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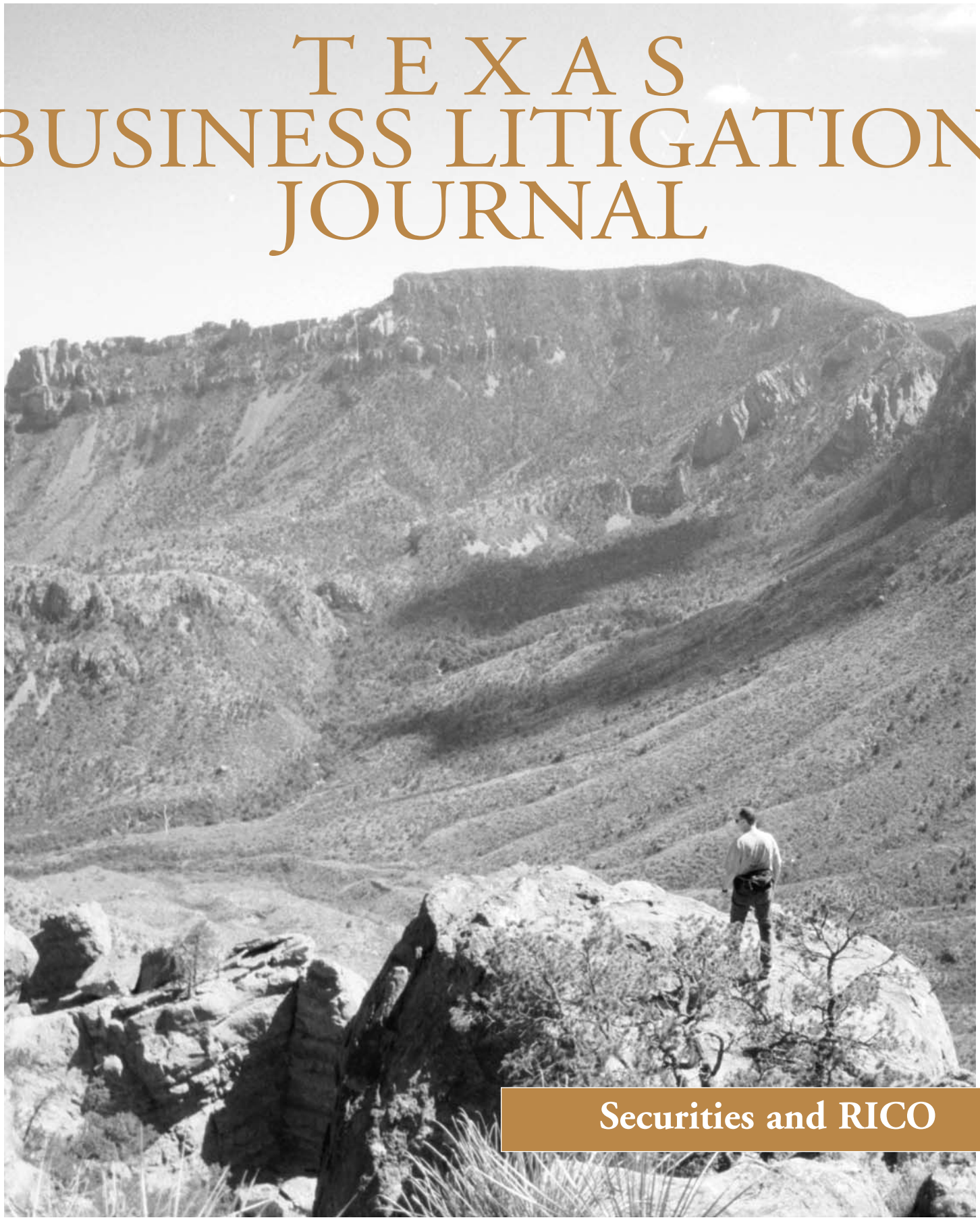

Securities and RICO

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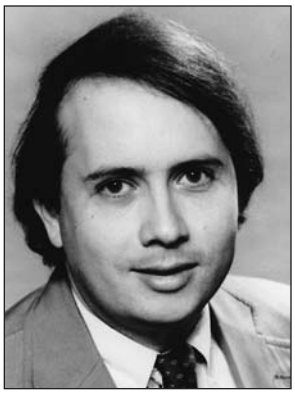
FROM ▪ THE ▪ EDITOR



This issue of the Journal features the annual survey article on securities litigation by Gerry Pecht and Peter Stokes, the annual survey of RICO developments by Randy Gordon and Sam Joyner and an article on arbitration by Andrew Wooley.

As always, we solicit written contributions. Anyone interested in contributing an article should contact me at 112 E. Pecan, Suite 1800, San Antonio, Texas 78205 (210) 554-5282; (210) 226-8395 (fax), amferril@coxsmith.com.

A. Michael Ferrill
Editor

Report from the Annual Meeting

New officers and council members were elected at the section's annual meeting at the State Bar. Officers for the 2006-07 year are as follows:

Justice Jim Moseley	Chair
Randy D. Gordon	Chair-Elect
William M. Katz, Jr.	Secretary/Treasurer
Leslie Sara Hyman	Assistant Secretary/Treasurer

Additionally, the following council members were elected for the 2006-2009 term:

Todd Murray	Dallas
Leslie Sara Hyman	San Antonio
Thomas Malone	Houston
Paul Genender	Dallas
Carrie Huff	Dallas

Fifth Circuit Securities Update

By By Gerard G. Pecht and Peter A. Stokes [1]

Gerard G. Pecht

Peter A. Stokes

Since the last survey period, the Fifth Circuit has addressed issues in securities law involving: (1) the pleading standards under the Private Securities Litigation Reform Act ("PSLRA"); (2) the propriety of class certification when the proposed class representative engages its own attorney who is paid by class counsel; (3) the loss causation requirement for sentencing criminal defendants in securities cases; (4) the qualifications required for National Association of Securities Dealers ("NASD") arbitrators; (5) the application of section 12(a)(2) of the Securities Act of 1933 to private placements; and (6) the standard of proof for fraud under the Texas Securities Act.

