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RICO and Securities Law Developments

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Click on any title to go directly to article.

TABLE OF CONTENTS

Cover: Ministerstvo Pro Mistni Rozvoj, one of the finest Art Nouveau buildings in Prague.
Photograph by Larry Gustafson, Dallas

Back to Table of Contents

Dear Section Members:

As the new Chair, it is my privilege to introduce this latest edition of the *Journal*. As always, the Council wants to thank Mike Ferrill for his tremendous work assembling and editing this publication. I'd also like to thank my predecessor, Wallis Hampton, for his service as the Section Chair over the previous year.

The Section held its annual meeting at the State Bar's annual conference in Houston this summer. This year's recipient of the Distinguished Counselor award was Gary McGowan, a past Chair of the Section with a distinguished career as litigator, mediator and arbitrator. The Section also welcomed Bruce Blefeld of Jackson Walker LLP, Brad Weber of Locke Lord LLP, and Bill Whitehill of Gardere Wynne Sewell LLP as its newest Council members. Frank Carroll of Cox Smith Mathews Inc. was elected as the Chair Elect, and Tom Jackson of Jones Day was elected as our Secretary-Treasurer. The Section sponsored a CLE panel discussion during the annual meeting titled "Supreme Court Class Action Decisions Update." The discussion was moderated by Carrie Huff of Haynes and Boone, LLP and panelists were United States District Court Judges W. Royal Ferguson, Jr., Xavier Rodriquez and Vanessa D. Gilmore along with Frank Carroll, Danielle Fitzpatrick of King & Spalding and Daniel Gold of Haynes and Boone, LLP.

In today's economic and regulatory environment, it is more essential than ever to stay abreast of developments in the commercial law. To that end, the Section sponsored a CLE event this summer titled "Antitrust under the Obama Administration" with panelists Jeff Perry, Assistant Director of the Bureau of Competition at the FTC, Jeff Spigel of King & Spalding, William Stallings with the U.S. Dept. of Justice Antitrust Division and Kim Van Winkle the Chief of the Antitrust Section at the Texas Attorney General's office. We are always interested in learning what CLE topics are of interest to our Section members. If you have any ideas for CLEs, please let me know.

This issue of the *Journal* is the first issue to be in electronic format only. There are two articles in this issue: the annual Fifth Circuit Securities Update by Gerry Pecht and Peter Stokes and the annual RICO update by Heather Lohman. The cover photo is by Larry Gustafson. Thanks to all of our authors for their articles. If you are interested in submitting an article for publication, please contact Mike Ferrill (amferrill@coxsmith.com).

I look forward to hearing from you with your suggestions for the Section.

Regards,

L. James Berglund II
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Back to Table of Contents

This issue of the Journal features the annual survey articles on securities law and RICO developments.

As always, we solicit written contributions to the Journal. We currently have commitments for annual survey articles on antitrust, securities, RICO, business torts, arbitration, class actions D&O and expert witness developments. If you have an idea for a survey article in another area of business litigation, or an article focusing on a particular aspect of or development in the law (even if it falls within one of the broad survey categories), 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

Back to Table of Contents

New Officers and Council Members

New officers and council members were elected at the annual meeting of the State Bar. Officers for the 2012-13 year are as follows:

L. James Berglund II	Chair
William Frank Carroll	Chair-Elect
Thomas R. Jackson	Secretary/Treasurer

The following council members were elected for the 2012-2015 term:

Todd Murray	Dallas
Carrie Huff	Dallas
Bruce Blefeld	Houston
Bradley Weber	Dallas
William Whitehall	Dallas
Nicole Williams	Dallas
John Shoemaker	Houston

FIFTH CIRCUIT SECURITIES UPDATE

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

Since the end of the last survey period, the Fifth Circuit has addressed numerous important securities-related issues, including: (i) the scope of the "in connection with" requirement under the Securities Litigation Uniform Standards Act ("SLUSA"); (ii) several issues arising from the collapse of Stanford Financial Group; (iii) the standards for approving settlements of securities fraud actions, including the appropriateness of the "percentage" method for awarding attorneys' fees; (iv) the constitutionality and scope of the Commodities Exchange Act's antifraud provisions; (v) the definition of a "Ponzi scheme" for purposes of recovering an alleged fraudulent transfer in an SEC receivership; (vi) the right of issuers to exclude proxy proposals by shareholders that do not comply with SEC Rule 14a-8; (vii) whether sellers of annuity contracts are liable for "redemption fees" charged by mutual funds; (viii) whether the acquirer of a brokerage firm can enforce arbitration agreements against customers of the acquired firm; and (ix) the criminal consequences of making material misstatements in the sale of secured debt obligations.

