Summer 1998

The Private Securities Litigation Reform Act of 1995: Did The "Rushed Debate: Really Spell the End of Securities Claims and RICO?

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The Private Securities Litigation Reform Act of 1995 amended the Securities Act of 1933 and the Securities Exchange Act of 1934 in hopes of decreasing the number of class action lawsuits by enhancing procedural requirements to be met by private plaintiffs. The "RICO Amendment" removed securities fraud as a predicate act for civil RICO liability. In this article, the author argues that the Congress' poor drafting and "rushed debate" of the Amendment essentially enabled the courts to circumvent Congress' clear attempt to reform RICO.

Introduction

On December 22, 1995, the 104th Congress overrode President Clinton's first veto and passed the Private Securities Litigation Reform Act of 1995 (the "Reform Act" or the "Act").[1] In the main, the Act amended the Securities Act of 1933 (the "1933 Act")[2] and the Securities Exchange Act of 1934 (the "1934 Act")[3] to hopefully diminish abounding class action lawsuits arising thereunder by, among other things, enhancing procedural requirements to be met by private plaintiffs. The Reform Act also appeared to eliminate securities fraud

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[1] Pub. L. No. 104-67, 109 Stat. 737.

[2] 15 USC § 77a et seq. (1995).

[3] 15 USC § 78a et seq. (1995).

as a basis for civil suits that had been brought under the Racketeer Influenced and Corrupt Organizations Act of 1971 ("RICO"), a move expressly designed to stem the universally accepted unintended use of that statute.

The Reform Act was heralded by its proponents as the long-awaited answer to the pleas of corporate America for shelter from the plaintiff's bar. But, if one judges the lumberjack by the trees he leaves standing, then the Reform Act is a veritable Paul Bunyan, for, as practitioners and scholars predicted, the Act invited more storm than it quelled. Indeed, the Act has succeeded to date mainly in spawning novel litigation and diametrically opposed results concerning such doggedly vague phrases as "strong inference" and "undue prejudice."

On its face, the amendment to RICO contained no such ambiguity. However, the judiciary's suspicion of the Reform Act apparently could not help but spill over to a provision designed to summarily stamp out a genus of securities suits; accordingly, the author argues that the "RICO Amendment," which one judge called the product of a "rushed debate," has proven the Act inefficacious once again, as the Congress' desire to spell the immediate death of RICO is being thwarted by the courts.

The Reform Act—What Went Wrong?

Inspired by abuses of the *class action* process, the Reform Act, nonetheless, spoke to any form of civil securities litigation. While offering to jurists the means of dismissing lawsuits and halting discovery, perhaps the Act's proper focus should have been the fact that accountants, brokerage houses, and corporate directors were being *joined* in lawsuits, regardless of the case's disposition.[4] To date, the

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[4] Statistics show that only approximately 50 percent of all lawsuits against large accounting firms end with some form of award; however, it takes an estimated $3.7 million to defend against the claims the 50 percent of suits that are dismissed or settled for nothing. "Who Got Sued? Suits Against Auditors," *AICPA Journal of Accountancy*, Mar. 1997, at 67 (study of 1,000 litigations against approximately 20 accounting firms).

The lawsuits in issue are generally brought under Section 10(b) of the 1934 Act (and its effectuating Rule 10b-5 ("10b-5") [15 USC § 78(j)(b) (1995) and 17 CFR

Act has not caused a decline in the types of suits accounting firms, brokerage houses and Silicon Valley companies fear.[5] The only consistent commentary on the law is that it has not reduced lawsuits; likewise[6] criticism of the efficacy of the Act abounds.[7]

As one attorney commented after the first application of the Act in 1996:

240.10b-5, respectively], 1933 Act Sections 11(a) [15 USC § 77(k) (1995)] and 12(2) [77(l)(2)], and section 1964(c) of RICO. The hope of defendants is that the suit is disposed of by means of dismissal or summary judgment under Federal Rule of Civil Procedure ("FRCP") 12(b)(6), which has been interpreted, when fraud is asserted, to incorporate the pleading "particularity" requirement of FRCP 9(b) ["Rule 9(b)"]. FRCP 12(b)(6) reads in relevant part as follows:

DEFENSES AND OBJECTIONS—WHEN AND HOW PRESENTED—BY PLEADING OR MOTION—MOTION FOR JUDGMENT ON THE PLEADINGS

How Presented. Every defense, in law or fact, to a claim for relief in any pleading, whether a claim, counterclaim, cross-claim, or third-party claim, shall be asserted in the responsive pleading thereto if one is required, except that the following defenses may at the option of the pleader be made by motion: . . . (6) failure to state a claim upon which relief can be granted. . . . If, on a motion asserting the defense numbered (6) to dismiss for failure of the pleading to state a claim upon which relief can be granted, matters outside the pleading are presented to and not excluded by the court, the motion shall be treated as one for summary judgment and disposed of as provided in Rule 56, and all parties shall be given reasonable opportunity to present all material made pertinent to such a motion by Rule 56.

[5] In February of 1997, the National Economic Research Associates concluded a study finding no significant decline in the filing of federal class action suits since the Act's passage. The report, entitled "What Explains Filings and Settlements in Shareholder Class Actions," was summarized in "Private Securities Litigation Reform Act Falls Short," Corporate Legal Times, Feb. 1997, at 13.

See also "Securities Litigation Reform Hasn't Halted Suits: Study," Business Insurance Mar. 24, 1997, at 14, discussing a study by two Stanford University law professors which concluded that, while the number of class actions filed in 1996 (109) was lower than in preceding years (an average of 176 suits between 1991 and 1995), between 148 and 163 suits would have been filed had litigants been more familiar with the Act and its new requirements. Further, 39 of the 109 suits from 1996 were filed in *state* courts, whereas the number of class actions filed there in previous years had been near 0.

[6] See "Securities Industry Trends: Up, Down, or Sideways?," NYLJ, Aug. 28, 1997, at 1. Despite the successful lobbying of Silicon Valley, the article noted that, as of February 1997, the percentage of federal cases involving high-technology cases had not changed, and that, as of July 1997, there had been a *rise* in the number of securities lawsuits in general.