In *Financial Acquisition Partners, L.P. v. Blackwell*,[2] the Fifth Circuit reaffirmed the rigorous requirements for pleading a federal securities fraud claim under the PSLRA. The plaintiffs were investors in Amresco Inc., a publicly traded lending company that filed for bankruptcy in July 2001.[3] The complaint alleged that Amresco's officers and directors made false statements and material nondisclosures in the company's 2000 Form 10-K, which was filed approximately three months before the bankruptcy, and in other communications to investors, including statements allegedly made during a stockholders meeting.[4] After the plaintiffs had twice amended their complaint, the Northern District of Texas granted the defendants' motion to dismiss, struck the opinion portions of an expert affidavit that the plaintiffs had attached to the complaint, and denied further leave to amend.[5] The district court also rejected the plaintiffs' argument that the denial of the defendant's motion to dismiss in a parallel action pending in the Northern District of Oklahoma collaterally estopped the Northern District of Texas from dismissing the case.[6]

The Fifth Circuit affirmed the district court's judgment in its entirety. The court first observed that the Oklahoma court's ruling was based in part on the "group pleading" doctrine.[7] Because the Fifth Circuit has rejected group pleading as incompatible with the PSLRA,[8] the Oklahoma decision was grounded in a different legal standard and could not serve as a basis for collateral estoppel.[9] The Fifth Circuit also affirmed the district court's decision to strike the opinion portions of the expert affidavit, holding that "opinions cannot substitute for facts under the PSLRA."[10]

In affirming dismissal, the Fifth Circuit emphasized that the PSLRA "was enacted in response to an increase in securities fraud lawsuits perceived as frivolous" and "requires the complaint to specify each allegedly misleading statement and the reason why it is misleading; if an allegation is made on information and belief, the complaint must also state with particularity all facts on which the belief is formed."[11] Plaintiffs may not rely on "group pleading" and must instead "distinguish among defendants and allege the role of each."[12] "Corporate officers are *not* liable for acts solely because they are officers, even where their day-to-day involvement in the corporation is pleaded."[13] Instead, the complaint must allege that the individual defendants signed the documents containing the false statements or "allege adequately their involvement in creating the documents."[14]

The court also reiterated that the complaint must "plead specific facts establishing a strong inference of scienter."[15] The "mere allegation that the Individual Defendants were motivated by a desire to retain their jobs does *not* satisfy the scienter requirement."[16] Likewise, the "failure to follow accounting standards, without more, does not establish scienter."[17] In addition, while ordinarily a district court may only consider the complaint and its attachments on a motion to dismiss, the court may also rely on "public disclosure documents required by law to be, and that have been, filed with the SEC, and documents that the plaintiffs either possessed or knew about and upon which they relied in bringing the suit."[18]

Notably, the Fifth Circuit distinguished its prior holding in *Barrie v. Intervoice-Brite, Inc.*,[19] in which a different Fifth Circuit panel allowed a plaintiff to avoid the ban on group pleading by alleging that one defendant made a statement and the other defendant, knowing it was false, remained silent, even though the complaint did not specify which defendant made the statement and which remained silent.[20] By contrast, the *Financial Acquisition* panel reaffirmed the ban on

group pleading and held that the complaint must identify the speaker to satisfy the PSLRA.[21] Because the *Financial Acquisition* complaint merely alleged that an unspecified group of defendants made statements and did not identify which defendant(s) made a false statement and which defendant(s) remained silent, the case was subject to dismissal.[22] The court further held that "to the extent *Barrie* might be read to conflict with *Southland* and permit group pleading, *Southland* controls."[23] Accordingly, to the extent *Barrie's* "silent participation" exception is still good law after *Financial Acquisition*, the exception appears to be limited to situations where the complaint identifies precisely which defendants made the alleged false statements and which defendants remained silent.

In rejecting the plaintiffs' factual allegations as insufficient, the Fifth Circuit held that "Plaintiffs provide no specific facts either tying any of the Individual Defendants to [the company's SEC filings] they did not sign or demonstrating scienter for any filings they did sign."[24] Moreover, Amresco's Form 10-K expressly disclosed that the loans could be subject to different discount rates that could materially alter Amresco's financial results, which is precisely the risk that materialized.[25] While the complaint alleged in conclusory fashion that the defendants failed to disclose the implosion of a $50 million loan and the existence of a lucrative executive compensation plan, it failed to provide sufficient detail regarding either of these issues to demonstrate that any defendant had a duty to disclose these facts or acted with scienter.[26]

The plaintiffs also failed to plead sufficiently particularized facts demonstrating that the company's auditor acted with severe recklessness in declining to issue a "going concern" qualification pursuant to AICPA Code of Professional Standards section 341.06.[27] The court observed that an auditor is only required to issue a going concern qualification "if there is substantial doubt the entity will continue, and only after determining the company's plan to deal with its problems would be ineffective."[28] The complaint did not plead specific facts demonstrating that the auditor was severely reckless in determining that Amresco did not have a reasonable turnaround plan, thus requiring dismissal of the claims against the auditor.[29] Finally, the court affirmed the denial of plaintiffs' request for leave to amend, noting that they already had been given three opportunities to plead their claims.[30]

In *Feder v. Electronic Data Systems Corporation*,[31] the Fifth Circuit affirmed an order from the Eastern District of Texas certifying a nationwide class in a securities fraud case against EDS and appointing the Department of the Treasury of the State of New Jersey ("New Jersey") as the lead plaintiff.[32] The complaint alleged that EDS inflated its revenues by improperly using "percentage of completion" accounting to conceal problems with a $6.9 billion contract.[33] After EDS disclosed its revised earnings, the stock price declined by more than 50% in one day, with a total single-day market loss of $9.7 billion.[34]

On appeal, the defendants primarily challenged the fact that New Jersey had engaged its own private attorney, retired New Jersey Superior Court Judge C. Judson Hamlin, to oversee the litigation on New Jersey's behalf and to serve as liaison to outside class counsel.[35] Under Hamlin's engagement (which did not involve a contingent fee), Hamlin was paid by the outside class counsel, though New Jersey's Attorney General had to review and approve every invoice before Hamlin could receive payment.[36] The defendants asserted that this arrangement prevented New Jersey from adequately representing the class and created conflicts with other class members.

