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State RICO and the PSLRA

By David M. Zensky and Joseph L. Sorkin

THE 1980S AND early 1990s witnessed explosive growth in the use of the federal Racketeer Influenced and Corrupt Organizations Act (RICO)—and its treble-damages remedy—in civil suits predicated on alleged violations of the anti-fraud provisions of the Securities and Exchange Act of 1934. See RICO Amendments Act of 1991: Hearing on H.R. 1717 Before the Subcommittee on Intellectual Property and Judicial Administration of the House Judiciary Committee, 102d Cong. 46 (1991) (statement of Mary L. Schapiro, commissioner, U.S. Securities and Exchange Commission). However, Congress put a stop to this practice in 1995. As part of the Public Securities Litigation Reform Act of 1995 (PSLRA), Congress made the federal RICO statute off-limits to plaintiffs whose claims are based on alleged fraud in the purchase or sale of securities. See Pub. L. No. 104-67, § 107, 109 Stat. 737, 758 (1995) (amending 18 U.S.C. 1964(c)) ("No person may rely upon conduct that may have been actionable as fraud in the purchase or sale of securities to establish a violation of [18 U.S.C.] 1962.").

With increasing frequency, however, plaintiffs have attempted to end-run Congress' prohibition and, through state RICO claims, are seeking the RICO-type remedies Congress sought to eliminate with the PSLRA. This article briefly addresses the following question: Should such state RICO claims be permitted or are they barred by the federal doctrine of "conflict pre-emption"?

David M. Zensky *is a partner and* **Joseph L. Sorkin** *is counsel in the litigation practice of Akin Gump Strauss Hauer & Feld LLP in New York. Joseph O. Boryshansky, former counsel in that office, provided assistance with this article. The firm represents several defendants in the* Fairfax Financial Holdings *case discussed in this article.*

SEC leaders warned of use of RICO in securities suits

During the congressional hearings leading to the PSLRA, then-Securities and Exchange Commission (SEC) Chairman Arthur Levitt criticized the use of RICO in civil securities fraud actions and testified that subjecting defendants to treble damages for securities violations was unnecessary and unfair since the federal securities laws already provided adequate remedies. Levitt also warned that the threat of treble damages tended to coerce settlements and complicate securities actions by introducing RICO-related questions. See Litigation Reform Proposals: Hearing Before the Subcommittee on Telecommunications and Finance of the House Committee on Commerce, 104th Cong. 2, 12 (1995) (statement of Arthur Levitt, chairman, SEC).

Several years earlier, in congressional testimony relied on by Levitt, former SEC Chairwoman Mary Schapiro voiced concerns that the use of RICO in civil securities cases upset the careful checks and balances of the federal securities laws and undermined the competitiveness of the nation's capital markets by considerably raising the costs of doing business. See Schapiro Statement, at 38-47.

And, echoing Levitt's testimony, the congressional reports underlying PSLRA noted that the threat of treble damages had the undesirable effect of chilling free discussion about companies' affairs by participants in the securities markets. See H.R. Rep. No. 104-369, pt. 1, at 47 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 746; S. Rep. No. 104-98, at 9 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 688.

Thus, to completely eliminate the "treble damage blunderbuss of RICO" in securities fraud cases, Congress amended the federal RICO statute in § 107 of the PSLRA to foreclose the use of RICO in such cases. *Mathews v. Kidder, Peabody & Co.*, 161 F.3d 156, 164 (3d Cir. 1998) (quoting 141 Cong. Rec. H2771 (daily ed. March 7, 1995) (statement of then Representative Christopher Cox, R-Calif., now chairman, SEC)).

For the next several years, the PSLRA seemed to have its intended effect. Plaintiffs in more recent years, however, have begun alleging state RICO claims and seeking treble damages based on alleged predicate violations of the 1934 Act that they are barred from bringing under the federal RICO statute. See, e.g., *In re Tyco Int'l Ltd.*, MDL Docket No. 02-1335-B, 2007 U.S. Dist. Lexis 42401, at *53-*80 (D.N.H. June 11, 2007); *Capitol First Corp. v. Todd*, No. 04-6439, 2006 U.S. Dist. Lexis 933359, at *44-*49 (D.N.J. Dec. 27, 2006); *Ferris, Baker, Watts Inc. v. Deutsche Bank Sec. Ltd.*, nos. 02-3682, 02-4845, U.S. Dist. Lexis 22588, at *11-*18 (D. Minn. Nov. 5, 2004); *Metz v. United Counties*

Bancorp., 61 F. Supp. 2d 364, 371 (D.N.J. 1999); *Biovail Corp. v. S.A.C. Cap. Mgmt. LLC*, No. L-1583-06 (Essex Co., N.J., Super. Ct. filed Feb. 22, 2006). This tactic appears to conflict with Congress' desire to prohibit the use of federal RICO to obtain treble damages for conduct actionable as securities fraud. It, therefore, raises the question of whether such use of state law is pre-empted by § 107 of the PSLRA.

