Second Circuit Holds That PSLRA Section 107 Bars RICO Claims Alleging Any Acts of Securities Fraud Even Where Plaintiff Cannot Itself Pursue a Securities Fraud Action Against the Defendant

On July 7, 2011, the Second Circuit in *MLSMK Investment Company* v. *JP Morgan Chase & Company*,[1] ruled that a plaintiff's RICO claim against two financial firms for aiding and abetting a company's securities fraud was barred by Section 107 (referred to as the "RICO Amendment") of the Private Securities Litigation Reform Act ("PSLRA").

In affirming the District Court for the Southern District of New York's dismissal of the complaint as a whole, the panel elaborated on the dismissal of the RICO claim by explaining the scope of the exception under Section 107:

> "[S]ection 107 of the PSLRA bars civil RICO claims alleging predicate acts of securities fraud, even where a plaintiff cannot itself pursue a securities fraud action against the defendant."[2]

The decision has broad implications in the Second Circuit for underwriters, lawyers, trading partners and others as to whom claims of aiding and abetting securities fraud are barred by *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994).

I. Alleged Facts and Procedural History

This case stems from the notorious Ponzi scheme orchestrated by Bernard L. Madoff ("Madoff") through his company, Bernard L. Madoff Investment Securities ("BMIS"). JP Morgan Chase & Company ("JPMC") was a trading partner for Madoff's market making business, and JP Morgan Chase Bank, N.A. ("Chase Bank") was where Madoff kept his BMIS account. As one of its products, JPMC offered a note specifically related to Madoff investments, which guaranteed a return three times the amount of any return generated by the Fairfield Greenwich Group's fund, known as the "Sentry Fund," 95 percent of which was invested with BMIS. JPMC hedged against this obligation by investing a substantial amount of its own money in the Sentry Fund, whose investment results were essentially linked to the investment results produced by BMIS. When the financial markets were collapsing in the middle of 2008, the Sentry Fund continued to report solid returns, which caused JPMC to investigate the validity of Madoff's operations. Determining that the enterprise was fraudulent, JPMC protected itself by removing all of its own capital from Madoff-related investments. However, despite having drawn these conclusions concerning Madoff's investments, "JPMC continued to trade with Madoff's market making business, and Chase Bank continued to provide Madoff with banking services."[3]

Meanwhile, Plaintiff-appellant, MLSMK Investment Company ("MLSMK") had invested $12.8 million with BMIS between October and December of 2008 by wiring the funds to BMIS's account at Chase Bank, which were subsequently seized when Madoff was arrested on December 11, 2008. MLSMK sued JPMC and Chase Bank in the United States District Court for the Southern District of New York in April 2009 for the lost

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1 MLSMK Inv. Co. v. JP Morgan Chase & Co. ("MLSMK Opinion"), No. 10-3040-cv, (2d Cir. July 7, 2011), available at http://www.ca2.uscourts.gov/decisions/isysquery/6f852fbe-f1fc-451f-96db-08a4e78433a3/1/doc/10-3040_opn.pdf#xml=http://www.ca2.uscourts.gov/decisions/isysquery/6f852fbe-f1fc-451f-96db-08a4e78433a3/1/hilite/.

2 *Id*. at 21.

3 *Id*. at 9.

investment, alleging that the defendants' business relationships with BMIS gave them actual knowledge of Madoff's fraudulent enterprise, but instead of freezing BMIS's account, they continued to do business with him. MLSMK asserted a claim for conspiracy to violate the Racketeer Influenced and Corrupt Organizations Act ("RICO")[4] by aiding and abetting Madoff's breach of fiduciary duty, commercial bad faith, and negligence.

Defendants moved to dismiss the complaint in its entirety pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure for failure to adequately plead the defendants' requisite state of mind, and moreover that the federal claim under RICO was barred by Section 107 of the PSLRA. The district court agreed with the defendants that MLSMK failed to adequately plead scienter, and dismissed the complaint in its entirety. However, the court did not address the issue of whether PSLRA section 107 barred plaintiff's RICO claim. MLSMK appealed to the Second Circuit.

