



Today, creative attorneys are trying hard to find a way around the Reform Act. Plaintiffs have brought RICO suits not for fraudulent inducement to purchase or sell securities, but for “fraudulently inducing” plaintiffs into “retaining” their securities. Because the Amendment, by its terms, applies to a “purchase or sale” of securities, not a fraudulent inducement to cause a person to “hold securities,” plaintiffs have argued that common law frauds, effected through the mails, may serve as RICO predicate acts of mail fraud, notwithstanding the Amendment. If plaintiffs are right, damages sought in securities class suits, as well as in private suits, could potentially explode, with increased exposure in the billions of dollars to businesses and their insurers.

#### **Blue Chip Stamps, the Purchaser/Seller Rule and Its Application in RICO Cases**

The argument above relies on a creative exploitation of the United States Supreme Court’s decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). In *Blue Chip Stamps*, the Supreme Court held that no party may sue under the securities laws unless they actually “purchased or sold” securities and, therefore, that a plaintiff defrauded into merely “holding” securities lacks a federal securities claim. Although it has been clear, since *Blue Chip Stamps*, that Rule 10b-5 plaintiffs must be purchasers or sellers to have standing to

sue under Rule 10b-5, it has been less clear whether a plaintiff suing under RICO and claiming securities fraud as a predicate act must satisfy the same standing requirement as would be required if only a securities fraud claim were made.

Several federal circuits addressed this issue in the late 1980s and early 1990s.

The Fourth Circuit, in *International Data Bank, Ltd. v. Zepkin*, 812 F.2d 149 (4th Cir. 1987), concluded that the phrase “fraud in the sale of securities” was intentionally narrow, designed to suggest a “pivotal role of the actual sales transaction.” The court observed that securities litigation presents a “danger of vexatiousness different in degree and kind from that which accompanies litigation in general.” 812 F.2d at 152. Noting the policy of avoiding disruption of business activity through lawsuits “designed to poison the atmosphere with accusations of fraud,” the court stated that the same proof problems addressed in *Blue Chip Stamps* would apply to “holding” securities-based RICO cases. Specifically, the court pointed to the difficulties facing non-sellers and non-buyers in attempts to prove non-events (*i.e.*, their failure to buy or sell stock while they waited to see how market events played out). *Id.* It concluded that RICO plaintiffs alleging securities fraud predicate acts had to allege an actual purchase or sale to recover treble damages.

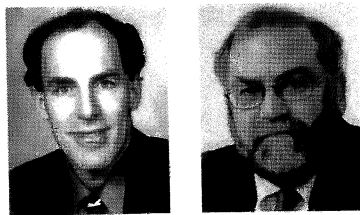
The Ninth Circuit reached exactly the opposite conclusion in *Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461 (9th Cir. 1990), holding that SIPC had standing to assert a securities fraud-based RICO claim even though it was not a purchaser or seller of securities. Defendants were alleged to have created an illusion of active markets by engaging in

misleading transactions in their corporate and customer accounts. After investors discovered the scheme, the stock prices dropped dramatically and the brokerage firms went out of business, ending up in liquidation. The district court ruled SIPC had no standing to assert a RICO claim because SIPC was not a purchaser or seller. The Ninth Circuit reversed, reasoning that because RICO’s text contains no express purchaser/seller limitation and, instead, grants standing to “(a)ny person injured in his business or property by reason of a violation of section 1962,” any person injured “by reason of” fraud in the purchase or sale of securities may sue under RICO, regardless of whether or not that person actually bought or sold the securities at issue. It contrasted RICO’s language with that of Rule 10b-5—the latter requiring that the unlawful conduct be “in connection with the purchase or sale of any security.” Because the 10b-5 remedy was judicially created, the Ninth Circuit concluded it was appropriate for the *Blue Chip Stamps* court to impose a standing requirement. However, Congress created RICO’s private civil claim and it did not impose a purchaser/seller standing requirement. The Ninth Circuit concluded that it would be inappropriate for courts to add a RICO standing requirement when Congress did not.