Under the doctrine of conflict pre-emption, the application of a state law is pre-empted if it is inconsistent with, or stands as an obstacle to the accomplishment of, the purposes of federal legislation. See *Geier v. Am. Honda Motor Co. Inc.*, 529 U.S. 861, 873 (2000). The doctrine, which is rooted in the supremacy clause of the U.S. Constitution, requires that a court examine the federal legislation at issue as a whole to determine whether the state law is consistent with the structure and purpose of the federal legislation. See U.S. Const., art. VI ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof…shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby"); *Gade v. Nat'l Solid Waste Mgmt. Ass'n*, 505 U.S. 88, 98 (1992); *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 373 (2000).

What amounts to a sufficient obstacle is a matter of judgment for the court. See *Crosby*, 530 U.S. at 373. And once a court determines that there is a conflict, it must assume that Congress did not intend to permit the conflict. See *Geier*, 529 U.S. at 885.

Importantly, the U.S. Supreme Court has instructed that conflict pre-emption does not depend on an express statement from Congress; the doctrine is also referred to as "implied" pre-emption. See *Crosby*, 530 U.S. at 372. Nor does a statutory "savings" clause, in which Congress makes clear that it intends to preserve state laws on similar matters, suggest a finding against pre-emption. See *Geier*, 529 U.S. at 869, 870.

The argument in favor of pre-emption posits that a plaintiff's state RICO claims, which seek treble damages for alleged violations of the 1934 Act and Rule 10b-5, whether based on false or deceptive information or manipulative trading practices, present a direct conflict with the purpose of § 107 of the PSLRA—eliminating treble damages for conduct actionable as federal securities fraud. Congress' purpose in passing § 107 of the PSLRA would be rendered virtually meaningless if plaintiffs can avoid the prohibition by filing state RICO, instead of federal RICO, claims.

Interpreting lack of express congressional pre-emption

The argument opposing pre-emption is grounded in the presumption against pre-emption, especially when a state's historic police powers are implicated, and the express state law savings provision in the original RICO statute passed in 1970. See *Medtronic Inc. v. Lohr*, 518 U.S. 470, 785 (1996); Pub. L. No. 91-452, § 904(b), 84 Stat. 941, 947 (1970). Opponents of pre-emption also rely on Congress' failure to expressly pre-empt state racketeering claims in the PSLRA and subsequently in the Securities Litigation Uniform Standards Act of 1998 (SLUSA). See Pub. L. No. 105-353, 112 Stat. 3227 (1998). According to this argument, if Congress had a problem with state law RICO claims, it could have acted when it drafted the PSLRA or SLUSA, but it did not.

Do the PSLRA and the federal 'conflict pre-emption' doctrine bar state RICO claims for federal securities fraud violations?

However, as dictated by the Supreme Court, the lack of express congressional pre-emption plays no part in determining whether implied pre-emption is appropriate. (It is also worth noting that at the time the PSLRA and SLUSA were enacted there was no evidence that the use of state RICO was widespread.) Moreover, a law's relative importance to the state is not material once a conflict is found. See *Gade*, 505 U.S. at 108. Further, before 2007, no court had ever addressed whether such state law RICO claims were pre-empted by the PSLRA.

Last fall, in the first case to squarely present the pre-emption question, a New Jersey superior court judge considered these very arguments in the context of a motion to dismiss. The court ruled that state law RICO claims based on alleged predicate federal securities fraud violations are not pre-empted by the PSLRA. See Order Denying Defendants' Motion to Dismiss, *Fairfax Financial Hldgs. Ltd. v. S.A.C. Cap. Mgmt.*, No. MRS-L-2032-06 (Morris Co., N.J., Super Ct. Oct. 3, 2007). In explaining its decision, the court recognized that it was a "very close issue," but ultimately reasoned that the plaintiffs' state law racketeering claims would only present a "slight disruption" to the purposes of § 107 of the PSLRA and, therefore, should not be pre-empted. Transcription of Oral Argument, *Fairfax* (Morris Co., N.J., Super. Ct. Sept. 7, 2007).

If decisions allowing state law RICO claims to go forward are widely followed, however, state law RICO claims for treble damages may again become routine in securities fraud litigation, whether brought in state courts as pure state law RICO claims or as supplemental state law claims accompanying claims under the 1934 Act and Rule10b-5 in federal courts. If so, the implications for the nation's capital markets and the securities industry could be, as Congress recognized in 1995 when it passed the PSLRA, far-reaching.