The Fifth Circuit rejected this argument and emphasized that its review of certification orders was limited to an abuse of discretion standard.[37] While the PSLRA "raises the standard adequacy threshold" for class representatives in securities actions, the deposition testimony of New Jersey's internal Attorney General employees demonstrated that they understood the factual basis and legal concepts underlying the complaint and exercised control over the litigation.[38] Moreover, while "class counsel cannot also serve as the class representative" due to potential conflicts with the class, the court found that Hamlin's engagement posed no potential conflicts because his "pay is not contingent on the outcome of the class action, nor is it contingent on any approval thereof by class counsel or on keeping class counsel happy."[39] The court also held that the benefits afforded to New Jersey as a result of Hamlin's engagement did not constitute a "payment for serving as a representative party" (as prohibited by the PSLRA), since Hamlin's compensation was "an open part of the general proposal process for all law firms seeking to represent New Jersey in securities class actions."[40]

The Fifth Circuit also rejected the defendants' remaining challenges to adequacy, typicality and superiority. While the defendants faulted New Jersey for failing to sue KPMG (which counted New Jersey as a client as well as EDS) and suggested that New Jersey was unwilling to name KPMG because of its business relationship with the state, the Fifth Circuit concluded that New Jersey "has no self-interest in appeasing KPMG" and had valid factual and tactical grounds for not naming KPMG as a defendant.[41]

The defendants also argued that New Jersey was subject to unique defenses because it purchased additional stock after the alleged fraud was disclosed and allegedly made poor investment decisions. The Fifth Circuit swept aside both of these theories, declaring that "[w]e reject the argument that a proposed class representative in a fraud-on-the-market securities suit is as a matter of law categorically precluded from meeting the requirements of Rule 23(a) simply because of a post-disclosure purchase of the defendant company's stock," and that even investors who mismanage their portfolios are "entitled to accurate information."[42] Finally, the court rejected the defendants' argument that New Jersey's failure to provide a trial plan was fatal to class certification, noting that the district court "carefully considered any possible difficulties in a trial on the alleged cause of action" before certifying the class.[43] Accordingly, the Fifth Circuit affirmed the trial court's certification order in its entirety.

In *United States v. Olis*,[44] the Fifth Circuit overturned the 24-year prison sentence handed down to former Dynegy attorney and accountant Jaime Olis for his participation in "Project Alpha," an alleged scheme through which Dynegy disguised a $300 million loan as proceeds from business operations. To accomplish the alleged scheme, the lending banks set up a special purpose entity ("SPE") that arranged to sell natural gas to Dynegy at below-market prices in 2001, with Dynegy repaying the loan by agreeing to buy gas from the SPE at above-market prices during 2002-2005.[45] Olis, along with his boss and one of his colleagues, allegedly made arrangements for secret "parent level" hedge and "tear-up" agreements between Dynegy, the SPE, and the banks to guarantee that the banks would not lose money, which should have prevented Dynegy from recognizing the $300 million as cash from operations.[46] Based on documentary evidence and the testimony of his co-conspirators (who received substantially shorter sentences), a jury in the Southern District of Texas convicted Olis of securities fraud, mail and wire fraud, and conspiracy.[47] The Fifth Circuit affirmed the conviction in its entirety, holding that there was "a wealth of evidence" connecting Olis to the fraud.[48]

The Fifth Circuit, however, vacated Olis's 292-month prison sentence in light of the Supreme Court's decision in *United States v. Booker*,[49] since the sentence was enhanced based on factors not proved to the jury beyond a reasonable doubt.[50] The most significant factor was the calculation of the loss to investors allegedly caused by Olis's conduct, given U.S. District Judge Simeon Lake III's finding that the alleged fraud caused a $105 million loss to a single investor (the University of California Retirement System, or "UCRS").[51] The Fifth Circuit observed that for criminal sentencing purposes, "actual loss" means "the reasonably foreseeable pecuniary harm that resulted from the offense" and incorporates a causation standard that, at a minimum, requires "factual causation" (*i.e.*, "but for" causation).[52] While the issue of loss causation in criminal sentencing has traditionally been less precise than in civil cases, the court held that the measure for loss causation in civil cases[53] "should be the backdrop for criminal responsibility both because it furnishes the standard of compensable injury for securities fraud victims and because it is attuned to stock market complexities."[54]

The court remanded Olis's case to the district court for resentencing on the issue of loss causation, noting that "a substantial portion" of UCRS's $105 million loss was unrelated to Olis's conduct. The evidence suggested that two-thirds of the loss occurred either before Project Alpha's problems were revealed to the market or more than a week after the resulting restatement.[55] In addition, there was evidence that Dynegy's stock price declined in tandem with the stocks of other energy trading firms, thus suggesting that the loss resulted from an industry-wide downturn rather than Project Alpha itself.[56] Accordingly, the Fifth Circuit vacated Olis's sentence and ordered Judge Lake to "take into account the impact of extrinsic factors on Dynegy's stock price decline" when he is resentenced this September.[57] Olis still faces a lengthy sentence, however, as the Fifth Circuit affirmed Judge Lake's findings as to the other sentencing enhancements (*i.e.*, that Olis used "sophisticated means" and "special skill" to commit fraud, and that his crimes harmed more than 50 investors).[58]

In *Bulko v. Morgan Stanley DW Inc.*,[59] the Fifth Circuit reversed a decision by the Northern District of Texas to overturn an NASD arbitration award based on alleged irregularities in the selection of the non-public arbitrator. Bulko initiated the arbitration after suffering approximately $16 million in stock market losses during a span of 14 months.[60] Pursuant to NASD rules, the arbitration was heard by a panel consisting of two "public" and one "non-public" arbitrators.[61] The NASD Code of Arbitration Procedures defined "non-public arbitrator" as "an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged" in the securities industry.[62]

After the arbitration panel rejected Bulko's claims against Morgan Stanley, Bulko contested the award in federal court, asserting that the arbitration panel acted outside the scope of its authority because the non-public arbitrator did not meet the NASD Code's requirements.[63] Specifically, Bulko alleged that while the arbitrator had practiced securities law since 1988, she had taken inactive status with the Texas State Bar in 1999, which in Bulko's view rendered her unfit to serve as a non-public arbitrator at the time of the arbitration in 2003.[64] The Fifth Circuit rejected this argument, noting that the arbitrator continued to serve in an "of counsel" capacity with her firm until 2003.[65] Because the NASD Code definition of "non-public arbitrator" is not limited to practicing attorneys and includes "other professional[s]," and because the definition of "attorney" encompasses "more than practicing law," the Fifth Circuit held that the arbitrator's alleged inactive status did not disqualify her from serving as a non-public arbitrator.[66] At most, her selection was a "trivial departure not warranting vacatur," since she clearly "fulfilled the purpose of a non-public arbitrator, which is to serve as an industry insider on the arbitration panel."[67] Accordingly, the Fifth Circuit reversed and rendered judgment in favor of Morgan Stanley.