In 1992, the Supreme Court granted *certiorari* in *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258 (1992), to resolve the split among the federal circuits. The majority opinion, however, avoided the issue, focusing instead on issues of causation. The split remained intact but the divergence of views was largely viewed as moot after the Reform Act. Defense counsel, to the extent they thought about the issue, probably thought it was of historical/academic interest only.

#### **Plaintiffs’ Arguments Based on Fraud-Induced Holding Securities Mail Fraud Predicates**

Plaintiffs have argued that the RICO Amendment, which by its terms precludes RICO claims based on fraud in the “purchase or sale” of securities, is no bar to



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a RICO claim brought by a person who alleges to have been defrauded, through the mails, into holding securities. While no court has yet published a decision addressing the issue head-on, a number of cases have addressed related issues, with defense-friendly results.

In *Gatz v. Ponsoldt*, 297 F.Supp.2d 719 (D.Del. 2003), for example, plaintiffs alleged as predicate acts the intentional commission of mail fraud and wire fraud, in violation of 18 U.S.C. §§1341 and 1343. Defendants argued that plaintiffs' claims were barred by the Amendment, despite the fact that plaintiffs had not pleaded that they were purchasers or sellers of securities. The district court began its analysis, 297 F.Supp.2d at 729-731, as follows:

Section 107 of the PSLRA 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." 18 U.S.C. §1964(c) ("RICO Amendment"). The Third Circuit has held that under §1964(c) "a plaintiff cannot avoid the RICO Amendment's bar by pleading mail, wire fraud and bank fraud as predicate offenses in a civil RICO action if the conduct giving rise to those predicate offenses amounts to securities fraud." *Bald Eagle Area Sch. Dist. v. Keystone Financial, Inc.*, 189 F.3d 321, 328 (1999). The proper test is whether "the conduct pled as predicate offenses is actionable as securities fraud." . . . The predicate acts consist of the use of the mails and wires to conduct a series of transactions, each involving or related to covered securities. . . Applying the *Bald Eagle* test, the court concludes that the conduct alleged as predicate acts by the plaintiffs would be actionable as securities fraud and, consequently, may not serve as predicate acts for purpose of a civil RICO action.

Although plaintiffs attempted to exploit the fact that they had not pleaded a "purchase or sale," the court concluded that plaintiffs *could* have so pleaded. The Amendment, the court concluded, could not be "artfully" avoided. As long as a purchaser/seller allegation could have been made, the Amendment would be applicable to bar the claim:

A plaintiff cannot circumvent the PSLRA's exclusion of securities fraud as a RICO predicate act through artful pleading. . . Whether plaintiffs were purchasers or sellers of securities would only be relevant to the inquiry of their standing to bring a securities fraud claim, whereas the PSLRA's exclusion of securities fraud as a RICO predicate act applies regardless of whether a particular plaintiff has standing to bring a

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civil action under §10b and Rule 10b-5. See *In re Enron Corp. Securities, Derivative & ERISA Litig.*, 284 F.Supp.2d 511, 620 (S.D.Tex.2003) ("The RICO Amendment bars claims based on conduct that could be actionable under the securities laws even when the plaintiff, himself, cannot bring a cause of action under the securities laws.").

In other cases involving so-called "unitary frauds," *i.e.*, frauds that begin prior to purchase of securities and are alleged to have continued as plaintiffs continue to hold securities, the entire claim has been held to be barred. For example, in *Zoren v. Genesis Energy, L.P.*, 195 F.Supp.2d 598, 605 (D.Del. 2002), the district judge wrote:

Courts have found that an allegation of an "unitary scheme of fraud" which began before the "purchase or sale" of securities and continued afterward may nevertheless satisfy the "in connections with" requirement. See, *e.g.*, *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1046 (11th Cir.1986). Courts interpreting SLUSA have agreed. See *Shae v. Clafin*, 2001 WL 548567 (N.D.Cal. May 21, 2001) (finding "fraud related to the purchase and holding of a security may satisfy [SLUSA's] 'in connection with' requirement where the plaintiff

alleges an 'unitary scheme of fraud' which began before a stock purchase and continued afterward.").

