law students or for courts. Now the Supreme Court will likely provide clarity for a difficult issue under a difficult statute.

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1. The Court granted cert. in a third civil RICO case, *Bank of China v. NBM L.L.C.*, 125 S.Ct. 2956 (2005), on June 27, 2005 to address the requirement of "reasonable reliance" in cases where mail or wire fraud was alleged. However, the cert. petition was dismissed pursuant to a stipulation received Nov. 15, 2005. See *infra* for a discussion of *Bank of China*.

2. 74 U.S.L.W. 3321, 2005 U.S. LEXIS 8571.

3. 74 U.S.L.W. 3351, 2005 U.S. LEXIS 9254.

4. 503 U.S. 258, 274 (1992) (citations and internal quotations omitted).

5. *Ideal Steel Supply Corp. v. Anza*, 254 F. Supp. 2d 464, 468 (S.D.N.Y. 2003) (Berman, J.) (citations and internal quotations omitted).

6. *Ideal Steel Supply Corp. v. Anza*, 373 F.3d 251, 263 (2d Cir. 2004).

7. *Id.* at 256.

8. *Holmes*, 503 U.S. at 269.

9. 271 F.3d 374 (2d Cir. 2001).

10. *Ideal*, 373 F.3d at 262.

11. 359 F.3d 171, 178 (2d Cir. 2004).

12. 2005 U.S. Dist. LEXIS 17996, *7-8 (E.D.Pa.).

13. 182 F.3d 237, 261 (3d Cir. 1999).

14. 2003 U.S. App. LEXIS 27918 (3d Cir. 2003).

15. 242 F.3d 539, 565 (5th Cir. 2001).

16. 503 U.S. at 266.