In *Holland v. GEXA Corp.*,[68] the Fifth Circuit issued an unpublished *per curiam* opinion affirming the dismissal of an individual plaintiff's securities fraud action filed against GEXA Corporation in the Western District of Texas. The court held that the plaintiff lacked standing under Rule 10b-5 because he was "neither a purchaser nor seller of securities in connection with the subject stock exchange" and merely asserted a claim for "dilution of shareholder's equity," which is inadequate to confer standing.[69] In addition, the complaint failed to allege the purchase price that Holland paid for his stock or that the alleged misrepresentations caused his stock to lose value, since the alleged fraud occurred after Holland had already purchased his securities.[70] The court also affirmed dismissal of Holland's purported shareholder derivative claim, holding that it was not pled with particularity.[71]

Holland's remaining claims fared no better. The Fifth Circuit affirmed dismissal of his claim under section 12(a)(2) of the Securities Act of 1933 (the "Securities Act") because the allegation was based on "allegedly fraudulent *private placement memoranda*," not a public prospectus as required by section 12(a)(2), and because Holland failed to plead reliance.[72] "To the extent that Holland claims the private placement memoranda were unlawful because the offerings should have been made through a registered prospectus, his actual claim would be under Section 12(a)(1), which provides for rescission of sales of securities improperly accomplished without registration."[73] Finally, the Fifth Circuit affirmed the district court's decision to decline supplemental jurisdiction over the pendant state law claims, given that no viable federal claim existed.[74]

In *Gonzalez v. Morgan Stanley Dean Witter, Inc.*,[75] the Fifth Circuit affirmed a judgment as a matter of law ("JMOL") in favor of Morgan Stanley Dean Witter in a fraud case brought by a Morgan Stanley customer in the Western District of Texas. Ramon Gonzalez, Jr. asserted claims under section 33 of the Texas Securities Act and for common law fraud, contending that the defendants mismanaged his account and made misrepresentations.[76] After Gonzalez presented his case to the jury, the trial court granted JMOL for the defendants, holding that there was no legally sufficient basis for a reasonable jury to find in favor of Gonzalez on his fraud claim.[77] The Fifth Circuit affirmed in an unpublished *per curiam* opinion, noting that Gonzalez had a nondiscretionary account and, together with his wife, assessed each of Morgan Stanley's recommendations before making their own investment decisions.[78] The court concluded that Gonzalez had failed to present more than a scintilla of evidence that the defendants made a fraudulent misrepresentation and affirmed the trial court's judgment in its entirety.[79]

ENDNOTES

1 Gerard Pecht is a partner in the Houston office of Fulbright & Jaworski L.L.P., and Peter Stokes is a senior associate in the Austin office of Fulbright & Jaworski, L.L.P.

2 440 F.3d 278 (5th Cir. 2006).

3 *Id.* at 282.

4 *Id.* at 283.

5 *Id.* at 284.

6 *Id.*

7 *Id.* at 284-85.

8 *See* Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 363 (5th Cir. 2004).

9 440 F.3d at 285.

10 *Id.* at 285-86.

11 *Id.* at 287 (internal citations and quotation marks omitted).

12 *Id.* (internal citations and quotation marks omitted).

13 *Id.* (emphasis in original).

14 *Id.*

15 *Id.*

16 *Id.* at 290 (emphasis in original).

17 *Id.* at 290.

18 *Id.* at 286.

19 397 F.3d 249 (5th Cir. 2005).

20 *Id.* at 263.

21 440 F.3d at 288.

22 *Id.*

23 *Id.*

24 *Id.*

25 *Id.* at 288-89.

26 *Id.* at 289.

27 *Id.* at 290.

28 *Id.* at 290-91.

29 *Id.* at 291.

30 *Id.* at 291-92.

31 429 F.3d 125 (5th Cir. 2005).

32 *Id.* at 128-29.

33 *Id.* at 128.

34 *Id.*

35 *Id.* at 128.

36 *Id.* at 133.

37 *Id.* at 129.

38 *Id.* at 131-32.

39 *Id.* at 133.

40 *Id.* at 134. The court also rejected the defendants' argument that New Jersey had conflicts with class members who were also participants in an ERISA class action against the same defendants with a different theory of damages, holding that the damage theories of the two actions were complementary, not contradictory. *See id.* at 135-36.

41 *Id.* at 135-36.

42 *Id.* at 138-39.

43 *Id.* at 139-40.

44 429 F.3d 540 (5th Cir. 2005), later proceeding at 2006 U.S. App. LEXIS 12591 (5th Cir. May 22, 2006).

45 *Id.* at 541-42.

46 *Id.* at 542.

47 *Id.* at 542-43.

48 *Id.* at 543.

49 543 U.S. 220, 125 S. Ct. 738, 756, 160 L. Ed. 2d 621 (2005.

50 *Id.* at 544-45.

51 *Id.* at 542.

52 *Id.* at 545.

53 *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 125 S Ct. 1627, 1631-32, 161 L. Ed. 2d 577 (2005).

54 429 F.3d at 546.

55 *Id.* at 548.

56 *Id.* It was also suggested that the demise of Dynegy's attempt to acquire Enron may have also contributed to the loss.

57 *Id.* at 548-49.

58 *Id.* at 549. In a subsequent proceeding, the Fifth Circuit rejected Olis's request to be released on bond pending resentencing, noting that Olis would still face an imprisonment range of 97 to 121 months even if the court attributed only one percent of the total stock price decline to Project Alpha. *See* United States v. Olis, No. 06-20103, 2006 U.S. App. LEXIS 12591, at *9(5th Cir. May 22, 2006).

59 __ F.3d __, No. 05-10242, 2006 U.S. App. LEXIS 13322 (5th Cir. May 30, 2006).

60 2006 U.S. App. LEXIS 13322, at *2.

61 *Id.*

62 *Id.*

63 *Id.* at *3-4.

64 *Id.* at *3.

65 *Id.* at *5, 9-11.

66 *Id.* at *9.

67 *Id.* at *10-11.

68 161 Fed. Appx. 364 (5th Cir. Dec. 30, 2005).

69 *Id.* at 365.

70 *Id.*

71 *Id.* at 366.

72 *Id.*

73 *Id.*

74 *Id.*

75 No. 05-50325, 2006 U.S. App. LEXIS 17317 (5th Cir. July 11, 2006).

76 *Id.* at *1-2; *see also* Gonzalez v. Morgan Stanley Dean Witter, Inc., No. SA-03-CA-901-H, 2004 U.S. Dist. LEXIS 26709, at *2-3 (W.D. Tex. July 13, 2004).

77 2006 U.S. App. LEXIS 17317, at *2.

78 *Id.* at *3.

79 *Id.* at *3-4.

Annual RICO Update

By Randy D. Gordon and Samuel E. Joyner[1]

Randy D. Gordon

Samuel E. Joyner

After *Sandwich Chef of Texas, Inc. v. Reliance National Indemnity Insurance Co.*,[2] civil RICO actions within the Fifth Circuit have slowed to a trickle. None of the reported opinions issued during the last year—all of which are from district courts—expand in any significant way the corpus of RICO law in this circuit. The same cannot be said, however, of a recent United States Supreme Court opinion.