[7] See, e.g., "Securities Class-Action Suits Seem Immune to Effects of New Law," Wall St. J., Nov. 12, 1996, at B7, and "Reform Rings Hollow for Firms Worried About Class Action Suits," Wall St. J., Apr. 4, 1997, at B8.

> As the court's and the SEC's conflicting examination of the legislative history revealed, Congress did not give many examples or definitions for numerous terms and phrases in the Reform Act. This lack of clear direction will place a burden on litigants who will face uncertainty, and courts that must give practical meaning to terms developed in the process of legislative compromise rather than by the courts.[8]

The first application of the Act could scarcely have been more comical. In *Medical Imaging Centers of America Inc. v. Lichtenstein*,[9] the *corporation* was the plaintiff, seeking to prevent a group of insurgent shareholders from removing directors at a special shareholders meeting. The plaintiff corporation's motion for discovery of the shareholder group was stayed by a magistrate pursuant to the Reform Act (the suit itself was later dismissed by a district court judge on other grounds). The case invited the mirthful comment from Professor John Coffee of Columbia Law School: "Its immediate and primary significance is the delicious irony it presents: Corporate America, having fought for heightened pleading standards and restrictions on discovery, finds that the first occasion in which these new restraints are enforced is against a public corporation seeking to protect itself from the proverbial raider."[10]

Perhaps Congress simply talked too much, too quickly. Addressing approximately a dozen topics and issuing new mandates to judges, litigants and accountants, it's safe to say that the Reform Act treaded on a lot of turf. Overall, the Act effectively amended the Securities Acts, RICO, the auditing standards of the American Institute of Certified Public Accountants (the "AICPA"),[11] and the (FRCP).

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[8] Elizabeth Stong, "First Application of Reform Act Yields Unexpected Result," NYLJ, Mar. 7, 1996, at 1, 4.

[9] Case No. 96–0039B (AJB) (SD Cal., Jan. 19, 1996).

[10] "Securities Litigation Reform Act: Emerging Issues," NYLJ, Feb. 29, 1996, at 3.

[11] As a legislative compromise, late in the deliberations an amendment to the 1934 Act was added by Senator Ron Wyden (Dem.-Ore.) which imposed new—and unrequested—duties on independent auditors to detect and report corporate fraud (Reform Act § 301). Corporate counsel was quick to point out that the Act thus giveth and taketh away: "The price of . . . 'reform', however, is high—new Securities Exchange Act sec. 10A requires accountants to employ audit procedures designed to detect illegal acts by their clients and to report to corporate boards and, in some cases, directly to the SEC, if a client fails to take 'appropriate

In sum, the thrust of the Act has been deflected due to consumer and judicial mistrust of its inartful phrases. The Reform Act's inefficacy can be summed up by the responses to its three main provisions, described below.

(1) The Act established an "automatic stay" of plaintiff's discovery (absent proof of "undue prejudice") pending the court's disposition of a motion for summary judgment.[12] While the goal may have been protecting corporations from unwarranted, time-consuming and expensive litigation tactics, the reality is that the automatic stay, by its own terms, can be used by any party against any party, for almost any reason. The free-wheeling nature of the stay has even led to its attempted use by a defendant to seek protection from the plaintiff's discovery while simultaneously moving for immediate discovery of "necessary" documents in the plaintiff's possession. The court denied the enterprising defendant's motion.[13]

(2) Arguably the most significant provision was the Act's heightened pleading requirement.[14] Despite the statement in the Conference Report accompanying the Act (the "Conference Report") that Congress did not "intend to codify the Second Circuit's case law interpreting this pleading standard,"[15] the Act's lack of a new standard inevitably led jurists back to that circuit's analyses. In the Southern District of New York, the preexisting "strong inference" test either survives unchanged, or it doesn't.[16] Other circuits, have simply adopted the Second Circuit's pre-Reform Act pleading test, as evidenced by the words of an Illinois court in 1997:

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remedial action to address auditor concerns.' The significance of this legislation cannot be ignored." (emphasis in original) Client Letter of Fried, Frank, Harris, Shriver & Jacobson, Feb. 5, 1996, at 1–2.

[12] Reform Act Section 101, new 1933 Act section 27A(f)(1) and (2).

[13] Levy v. United HealthCare Corp., Civ. No. 3–96-750 (D Minn. Sept. 10, 1996).

[14] New 1934 Act section 21D(b).

[15] Fed. Sec. L. Rep. (CCH) 1696 (extra edition, Jan. 10, 1996). [hereinafter cited as "(CCH) 1696"], at 66.

[16] See Sloane Overseas Fund Ltd. v. Sapiens Int'l Corp., 941 F. Supp. 1369 (SDNY 1996) (pre-Act case; court held that the Act simply "codif[ied] [the] Second Circuit standard for pleading scienter"; at 1377), and In re Baesa Sec. Litig., No. 96, Civ. 7435, 1997 WL 379690 (SDNY July 9, 1997) (while "particulars regarding motive and opportunity" may be sufficient to satisfy scienter under the Reform Act, "they are not presumed sufficient to do so," at 4). See also In re Health Management, Inc. Sec. Litig., 970 F. Supp. 192 (EDNY 1997) (holding that "motive and opportunity" are still sufficient).

> To impose a higher pleading standard would make it extremely difficult to sufficiently plead a 10b-5 claim—an outcome which would be contrary to the broad remedial purpose of the federal securities laws.[17]

(3) Finally, the Reform Act included a "safe harbor" for forward-looking statements made by issuers, their agents, or their underwriters if such statements were accompanied by undefined "meaningful cautionary statements."[18] The forward looking statements that were to receive protection were, in the main, projections of revenues and objectives for future operations.[19]

By mid-March 1996, the SEC had not noted any significant new disclosure by issuers. "So far, I've been personally disappointed. . . . There doesn't appear to be any new type of disclosure. . . . We had more in mind than that [boilerplate warnings]" stated the deputy director of Corporation Finance.[20] In January 1997, over a year after the Act's passage, counsel to the six largest accounting firms and the AICPA was not noting any increase in disclosure, acknowledging that companies still "don't know what the safe harbor means."[21] In April 1997, the SEC reported to the Congress and the President that "[c]ompanies do not appear to be disclosing much additional forward looking information."[22]

Thus, judicial antagonism and consumer distrust have worked to dampen, if not, silence the Act's biggest guns. But surely, the Act's attempt to limit the dreaded RICO, with its storied judicial support and seemingly unequivocal terms, would fare better, wouldn't it? Not necessarily. In amending RICO, the hope was for a prophylactic measure that precluded even the debate; however, the Congress is

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[17] Rehm v. Eagle Fin. Corp., 1997 US Dist. LEXIS 767, 785 (ED Ill. 1997) (class action suit).