A. The Scope of SLUSA's "In Connection With" Requirement

In *Boland v. Green*, 675 F.3d 503 (5th Cir. 2012), the Fifth Circuit reversed the Northern District's dismissal of several shareholder class actions under SLUSA and the district court's denial of a motion to remand. One of the class actions was a consolidated action originally filed by Louisiana investors in Louisiana state court that was removed to the Middle District of Louisiana and transferred to the Northern District Stanford MDL. The Louisiana plaintiffs asserted state law claims for breach of contract, negligent misrepresentation, breach of fiduciary duty, and violations of the Louisiana Securities Act. The other two class actions were filed by a group of Latin American investors against Stanford International Bank's insurance brokers and lawyers. The Latin American plaintiffs asserted Texas Securities Act primary liability claims against the insurance brokers for making misrepresentations and aiding and abetting claims against the lawyers. All of the actions alleged that Stanford International Bank sold worthless certificates of deposit ("CDs") by falsely presenting them as safe investments with guaranteed returns.

The defendants moved to dismiss based on SLUSA's preclusion of state law class action claims involving "covered securities." SLUSA provides that "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A). While the Northern District agreed with plaintiffs that the CDs themselves were not "covered securities," it nonetheless granted the motion to dismiss and held that the claims were sufficiently connected with other covered securities to fall within SLUSA's preclusion clause. The district court found that SIB sold the certificates based in part on representations that SIB invested in a portfolio that included SLUSA-covered securities, and that at least some of the Louisiana plaintiffs had sold their holdings in SLUSA-covered securities to finance their purchase of the Stanford certificates. The Northern District reasoned that these connections established a sufficient nexus between the alleged misrepresentations and SLUSA-covered securities to trigger SLUSA preclusion. 675 F.3d at 509-10.

The Fifth Circuit reversed. After surveying the approaches taken in other circuits, the court adopted the Ninth Circuit's version of the "in connection with" test as stated in *Madden v. Cowen & Co.*, 576 F.3d 957 (9th Cir. 2009), which requires "'a relationship in which the fraud and the stock sale coincide or are *more than tangentially related*. . . .'" 675 F.3d at 520 (quoting *Madden*, 576 F.3d at 965-66) (emphasis added in Fifth Circuit opinion). The Fifth Circuit reasoned that while SLUSA's preclusion clause is broadly worded, the statute was not intended to deny state law remedies for non-national securities. Applying the *Madden* standard, the Fifth Circuit reasoned that the representation regarding the inclusion of covered securities in SIB's portfolio was merely "one of a host of (mis)representations made to the Appellants in an attempt to lure them into buying the worthless CDs" and was thus only "tangentially related" to the "gravamen" of the alleged fraud. In the Fifth Circuit's view, the "heart, crux, and gravamen" of the defendants' alleged scheme were the representations regarding the certificates' consistent rates of return, regulatory oversight, and due diligence undertaken by the Stanford entities in ensuring the certificates' value and liquidity, rather than the alleged inclusion of SLUSA-covered securities in SIB's underlying investment portfolio. The Fifth Circuit contrasted the Stanford allegations to those in the Madoff feeder fund cases, noting that there were "multiple lawyers of separation" between the certificates and any portfolio securities held by SIB and that the Stanford CDs promised a fixed rate of return not tied to the securities in SIB's portfolio. Likewise, the allegation that at least one of the Louisiana plaintiffs sold covered securities to finance the purchase of the Stanford certificates was too tangential to satisfy the "in connection with" requirement. The Fifth Circuit thus reversed the district court's dismissal of the cases and ordered that the Louisiana case be remanded to state court.

B. Other Issues Arising From The Collapse Of Stanford Financial Group

The Fifth Circuit also decided several other appeals relating to the Stanford Financial collapse. In *SEC v. Stanford International Bank Ltd.*, 465 Fed. Appx. 316 (5th Cir. 2012), the Fifth Circuit affirmed the Northern District's refusal to allow Trustmark National Bank to use Stanford receivership funds to pay a letter of credit that Trustmark had issued to HP Financial Services Venezuela ("HPFSV") to secure payment on a lease of computer equipment to Stanford. By issuing the letter, "Trustmark became a secured creditor with set-off rights against cash collateral that Stanford had placed on deposit with Trustmark." HPFSV later demanded payment from Trustmark on the letter of credit after Stanford defaulted on the underlying lease. The Fifth Circuit agreed with the district court that the subsequent freezing of Stanford's assets under the receivership order did not preclude HPFSV from enforcing the letter of credit against Trustmark, given that the letter did not divest the Stanford receivership estate of funds, but did prevent Trustmark from exercising its set-off rights against the Stanford cash collateral (which was property of the receivership). As a result, Trustmark had to pay HPFSV out of its own funds without accessing the Stanford funds, which remained property of the receivership and could only be accessed through the receivership process.