Anza v. Ideal Steel Supply Corporation

In June 2006, the Supreme Court issued an opinion that has the potential to severely narrow the category of plaintiffs eligible to bring civil RICO actions. In *Anza v. Ideal Steel Supply Corporation*,[3] the Court considered whether a competitor is "injured in his business or property by reason of a violation"[4] of the Racketeer Influenced and Corrupt Organizations statute where the alleged predicate acts of racketeering activity were mail and wire fraud but the competitor was not the party defrauded and did not rely on the alleged fraudulent behavior. Expanding on its holding in *Holmes v. Securities Investor Protection Corporation*,[5] the Court answered the question in the negative.[6]

Ideal Steel Supply Corporation sued its chief competitor, National Steel Supply, Inc., and National's owners and operators, Joseph and Vincent Anza, alleging that National failed to charge New York's sales tax to cash-paying customers and thus allowed it to reduce its prices without affecting its profit margin. Further, National allegedly submitted fraudulent state sales tax reports that intentionally omitted information concerning National's cash transactions. Ideal asserted two RICO claims. First, Ideal claimed that, by submitting fraudulent tax returns to conceal its conduct, National committed various acts of mail and wire fraud that violated section 1962(c) of the RICO statute, which forbids conducting or participating in the conduct of an enterprise's affairs through a pattern of racketeering activity. Ideal alleged that, under section 1964(c), it was injured "by reason of" National's scheme to avoid state sales taxes and gain a competitive advantage over Ideal. Second, Ideal brought a claim under section 1962(a), alleging that National had earned profits by its "cash, no tax"[7] scheme and used the profits to open an outlet in close proximity to Ideal's sales facility. Section 1962(a) makes it unlawful for any person who has received income derived from a pattern of racketeering activity "to use or invest" that income "in acquisition of any interest in, or the establishment or operation of," an enterprise engaged in or affecting interstate of foreign commerce.[8] According to Ideal, the opening of National's new facility caused Ideal to lose "significant business and market share."[9]

National moved to dismiss Ideal's complaint. Because Ideal did not rely on National's fraudulent sales tax reports, the district court concluded that Ideal could not satisfy RICO's causation requirement that a plaintiff be injured "by reason of" National's alleged RICO violation. Ideal's action was thus dismissed.[10]

Ideal appealed, and the Second Circuit vacated the judgment. Regarding Ideal's section 1962(c) claim, the Second Circuit "held that where a complaint alleges a pattern of racketeering activity 'that was intended to and did give the defendants a competitive advantage over the plaintiff, the complaint adequately pleads proximate cause, and the plaintiff has standing to pursue a civil RICO claim.'"[11] According to the Second Circuit, this is the case "even where the scheme depended on fraudulent communications directed to and relied on by a third party rather than the plaintiff."[12] The Second Circuit reached the same conclusion with respect to Ideal's section 1962(a) claim. Here, it reasoned that Ideal adequately pleaded its claim because it alleged an injury by reason of National's use and investment of racketeering proceeds, "as distinct from injury traceable simply to the predicate acts of racketeering alone or to the conduct of the business of the enterprise."[13] National appealed the decision.

Section 1962(c) claim rejected: Harm Ideal suffered from National's alleged actions was too indirect to support such a claim.

Applying the principles of *Holmes*, the Supreme Court concluded that Ideal could not

maintain its section 1962(c) claim. The Court explained that "the compensable injury flowing from a violation of that provision 'necessarily is the harm caused by predicate acts sufficiently related to constitute a pattern, for the essence of the violation is the commission of those acts in connection with the conduct of an enterprise.'"[14] Here, Ideal alleged that the Anzas conducted National's affairs through a pattern of mail fraud and wire fraud. According to the Court, "[t]he direct victim of this conduct was the State of New York, not Ideal. It was the State that was being defrauded and the State that lost tax revenue as a result."[15] The Court found that while "Ideal assert[ed] it suffered its own harms when [National] failed to charge customers for the applicable sales tax . . . [t]he cause of Ideal's asserted harms . . . is a set of actions (offering lower prices) entirely distinct from the alleged RICO violation (defrauding the State)."[16]

In contemplating the directness requirement's underlying premises, the Supreme Court identified several factors that reinforced its conclusion. First, the Court noted the difficulty that can arise "when a court attempts to ascertain the damages caused by some remote action."[17] For example, the Court explained that while "[t]he injury Ideal alleges is its own loss of sales resulting from National's decreased prices for cash-paying customers," National "could have lowered its prices for any number of reasons unconnected to the asserted pattern of fraud."[18] Additionally, "Ideal's lost sales could have resulted from factors other than [National's] alleged acts of fraud."[19] Second, the attenuated connection between Ideal's injury and National's injurious conduct implicates fundamental concerns expressed in *Holmes*. In particular, the Court noted "the speculative nature of the proceeding that would follow if Ideal were permitted to maintain its claim."[20] A district court would need to calculate that portion of National's price drop attributable to the alleged pattern of racketeering activity and then determine the portion of Ideal's lost sales attributable to the relevant part of the price drop. According to the Court, "[t]he element of proximate causation recognized in *Holmes* is meant to prevent these types of intricate, uncertain inquiries from overrunning RICO litigation."[21] Third, "the immediate victims of an alleged RICO violation can be expected to vindicate the laws by pursuing their own claims."[22] In this instance, if Ideal's allegations were true, the State of New York could "be expected to pursue appropriate remedies."[23] According to the Court, there was "no need to broaden the universe of actionable harms to permit RICO suits by parties who have been injured only indirectly."[24]

To be certain, the Supreme Court expressly rejected the Second Circuit's contrary conclusion—*i.e.*, "reasoning that because [National] allegedly sought to gain a competitive advantage over Ideal, it was immaterial whether they took an indirect route to accomplish [its] goal."[25] Writing for a seven-member majority, Justice Kennedy declared:

> This rationale does not accord with *Holmes*. A RICO plaintiff cannot circumvent the proximate-cause requirement simply by claiming that the defendant's aim was to increase market share at a competitor's expense. When a court evaluates a RICO claim for proximate causation, the central question it must ask is whether the alleged violation led directly to the plaintiff's injury. In the instant case, the answer is no.[26]

The Court thus rejected Ideal's section 1962(c) claim, holding that any harm Ideal suffered from National's alleged actions was too indirect to support such a claim.

Section 1962(a) claim vacated: Second Circuit failed to address proximate causation.

Next, the Supreme Court vacated the Second Circuit's judgment with respect to Ideal's section 1962(a) claim. This claim, as described above, alleged that National's tax scheme provided it with funds to open a new store that attracted customers who otherwise would have purchased from Ideal. Without addressing section 1964(c) causation, the Second Circuit held that this claim was adequately pleaded. The Supreme Court refused, however, to consider Ideal's section 1962(a) claim "without the benefit of the Court of Appeals' analysis"[27] regarding whether National's alleged RICO violation proximately caused the injuries Ideal asserted.