[18] Reform Act Section 102, new 1934 Act § 21E(a). The Reform Act makes identical safe harbor (and other amendments) to Section 27A of the 1933 Act and Section 21E of the 1934 Act.

[19] Reform Act Section 102, new 1934 Act sec. 21E(h)(i)(1).

[20] "SEC's Brave New World," NYLJ, Mar. 14, 1996, at 5.

[21] "Lawyers Report on 'Year 1' Under Securities Act," NYLJ, Jan. 16, 1997, at 5, 7 (comments of Mark H. Gitenstein, Esq.).

[22] U.S. Securities and Exchange Commission, Office of the General Counsel, "Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995," available on the Internet and www.SEC.GOV (visited on September 18, 1997).

finding itself woefully shortchanged, as litigants are currently urging upon courts competing constructions of the Act's express limitation on RICO.

The RICO Amendment

RICO Background

It is axiomatic to state that, since its passage in October 1970, RICO[23] has been broadly construed by the courts. The 1980s saw a burst of civil RICO litigation, as courts blessed usage of the statute against both legitimate and illegitimate "enterprises,"[24] held that the plaintiff need not establish a special "racketeering" injury apart from the injury caused by any acts occasioned by racketeering activity,[25] and stated that neither the defendant nor the enterprise need be shown to be connected to organized crime.[26] Additionally, unlike securities law considerations of whether redress may properly lie elsewhere,[27] it matters not if the alleged RICO violation is addressed by other legislation.[28]

Most notably, civil RICO has proven to be the choice of the plaintiff attorney because it grants an express right of action (unlike 10b-5's *implied* right[29]) and provides for treble damages from the defendant,[30] which can be a powerful leveraging tactic during settle-

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[23] 18 USC §§ 1961–1968 (1995).

[24] United States v. Turkette, 452 US 576 (1981).

[25] Sedima, S.P.R.L. v. Imrex Co., 473 US 479 (1985).

[26] Moss v. Morgan Stanley, Inc., 719 F2d 5 (2d Cir. 1983).

[27] See Reves v. Ernst & Young, 494 US 56 (1990) ("nonsecurity" found where instrument was regulated by federal banking laws).

[28] See Bankers Trust Co. v. Rhoades et al., 859 F2d 1096 (2d Cir. 1988) (holding that an "overlap" of RICO and bankruptcy law speaks to damages, and not standing).

[29] An implied cause of action for antifraud provisions in the Securities Acts was first found in J.I. Case Co. v. Borak, 377 US 426 (1964) (re section 14(a) of the 1934 Act). In Superintendent v. Bankers Life, the Supreme Court, in a footnote, simply stated that it was "established" that a private cause of action under 10b-5 existed. 404 US 6 (1971).

Separately, private rights of action under the securities laws have been described by the Supreme Court as "a judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores, 421 US 723, 737 (1975).

[30] Section 1964(c) of RICO permits "[a]ny person injured in his business or property by reason of a violation of Section 1962" to sue and recover treble damages and the cost of the suit, including reasonable attorneys' fees.

ment negotiations. As one judge artfully coined it, "RICO's lure of treble damages and attorneys' fees draws litigants and lawyers . . . like lemmings to the sea."[31]

Amidst flamboyant House Commerce Committee debate, the Reform Act extended beyond the securities laws to amend section 1964(c) of title 18 of the U.S. code to remove securities fraud as a predicate offense for civil RICO liability (the "RICO Amendment").[32] Expediency was urged to protect capital formation, as evidenced by the comments of Representative W.J. Tauzin (Rep.–La.), who declared that, if RICO weren't amended, lawyers could continue to "wreak havoc upon a legal system that is creating some awful problems for us in the marketplace."[33] While in the past, judges had specifically stated that it was up to Congress to decrease the number of securities lawsuits based upon RICO,[34] it was perhaps indicative of Congress's desire to forge ahead without pause that the House Commerce Committee effectively amended a *criminal* statute.[35] Witness the warnings of Congressman John Conyers (Dem.–Mich.):

> Are you aware of the magnitude of what it is we are proposing to do here as the first amendment to this legislation on the floor? We are now saying that the fact that RICO was used in all of the major fraud cases, that we have

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[31] Wolin v. Hanley Dawson Cadillac, Inc., 636 F. Supp. 890, 891 (ND Ill. 1986) (J. Shadur).

[32] Reform Act, § 107.

[33] 141 Cong. Rec. H2776.

[34] See, for example, Comments of Chief Justice Rehnquist, "Reforming Diversity Jurisdiction and Civil RICO," presented at the Brookings Institution's Eleventh Seminar on the Administration of Justice, April 7, 1989 (printed in 21 St. Mary's L.J. 5, 9) (1989) ("Virtually everyone who has addressed the question agrees that civil RICO is now being used in ways that Congress never intended. . . . Most of the civil suits filed under the statute have nothing to do with organized crime.").

[35] Congressman John Dingell (Dem.-Mich.) was passionate about the Commerce Committee's amending RICO. Noting that he and his colleagues first learned of the RICO amendment the night before it was to be debated and that "RICO had securities violations as the subject of civil suits from the very first day that it was enacted into law," he stated:

> We are amending a statute which is not even under the jurisdiction of the Committee on Energy and Commerce, and we are amending it without ever having a word of hearings or a bit of evidence or testimony taken on the subject. Why is RICO taken up now when it could be addressed in another committee in proper fashion after appropriate hearings?

