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CIVIL RICO LIABILITY—THE SECOND CIRCUIT'S INTERPRETATION OF THE PSLRA AMENDMENT HAS BROAD IMPLICATIONS FOR VICTIMS OF SECURITIES FRAUD CONSPIRACY

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IN *MLSMK Investment Co. v. JP Morgan Chase & Co.*, the Second Circuit faced a first-impression issue regarding the specific applicability of section 107 of the Private Securities Litigation Reform Act (PSLRA) to private securities fraud claims brought under the Racketeer Influenced and Corrupt Organizations Act (RICO).[1] After finding the amendment's language to be unambiguous, further exploring the amendment's legislative history, and analyzing the opinions of several district courts dealing with the same issue, the court held that the PSLRA "bars a plaintiff from asserting a civil RICO claim premised upon . . . securities fraud . . . *even where* the plaintiff [can] not bring a private securities law claim against the same defendant."[2] While the decision may be consistent with the Supreme Court's general trend in narrowing the scope of civil RICO claims,[3] the court's analysis glossed over the amendment's linguistic ambiguity. More importantly, it clearly deprives securities fraud victims in a manner inconsistent with the *overall* goal of the PSLRA amendment itself.[4]

In 2008, plaintiff MLSMK Investment Company invested $12.8 million with Bernard L. Madoff Investment Securities LLC (BMIS), the "broker-dealer business" Bernard L. Madoff owned and operated in order to carry out his "notorious" Ponzi scheme.[5] Included within BMIS was an initially well-respected, market-making business for which defendant JP Morgan Chase & Co. (JPMC) was a trading partner.[6] Additionally, BMIS ran an "investment-advisory entity through which the clients [were

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1. MLSMK Inv. Co. v. JP Morgan Chase & Co., 651 F.3d 268, 269 (2d Cir. 2011).
2. *Id.* at 280 (emphasis added).
3. *See* David Martinez, *What Remains After Anza?*, ROBINS, KAPLAN, MILLER & CIRESI (June 26, 2006), http://www.rkmc.com/Civil-RICO-What-Remains-After-Anza.htm.
4. S. REP. NO. 104-98, at 42–44 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 727–28.
5. *MLSMK*, 651 F.3d at 270.
6. *Id.*

told they] would earn returns of 'up to 10–12% a year.'"[7] However, the investment-advisory business was allegedly non-existent; "Madoff never made [the] investments. Instead, he used later-invested money to pay 'returns' to other investors and to fund his lavish lifestyle . . . ."[8] BMIS held its main bank account at JPMC, who later offered a derivative instrument specially designed for Madoff's investments.[9] JPMC's special product "guaranteed a return of three times the earnings" of the "Sentry Fund," which was composed of primarily BMIS investments.[10] JPMC hedged the risk of its product by investing up to $250 million into the "Madoff-linked Sentry Fund."[11] Consequently, "'due to the [phony] returns Madoff was showing on the money invested with BMIS,'" the fund reported a very high yield throughout the financial crisis of 2008, which raised a few eyebrows at JPMC and later prompted their investigation of Madoff's business dealings.[12]

After discovering Madoff's fraudulent activity through BMIS, JPMC removed its investment from the Sentry fund, yet continued its trading relationship with the BMIS market-making business and continued to hold the BMIS bank account.[13] MLSMK asserted that "despite [JPMC's] actual knowledge" of Madoff's fraudulent activity, JPMC continued to serve BMIS because of the account's high earnings and fees.[14] Additionally, MLSMK pointed out that JPMC avoided its opportunities to protect other victims of Madoff's scams while liquidating its own investments and protecting itself.[15]

In April of 2009, MLSMK sued JPMC in the U.S. District Court for the Southern District of New York, claiming, among several other complaints, that by continuing to serve Madoff and BMIS with the knowledge of their fraudulent activity, JPMC "conspired to violate" the RICO statute, specifically 18 U.S.C. § 1962(d).[16] JPMC subsequently moved to dismiss this claim, arguing that Section 107 of the PSLRA barred "any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962."[17] The District Court granted JPMC's motion, and MLSMK later appealed the court's decision.[18]