***Anza* will preclude recovery in many civil RICO actions.**

Demonstrating the breath of *Anza*, the Supreme Court, in another argued case last term, ordered the Eleventh Circuit to reconsider the case of *Williams v. Mohawk Industries*.[28] In *Williams*, several employees filed a class action complaint alleging that Mohawk, the second largest carpet and rug manufacturer in the United States, had conspired with recruiting agencies to hire and harbor illegal workers "in an effort to keep labor costs as low as possible,"[29] in violation of the RICO statute.[30] The employees alleged that Mohawk was part of a separate RICO "enterprise" made up of a combination of the employer plus recruiting agencies with the common purpose of hiring and harboring illegal workers. The district court denied Mohawk's motion to dismiss the section 1962(c) claim, and the Eleventh Circuit affirmed, concluding that the "enterprise" was the association-in-fact between Mohawk and the third-party recruiters. The Eleventh Circuit also concluded that the employees had sufficiently alleged proximate cause.

The Supreme Court granted certiorari to hear only one of the two questions presented—*i.e.*, whether RICO applies to a corporation and agents that work for it on the theory they were part of a racketeering enterprise.[31] The Court refused to address the question concerning proximate causation—*i.e.*, "whether [the employees] state proximately caused injuries to business or property by alleging that the hourly wages they voluntarily accepted were too low."[32] In a *per curiam* decision issued the same day as *Anza*, the Court dismissed its grant of review on the definition of enterprise under RICO as "improvidently granted," and ordered the Eleventh Circuit to reconsider the case in light of *Anza*.[33]

Anza clarifies prior Supreme Court precedent requiring that a plaintiff be directly injured by the alleged RICO predicate acts. It is noteworthy that *Anza* came before the Court on an appeal of the district court's grant of National's motion to dismiss. This is good news for the defense bar: where a plaintiff is only indirectly injured by alleged predicate acts, the *Anza* decision will defeat a RICO claim during the motion to dismiss stage of the litigation.

Recent Fifth Circuit Opinions

As in previous years, we have categorized the reported opinions from the Fifth Circuit under the specific RICO elements to which those opinions provide further clarification.[34] To this end, we examine those opinions addressing predicate acts and then section 1962 violations and their constituent elements. At the outset, we identify the first opinion within the Fifth Circuit to dismiss a civil RICO claim relying on *Anza*.

Section 1964(c)—Injury to business or property by reason of prohibited conduct

Where the cause of plaintiff's asserted injury (*i.e.*, competitor charges lower prices) was distinct from the alleged RICO violations (*i.e.*, competitor is operating without a required license), plaintiff could not meet the proximate-cause requirement. *Downstream Env't, LLC v. Gulf Coast Waste Disposal Auth.*, No. H-05-1865, 2006 WL 1875959, at *7 (S.D. Tex. July 5, 2006) (relying on *Anza*).

Predicate Acts

For a complaint adequately to allege mail fraud as predicate acts, it must contain allegations of facts establishing that the mailings were made with the intent to defraud. *Shawver v. Mann Bracken, LLC*, No. 4:05-CV-378-A, 2005 U.S. Dist. LEXIS 22975, at **7-8 (N.D. Tex. Oct. 6, 2005).

No pattern of racketeering activity exists where predicate acts (*i.e.*, issuance of three debt-collection letters) constituted part and parcel of a single lawful endeavor (*i.e.*, collection of debt). *Shawver*, 2005 U.S. Dist. LEXIS 22975, at *8.

No pattern of racketeering activity exists when plaintiff fails to provide any specifics regarding alleged fraud or how such representations were made. *FMC Int'l A.G. v. ABB Lummus Global, Inc.*, No. Civ.A. H-04-3896, 2006 WL 213948, at **8-9 (S.D. Tex. Jan. 25, 2006).

Section 1962(c)—Conduct of an enterprise through a pattern of racketeering

Enterprise-Person Distinction

Where plaintiffs' allegations demonstrated that there was no distinction between the purported RICO enterprise and the RICO persons, complaint failed to state a viable RICO claim. *FMC Int'l A.G.*, 2006 WL 213948, at *9.

Enterprise-Racketeering Activity Distinction

Where the sole, discrete goal of association was to engage in fraudulent activity, plaintiff could not establish that the association was a RICO enterprise because the enterprise did not exist as an entity separate and apart from the pattern of illegal activity. *Clark v. Nat'l Equities Holding, Inc.*, No. 4:05-CV-290, 2006 WL 335577, at *6 (E.D. Tex. Feb. 13, 2006).

ENDNOTES

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2 319 F.3d 205 (5th Cir. 2003).

3 126 S. Ct. 1991 (2006).

4 18 U.S.C. § 1964(c).

5 503 U.S. 258, 268 (1992) (holding that a plaintiff may sue under section 1964(c) of the RICO statute only if the alleged RICO violation was the proximate cause of the plaintiff's injury).

6 *Anza*, 126 S. Ct. at 1998.

7 *Ideal Steel Supply Corp. v. Anza*, 373 F.3d 251, 254 (2d Cir. 2004).

8 18 U.S.C. § 1962(a).

9 *Anza*, 126 S. Ct. at 1995.

10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.* at 1996.

15 *Id.* at 1997.

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.*

20 *Id.* at 1998.

21 *Id.*

22 *Id.*

23 *Id.*

24 *Id.*

25 *Id.*

26 *Id.* (internal citation omitted).

27 *Id.* at 1999.

28 *See Mohawk Industries, Inc. v. Williams*, 126 S. Ct. 2016, 2016 (2006) (per curiam).

29 *Williams v. Mohawk Industries, Inc.*, 411 F.3d 1252, 1261 (11th Cir. 2005).

30 *Id.* at 1255.

31 *Mohawk Industries, Inc. v. Williams*, 126 S. Ct. 830, 830 (2005).

32 *Mohawk Industries, Inc.'s Petition for a Writ of Certiorari*, No. 05-465, 2005 WL 2566486, at *1 (Oct. 7, 2005).

33 *Mohawk Industries, Inc.*, 126 S. Ct. at 2016.

34 The individual elements of section 1962 are catalogued in "Parsing Civil RICO," which appeared in the Fall 2001 issue of this publication. It is available at www.texbuslit.org/members/newsletter.

Is Temporary Judicial Relief Available Ancillary to Arbitration?