Congressional Record Statements of March 8, 1995 Regarding Floor Amendments to H.R. 1058, as reproduced in (CCH) 1696, at 109.

now reached the point on the basis of a Supreme Court case that goes back ten years to say that now RICO is so abused we must now get rid of it.[36]

Congressman Dingell, experienced in drafting securities laws, was less kind:

> The hard fact is the legislation is poorly drawn, it is hurried to the floor without proper hearings, without any intelligent consideration, and it has results far different, far broader, far worse from the standpoint of RICO, law enforcement, and getting at criminals generally. . . . The amendment ought to be rejected, if for no other reason than it is sloppy work. It is an embarrassment to the House.[37]

The "Midnight" Amendment

Nevertheless, the day after being introduced, the RICO Amendment (Section 107 of the Reform Act) was passed. It reads as follows:

> Section 1964(c) of title 18, United States Code, is amended by inserting before the period, "except 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.[38] The exception contained in the preceding sentence does not apply to an action against any person that (sic) is criminally convicted in connection with the fraud, in which case the statute of limitations shall start to run on the date on which the conviction becomes final.[39]

The Conference Report stated that the provision, in addition to removing securities fraud as a predicate act under RICO, also prevented the pleading of "other specified offenses, such as mail and

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[36] (CCH) 1696, at 107 (citing Thurgood Marshall's 1985 dissent in *Sedima*, 473 US 479).

[37] 141 Cong. Rec. H2778.

[38] Section 1964 sets forth remedies. Section 1962(c) reads as follows:

> (c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

[39] 18 USC 1964(c) (1995).

wire fraud . . . if such offenses are based on conduct that would have been actionable as securities fraud."[40]

Key to an understanding of the RICO Amendment is the Reform Act's general applicability section, which is found in Section 108 (the "Applicability Provision"). The Applicability Provision states that, "The amendment made by this title shall not affect or apply to any private action arising under Title of the [Securities Acts] commencing before and pending on the date of this Act."[41]

The Applicability Provision did not address pending RICO lawsuits,[42] and the Congress did not alter the Applicability Provision when it hurriedly passed the RICO Amendment. Additionally, the House rejected a proposed amendment which would have permitted plaintiffs to sue under existing law for three years after the Reform Act's enactment.[43] Not surprisingly, litigants and jurists have seized upon these procedural inconsistencies in successful attempts to salvage claims; to wit, there have already been a number of decisions refusing to hold that the RICO Amendment effectively dismissed pending RICO claims based upon securities fraud.[44]

Unintended Use of the Amendment to the Unintended Use Statute?

The tenor and language of the RICO Amendment seemed clear: to quickly end RICO claims in securities lawsuits.[45] After all, the Congress chose to make the Act effective immediately, upon its "date of enactment" (December 22, 1995).[46] But analysis of the claims brought, and surviving, in relevant cases evince a judicial adherence to loftier aims. And any continuation of pre-Act analyses constitutes a setback for corporate entities wishing to avoid litigation.

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[40] H.R. Conference Report, No. 369 at 47.

[41] Reform Act Section 10815 USC § 78u-4 (1995).

[42] By September 1997, courts were simply accepting that the Applicability Provision had not contemplated RICO. See Havenick v. Network Express, Inc., 1997 US Dist. LEXIS 16687 (ED Mich. 1997) (". . . RICO, a statute which is not mentioned in the [Reform Act's] applicability provision"; at 141).

[43] See 141 Cong. Rec. H2831 (Mar. 8, 1995).

[44] See notes 47, 61-68, and accompanying text.

[45] See infra note 91, and accompanying text.

[46] Reform Act § 108.

When a Duck's Not a Duck

The existence of the "fraud in the purchase or sale of securities" language in the RICO Amendment means that courts may prolong RICO's use, particularly when the alternative is dismissal of the plaintiff's claims altogether. In this regard, the failure of the Congress to address the statute of limitations ("SOL") for securities laws claims[47] may have worked to undermine yet another of the Reform Act's provisions.

In *Farmers & Merchants National Bank v. San Clemente Financial Group Securities Inc.*,[48] a bank sued a brokerage over two contracts, each for a $5 million certificate of deposit. The bank's "deposit teller" had signed and returned two "funds letters" prepared by the brokerage. The parties debated the binding nature of the letters. The plaintiff bank's allegations of federal law violations were limited to RICO; its pendent state law allegations were based upon the weaker premises of "unethical business practices" and common law fraud.[49]

Although the court noted the presence of evidence of a "brokered transaction," it summarily concluded that the "funds letters" did not constitute "securities" as defined by the Supreme Court's landmark *Howey* test.[50] If no "securities" were involved, then the RICO claim persisted based upon the (implied) existence of mail/wire fraud as a predicate offense (despite the Conference Report's advisions against such a substituion").[51] The New Jersey district court thus denied the defendant's motion to dismiss the RICO claim, and the plaintiff was thus afforded the opportunity to continue litigating in federal court.

The tautology of this holding cannot be overemphasized. Not only were the Congress' attempts to strip courts of jurisdiction over RICO suits based upon securities fraud discarded, but a lawsuit brought under the auspices of one controversial statute (RICO) led discussion back to a controversial, decades-old debate, namely, what is and isn't a "security" under the 1933 Act. On that issue, in particular, it

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[47] Since 1991, actions brought under Section 10(b) of the 1934 Act have been subject to a time limit of three years from the date of the fraud or one year from the discovery thereof. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 111 S. Ct. 2773 (1991) [hereinafter, the "*Lampf* SOL"].

[48] 1997 US Dist. LEXIS 11608 (DNJ 1997).

[49] Id. at 11609.

[50] SEC v. Howey, 328 US 293 (1946).

[51] In the instant case, the issue was whether funds letters relating to a certificate of deposit constituted securities. While certificates of deposit have been held by the Supreme Court to not constitute a "security" under the 1933 Act, (Marine Bank

has been said that the "courts seem to be result-oriented" and "influenced by who is suing whom for what."[52]

When Clocks Stop Ticking

The "Conviction Exception"

Congress explicitly stated that the RICO Amendment's "conviction exception" deprives a felon of the protections of the Act. But what if a civil suit defendant is convicted in a parallel criminal trial while a judge is considering the civil trial's motion to dismiss? What if the defendant just looks like he may be convicted, and no good judge wants to let him off the hook?