Because federal case law barred MLSMK from bringing an "aiding and abetting" claim under the Securities Exchange Act, its only hope for a

7. *Id.*
8. *Id.*
9. *Id.* at 271.
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.* at 272.
14. *Id.*
15. *Id.*
16. *Id.* at 272–73.
17. *Id.* at 273, 278; *see also* Racketeer Influenced and Corrupt Organization Act (RICO), 18 U.S.C. § 1964(c) (2010).
18. *MLSMK*, 651 F.3d at 273.

private right of action was under RICO.[19] However, JPMC claimed that the PSLRA ("which was enacted as an amendment to the RICO statute") barred the use of conduct that "'would have been actionable'" under current securities law to establish a violation of Section 1962 of the RICO statute.[20] Consequently, the Second Circuit faced the question of whether the PSLRA barred *all conduct* that *could* be actionable under securities laws from being a predicate offense under the RICO statute, even if the plaintiff had no valid alternative claims under securities laws, or whether the bar only applied where the particular plaintiff in the case had an "actionable" claim under securities law against the named defendant.[21]

In analyzing the issue of where the bar applied, the court first focused on the "plain language" of the PSLRA amendment to the RICO statute, which reads: "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."[22] Agreeing with a few district court opinions, the Second Circuit found that the language unambiguously bars *all* RICO claims based upon *any* securities fraud conduct, not only those specific plaintiffs with valid securities fraud claims against particular defendants.[23] Although the court was convinced based on the mere language of the statute, it explored the legislative history of the PSLRA in order to further support its holding.[24] The court focused primarily on provisions of the Committee Report which *suggested* the purpose of the amendment 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 under civil RICO.'"[25] Additionally, the Senate Report included provisions which showed that Congress was aware that the amendment might leave certain securities fraud victims—those claiming conspiracy or aiding and abetting—without recourse.[26] Moreover, the court pointed out that the Senate specifically granted the Securities and Exchange Commission full authority to bring action against aiding and abetting violators.[27]

The Second Circuit found support in several district court opinions that MLSMK's proposed interpretation of the RICO Amendment would inevitably lead to abuse of RICO's remedies of treble damages.[28] In *Fezanni v. Bear Stearns & Co.*, the district court held that such a narrow

19. *Id.* at 274; *see also* Cent. Bank of Denver v. First Interstate, 511 U.S. 164, 177 (1993).

20. *MLSMK*, 651 F.3d at 273.

21. *Id.* at 274.

22. 18 U.S.C. § 1964(c).

23. *MLSMK*, 651 F.3d at 277.

24. *Id.* at 278–79.

25. *Id.* at 279 (alteration in original) (quoting H.R. REP. No. 104-369, at 47 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 746).

26. *Id.*

27. *Id.*

28. *Id.* at 275.

interpretation would allow plaintiffs to "deliberately plead facts that established no more than that a particular defendant aided and abetted another's securities fraud" in order to avoid the PSLRA bar in obtaining treble damages under RICO.[29] Moreover, in *Thomas H. Lee v. Mayer Brown*, another district court held that the idea of allowing those plaintiffs claiming aiding and abetting of securities fraud to take advantage of the RICO statute was almost fraudulent in itself, and thus completely contrary to Congress's intent in passing the RICO amendment.[30] MLSMK attempted to distinguish itself, however, by showing that the plaintiffs in *these* cases "pled fraud and RICO claims in the *alternative*, whereas in *this* case, the plaintiff pleads only a civil RICO claim" without any alternative route under securities laws.[31] However, the Second Circuit rejected this argument, concluding that the district court's holdings "were not limited to concerns about 'gamesmanship' in pleadings."[32] Rather, the court found that these cases were primarily concerned with the meaning of the statute, "[independent] from the specific facts of the cases before them."[33] MLSMK also relied on two district court cases that held the bar did in fact only apply when the specific plaintiff actually had a valid avenue under securities laws.[34] However, the circuit court rejected the reasoning of these cases, holding that their interpretation of the statute was far too narrow to align with Congress's intent. Consequently, because MLSMK based its RICO claim on JPMC's conduct of conspiring with Madoff and BMIS in their fraudulent securities scheme, the court held that the amendment did, in fact, bar MLSMK from recovering under RICO, *even though* they had no alternative right of action under current securities law.[35]