In *Janvey v. Libyan Investment Authority*, 2012 WL 2136603 (5th Cir. 2012), the Fifth Circuit affirmed the Northern District's denial of a preliminary injunction that would have frozen \$53.8 million in funds "belonging to the Libyan Investment Authority" ("LIA"). The LIA was formed by the Libyan government in 2006 and is the sole shareholder of the Libyan Foreign Investment Company ("LFICO"), which had invested more than \$138 million in Stanford International Bank ("SIB") CDs. The receiver sought a preliminary injunction to freeze approximately \$53.8 million in funds that LFICO withdrew from the CDs. Under the Foreign

Sovereign Immunities Act ("FSIA"), however, a court may not attach property of a sovereign foreign state unless: (i) the foreign state has "explicitly waived its immunity from attachment prior to judgment" and (ii) the purpose of the attachment is to enforce a judgment rather than to obtain jurisdiction (quoting 28 U.S.C. § 1609). Because the LIA was a foreign governmental entity that had not explicitly waived its immunity, and because a temporary injunction is the functional equivalent of an attachment, the Fifth Circuit held that the FSIA barred the receiver from obtaining injunctive relief. The Fifth Circuit also rejected the receiver's argument that the funds were fraudulent transfers that remained property of the Stanford estate as a matter of law, holding there was no evidence that the funds "have ever been the subject of a fraudulent transfer by the SIB."

In *Janvey v. Alguire*, 647 F.3d 585 (5th Cir. 2011), the Fifth Circuit withdrew and modified its prior opinion, 628 F.3d 164 (5th Cir. 2010), affirming a preliminary injunction freezing certain assets in the accounts held by numerous former Stanford financial advisors and employees (the "Employee Defendants") at Pershing LLC and JP Morgan Clearing Corp. The SEC receiver for the Stanford entities asserted that the frozen assets represented proceeds from the alleged Ponzi scheme and thus constituted fraudulent transfers that should be returned to the receivership. The Employee Defendants argued on appeal that: (i) the district court did not have power to grant the injunction because the Employee Defendants had moved to compel arbitration; (ii) the district court abused its discretion in granting the injunction; (iii) the injunction was overbroad; (iv) to the extent any relief was warranted, the district court should have issued a writ of attachment instead of a preliminary injunction; and (v) the district court should have compelled arbitration.

As with the original opinion, the Fifth Circuit's modified opinion rejected all of the Employee Defendants' grounds for appeal. The only substantive change to the prior opinion was the court's conclusion that it lacked jurisdiction to consider whether the district court should have compelled arbitration because the district court never issued an appealable order on the motion to compel. In all other respects, the new opinion was substantively identical to the prior opinion. The Fifth Circuit again concluded that the district court had authority to grant the injunction, noting that the Federal Arbitration Act is silent on whether a district court could grant a preliminary injunction before determining arbitrability and that the district court "merely sought to preserve the status quo before deciding the motion to compel arbitration." The new opinion likewise held that the district court did not abuse its discretion in finding that the receiver satisfied the elements for obtaining a preliminary injunction or in granting an injunction instead of a writ of attachment. In finding a substantial likelihood of success on the merits, the appellate panel held that the guilty plea of former Stanford International Bank CFO James Davis and the declaration of the receiver's forensic accountant sufficiently established that the Stanford enterprise operated as a Ponzi scheme, and that the frozen assets were proceeds from the alleged scheme. Under Fifth Circuit precedent, proof that a transferor operated as a Ponzi scheme is sufficient to satisfy the intent element for establishing a fraudulent transfer.[2] The court also agreed the receiver sufficiently established that the Employee Defendants would dissipate the frozen assets if an injunction were not issued and thus satisfied the "irreparable harm" requirement. In addition, the Fifth Circuit again rejected the Employee Defendants' argument that the injunction was overly broad and should not have included IRA accounts, was improperly calculated based on pre-tax amounts that did not reflect taxes that were already allegedly paid by the accountholders, and should have included offsets to reflect amounts that the Employee

Defendants allegedly lost on their own investments in Stanford CDs. The Fifth Circuit thus again affirmed the injunction while remanding the arbitrability issue to the district court.

C. Standards For Approval of Securities Class Action Settlements

In *Union Asset Management Holding A.G. v. Dell, Inc.*, 669 F.3d 632 (5th Cir. 2012), the Fifth Circuit affirmed the approval of a securities class action settlement in the Western District of Texas arising from Dell's restatement of financial information for fiscal years 2003-06 and the first quarter of 2007. After the district court granted the defendants' Rule 12(b)(6) motion to dismiss, and while that decision was on appeal, the parties negotiated a $40 million settlement of all claims on a classwide basis. The district court rejected numerous objections at the final approval hearing and approved the settlement with one modification – the replacement of the "*de minimis*" provision (which bars payouts to shareholders whose total recovery is less than ten dollars) with a provision limiting each claimant to one check, negotiable within 60 days. The court did not reopen the claims period on account of this issue or require further notice to class members regarding this change. The court awarded class counsel attorney's fees of $7.2 million, or 18% of the settlement fund, based on the percentage method. Two of the objectors appealed.

The Fifth Circuit affirmed the district court's rejection of the objections. The appellate court concluded that the Western District "systematically analyzed the proposed settlement under each factor" of the fairness test articulated in *Reed v. General Motors Corp.*, 703 F.2d 170 (5th Cir. 1983),[3] and did not abuse its discretion in concluding that the settlement was fair, reasonable, and adequate. The fact that no formal discovery occurred before settlement due to the Private Securities Litigation Act ("PSLRA") discovery stay and subsequent dismissal order did not preclude approval of the settlement, given that the plaintiffs conducted informal discovery by hiring private investigators and experts to assess their position. 669 F.3d at 639. The Fifth Circuit also rejected the objectors' argument that defining the class to include all persons who bought Dell stock during the class period and "were damaged thereby" would lead to "mini-trials" on the merits, noting that courts routinely approve the use of this language in class action settlements. The court also held that the claim submission requirement did not unduly prejudice small investors, that the modification of the "*de minimis*" provision was simply a change to the plan of allocation that did not necessitate new notice or reopening of the claims period, and that objectors were not entitled to a second fairness hearing to challenge documents submitted after the hearing to substantiate the attorneys' fee award.