In *Krear v. Malek*,[53] the plaintiffs alleged a Ponzi scheme by a broker employed by Dean Witter Reynolds, Inc. between 1989 and 1995. The complaint was filed on December 8, 1995, weeks before the enactment of the Reform Act; however, in October 1996, the court requested of the plaintiffs a "RICO case statement" which, along with the defendants' motion to dismiss, was considered in light of the Act. Noting that the court had "the benefit of being apprised" of criminal investigations during the pendency of pleadings, and that circumstances "would change if [defendant] Turner is subsequently convicted," the court dismissed the complaint against the two principals in the scheme *without prejudice* and *with leave to amend.*[54]

Clearly the court could have dismissed the claims *with prejudice*, as it did against several other of the named defendants in the same action.[55] The bottom line? The plaintiffs were afforded the opportu-

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v. Weaver (455 US 551 (1982)), agreements relating to similar instruments have been declared securities. See Tcherepin v. Knight, 389 US 332 (1967) (holding withdrawable capital shares of a savings and loan to be securities) and Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F2d 1126 (2d Cir. 1976) (holding a note given to a bank evidencing a loan to be a security; decision pointed out that the note—like the funds letters in *Farmers*—was negotiated with a bank employee and drafted by the defendant).

Further, a *participation* in a certificate of deposit may itself be a security. Lehigh Valley Trust Co. v. Central Nat'l Bank of Jacksonville, 409 F2d 989 (5th Cir. 1969).

[52] Carl W. Schneider, "The Elusive Definition of a Security," 14 Rev. Sec. Reg. 981, 984 (1981).

[53] 961 F. Supp. 1065 (ED Mich. 1997).

[54] Id. at 1081.

[55] Id. at 1087.

nity to add another RICO defendant to the pleadings approximately 14 months after the effective date of the Act, and almost a year-and-a-half after filing their complaint. Such would hardly seem to be the fault of the judge, who did the best he could with both novel facts law, and who commented, "While this court is loath to engage in judicial legislation, it does note that Congress could certainly have been more lucid in the drafting of this [RICO] amendment."[56] Lest this analysis be deemed aberrational, note the decision in *McKowan Lowe & Co., Ltd. v. Jasmine, Ltd.*,[57] in which the court denied the request for a stay of discovery made by certain defendants added to the suit after the operative date of the Act,[58] as well as *Mathews v. Kidder Peabody*, which held that the Act does not apply where the complaint was dismissed with leave to amend and the amended complaint was filed after the effective date of the Act.[59]

But, as one will see, much more ink has been spilled on the problem of whether the Act applies forwards or backwards.

The Retroactivity Debate

While the Applicability Section expressly negates the applicability of the Reform Act to pending lawsuits based upon *securities fraud,* the Congress did not state that the Act excepts pending lawsuits based upon *RICO* violations. To be sure, this omission has led to holdings that require repetitive reading, such as the following: "It is only in cases such as this that RICO claims can no longer be brought and hence only in cases such as this that were pending on the date of enactment that the right to maintain a RICO claim is preserved."[60]

Defendants have argued that, although the Applicability Provision does not say so, it curtails *existing* claims of RICO violations based upon *pre-Act* conduct (the "negative inference" argument). Conversely, plaintiffs have argued that, since the provision does not preclude it, the Act does not apply to RICO claims pending as of

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[56] *Krear*, 961 F. Supp. n.20 (1997).

[57] 1997 US Dist. LEXIS 13440 (DNJ 1997).

[58] Id. at 13 (the defendant was held "deprived" of the "benefits of the Act"; court held that he "had notice of the claims . . . before the passage of the Act. . . . Therefore, the Reform Act does not apply to this case and defendant's application for a stay . . . will be denied.").

[59] 947 F. Supp. 180, 185–187 (WD Pa. 1996).

[60] Fujisawa Pharmaceutical Co. v. Kapoor, 115 F3d 1332, 1347 (7th Cir. 1997).

December 22, 1995. Pivotal to judicial determinations of both arguments would appear to be whether the *Lampf* SOL—which the Congress refused to address in the Reform Act—works *for* or *against* the plaintiff in the particular case.

Civil RICO has a four-year (SOL),[61] which begins to run "when [the] plaintiff discovers or should have discovered an injury."[623] A fact apparently not sufficiently appreciated by the Congress is that this RICO SOL exceeds the one-year/three-year *Lampf* SOL. Although an early version of the Senate bill included a variation on the *Lampf* SOL, the measure fell out in deliberations.[63] The Congress' refusal to confront time limitations has led sympathetic jurists to consider both SOLs; faced with the option of salvaging a claim under RICO or dismissing it in the absence of direction from the Congress, courts have often chosen the former.[64]

Thus, despite the efforts and fears of the reformers, as late as 1997, appellate courts were still dealing with RICO actions based upon facts from the 1980s, as pre-Reform Act litigation wound its way through the court system, invoking tried-and-true (but unpredictable) RICO considerations of continuing "enterprise," 10-year "pattern," etc.[65] Not surprisingly, there is currently a split as to what time frame of cases the Reform Act actually addresses; these holdings center on arguments either proffering the above-referenced "negative inference" in the RICO Amendment, or its kissing cousin, the "substantive" change (as opposed to a "jurisdictional" change) in the law.

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[61] See Agency Holdings Corp. v. Malley-Duff & Assoc., 483 US 143, 144 (1987) (holding that the four-year statute of limitations applicable to Clayton Act civil enforcement actions applies also to civil RICO actions because of the "similarities in purpose and structure between the statutes").

[62] Bankers Trust Co. v. Rhoades, 859 F2d 1096, 1103 (2d Cir. 1988), cert. denied, 490 US 1007 (1989).

[63] Testimony of Arthur Levitt, Chairman of the U.S. Securities and Exchange Commission, Concerning Litigation Reform Proposals Before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, United States Senate, April 6, 1995 (available from the SEC), at 30.

[64] See notes 67 and 78, infra, and accompanying text.

[65] See, e.g., Dennis Williams v. WMX Technologies & Envtl. Indus. Ass'ns, 112 F3d 175 (5th Cir. 1997) (class action securities suit alleging, inter alia, RICO violations based upon mail and wire fraud dismissed because alleged misstatements concerning a disputed landfill "shortage" in *1987* failed to fulfill Rule 9(b)'s particularity requirement).