The Second Circuit's decision seems to be consistent with a trend of judicial narrowing of civil RICO claims across the board. In 1985, the U.S. Supreme Court noted that private action under RICO was beginning to evolve "into something quite different from the original conception of its enactors": originally designed to decrease the activity of "mobsters and organized criminals," RICO was beginning to become a common "tool for everyday fraud cases brought against 'respected and legitimate' enterprises."[36] Courts subsequently began narrowing the scope of the civil RICO context by increasing the required showing in order to recover under the statute.[37] The Supreme Court also narrowed the scope of the

29. Fezzani v. Bear, Stearns & Co., No. 99CIV0793RCC, 2005 WL 500377, at *4 (S.D.N.Y. Mar. 2, 2005).

30. *MLSMK*, 651 F.3d at 276.

31. *Id.* at 279 (emphasis added).

32. *Id.*

33. *Id.*

34. *Id.* at 277; *see also* OSRecovery, Inc. v. One Groupe Int'l., Inc., 354 F. Supp. 2d 357, 369–71 (S.D.N.Y. 2005); Renner v. Chase Manhattan Bank, No. 98 CIV. 926 (CSH), 1999 WL 47239, at *4–5 (S.D.N.Y. Feb. 3, 1999).

35. *MLSMK*, 651 F.3d at 280.

36. Sedima v. Imrex Co., 473 U.S. 479, 499–500 (1985).

37. *See* Holmes v. SIP Corp., 503 U.S. 258, 266–69 (1992); *see also* Anza v. Ideal Steel Supply, 547 U.S. 451, 458–62 (2006).

statute by adopting a strict textual analysis of civil liability under RICO.[38] In *this* respect, it seems clear that the Second Circuit's holding in this case was consistent with the narrowing trend of the RICO statute pursued by the Supreme Court.

However, when *Central Bank* prohibited aiding and abetting claims under the Securities and Exchange Act, plaintiffs were forced to turn to RICO as their last hope of relief when claiming conspiracies to violate securities laws, and several courts obliged.[39] Therefore, by completely removing *any* conduct relating to the sale or purchase of securities as predicate acts under RICO, the Second Circuit knowingly eliminated this entire class of possible plaintiffs and unjustly left them without valid recourse against those profiting from fraudulent securities conspiracy.

In the current case, while the Second Circuit held the language added to the RICO statute by the PSLRA *unambiguously* bars plaintiffs from making civil RICO claims predicated on securities fraud,[40] it failed to fully explore the ambiguity stemming from the word "actionable." At first glance, it seems clear that because MLSMK had *no* alternative cause of action under existing securities laws, due to the bar on aiding and abetting claims, it was *not relying* on conduct that was at all "actionable as fraud" under securities laws; thus, MLSMK should have avoided the breadth of the RICO amendment.[41] Although consistent with the Supreme Court's trend of narrowing the scope of predicate acts brought under RICO, the court clearly overstated the alleged clarity of the statute's wording. Further, because at least two district courts had relied on the term actionable in determining that an aiding and abetting securities fraud claim escaped the RICO amendment,[42] the language at issue obviously is not as plainly "unambiguous" as the court found.

Nevertheless, while the court ultimately continued on to note the amendment's legislative history for support,[43] it glossed over even more potential ambiguity found throughout the Senate Report of the PSLRA. The report clearly noted that there was a growing amount of frivolous litigation under federal securities laws, much of which was in an attempt to abuse corporate reputations at the "cost of raising capital."[44] Moreover, the report explicitly states that the PSLRA aims "to encourage plaintiffs' lawyers to pursue *valid* claims," and that the legislation is expected to continue "'to provide the highest level of protection to investors in our capital markets.'"[45] Here, it is very difficult to see how MLSMK's complaint against JPMC falls outside of the scope of this alleged "protection