Finally, the Fifth Circuit held that the district court did not abuse its discretion in using the percentage method to award attorneys' fees equal to 18% of the class recovery. Observing that "the Fifth Circuit has never reversed a district court judge's decision to use the percentage method" and that Congress contemplated such a method in enacting the PSLRA, the Fifth Circuit held that district courts should have "the flexibility to choose between the percentage and lodestar methods in common fund cases, with their analyses under either approach informed by" the traditional 12-factor *Johnson* test for evaluating an attorneys' fee award in this circuit.[4] The district court thus did not abuse its discretion in using the percentage method instead of the lodestar method to calculate the 18% fee, given that it rigorously considered the *Johnson* factors in conducting its analysis. Finally, the objectors cited no authority in support of their claim that the district court erred by awarding interest to class counsel on the fee award from the date the settlement was funded to the date of payment. The Fifth Circuit thus affirmed the district court's judgment.

D. The Commodity Exchange Act's Antifraud Provisions

The Fifth Circuit also decided several cases involving the antifraud provisions of the Commodities Exchange Act ("CEA"). In *United States v. Brooks*, 681 F.3d 678 (5th Cir. 2012), the Fifth Circuit affirmed the conviction of three former El Paso Merchant Energy Corporation ("EPME") gas traders for CEA violations. The traders were accused of conspiring to report false natural gas price information to *Inside FERC Gas Market Report* and *Natural Gas Intelligence* with the intent to manipulate the index prices reported in those publications. The government presented evidence that fewer than 3.6% of the trades reported to these publications by the defendants matched actual trades by the company. Following three days of jury deliberations, all three defendants were convicted of conspiracy and multiple counts of wire fraud and false reporting in violation of the CEA. One of the defendants received 168 months in prison, and the other two received 135 months.

The Fifth Circuit considered and rejected numerous arguments for overturning the convictions. The defendants first argued that the government violated their Fifth and Sixth Amendment rights by allegedly coercing EPME to cut off payment of their attorneys fees under the company's bylaws. The Fifth Circuit, however, concluded that EPME had discretion under its bylaws not to pay the fees and exercised its own discretion in deciding to cut off payments. The Fifth Circuit also rejected the argument that the mere existence of the so-called "Thompson Memorandum," which was a Department of Justice memorandum advising investigators to consider whether a company is advancing legal fees to culpable agents as one of the criteria for assessing whether the company is cooperating with the government, was insufficient to show that the government had improperly compelled EPME to terminate payment of the defendants' legal fees. Unlike in *United States v. Stein*, 541 F.3d 130 (2d Cir. 2008), in which a district court in the Second Circuit had made factual findings that the government forced KPMG to stop paying the defendants' legal costs, the district court in *Brooks* had made no such findings that would bind the appellate court.

The Fifth Circuit also rejected the defendants' arguments regarding the CEA's applicability and constitutionality. The defendants argued that the CEA only prohibited false "reports" and generally used the word "report" to refer to formal documents directly regulated by the CFTC. The Fifth Circuit, however, held that the ordinary meaning of the word "reports" includes the price information submitted to *Inside FERC* and *Natural Gas Intelligence* and noted that the CFTC has consistently interpreted such information as "reports" under the CEA. The Fifth Circuit likewise rejected the defendants' arguments that the CFTC's 1993 exemption for natural gas contracts also exempted the false reporting of nonexistent gas contracts. Nor was the court persuaded by the defendants' contention that only natural gas that is physically traded through Henry Hub in Louisiana qualifies as a "commodity" under the CEA, reasoning that "it would be peculiar that natural gas at another hub is not a commodity, but suddenly becomes a commodity solely on the basis that it passes though Henry Hub, and ceases to be a commodity once it moves onto some other locale." 681 F.3d at 694-95. The government's alleged failure to prove that the defendants' actions specifically affected the price of gas at Henry Hub therefore was not fatal to the defendants' false reporting convictions. The court also found that the CEA's prohibition of false or misleading reports that tend to affect the "price" of any commodity was not unconstitutionally vague or overbroad, given that there is no First Amendment protection for intentional or reckless falsehoods and that the reported gas price indexes at issue fell within the plain meaning of the word "price." The Fifth Circuit also rejected the defendants' challenges to the district court's jury instructions, evidentiary rulings, and sentencing considerations.