The "Negative Inference" Cases

The Southern District of New York has more often than not ruled that the RICO Amendment *is not* retroactive, a decision which salvages claims involving facts over a decade old for further adjudication. In *In re Prudential Securities Incorporated Limited Partnership Litigation*,[66] Judge Milton Pollack denied the defendant's motion for summary judgment on four of six counts. The plaintiffs had alleged RICO violations based upon mail, wire, and securities fraud stemming from an allegedly fraudulent scheme in the marketing of limited partnership interests between January 1980 and December 1991. The suit was filed in June 1994, 18 months prior to the effective date of the Reform Act; however, the Act was raised by the defendants as a defense. Noting that the RICO Amendment was "proposed on March 6 [1995] and voted on the next day, without any hearings or testimony," Judge Pollack stated that "neither proponents or opponents of the [Act] made any explicit reference to the question of whether the provision would permit pending [RICO] actions to continue."[67]

Having determined that the Act was not clear on the topic of retroactivity, the court was thus free under the test announced by the Supreme Court in *Landgraf v. USI Film Products*[68] to determine whether applying the Reform Act retroactively would "impair rights a party had when he acted."[69] The court also noted that, pursuant to *Landgraf*, the presumption should be against retroactive application "absent clear Congressional intent favoring such a result."[70]

Ruling that the defendant's "negative inference" interpretation of the Applicability Section did not satisfy the standard of clear congressional intent, the court held that retroactive application, in light of the running of the *Lampf* SOL on the securities fraud claims, would wrongfully impair the plaintiffs' rights. The court stated in conclusion:

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[66] 930 F. Supp. 68 (SDNY 1996) [hereinafter cited as "Prudential"]. Judge Pollack's holding on retroactivity was expressly followed in a subsequent Southern District case in 1996, LaSalle National Bank v. Duff & Phelps Credit Rating Co., 1996 US Dist. LEXIS 18101 n.16 (SDNY 1996).

[67] *Prudential*, at 78.

[68] 114 S. Ct. 1483 (1994).

[69] Id. at 1505.

[70] Id. This construction opens the door for future RICO suits based upon pre-Act facts, as is noted later herein.

> The language of the statute expressly states that the provisions applicable to securities fraud actions do not apply retroactively. The statute does not address whether the provision applicable to RICO applies retroactively or not. It is possible that this failure to provide a clear expression of intent resulted from *the rushed nature of the debate* and the proposal of the amendment. Whatever the reason, the statute does not include the type of clear expression that the RICO provision is to apply retroactively required under the Landgraf decision. (*Emphasis added.*)[71]

Likewise, a Georgian court has denied defendants' attempted retroactive application of the RICO Amendment where such would have eliminated the plaintiff's securities claims. In *District 65 Retirement Trust v. Prudential Securities, Inc.*,[72] a voluntary pension plan had been invested between 1986 and 1993 in options and other speculative instruments allegedly in violation of both Prudential's internal policy and ERISA regulations. The trading generated between three and four million in commissions.[73] The party who monitored the activities of Prudential and its salesman was alleged to have been suffering from "severe health problems including alcoholism."[74] The suit alleged ERISA and RICO violations premised on securities fraud, mail and wire fraud.[75] Filed by "aging, ill" or deceased retirement plan trustees in 1994,[76] the securities fraud claims were outside the *Lampf* SOL but still viable under RICO.

Citing *Landgraf*, the Georgian court also rejected the argument for a "negative inference." Further, the court effectively utilized the Act's vagueness to save claims that would have been time-barred but for RICO, stating:

> Eliminating predicate acts upon which plaintiffs have rested their complaint for civil RICO remedies, and thereby causing their RICO claims to collapse, impairs the plaintiffs' ability to recover for actions which may have violated federal law. Thus, the [Act] "would operate retroactively" . . . the statute

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[71] *Prudential*, at 80–81.

[72] 925 F. Supp. 1551 (ND Ga. 1996) (upon motion to dismiss in light of legislative enactment) [hereinafter cited as "District 65"].

[73] Id. at 1557.

[74] Id. at 1556.

[75] Id. at 1563–1564.

[76] Id. at 1565.

> should not so function in the absence of "clear congressional intent favoring such a result" . . . (*citations omitted*).[77]

Such a construction was undoubtedly inspired by the alleged predatory behavior by the brokerage. But this same construction is indeed ironic in view of the deliberate attempts of the Act's proponents in Congress to "identify oversights or omissions in our legislation that could potentially hamper the effectiveness of [the Act]" as well as the intent to preclude plaintiffs' attorneys from "us[ing] RICO to evade our efforts at reform."[78] The point being that the Congress' haste and inarticulation has, once again, opened the door for another jurist when faced with a new provision from the Act to benevolently exercise discretion in favor of a sympathetic plaintiff.

The Seventh Circuit has found the question of retroactivity less vexing; in one case, the whole issue drew a total of a paragraph which labeled the defendant's argument for retroactive application "hard to fathom."[79] In this suit, which involved a claim pending as of the effective date of the Reform Act, the court ruled the "suspension" of the RICO Amendment equally inapplicable to securities and RICO claims, thus salvaging the pending RICO claim, and its judicial scrutiny of attendant facts, which dated back to 1984.[80]

The "Substantive vs. Jurisdictional Change" Cases

Concurrently, in a November 1996 Pennsylvania case, *Klein v. Boyd*,[81] the plaintiffs had invested in a limited partnership which subsequently failed and became worthless. The plaintiffs brought 10b-5 claims against a total of eight defendants premised upon the failure of a brokerage house to disclose the disciplinary history of the partnership's principal, who had been disciplined by five different regulatory agencies.[82] Plaintiffs, citing *Prudential* and *District 65*, argued that the Reform Act's RICO provision was a *substantive* change

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[77] *District 65*, at 1570.

[78] (CCH) 1696, at 109–110 (comments of Congressman Fields during committee debate).

[79] Fujisawa Pharmaceutical Co. v. Kapoor, 115 F3d 1332, 1347 (7th Cir. 1997).

