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Causation in Civil RICO: Mrs. Palsgraf, 'Rough Justice'

The definition of the word "causation" seems straightforward. However, "proximate causation," denoting causation leading to liability, is more complex, as suggested by Helen Palsgraf's injury on the railroad platform. *Palsgraf v. Long Island R.R. Co.*, 248 NY 339, 162 NE 99 (1928) (*Palsgraf*).

Some federal statutory torts such as civil RICO (Racketeer Influenced and Corrupt Organizations Act) have as an element of the cause of action the defendant's "causation" of damage, generally relying on common-law concepts of proximate causation. Federal courts still resort to the language of Palsgraf, while proximate causation in federal litigation remains an elusive notion.[1]

This article reviews a recent U.S. Court of Appeals for the Second Circuit decision, *Ideal Steel Supply Co. v. Anza*, 373 F3d 251 (2d Cir. 2004), petition for cert. filed, 73 USLW 3216 (U.S. Sept. 28, 2004)(No. 04-433)(*Ideal*), that has departed from traditional causation requirements in civil RICO cases involving fraud. An appreciation of the significance of *Ideal*, however, requires review of the common-law origin of proximate cause and its application in federal litigation before Ideal.

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'Ideal' preserved the rubric of proximate cause as the test for causation under RICO, but found the transaction causation requirement unneeded as plaintiff was an intended target of RICO misconduct.

Common-Law Causation

While Mrs. Palsgraf waited for a train, she was injured by a scale knocked down by the explosion of a package of fireworks belonging to a passenger who was pushed onto a moving train by a railroad employee "a considerable distance away" from Mrs. Palsgraf. Reviewing whether the employee (and the railroad via respondeat superior) was legally responsible for Mrs. Palsgraf's injuries, the New York Court of Appeals, in its famous 1928 decision (4-3), denied recovery because of the absence of proximate causation. Chief Judge Benjamin N. Cardozo's majority opinion reasoned that the employee's act, even if negligent as to the passenger carrying the fireworks, did not violate any duty owed to Mrs. Palsgraf. In dissent, Judge William S. Andrews found Judge Cardozo's "duty to take care" analysis "too narrow," although he recognized that the phrase "proximate cause" had never been adequately defined:

> What we do mean by the word "proximate" is, that because of convenience, of public policy, of a *rough sense of justice*, the law arbitrarily declines to trace a series of events beyond a certain point. This is not logic. It is practical politics. *Palsgraf*, 248 NY at 349, 352 (emphasis added).

Federal courts nationwide, and even the Supreme Court, have resorted to this phrase 33 times in discussing the boundaries of "proximate cause," including in RICO cases

The Restatement (Second) of Torts (§281, comment c) accepted Judge Cardozo's view that there is no duty to an unforeseeable plaintiff, and, hence, no liability. However, case law has left unsettled whether this is the favored rule.

Causation in Fraud Cases

The Court of Appeals for the Second Circuit has long held that a complaint for fraud must allege two types of causation: "transaction causation" and "loss causation." Precisely what factual allegations support each type of causation is the subject of

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numerous, and prolix, opinions.

Transaction causation is often established when "but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental…transaction." *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, 343 F3d 189, 197 (2d Cir. 2003), cited with approval in *Dura Pharmaceuticals, Inc. v. Broudo*, — US—, 125 SCt 1627, 1633 (2005)(*Dura*). Courts thus frequently liken transaction causation to the plaintiff's reliance on the defendant's misstatement or omission. *Dura* at 1631. Loss causation, on the other hand, is "the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." *Lentell v. Merrill Lynch*, 396 F3d 161, 172 (2d Cir. 2005). The loss causation inquiry often focuses on whether the plaintiff's loss was a foreseeable consequence of the defendant's actions, thus invoking the common-law tort concept of proximate cause.[2] In decades of analyzing this dual transaction-loss causation requirement, the Second Circuit has displayed an admitted inconsistency.[3]

• ***Causation in Civil RICO.*** The Racketeer Influenced and Corrupt Organizations Act, 18 USC §§1961 et seq. (RICO), makes it unlawful for "any person employed by or associated with any enterprise …to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity…." 18 USC §1962(c). "Racketeering activity" includes mail and wire fraud. 18 USC §1961(1)(B).[4] "Any person injured in his business or property *by reason of* a violation of §1962 …may sue therefor…." 18 USC §1964(c) (emphasis added). A "'pattern of racketeering activity' requires at least two acts of racketeering activity," while the specific acts of racketeering activity alleged are often referred to as RICO "predicates." 18 USC §1961(5). In 1992, the Supreme Court held in *Holmes v. Securities Investor Protection Corp.*, 503 US 258, 266 n.12, 267, 112 SCt 1311, 1317 (1992), that RICO standing, like standing in the antitrust laws, on which civil RICO was modeled, "carries a [common law] proximate-cause requirement within it."