In *Amacker v. Renaissance Asset Management LLC*, 657 F.3d 252 (5th Cir. 2011), the Fifth Circuit affirmed a judgment of the Southern District of Texas dismissing a CEA claim against futures commission merchants for aiding and abetting an investment pool operator who was allegedly defrauding investors. The plaintiffs were investors in a commodity pool operated by Anthony Romunno, who pooled the investors' funds into brokerage accounts and traded the pooled funds through various futures commissions merchants. Romunno later pleaded guilty to wire fraud and mail fraud for running the pool as a classic Ponzi scheme. The investors then sued the futures commission merchants who traded with Romunno for allegedly aiding and abetting his violations of the CEA. While acknowledging they had no evidence that the merchants knew about Romunno's fraud, the investors alleged that the merchants could have discovered the fraud within a week had they conducted their own investigation.

The Fifth Circuit affirmed the district court's Rule 12(b)(6) dismissal of the complaint. To state an aiding and abetting claim, a plaintiff normally must allege that the defendant acted with actual knowledge of the fraud. To the extent that a plaintiff may state an aiding and abetting claim in this circuit based on allegations of "severe recklessness" rather than conscious intent (a question the Fifth Circuit did not resolve), the Fifth Circuit held that the circumstances where recklessness would suffice are limited to those where there is a "special duty of disclosure" or where the assistance provided by the alleged aider is "unusual in character." Because the merchants "did no more than execute regular trades requested by Ramunno," and because they did not owe special duties of disclosure to private investors under the CEO, the Fifth Circuit held that the plaintiffs must show actual knowledge to establish aiding and abetting liability. Even if plaintiffs could show scienter through severe recklessness instead of actual knowledge, the allegations failed to show that the merchants had any reason to know that Romunno was trading on behalf of other investors or engaging in fraudulent activity. The Fifth Circuit thus affirmed the district court's dismissal of the complaint.

E. The Definition Of "Ponzi Scheme"

In *American Cancer Society v. Cook*, 675 F.3d 524 (5th Cir. 2012), the Fifth Circuit reversed a Northern District of Texas judgment ordering the American Cancer Society ("ACS") to repay $240,000 in contributions from several entities that were later placed into SEC receivership. The SEC accused the entities of misspending investor funds on personal expenses and obtained a district court order authorizing the receiver to recover company assets. The receiver sued ACS to recover the entities' charitable contributions. The district court ordered ACS to return the contributions under a fraudulent transfer theory, holding that the entities had been operating a "Ponzi-like scheme." Under Fifth Circuit precedent, transfers from a Ponzi scheme are presumed to be made with actual intent to defraud creditors because a Ponzi scheme is, "'as a matter of law, insolvent from its inception.'"[5]

The Fifth Circuit reversed the district court's turnover order. Noting that the use of investor funds to pay returns to other investors is a "*sine qua non* of any Ponzi scheme," the Fifth Circuit rejected the district court's characterization of the receivership entities as a Ponzi scheme because there was no evidence the entities paid any returns to investors at all. 675 F.3d at 528. The Fifth Circuit also rejected the receiver's alternate theories that the contributions were made with actual intent to defraud investors and/or should be recovered under a constructive trust theory, holding there was no evidence that the contributions were made for the purpose of luring other investors into the scheme other than conclusory affidavit testimony. The Fifth Circuit thus reversed the district court's judgment.

F. The Right To Exclude Proxy Proposals That Violate SEC Rule 14a-8

In *KBR v. Chevedden*, No. 11-20921, 2012 WL 2094081 (5th Cir. 2012), the Fifth Circuit affirmed a Southern District of Texas summary judgment order granting declaratory relief that an alleged shareholder of KBR was not eligible to have his proposal included in KBR's proxy materials. KBR requested that the alleged shareholder, John Chevedden, voluntarily withdraw his proposal after Chevedden failed to document his stock ownership or otherwise demonstrate his eligibility under SEC Rule 14a-8.[6] After Chevedden repeatedly refused to withdraw his request or confirm his eligibility, KBR obtained a declaratory judgment that it could exclude his proposal.

In affirming the district court's judgment, the Fifth Circuit rejected Chevedden's argument that there was no private right of action under section 14 of the Securities Exchange Act, noting that the Supreme Court specifically recognized a private right of action under section 14(a) to enforce proxy regulations.[7] The Fifth Circuit also held that the proposal dispute was an "actual controversy" that impacted KBR's duties to other shareholders and therefore was a proper subject of declaratory relief.

.G. No Liability For Redemption Fees Charged By Mutual Funds In Annuity Contracts

In *Miller v. Nationwide Life Insurance Co.*, 448 Fed. Appx. 423 (5th Cir. 2011), the Fifth Circuit addressed whether a life insurance company breached its contract and violated securities laws by failing to absorb third party mutual fund fees. The plaintiff, Edward Miller, purchased two annuity contracts from Nationwide that were comprised of underlying sub-accounts that each corresponded with a particular mutual fund. Nationwide provided Miller with a "Summary of Participation" document stating that Miller could "transfer variable assets among the various funds without a charge" and "make telephone exchanges where permitted by state law." After Miller purchased the annuity contracts, the mutual fund companies (which were third parties not under Nationwide's control) began charging "redemption fees" for short-term trades to limit "market timing" trading activity by investors who frequently trade into and out of the funds. Nationwide also subsequently limited Miller to twenty telephone transfers per year. Miller alleged that the mutual fund redemption fees and telephone transfer restrictions breached his annuity contract with Nationwide, and that Nationwide violated section 5(b)(2) of the Securities Act by failing to provide Miller with an updated prospectus before Miller was charged a redemption fee by the mutual fund after transferring money between accounts.