[80] *Fujisawa*, at 1333.

[81] 1996 US Dist. LEXIS 17153 (ED Pa. Nov. 18, 1996) [hereinafter cited as "*Klein*"], affirmed, 1998 US App. LEXIS 2004 (3d Cir. 1998).

[82] *Klein*, at 2–3.

to law intended to end all RICO claims based upon alleged securities law violations. As a substantive change, it thus cannot be applied retroactively in the absence of a clear manifestation of Congressional intent, according to the Supreme Court in *Landgraf*.

The *Klein* defendants argued that the RICO provision was a *jurisdictional* amendment, designed to strip the courts of all authority to hear RICO cases premised upon securities fraud, and thus barring a court from hearing such a RICO case at any time, regardless of the date of the case's facts or filing. The defendant relied heavily on the Act's general purpose and tone.[83]

The court noted that the Reform Act was silent on whether it has retroactive application to actions brought under RICO. Further, the Court stated "in light of Congress' omission of a retroactive application provision, the new civil RICO provision of the [Reform Act] does not apply retroactively to bar plaintiff's claims."[84] The court went on to test the defendants' actions against the "participation," "enterprise" and "continuing unit" requirements of RICO and dismissed the claims. The RICO claims were dropped, and defendants got their wish, but only after judicial inquiry which mirrored the pre-Reform Act analyses. Less the significance of this type of continuing inquiry be understated, it bears noting that there is less than certainty whenever the "participation" test under RICO (promulgated by *Reves v. Ernst & Young*[85]) is invoked by the courts.[86]

Thus, whether holding that Congress did not contemplate certain matters or simply did not speak clearly, courts have refused to dismiss pending RICO claims based solely upon their reading of the RICO Amendment. In January 1997, another Pennsylvania court expended less thought in disposing of the applicability of the RICO Amendment and keeping alive the plaintiffs' claims. In *Frankford Trust Co. v. Advest, Inc.*,[87] the plaintiffs were a Pennsylvania trust

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[83] *Klein*, at 90.

[84] *Klein*, at 94.

[85] 113 S. Ct. 1163 (1993). The participation test promulgated by the Supreme Court in that case (the "*Reves* Test") weighs whether the defendant sought to be joined in the RICO claim, to some degree, directed the affairs of the enterprise.

[86] See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Young, Serino, Fraser, 1996 WL 383135 (SDNY 1996) (following *Reves* Test, the court held "where plaintiffs see allegations of control [of enterprise], I see an allegation of control by three"; additionally, certain allegations dismissed upon failure to allege an "enterprise" were nonetheless salvaged by assertions of an "association in fact" [at p.8]).

[87] 1997 US Dist. LEXIS 3441 (E.D. Pa. Jan. 14, 1997).

company and a funeral home who had delegated to a brokerage the authority to manage funds collected from funeral home customers to pay for funeral services after death ("pre-need customers"). In a complaint filed in July 1993, Advest's broker was alleged to have "churned" the plaintiff's account through purchases of speculative bonds and options, and to have covered up his actions by mailing fictitious confirmations to the customer.[88]

The defendant brokerage put forth five grounds for dismissal of the plaintiffs' RICO claims, including the argument that the Reform Act had ended the courts jurisdiction over RICO claims premised upon securities fraud. The court, in denying four out of five of the defendant's arguments, held that the Reform Act had made a substantive change (thus, again, preventing retroactive application).[89] The court cited the *Prudential* holding that the omission of any mention of RICO in the Applicability Section did not mean that the Congress wanted its RICO provision to apply retroactively:

> The [*Prudential*] court stated that while Congress' failure to provide a clear expression of whether the RICO amendment applies retroactively may have "resulted from the rushed nature of the debate and the proposal of the amendment," the new statute does not contain the clear expression of congressional intent required to give retroactive application to the amendment (citing *District 65*, 925 F. Supp. at 1570).[90]

Also in 1997, Judge Robert Sweet of the Southern District of New York ruled, in a suit filed by shareholders of a limited partnership against a management fund and three brokerage houses, that the Reform Act's RICO provision *is* retroactive.[91] Where his brethren had focused on the plaintiff's remedy, Judge Sweet centered on Con-

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[88] Id. at 5.

[89] Id. at 9–10.

[90] Id. at 11.

[91] ABF Capital Management, et al., v. Askin Capital Management, L.P., Kidder, Peabody & Co., Bears Stearns & Co. and Donaldson, Lufkin & Jenrette Securities Corp., 96 Civ. 2978 (RWS), 1997 US Dist. LEXIS 621 (SDNY 1997). The same month the Western District of Tennessee also held the RICO Amendment to be retroactive. Rowe v. Marietta Corp., 1997 US Dist. LEXIS 2735 (D Ga. 1997). See also Hockey v. Medhekar, 1997 US Dist. LEXIS 8558 (ND Cal. 1997) (class action suit dismissed because the Congress had "specifically addressed the reach of the [Act]," thus obviating the need for the second step of the *Landgraf* analysis to be reached; at 8).

gress' intent, declaring that the Reform Act "is not limited to future conduct, and its prohibition is absolute: no person may rely on securities fraud to make out a RICO claim."[92]

Even so, while acknowledging in footnote one that the plaintiffs filed suit after the enactment of the Act, and thus came within the proscription of the Applicability Section, the decision in *ABF Capital* is ultimately based on a *Landgraf* analysis. Indeed, in discussing "vested rights," the court quoted a 1995 Southern District case which held that a "cause of action that has not been reduced to a final judgment is not a 'vested right.' "[93] Thus, the stage is now set for future courts to ignore the date of the filing of the complaint and focus solely on whether or not application of the Reform Act would (1) impair a right, and (2) whether or not the "right" in question has been perfected. Such judicial reliance on concepts of fairness, as opposed to the express language of the RICO Amendment itself, can only work to prolong the retroactivity debate, while providing resource for future litigants.