38. *See generally* Reeves v. Ernst & Young, 507 U.S. 170 (1992).
39. *See OSRecovery*, 354 F. Supp. 2d at 368; *see also Renner*, 1999 WL 47239, at *6–7.
40. *See MLSMK*, 651 F.3d at 278.
41. RICO, 18 U.S.C. § 1964 (2010).
42. *See OSRecovery*, 354 F. Supp. 2d at 368–70; *see also Renner*, 1999 WL 47239, at *6–7.
43. *See MLSMK*, 651 F.3d at 278.
44. S. REP. NO. 104-98, at 4 (1995) *reprinted in* 1995 U.S.C.C.A.N. 679, 683.
45. *Id.* (emphasis added).

to investors." The court here clearly ignored the general *theme* underlying the amendment: to deter and bar *meritless* claims. It is clear that MLSMK's claim against JPMC was meritorious: JPMC continued to collect fees, to provide services to, and to benefit from the business of BMIS, which after investigation JPMC *knew* was fraudulently scheming investors out of their money. Interpreting the PSLRA to bar exactly what it claims to encourage is counter-intuitive. Moreover, as the court acknowledged, not only does this ruling bar MLSMK from bringing this claim, it essentially leaves them without *any* claim against JPMC.[46] The court itself recognized that the core purpose behind enacting the bar "was to prevent litigants from using artful pleading to boot-strap securities fraud cases into RICO cases, with their threat of treble damages."[47] It is clear that because investors like MLSMK have no alternative securities fraud claim, there is simply no "boot-strapping" of which they might take advantage, and as consequent, they are unjustly left without *any* private cause of action against a party who clearly benefitted at its customers' expense.

In the end, the Second Circuit solely focused on the particular provision of the committee reports which does show Congress's specific intent to bar all securities-related conduct as predicate acts for RICO claims: "The Committee intends this amendment to eliminate securities fraud as a predicate act of racketeering in a civil RICO action."[48] However, the misalignment of these isolated intentions within the overall theme of promoting *meritorious* claims present throughout the legislative history of the PSLRA is quite troubling when victims such as MLSMK are left without private recourse. JPMC clearly benefitted from the corrupt business dealings of Madoff and BMIS, but MLSMK is barred from taking direct private action. While the court and the legislative history acknowledge the fact that some will be left without a course of action against aiders and abettors of securities fraud, the additional views of Senators Sarbanes, Bryan, and Boxer included within the Senate Report shed light on some of their relevant concerns: "We support efforts to deter frivolous securities lawsuits, but . . . . [this amendment] erodes the ability of investors to seek recovery in cases of fraud."[49] The Senators believed that in order to strengthen the proper balance between deterring frivolous claims and encouraging meritorious ones, the bill should have at least restored the aiding and abetting of securities fraud liability that *Central Bank* previously barred.[50] In such a case, victims such as MLSMK would be entitled to bring their complaints under securities law without having to resort to RICO at all.

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46. *See MLSMK*, 651 F.3d at 280.

47. *Id.* at 274.

48. S. REP. NO. 104-98, at 19.

49. *Id.* at 49.

50. *Id.* at 50; *see also* Cent. Bank of Denver v. First Interstate, 511 U.S. 164, 177 (1993).

In conclusion, while the language of the statute itself was not at all as unambiguous as the Second Circuit made it seem, the specific provisions found within the legislative history of the act *are* supportive of the court's conclusion. Additionally, the court's decision *is* supported by the general trend in narrowing the civil scope of the RICO statute. However, the court clearly failed to acknowledge the bigger picture behind the amendment: to deter *meritless* claims. Moreover, as the dissenting senators pointed out in the Senate Report, leaving securities fraud victims without any private right of action should not be a repercussion of the Act.[51] According to Senator Dodd, while important to deter meritless claims, "we must do all that we can to ensure that legitimate victims can continue to sue and can recover damages quickly."[52] While leaving aiders and abettors of securities fraud immune from private causes of action *may* reduce the amount of frivolous, deep-pocket-seeking lawsuits, it clearly pushes the line too far by incentivizing companies such as JPMC to reap the benefits of other's fraudulent investment activities at the detriment of innocent investors like MLSMK.

51. S. REP. NO. 104-98, at 51.
52. *Id.*