The Fifth Circuit affirmed the Eastern District of Louisiana's grant of summary judgment in Nationwide's favor. It held that there was no breach of contract because Miller's contract only prevented Nationwide from charging transfer fees and did not preclude the third-party mutual fund companies from charging their own fees, nor did it preclude Nationwide from collecting the third-party fees or require Nationwide to absorb them. The Fifth Circuit also agreed with the district court that Miller's contract did not promise unlimited telephone transfers, noting that the "contract and prospectus sent to Miller state that Nationwide reserves the right to withdraw telephone exchanges and limit transfers in general." Finally, the court rejected Miller's Securities Act claim because the mere transfer of money between his accounts did not constitute a new sale of securities. Miller also admitted that he received the prospectus from the underlying mutual fund after ordering the transfer. Because 15 U.S.C. § 77e permits the delivery of a prospectus after the sale, Miller's Securities Act claim lacked merit. The Fifth Circuit also held that Miller could not show causation because Miller did not read the prior prospectus and took no steps to verify whether the fund charged a redemption fee. The Fifth Circuit thus affirmed the district court's summary judgment in its entirety.

H. The Enforcement Of An Arbitration Clause By The Acquirer Of A Brokerage Firm

In *Grant v. Houser*, No. 11-30161, 2012 WL 975060 (5th Cir. 2012), the Fifth Circuit reversed a decision by the Eastern District of Louisiana denying a motion to compel arbitration in a broker-customer dispute where another company had acquired the brokerage firm and sought to enforce the customer's arbitration agreement. The district court held that the acquiring company's declaration, which stated generally that the broker assigned all of its contracts to the acquiring company without attaching documentary evidence specifically showing that the broker assigned its rights under the arbitration agreement, was insufficient to show that the broker had assigned its rights under the arbitration agreement to the acquiring company.

The Fifth Circuit reversed, holding that the declaration itself was sufficient to establish the existence of the assignment by a preponderance of the evidence.[8] The appellate court further held that the dispute fell squarely within the scope of the arbitration provision, which covered "any controversy" between the broker and customer. The Fifth Circuit also held that the district court lacked jurisdiction to decide a second motion to compel arbitration filed after the appeal was pending, noting that the second motion raised the same issues that were being considered during the appeal. Judge Rhesa Hawkins Barksdale dissented from the majority's conclusion on this issue, reasoning that the second motion applied to several additional claims in a new amended complaint that were not part of the initial motion and order.[9]

I. Criminal Liability For Selling Secured Debt Obligations Through False Statements

In *United States v. Bruteyn*, 2012 WL 2476808 (5th Cir. 2012), the Fifth Circuit affirmed a securities fraud conviction and 25-year prison sentence imposed on Jeffrey Bruteyn for selling fraudulent secured debt obligations ("SDOs"). Bruteyn falsely represented to investors that he held a Wharton School of Business M.B.A. and Baylor Law School J.D., and that the SDOs were as safe as FDIC-backed certificates of deposit. Only $34.1 million of the $58.7 million invested in Bruteyn's company have been recovered. The Fifth Circuit held it was not error for the district court to allow the government to introduce the SEC's TRO into evidence at the criminal trial, noting that Bruteyn himself referenced the government freezing of his company's assets in front of the jury. The appellate court also held that the misrepresentations regarding Bruteyn's education and qualifications were material and supported his securities fraud conviction. Finally, the panel rejected Bruteyn's challenges to the 25-year prison sentence, holding that the district court correctly applied the sentencing factors and properly calculated the actual losses caused by Bruteyn's scheme in determining the offense level.

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

[2] 647 F.3d at 597-98 (citing Securities and Exchange Commission v. Res. Dev. Int'l, LLC, 487 F.3d 295, 301 (5th Cir. 2007)).

[3] The *Reed* factors are: "(1) the existence of fraud or collusion behind the settlement; (2) the complexity, expense, and likely duration of the litigation; (3) the stage of the proceedings and the amount of discovery completed; (4) the probability of plaintiffs' success on the merits; (5) the range of possible recovery; and (6) the opinions of the class counsel, class representatives, and absent class members." 703 F.3d at 172.

[4] *See* Johnson v. Georgia Highway Express, 488 F.2d 714 (5th Cir.1974). The twelve *Johnson* factors are: (1) the time and labor required; (2) the novelty and difficulty of the questions; (3) the skill requisite to perform the legal service properly; (4) the preclusion of other employment by the attorney due to acceptance of the case; (5) the customary fee; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or circumstances; (8) the amount involved and the results obtained; (9) the experience, reputation, and ability of the attorneys; (10) the undesirability of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases. *See* 488 F.2d at 717.