What might be the most likely result in the future is for judges to simply sidestep the RICO Amendment. In *LaSalle National Bank v. Duff & Phelps Credit Rating Co.*,[94] the magistrate first used the *Reves* test to determine whether the defendants participated in the management of the alleged enterprise and accordingly stated that it "need not consider whether the provision of the [Reform Act] that precludes RICO actions based on predicate acts of securities law violations [citation] applies retroactively."[95] Other courts have similarly eschewed undertaking a nouveau analysis of RICO's applicability, opting to avoid weighing the merits of the RICO claim where plaintiffs had manifested an (unwritten) intention to drop the claim in the future[96] or where the case could be decided on traditional inquiries into

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[92] Id. at 24.

[93] Id. at 25–28 (citing Hyundai Merchant Marine Co. v. United States, 888 F. Supp. 543 (SDNY 1995)).

[94] 1996 US Dist. LEXIS 18101 (SDNY June 19, 1996). The magistrate concluded that the plaintiffs had failed to allege that the defendants had "participated"; analogizing to situations involving accountants, the magistrate discounted access to confidential information and even possible "substantial persuasive power" over the "enterprise" in finding RICO inapplicable. The magistrate's report was adopted (with one irrelevant modification) by the court on November 26, 1996. 1996 US Dist. LEXIS 17694.

[95] Id. at n.16.

[96] Richter v. Achs, 1997 US Dist. LEXIS 10982 (SDNY 1997).

the sufficiency of the pleadings.[97] Finally, at least one court has chosen simply to rely on the pre-Reform Act analysis while silently assuming that the RICO Amendment is inapplicable.[98]

To Infinity and Beyond?

Since jurists have openly decried both (a) the process by which the RICO Amendment was passed, and (b) its exasperating lack of guidance, is it really a stretch to believe that soon they will ignore it altogether? Further troubling is the Second Circuit's "separate accrual rule" for civil RICO injuries.[99] This rule treats each "new and independent injury" as triggering the four-year SOL. In light of the judicial dilution of the RICO Amendment and concomitant refusal to apply it to cases pending as of December 22, 1995, as well as RICO's four-year SOL and flexible 10-year "pattern" definition,[100] it is possible that existing and future filings may crystallize the fear expressed by Judge Sweet in *ABF Capital*, namely, RICO suits based upon securities fraud not ending "until nearly the next century."[101]

More importantly, does not a reluctance to apply the Reform Act retroactively affirm the premise that acts/omissions occurring right up until its effective date—December 22, 1995—may form the basis for a RICO violation? Witness the language of footnote 8 of the decision in *District 65*:

> Had this action primarily involved securities fraud claims under the [Securities Acts] Congress' explicit requirement of prospective application

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[97] Chang v. Gordon, 1997 US Dist. LEXIS 13570 (SDNY 1997) (allegation of fraud deemed too general, thus warranting dismissal of 10b-5 claim and the Court therefore "need not reach the issue of whether the claim is barred by the [Reform Act]"; at 24).

[98] See Sheridan v. Jaffe (suit related to class action suit, In re Towers Financial Corp. Noteholders Litig.), 94 Civ. 9344 (AJP)(WK), 1996 US Dist. LEXIS 8809 n.4 (SDNY June 21, 1996) (plaintiff sued a financial planner who had recommended that plaintiff purchase notes; magistrate granted defendant's motion for summary judgment by way of a seven-page analysis of whether defendant's actions satisfied the requirements in RICO sections 1962 (a)[income], (c)[predicate acts, pattern of activity, and participation in an "enterprise"], and (d)[conspiracy].

[99] See Pinnacle Consultants, Ltd. v. Leucadia Nat'l Corp., 923 F. Supp. 439 (SDNY 1995) (discussing Bankers Trust Co. v. Rhoades, 859 F2d 1096 (2d Cir. 1988), cert. denied, 490 US 1007 (1989)).

[100] 18 USC § 1961(5).

[101] *ABF Capital Management*, 1997 US Dist. LEXIS at 23.

> may very well have encompassed the entire action and allowed both the RICO claims and the securities fraud claims to proceed.[102]

Such language would seem to hint at the day when virtually *all* applications of the Act—i.e., to pre-Act facts and post-Act filings—are held to necessitate a *Landgraf* analysis.[103]

Conclusion

To be sure, various courts have openly criticized the nebulous wording of the Reform Act in general and even cloudier history of the RICO Amendment in particular. This criticism comports with the predictions of practitioners and jurists alike to other provisions in the well-meaning, but, at times, poorly drafted, litigation Reform Act.

In *Farmer's Bank*, a claim couched as a RICO violation survived where its brethren labeled as a securities violation would have surely fallen, surely an unintentional consequence of the Act. Despite the Congress' stated anathema to abounding securities litigation, the court, arguably, saved the plaintiff's claim by seemingly using the RICO Amendment to dress the plaintiff's wolf in sheep's clothing.

In *Krear*, the court all but instructed the plaintiff to "hang on" until one of the primary defendants is convicted.

In several cases, the court refused to apply the RICO Amendment where it would deprive the plaintiff of his day in court. And even in applying the RICO Amendment retroactively to dismiss a RICO claim, *ABF Management's* analysis opened the door for future controversy over "vested" rights.

Thus, it appears that the RICO Amendment represents another of the Act's provisions which has been ignored or diluted, despite the Congress' clear intent. Perhaps it's simply a matter of tradition; to quote Professor Coffee, "judicial reaction to the Reform Act reveals one consistent thread—a reluctance to create special rules of procedure for securities class actions."[104] Or perhaps it's because judges

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[102] *District 65*, at n.8.

[103] For an argument for the inapplicability of all sections of the Act to pending civil lawsuits in general see Susan Gonick and Joseph D. Daley, "The Nonretroactivity of the Private Securities Litigation Reform Act of 1995," 25 Sec. Reg. LJ (1997).

[104] John C. Coffee, Jr., "First Anniversary: PSLRA of 1995," NYLJ, Jan. 30, 1997, at 5.

are always going to look to the "broad remedial powers" of the Securities Acts and related legislation to salvage the claims of sympathetic plaintiffs, such as the cautious customers looking to ensure future funeral arrangements in *Frankford Trust*, the pensionless pensioners in *District 65*, or the individuals left holding worthless limited partnership units in *Klein*. While such a practical but technically flawed view is not novel, it has been made imminently possible—indeed, it has been exalted—by the Congress' "sloppy work" in crafting and rushing to passage the RICO Amendment.