The present question, however, is slightly different—can a plaintiff avoid the Amendment by pleading a RICO claim based on being defrauded into holding securities when no allegations are made that would permit a court to infer the existence of either a "unitary fraud" or a fraud-induced "purchase or sale." Plaintiffs will argue this is not a question of "artful pleading," but rather one of legitimate strategy. Resolution of this issue could have an enormous impact on securities cases, primarily because most suits based on fraud in the purchase or sale of securities are easily translatable into claims of wrongful inducement to "hold" securities.

Imagine, for example, a plaintiff purchases shares in an IPO based on an allegedly misleading prospectus. Every document defendant mails that fails to disclose the fraud, *i.e.*, that fails to state the information required to correct a misleading prospectus, would arguably constitute an instance of "mail fraud," pleadable as a RICO predicate act, based on material omissions in the mailed documents. Given that the Supreme Court held, in 2001, that plaintiff may properly plead a RICO enterprise by merely pleading a corporation is the RICO enterprise and its officers/employees the RICO "persons" controlling enterprise activity, the temptation to interpose RICO claims, through allegations of such mail fraud, seems practically irresistible. See *Cedric Kushner Promotions, Ltd. v. King*, 533 U.S. 158 (2001).

**Defense Arguments against Holding Securities-Based RICO Claims and Plaintiffs' Responses**

Several arguments are available to defendants.

First, defense counsel may argue that it could not possibly have been the legislature's intent to flood the state courts with RICO claims, by letting plaintiffs change a few words in their pleadings, from "purchase or sale" to "hold." Such interpretation would effectively render section 1964(c) a nullity. Specifically, every purchaser could

argue his/her holding (and injury) was caused by a mail fraud actionable under RICO in state court, even if those same factual allegations, for lack of a purchase or sale, would not be actionable as a Rule 10b-5 claim in federal court.

Second, defendants may argue that *Blue Chip Stamps* was intended to prevent “holding securities” claims from flooding the federal courts because they were so easy to plead but so hard to litigate. Allowing plaintiff’s exploitation of *Blue Chip Stamps*, in the manner indicated, would result in flooding of both the state and federal courts with nearly identical litigation, exacerbating already overly complex securities-involved litigation.

If plaintiffs are correct, they can plead stand-alone RICO cases in federal court—exploiting holding securities-based mail frauds as alleged patterns of RICO predicates—while using RICO itself as a basis for federal jurisdiction and relying on state common law holding-based frauds as mail frauds. In this scenario, plaintiffs would neither be subject to RICO Amendment-based dismissal motion practice nor the Reform Act’s discovery bar, as would otherwise be applicable in securities fraud litigation. The federal courts would, again, be potentially flooded with RICO claims, with RICO plaintiffs alleging holding securities-based violations that are not subject even to Reform Act procedural protections for securities fraud defendants.

Plaintiffs may respond that the Amendment says “purchase or sale” and that if Congress wanted to include “holding” securities within its scope, it would have said so. *Blue Chip Stamps* was obviously well known to the Amendment’s drafters, but they made no provision to cover frauds other than those that could sustain a Rule 10b-5 claim, *i.e.*, just actual purchasers and sellers. Plaintiffs may also argue that because the language “purchase or sale” has been clarified through decades of Exchange Act judicial construction under *Blue Chip Stamps* and its progeny, legislative intent should *not* be considered at all. Judicial construction of the language “purchase or sale” would

effectively usurp Congress’ role. Under settled principles of statutory interpretation, courts may not review legislative intent behind the Amendment to construe already “clear” statutory language. If the courts cannot reach the issue of legislative intent, of course, the arguments above go by the wayside.

Defendants may respond that the phrase “purchase or sale,” as used in the Reform Act, is not self-explanatory and has not been subjected to judicial construction, in the context of the Amendment. An entire body of law construes the meaning of these words under the Exchange Act and if, prior to construction, these words were not “clear” under the Exchange Act, they should not be viewed as “clear,” prior to construction, under the Amendment. At this writing, there appears to be no published judicial construction of “purchase or sale,” under the Amendment, applied to a pure “holding violation.”