By: Andrew Wooley[1]

The United States Supreme Court and the Supreme Court of Texas have endorsed arbitration as a preferred means for resolving disputes.[2] Not only do banks, credit card issuers, brokerage firms, automobile manufacturers, residential homebuilders, and mobile home manufacturers, to name just a few, often include arbitration provisions in their agreements with customers today, employers are increasingly doing the same with their employees.[3] The growing number of relationships subject to arbitration will inevitably lead to an increase in both the number of disputes arbitrated and the instances in which a party to an arbitration agreement desires temporary emergency relief from a court to preserve the status quo pending arbitration.

A party to an arbitration agreement who seeks temporary emergency relief from a court usually does so without initiating arbitration or simultaneously with its commencement,[4] and the opposing party typically responds with a motion to dismiss the lawsuit or to stay it and compel arbitration.[5] In such circumstances, a court must initially determine whether there is an enforceable agreement to arbitrate that encompasses the dispute.[6] If the court determines there is, then the court must decide what law governs the agreement[7] and summarily decide the motion to compel arbitration.[8] Whether the court can also grant temporary injunctive relief depends on the wording of the arbitration agreement and the applicable law.[9]

Section 3 of the Federal Arbitration Act ("FAA")[10] requires courts to "stay the trial" of all issues referable to arbitration if requested by one of the parties to an arbitration subject to the FAA.[11] This federal command has been construed to include an application for preliminary injunction: "[T]he issuance of a preliminary injunction is not appropriate when the underlying claims are subject to arbitration under the FAA."[12] The courts of appeals in Houston and San Antonio have applied this construction,[13] as have federal district courts in Texas.[14] And the Beaumont Court of Appeals relied in part on section 3 of the FAA for its holding that a trial court abused its discretion by ordering parties to mediation before ruling on a plea in abatement and motion to enforce an agreement to arbitrate.[15]

The FAA applies to all written arbitration provisions in contracts "evidencing a transaction involving commerce,"[16] a phrase the United States Supreme Court has construed as reaching to the full limits of the Commerce Clause of the United States Constitution.[17] The Supreme Court of Texas has similarly acknowledged that the FAA extends to "any contract affecting commerce, as far as the Commerce Clause of the United States Constitution will reach,"[18] and has held that the FAA is itself part of the substantive law of Texas.[19]

Very recently, the Supreme Court of Texas took pains to clarify that an agreement to arbitrate may be subject to both the FAA and the TAA, because the FAA only preempts contrary state law.[20] Even in that joint-applicability circumstance, however, any provision of the TAA construed in a manner to circumvent the FAA's "stay the trial" requirement would be preempted because such a provision would undeniably "affect the enforceability" of the parties' agreement to arbitrate under the FAA.[21]

The Fifth Circuit recognizes an exception to the prohibition against pre-arbitration temporary injunctive relief if the parties to an agreement to arbitrate have expressly agreed in their arbitration provision to maintain the status quo pending arbitration,[22] and federal district courts in Texas have held accordingly.[23] The courts of appeals in *Metra United Escalante* and *Feldman/Matz Interests* noted the exception recognized by the Fifth Circuit,[24] but no reported Texas appellate decision has affirmed a temporary injunction based on the exception.

All Texas decisions thus far holding that courts may not award temporary judicial relief ancillary to arbitration have based their holdings on section 3 of the FAA.[25] But at least two courts of appeals have construed the "summarily determine" and "stay" requirements found in section 171.021 of the TAA to be the functional equivalent of the "stay the trial" requirement contained in section 3 of the FAA. The Houston First Court of Appeals cited section 171.021's "summarily determine" requirement as the basis for holding that the trial court in *In re MHI Partnership, Ltd.*, had abused its discretion by refusing to rule on a motion to compel arbitration until after completion of discovery.[26] More recently, the Eastland Court of Appeals held in *In re Champion Technologies, Inc.*, that a trial court's

decision not to rule on a motion to compel arbitration until after completion of discovery was an abuse of discretion, citing *MHI* and section 171.021 of the TAA as authority for its holding.[27]

Even though the agreement in *Champion Technologies* was expressly subject to the FAA and some of the multiple agreements involved in *MHI* invoked the FAA,[28] section 3 of the FAA is not mentioned in either opinion, and the holdings in both cases are based entirely on section 171.021 of the TAA.[29] But the court of appeals in *MHI* certainly recognized the similarity of purpose expressed in section 171.021 of the TAA and sections 3 and 4 of the FAA. It compared the requirements in section 4 of the FAA with those in section 171.021 of the TAA, and cited and quoted from *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. McCollum*,[30] where the court of appeals affirmed a trial court's denial of a request for temporary injunction based on section 3 of the FAA. "[O]nce arbitration is started, it should 'be speedy and not subject to delay and obstruction in the courts.'"[31]

Conclusion

If an agreement to arbitrate does not provide for maintaining the status quo pending arbitration and is subject to the FAA, then pre-arbitration temporary injunctive relief is probably not available from a federal court in Texas or a Texas state court disposed to follow the court of appeals precedents discussed above. Furthermore, the holdings in *MHI* and *Champion Technologies* may presage difficulty even for a party seeking an injunction ancillary to an agreement subject only to the TAA.

ENDNOTES

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2 *See, e.g.*, Moses H. Cone Mem. Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24-15 (1983); In re Kellogg, Brown & Root, Inc., 166 S.W.3d 732, 737 (Tex. 2005).

3 *See, e.g.*, In re Dallas Peterbilt, Ltd., 49 Tex. Sup. Ct. J. 759, 2006 WL 1651694 (Tex. June 16, 2006) (per curiam); In re Dillard Dep't Stores, Inc., 49 Tex. Sup. Ct. J. 411, 2006 WL 508629 (Tex. Mar. 3, 2006); EZ Pawn Corp. v. Mancias, 934 S.W.2d 87 (Tex. 1996).

4 *See, e.g.*, Feldman/Matz Interests, L.L.P. v. Settlement Capital Corp., 140 S.W.3d 879, 882 (Tex. App. — Houston [14th Dist.] 2004, no pet.).

5 *Id.*

6 In making the determination, both federal and Texas courts apply state contract law principles. *See, e.g.*, Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681, 686-87 (1996); Wash. Mut. Fin. Group, LLC v. Bailey, 364 F.3d 260, 264 (5th Cir. 2004); In re Kellogg Brown & Root, Inc., 166 S.W.3d 732, 738 (Tex. 2005).