II. PSLRA Section 107

PSLRA Section 107 provides that "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962," effectively barring civil RICO claims based on allegations of securities fraud.[5] The policy behind this amendment was to prevent plaintiffs from routinely elevating securities fraud claims to RICO claims in order to collect treble damages, since "fraud in the sale of securities" is listed as a predicate offense.[6] However, district court decisions in the Second Circuit split regarding the scope of the RICO Amendment, specifically as applied to allegations that were not "actionable" under securities laws as private civil claims.

JPMC and Chase Bank argued on appeal that the RICO Amendment bars *all* civil RICO claims predicated on acts of securities fraud, even if the plaintiff has no private cause of action against the named defendant under securities laws.[7] In their argument, the defendants relied on three district court cases that agreed with their reasoning.

In *Fezzani* v. *Bear, Stearns & Co.*,[8] the district court held that the RICO Amendment bars RICO claims alleging any act of securities fraud. In *Fezzani*, the plaintiffs alleged under RICO that the defendants had engaged in predicate acts of aiding and abetting securities fraud, and defendants responded by moving to dismiss the complaint pursuant to the RICO Amendment. In granting the motion, the court explained that interpreting the RICO Amendment to permit RICO liability against "aiders and abettors" of securities fraud, but not the committers of securities fraud, would frustrate the policy behind the amendment:

> "A plaintiff could deliberately plead facts that established no more than that a particular defendant aided and abetted another's securities fraud. Such an incentive is particularly strong where, as here, a plaintiff might rely on the securities fraud of those with few assets to obtain treble damages against deeper pockets."[9]

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4 *See* 18 U.S.C. §§ 1962(d), 1964(c) (2006).

5 MLSMK Opinion at 13; *see* 18 U.S.C. § 1964 (c) (2006).

6 *Id*. (citing *In re* Enron Corp. Sec., Derivative & ERISA Litig., 284 F. Supp. 2d 511, 618 (S.D. Tex. 2003)).

7 *Id.* at 14–15.

8 No. 99 Civ. 0793, 2005 WL 500377 (S.D.N.Y. Mar. 2, 2005).

9 *Id*. at *4.

Similarly, in both *Thomas H. Lee Equity Fund V, L.P.* v. *Mayer Brown, Rowe & Maw LLP* ("*Thomas H. Lee*") [10] and *Cohain* v. *Klimley*,[11] the district courts reached the same conclusion as the court in *Fezzani*. In dismissing the plaintiffs' RICO claims against aiders and abettors of securities fraud pursuant to the RICO Amendment, the courts reasoned that it would be absurd for Congress to have intended to bar RICO claims against committers of securities fraud, but nonetheless permit treble damages against "aiders and abettors" who are immune from private suit under the securities laws.[12]

MLSMK argued that the RICO Amendment did not apply to their claim because it had no "actionable" securities fraud claim against the defendants.[13] MLSMK maintained that since it had no private cause of action under securities laws because the defendants only allegedly "aided and abetted" a securities fraud,[14] its underlying securities fraud allegation is therefore outside the scope of the RICO Amendment. MLSMK relied on two district court cases that agreed with its reasoning.

In both *OSRecovery, Inc.* v. *One Groupe International Inc.*[15] and *Renner* v. *Chase Manhattan Bank*,[16] the district courts held that the RICO Amendment does not bar a plaintiff's RICO claim against aiders and abettors of securities law violators. In both cases, plaintiffs alleged that the defendants aided and abetted a third party's securities fraud, and requested treble damages pursuant to RICO. The defendants then moved to dismiss the complaint, arguing that the RICO Amendment precluded claims based on any allegation of securities fraud. The judges in both cases denied the motions to dismiss, explaining that the plain language of the RICO Amendment only bars "actionable" securities fraud, and since there is no private right of action for aiding and abetting a securities fraud, then the plaintiffs may sue under RICO.[17]

III. The Second Circuit's Decision

The Second Circuit affirmed the district court's decision to dismiss the entire complaint under Rule 12(b)(6), and more significantly it elaborated on the rationale behind the dismissal of MLSMK's RICO claim. In holding that "section 107 of the PSLRA bars civil RICO claims alleging predicate acts of securities fraud, even where a plaintiff cannot itself pursue a securities fraud action against the defendant,"[18] the Court settled the split among district courts in the Second Circuit regarding the scope of PSLRA Section 107.