[5] 675 F.3d at 527 (quoting Warfield v. Byron, 436 F.3d 551, 558 (5th Cir. 2006)).

[6] 2012 WL 2094081 at *1 (citing 17 C.F.R. § 240.14a-8(b)(2), which requires that shareholders have investments totaling "at least $2,000 in market value, or 1% of the company's [voting] securities" to be eligible to submit a proxy proposal).

[7] *Id.* at *2 (citing J.I. Case Co. v. Borak, 377 U.S. 426, 431-33 (1964)).

[8] *Id.* at *4-5 (citing Doddy v. Oxy USA, Inc., 101 F.3d 448, 463 (5th Cir. 1996) (holding that affidavit is sufficient to establish contents of agreement)).

[9] *Id.* at *5-6 (Barksdale, J., dissenting in part).

Back to Table of Contents

Civil RICO Update Through July 2012

By Heather A. Lohman[1]

The Fifth Circuit has issued only a handful of civil RICO opinions in the past year, but they cover a broad spectrum of factual and legal issues. This article summarizes those decisions, as well as some of the civil RICO opinions and orders from federal district courts in Texas during the survey period. The summaries are organized by topic.

Multiple Elements

In *Davis-Lynch, Inc. v. Moreno,* 667 F.3d 539 (5th Cir. 2012), an oilfield equipment company sued its employee's husband and son-in-law for RICO violations. The company alleged that the employee and others had issued unauthorized checks from company accounts to the defendants. The trial court entered summary judgment for the company on the RICO claims. Reversing, the Fifth Circuit held that the RICO claim failed for four reasons. First, the company had not shown that its injuries resulted from the investment or use of the racketeering proceeds. The court noted that the company did not present facts showing how the defendants invested the money received from the unauthorized checks into any RICO enterprise, much less how the company was injured by the investment of such proceeds. Second, the company failed to show how the defendants participated in, operated, or managed the enterprise's affairs. Third, the company failed to show that it had standing under civil RICO because it did not allege injury from an independently wrongful act. Rather, the injury alleged—the stolen funds—resulted directly from the alleged racketeering activity itself. Fourth, the company failed to allege that the defendants engaged in any predicate acts of racketeering activity.

In *Allstate Ins. Co. v. Donovan,* No. H-12-0432, 2012 WL 2577546 (S.D. Tex. July 3, 2012), insurance companies sued doctors for RICO violations arising out of the defendants' billing for allegedly unnecessary exams, testing, and procedures. The plaintiffs alleged that the defendants converted otherwise "soft-tissue" bodily injury claims into major medical claims through inter-enterprise referrals. The district court granted the defendants' motion to dismiss but allowed the plaintiffs to replead. The court found that the complaint failed to allege predicate acts of mail fraud and made only vague, nonspecific allegations concerning a pattern of racketeering activity. Specifically, the court found that the plaintiffs did not allege how completion of the scheme depended on mailings or how or why the mailings furthered the scheme. Further, rote allegations that the defendants engaged in a pattern of activity between 2005 and 2010, without allegations of the dates on which any defendant engaged in a predicate act, were insufficient. The court also found that the plaintiffs failed to plead predicate acts of fraud with particularity as required by Federal Rule of Civil Procedure 9(b). Additionally, the court found that the plaintiffs sufficiently alleged an entity enterprise, but did not sufficiently allege an association-in-fact enterprise; the plaintiffs failed to plead that the association-in-fact existed for purposes other than to commit the predicate acts or that it functioned as a continuing unit over time. Finally, the court found that the plaintiffs failed to plead a conspiracy under 18 U.S.C. § 1962(d).

In *Cypress/Spanish Fort I, L.P. v. Prof'l Serv. Indus.,* 814 F. Supp. 2d 698 (N.D. Tex. 2011), a project developer sued its engineer for various causes of action, including RICO, claiming that the defendant falsified and concealed test results for the earthwork it did on the plaintiff's construction project. Ruling on a motion to dismiss, the district court found that Rule 9(b)'s particularity requirement applies to pleading fraud as a predicate act in a RICO case, and that the plaintiff adequately alleged the predicate acts of mail and wire fraud for purposes of Rule 9(b). The court also found that the plaintiff's allegations that the defendant willfully emailed or faxed false reports, bribed employees to remain silent about known defects on the project, and intimidated employees to prevent revelation of alleged misdeeds were sufficient to show a pattern of racketeering activity over the course of the construction project. The court further found that the plaintiff adequately alleged an association-in-fact and an enterprise distinct from the pattern of racketeering activity in which it was engaged. The court accordingly denied the motion to dismiss as to the RICO claims.