7 *See, e.g.*, Jack B. Anglin Co. v. Tipps, 842 S.W.2d 266, 269-70 (Tex. 1992). Federal and Texas courts apply their own procedural law to determine whether an agreement is subject to the FAA. *See, e.g.*, Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 273-74 (1995); *Anglin*, 842 S.W.2d at 268. And if the FAA is determined to apply, both assess the scope of the agreement pursuant to federal law, Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 US. 1, 24 (1983); In re Weekley Homes, 180 S.W.3d 127, 130 (Tex. 2005) (citing *Cone*), with any doubts resolved in favor of arbitration. Prudential Sec. Inc. v. Marshall, 909 S.W.2d 896, 899 (Tex. 1995) (citing *Cone*, 460 U.S. at 24-25).

8 *See, e.g.*, ASW Allstate Painting & Constr. Co. v. Lexington Ins. Co., 188 F.3d 307, 311 (5th Cir. 1999) (TAA); Smith v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 575 F. Supp. 904, 905 (N.D. Tex. 1983) (FAA); *Anglin*, 842 S.W.2d at 269 (FAA); In re MHI Partnership, Ltd., 7 S.W.3d 918, 921-23 (Tex. App. — Houston [1st Dist.] 1999, orig. proceeding) (FAA & TAA); Cf. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 403-04 (1967); Primerica Life Ins. Co. v. Brown, 304 F.3d 469, 471-72 (5th Cir. 2002).

9 *See* RGI, Inc. v. Tucker & Assocs., Inc., 858 F.2d 227, 230 (5th Cir. 1988); Metra United Escalante, L.P. v. Lynd Co., 158 S.W.3d 535, 540 (Tex. App. — San Antonio 2004, no pet.).

10 9 U.S.C.A. §§ 1-16 (1999 & Supp. 2006).

11 9 U.S.C.A. § 3 (1999).

12 Metra United Escalante, L.P. v. Lynd Co., 158 S.W.3d 535, 540 (Tex. App. — San Antonio 2004, no pet.) (citing *Feldman/Matz Interests*, 140 S.W.3d at 885-87)

13 *See, e.g., id.* at 540; *Feldman/Matz Interests*, 140 S.W.3d at 885-87; Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Maghsoudi, 682 S.W.2d 593, 594-95 (Tex. App. — Houston [1st Dist.] 1984, no writ). *Accord* Galtney v. Underwood Neuhaus & Co., 700 S.W.2d 602, 603-04 (Tex. App. — Houston [14th Dist.] 1985, no writ), *appeal dismissed per stipulation*, No. B14-85-397-CV, 1985 WL 668968 (Tex. App. — Houston [14th Dist.], Oct. 31, 1985) (not designated for publication); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. McCollum, 666 S.W.2d 604, 608 (Tex. App. — Houston [14th Dist.] 1984, writ ref'd n.r.e.), *cert. denied*, 469 U.S. 1127 (1985).

14 Smith v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 575 F. Supp. 904, 905 (N.D. Tex. 1983); Kellogg Brown & Root Int'l, Inc. v. Qatar Chem. Co., No. H-03-3337, slip op. at 11 (S.D. Tex. Sept. 1, 2003). *But see* Ruscitto v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 777 F. Supp. 1349, 1353 (N.D. Tex. 1991), *aff'd*, 948 F.2d 1286 (5th Cir. 1991) (unpublished table decision).

15 In re Heritage Building Systems, Inc., 185 S.W.3d 539, 542-43 (Tex. App. — Beaumont 2006, orig. proceeding).

16 9 U.S.C.A. § 2 (1999).

17 Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 274-77 (1995).

18 In re L & L Kempwood Assocs., L.P., 9 S.W.3d 125, 127 (Tex. 1999) (per curiam).

19 Capital Income Props. v. Blackmon, 843 S.W.2d 22, 23 (Tex. 1992) (per curiam). Faced with these expansive holdings, at least one Texas court of appeals has stated that "[f]or the FAA not to apply, an agreement must specifically exclude the application of federal law." Am. Med. Techs., Inc. v. Miller, 149 S.W.3d 265, 269 (Tex. App. — Houston [14th Dist.] 2004, orig. proceeding) (citing *L & L Kempwood Assocs.*, 9 S.W.3d at 127-28).

20 In re D. Wilson Constr. Co., 49 Tex. Sup. Ct. J. 909, 2006 WL 1792021, at *3 (Tex. June 30, 2006).

21 *Id.*

22 RGI, Inc. v. Tucker & Assocs., Inc., 858 F.2d 227, 230 (5th Cir. 1988).

23 *See, e.g.*, Positive Software Solutions, Inc. v. New Century Mortgage Corp., 259 F. Supp. 2d 531, 534 n.4 (N.D. Tex. 2003), *appeal dismissed*, No. 03-10585, 2004 WL 249595, at *730 (5th Cir. Feb. 10, 2004); Kellogg

Brown & Root Int'l, Inc. v. Qatar Chem. Co., No. H-03-3337, slip op. at 11 (S.D. Tex. Sept. 1, 2003); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Chapman, No. Civ.A.3:98-CV-1615D, 1998 WL 792501, at *2 (N.D. Tex. Nov. 3, 1998).

24 *Metra United Escalante*, 158 S.W.3d at 539-40; *Feldman/Matz Interests*, 140 S.W.3d at 88587.

25 *See* cases cited *supra* note 12.

26 In re MHI Partnership, Ltd., 7 S.W.3d 918, 921-23 (Tex. App. — Houston [1st Dist.] 1999, orig. proceeding).

27 173 S.W.3d 595, 598-99 (Tex. App. — Eastland 2005, orig. proceeding). The court in *Champion* acknowledged that Lambda Construction Co. v. City of Alice, 729 S.W.2d 377, 381 (Tex. App. — San Antonio 1987, no writ) ("trial court temporarily stayed its decision on the question of arbitrability of the claim"), and C P & Associates v. Pickett, 697 S.W.2d 828, 831 (Tex. App. — Corpus Christi 1985, no writ) (trial court entered "a temporary injunction staying arbitration and permitting discovery" pending a determination of arbitrability), are contrary precedents but distinguished them because they were decided before the Supreme Court of Texas held in *Anglin*, 842 S.W.2d at 269, that courts must summarily determine arbitrability. *Champion*, 173 S.W.3d at 598-99.

28 *Champion Technologies*, 173 S.W.3d at 598 n.1; *MHI*, 7 S.W.3d at 920.

29 *Champion Technologies*, 173 S.W.3d at 600; *MHI*, 7 S.W.3d at 923.

30 666 S.W.2d 604, 608-09 (Tex. App. — Houston [14th Dist.] 1984, writ ref'd n.r.e.), cert. denied, 469 U.S. 1127 (1985).

31 *In re MHI Partnership, Ltd.*, 7 S.W.3d at 922 (quoting from *McCollum*, 666 S.W.2d at 608.

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