The Second Circuit panel primarily relied on three rationales to support its decision. First, it explained that the plain language of the RICO Amendment does not state that the securities fraud allegation underlying the

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10 612 F. Supp. 2d 267 (S.D.N.Y. 2009).

11 Nos. 08 Civ. 5047, 09 Civ. 4527, 09 Civ. 10584, 2010 WL 3701362 (S.D.N.Y. Sept. 20, 2010).

12 *Thomas H. Lee*, 612 F. Supp. 2d at 282–283; *Cohain*, 2010 WL 3701362, at *8–*9; *see Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994) (holding that section 10(b) of the Securities Exchange Act of 1934 does not impose private civil liability on "aiders and abettors" of securities fraud).

13 MLSMK Opinion at 16.

14 *Id.* at 14–15; *see Central Bank of Denver*, 511 U.S. at 177.

15 354 F. Supp. 2d 357 (S.D.N.Y. 2005).

16 No. 98 Civ. 926, 1999 WL 47239 (S.D.N.Y. Feb. 3, 1999).

17 *See OSRecovery, Inc.*, 354 F. Supp. 2d at 368–369; *Renner*, 1999 WL 47239, at *6–*7.

18 MLSMK Opinion at 21.

RICO claim must necessarily be capable of being brought by that plaintiff against that defendant in order to be "actionable."[19]

Second, even assuming, *arguendo*, that the statutory language was ambiguous, the legislative history supports the court's interpretation. "[T]he RICO Amendment's purpose was to remove as a predicate act of racketeering any *conduct* that would have been actionable as fraud in the purchase or sale of securities as racketeering activity under civil RICO."[20] Even though Congress was aware that this amendment would be placing some legal claims outside the scope of private legal suit, it believed that "the securities laws generally provide adequate remedies for those injured by securities fraud," including the power of the SEC to file for injunctions and prosecute offenders.[21]

Finally, the panel disagreed with MLSMK's attempt to distinguish this case from *Fezzani* and *Thomas H. Lee*. MLSMK argued that those decisions should not apply since they were driven by a concern that plaintiffs would artfully plead "aiding and abetting" to avoid the RICO Amendment, whereas in this case MLSMK does not have that choice. [22] The panel responded that even though the complaint in this case slightly differs from the complaints in those cases, those court decisions did not exclusively rely on policy rationales regarding the fear of artful pleading -- they also "analyzed the meaning of the statutory language independently from the specific facts of the cases before them" to support their decisions.[23]

IV. Significance of the Decision

In holding that PSLRA Section 107 bars RICO claims based on any act of securities fraud, the Second Circuit agreed with several other federal circuit courts, specifically the Third Circuit, the Fifth Circuit, the Ninth Circuit, and the Tenth Circuit,[24] and resolved a conflict among district courts within the Second Circuit.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

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19 *Id.* at 22–23; *see* 18 U.S.C. § 1964 (c) (2006) ("*[N]o person* may rely upon *any* conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962.") (emphases added).

20 MLSMK Opinion at 24 (quoting H.R. REP. NO. 104–369 at 47 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 746) (emphasis in original).

21 *Id.* at 24–25 (quoting S. REP. NO. 104–98, at 19, 1995 U.S.C.C.A.N. at 698).

22 *Id.* at 25–26 ("[In those cases] plaintiffs pled fraud and RICO claims in the alternative, whereas in this case, the plaintiff pleads only a civil RICO claim without asserting that the defendants are liable for frauds or securities violations of their own.").

23 *Id*. at 25.

24 *See id.* at 26–27 (citing numerous cases that interpret the RICO Amendment to bar RICO claims based on predicate acts of securities fraud, even where the plaintiff had no other avenue for relief).