In *North Cypress Medical Center Operating Co. v. CIGNA Healthcare,* No. 4:09-cv-2556, 2011 WL 5325785 (S.D. Tex. Nov. 3, 2011), a hospital sued CIGNA, an insurance company, asserting various claims, including RICO, alleging that CIGNA reimbursed the hospital in amounts substantially less than what should have been paid under subscribers' health care plans and misrepresented that the payment amounts were calculated based on valid data or legitimate reasons. CIGNA moved to dismiss, and the court granted that motion as to the RICO claims. The court found that the hospital had adequately alleged a pattern of racketeering activity based on the complaint's allegations that CIGNA, as part of its regular course of doing business, investigated the hospital's billing practices in order to force the hospital to be "in network." The court, however, found that the hospital failed to plead: (1) that CIGNA used part of its income in acquiring an interest in an enterprise for purposes of section 1962(a); (2) how it was injured due to CIGNA's acquiring or maintaining an enterprise for purposes of section 1962(b); (3) a distinction between the person and the enterprise as required by section 1962(c); or (4) a conspiracy claim under section 1962(d).

Jurisdiction

In *Brown v. Offshore Specialty Fabricators,* 663 F.3d 759 (5th Cir. 2011), *cert. denied*, 132 S.Ct. 2103 (2012), a putative class of U.S. citizen workers sued the employer, an offshore oil and gas supplier, for allegedly maintaining a hiring scheme to employ foreign workers on projects on the Outer Continental Shelf. The plaintiffs argued that the defendant's conduct violated the Immigration and Nationality Act ("INA"), and therefore qualified as racketeering activity under RICO. The Fifth Circuit affirmed the district court's dismissal of the case. It held that there was no RICO violation because the INA does not apply in the place where the conduct at issue occurred – on vessels floating on the waters of the Outer Continental Shelf.

Legal Enterprise or Association-in-Fact

In *Capital Active Funding v. B&L Constr. & Remodeling,* No. EP-11-CV-257-DB, 2011 WL 6099372 (W.D. Tex. Dec. 7, 2011), the district court dismissed a RICO complaint arising out of the defendants' failure to pay the plaintiff (a creditor under a security agreement) proceeds from the defendants' governmental contract work. The district court held that the plaintiff failed to plead facts to establish that an association-in-fact existed for purposes other than to commit the predicate acts and failed to plead facts showing that the association functioned as a continuing unit over time.

Limitations

In *Jaso v. The Coca Cola Co.,* 435 F. App'x 346 (5th Cir. 2011), the owner of a copyrighted song sued Coca Cola for copyright infringement and RICO violations. The district court dismissed the case on limitations grounds. The Fifth Circuit reversed this holding, finding that the plaintiff alleged individual acts of racketeering within the limitations period. The court re-emphasized its "separate accrual" rule, holding that "even if Jaso knew RICO violations had occurred in 1994, he could still recover for injuries caused by criminal copyright infringement that occurred within four years of the date he commenced his lawsuit."

Pattern of Racketeering Activity

In *ISystems v. Spark Networks, Ltd.,* 428 F. App'x 368 (5th Cir. 2011), the registrant of the domain name "jdate.net" sued the holder of the "JDate" service mark for violations of anti-cybersquatting law and RICO. The district court dismissed the lawsuit, and the Fifth Circuit affirmed. As to the RICO claim, the court held that the plaintiff failed to connect the defendant to a RICO enterprise distinct from the corporation itself. The court also held that the plaintiff did not allege a pattern of racketeering activity, because its complaint was based on conduct arising from a single transaction to stop the alleged infringement of the JDate mark. Finally, the court held that the RICO claim based on fraud must fail because the plaintiff did not allege reliance on any misrepresentations.

In *Orthoflex, Inc. v. ThermoTek, Inc.*, Nos. 3:11-CV-0870-D, 3:10-CV-2618-D, 2012 WL 2864510 (N.D. Tex. July 12, 2012), a manufacturer of an electronic heating and cooling therapy system sued its distributor under RICO for allegedly making fraudulent warranty and product defect claims in order to obtain proprietary information regarding the therapy system. The court granted the motion to dismiss, finding that the plaintiff failed to allege a pattern of racketeering activity. The court reasoned that the plaintiff's allegations were limited to predicate acts in the defendant's role as distributor and under the distribution agreement and therefore were part of an otherwise lawful transaction that had since ended. Accordingly, the plaintiff failed to plead a threat of long-term criminal activity. On that same basis, the court dismissed the RICO conspiracy claim under section 1962(d).

Predicate Criminal Acts

In *Jones v. Liberty Bank & Trust Co.,* 461 F. App'x 407 (5th Cir.), *cert. dismissed*, No. 11-9896, 2012 WL 137924 (June 25, 2012), a hurricane relief applicant sued various banks and agencies for denying his disaster fund claim for improper racial and political reasons. In a brief opinion, the court held that the plaintiff did not state a claim under RICO because he did not allege any predicate criminal acts. Quoting *Sinclair v. Hawke*, 314 F.3d 934, 943 (8th Cir. 2003), the court reasoned that "bankers do not become racketeers by acting like bankers."

Standing

In *Robinson v. Castle,* No. H-11-649, 2011 WL 3813292 (S.D. Tex. Aug. 29, 2011), dental patients sued Castle (the operator of a dental office) and others for RICO violations and sought damages for physical pain, mental anguish, medical expenses, and lost earning capacity. The district court granted the motion to dismiss the RICO claims for lack of standing, based on the absence of any allegation of injury to business or property.

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