### **The Impact of the SLUSA Decisions**

The phrase “purchase or sale” has also been the focus of judicial attention in the context of removal and remand motions argued in highly publicized securities-based fraud suits. In very recent cases, plaintiffs have filed securities-based common law fraud claims in state courts and defendants have removed them to the federal courts under the Securities Litigation Uniform Standards Act (“SLUSA”). SLUSA allows defendants to remove suits that involve the “purchase or sale” of securities to federal court. SLUSA was largely enacted to prevent plaintiffs from avoiding the impact of the defense-friendly Reform Act by disguising securities fraud claims, in common law filings, in state courts.

Such state filings follow a broad trend in class action litigation wherein plaintiff attorneys that once sought a federal forum for their claims are now filing national class suits in state courts, where they perceive litigation advantages exist. When defense counsel remove such securities-based claims to federal court, under SLUSA, plaintiffs quickly move for a remand on the ground that plaintiff class

members are not purchasers or sellers, but, rather, only “holders” of securities. To date, plaintiffs have successfully argued that SLUSA is inapplicable in such cases, because SLUSA, by its own terms, applies only where plaintiff is a “purchaser or seller”—not a “holder” of securities, and remands have followed.

In April of 2004, for example, the district judge in *Grabow v. PricewaterhouseCoopers*, 313 F.Supp.2d 1152 (N.D.Okl. 2004), noted that SLUSA does not define “in connection with the purchase or sale” of securities. Because plaintiff’s claim dealt solely with holding securities, SLUSA did not apply, and the district court remanded the case. In *Grabow*, there were no allegations that the alleged fraud induced plaintiffs to buy or sell securities. The injury was alleged to have been caused *solely* by the inducement to “hold” securities. Hence, it was not what the courts refer to as a “mixed” or “hybrid” claim, that is, one where plaintiff alleges both a purchase and sale violation and, also, a holding-based violation. Specifically, the *Grabow* court, commenting on SLUSA, held:

Since SLUSA does not define the term “in connection with the purchase or sale” of a covered security, courts interpreting the term in SLUSA have consistently relied upon decisions interpreting the same term in section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j) and Securities Exchange Commission Rule 10b-5 (17 C.F.R. §240.10b-5). *See, e.g., Behlen v. Merrill Lynch*, 311 F.3d 1087, 1093 (11th Cir.2002). Where no purchase or sale of a security has been transacted by the claimant who seeks damages under section 10(b) or Rule 10b-5, the “in connection with” requirement is not met. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975). Hence, SLUSA does not preempt a state law claim where the plaintiff does not allege that defendant’s misrepresentations caused him or her to buy or sell a security. *See, e.g., Meyer v. Putnam Int’l Voyager Fund*, 220 F.R.D. 127 (D.Mass.2004); *Dacey v. Morgan Stan-*

ley Dean Witter & Co., 263 F.Supp.2d 706, 711 (S.D.N.Y.2003); *Shaev v. Claf-lin*, No. C 01-0009 MJJ, 2001 WL 548567 (N.D.Cal. May 17, 2001); *Gordon v. Buntrock*, No. 00 CV 303, 2000 WL 556763 (N.D.Ill. April 28, 2000). "SLUSA does not apply to claims dealing solely with the retention of securities, rather than with purchase or sale." *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1345 (11th Cir.2002).

*Id.* at 1154-55. [Emphasis in original.]

The *Grabow* court concluded:

Congress was aware of the Supreme Court's interpretation of §10(b) of the 1934 Act; nevertheless, Congress did not expand the scope of actions covered by SLUSA to holders of securities in addition to sellers and purchasers.... Although this Court recognizes that SLUSA is to be broadly applied... its language cannot be stretched to encompass the interpretation urged by defendant.

313 F.Supp.2d at 1157.

In June 2004, in *In re Alger, Columbia, Janus, MFS, One Group, Putnam Mut. Fund Litig.*, 320 F.Supp.2d 352 (D.Md. 2004), Judge Motz addressed the same issue in the Maryland Mutual Fund Multidistrict Litigation. Although Judge Motz deferred ruling on the issue, he observed that it was "reasonable and appropriate" for the courts to look to the Exchange Act to determine the meaning of "purchase or sale," and also to *Blue Chip Stamps*, which he noted was concerned with the "proliferation of securities litigation."

In 2002, in *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334 (11th Cir. 2002) the Eleventh Circuit wrote:

SLUSA does not define the term "in connection with the purchase or sale of a covered security." Nor has the Supreme Court yet had occasion to address this phrase in the context of SLUSA, although it has construed and applied the identical phrase as it appears in §10b-5. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975). As Performance Plan points out, however, one court of appeals and several

district courts have had an opportunity to construe the meaning of this phrase in SLUSA. See *Green v. Ameritrade, Inc.*, 279 F.3d 590, 597-98 (8th Cir.2002); *Shaev*, at 91456, 2001 WL 548567; *Gordon v. Buntrock*, No. 00 CV 303, 2000 WL 556763 (N.D.Ill. Apr.28, 2000) (unpublished opinion); *Shaw*, 128 F.Supp.2d at 1273-74; *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F.Supp.2d 584, 595 (W.D.Tex.2001); *Simon v. Inter-*

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*net Wire, Inc.*, Fed. Sec. L. Rep. P 91,408, 2001 WL 688542 (C.D.Cal. Apr.3, 2001); *Burns v. Prudential Sec.*, 116 F.Supp.2d 917, 922-23 (N.D.Ohio 2000). In interpreting this key term in SLUSA, each of these courts has looked, for guidance, to the law interpreting the same phrase, "in connection with the purchase or sale of a covered security," in the context of §10b-5. They have done so based on the principle that "[w]here Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms." *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329, 101 S.Ct. 2789, 69 L.Ed.2d 672 (1981).

*Id.* at 1342.

Plaintiffs can be expected to proffer cases like *Grabow* and *Alger*, and the circuit-level authorities upon which they rely, in support of their argument that Congress must have been aware of *Blue Chip Stamps* when the Reform Act was enacted, as it was when SLUSA was enacted. Because the Reform Act's drafters, like SLUSA's drafters, did not incorporate language extending application of the statute to "holders" of securities, persons defrauded into holding secu-

rities are free to pursue common law securities-based fraud claims, as plaintiffs opposing SLUSA removal have succeeded in having their "holding securities" claims remanded. In the RICO context, this means plaintiffs would be able to plead mail fraud violations predicated on efforts to fraudulently induce plaintiffs to hold their securities.

Defendants will argue that SLUSA and the RICO Amendment have different purposes.

The fact that SLUSA cases have relied on *Blue Chip Stamps* to interpret the phrase "purchase or sale" does not mean courts faced with RICO claims should look to *Blue Chip Stamps* to interpret the Amendment's use of the phrase "purchase or sale." SLUSA's removal remedy was intended to ensure that cases that should be in federal court end up there, where judges are more familiar with statutes, rules and legal precedent applicable to securities disputes, and where the Reform Act will be available to implement Congressional intent with respect to improperly pleaded securities fraud claims. The Amendment, on the other hand, was intended to stop plaintiffs from tacking RICO claims on to every garden variety investment dispute, including securities class claims. These claims massively complicated already difficult litigation, creating huge exposures in cases far removed from the prototypical cases RICO remedies were enacted to address. In light of the Amendment's purpose, defense counsel may argue it makes no sense to permit plaintiffs to deliberately craft pleadings so as to fail to state a claim under the securities laws, so that they can flood the state courts with RICO claims.

**Conclusions**

Given increased focus on the purchaser/seller rule in recent cases, including the multi-billion dollar Mutual Fund MDL, it seems likely that the "purchase or sale" debate is just beginning. From the defense perspective, the question is whether plaintiffs will be able to convince courts that Congress, in amending RICO, intended

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