'Statutory Intent'

Notwithstanding *Holmes*' holding that common-law proximate causation is required for RICO standing, Circuit Judges Ralph K. Winter and Guido Calabresi have sought to depart from that principle. In *Abrahams v. Young & Rubicam Inc.*, 79 F3d 234, 237-239 (2d Cir. 1996), Judge Winter found that common-law proximate causation is not the measure of causation under RICO. Rather, in a nuanced comparison of causation in common-law torts with causation in "suits on a statute," Judge Winter wrote that the proper analysis is "one of statutory intent," i.e., "was the plaintiff in the category of people meant by the statute to be safeguarded, and was the harm that which the [statute] meant to avoid?" His principal authority for this proposition was *Gorris v. Scott*, *L.R.* 9 Ex. 125 (1874), in which the defendant was held not liable for the loss of the plaintiff's sheep, washed overboard in a storm, because the purpose of the law requiring shipboard pens for containing livestock was to prevent disease, rather than loss of animals. Judge Winter also cited *Holmes* as supporting this test.[5]

Following *Abrahams*, the court in *Moore v. PaineWebber, Inc.*, 189 F3d 165, 172 (2d Cir. 1999), vacated the dismissal of a RICO complaint alleging mail and wire fraud predicates and held that both transaction and loss causation had been adequately pleaded. Judge Calabresi wrote for the majority: "We conclude that plaintiffs' case arises out of a harm *that is within the contemplation of the statute …and does so proximately*." (Emphasis added.) Notably, Judge Calabresi also wrote a separate concurring opinion because "[m]uch confusion [surrounds] …the relationship between causation in statutory cases and in common-law actions"; he said that the causation-standing requirements of RICO actions

> cannot simply be taken from the common law of torts. They must be derived instead from the purpose of the RICO statute, and— since the predicate offenses are incorporated into RICO—they must also flow from the *purposes* of the statutory provisions that define the predicate offenses. Id. at 173-74 (emphasis added)(citing *Abrahams*, 79 F3d at 237-38 n.3).[6]

The Supreme Court had declined to reach this very issue in *Holmes*. But see *Holmes*, 503 US at 280 (O'Connor, J., concurring).

In 2003, notwithstanding *Abrahams* and *Moore*, the Second Circuit closed ranks behind common-law proximate cause as the test for civil RICO.[7]

RICO Causation in 'Ideal'

Ideal raised the question whether RICO predicates consisting of fraud can "proximately cause" damage even when the plaintiff cannot demonstrate transaction causation. *Ideal* alleged that its competitor, National, sold products without charging (and paying) the requisite New York State sales tax, thereby giving National an unfair pricing advantage over Ideal. To conceal this wrongdoing, National's owners caused National to file false state sales tax returns, which Ideal alleged constituted mail and wire fraud RICO predicates. Unlike the typical RICO fraud victim, however, Ideal was neither itself misled by the false returns nor engaged in any transaction related to them.

The District Court dismissed the complaint, holding that, when the RICO predicates are mail or wire fraud, a plaintiff has standing only if it can allege that it has itself relied on the defendant's misrepresentations —because reliance is necessary to show transaction causation. As only New York State had relied on National's false returns, the District Court dismissed Ideal's RICO claim. 254 FSupp2d 464, 467-69 (SDNY 2003).

On appeal, Ideal argued that, though it had not itself relied on the misrepresentations in National's returns, it still had RICO standing because it had alleged facts

showing that National's fraudulent conduct nevertheless had "proximately caused" business injuries to Ideal in the form of lost sales revenue.

In an opinion by Circuit Judge Amalya L. Kearse, the Second Circuit agreed with Ideal and vacated the order of dismissal. Citing *Holmes*, the court held that RICO's "by reason of" language only requires a plaintiff to plead that the defendant's RICO violation proximately caused it injury; the court therefore reinstated Ideal's complaint in spite of Ideal's "claim[] to have been directly harmed by means of a fraud perpetrated on *another person* [i.e., the New York State Tax Department]." 373 F3d at 263 (emphasis added).

Ideal changed Second Circuit precedent by squarely holding that a civil RICO plaintiff can be any *target* of a defendant's fraud—even if not the person or entity to whom the defendant's misrepresentations were made. The court noted that "the foreseeability component of proximate cause is established where the plaintiff was 'a target []' and 'intended victim []' of the racketeering enterprise …*even if he was not the primary target or victim*[,]"concluding that "a RICO fraud claim based on mail fraud may be proved where the misrepresentations were relied on by a third person rather than by the plaintiff." Id. at 259, 261-62 (brackets in original; emphasis added; internal citation omitted).

The *Ideal* panel emphasized that "[no] precedent suggests that a racketeering enterprise can only have one 'target,' or that only the 'primary target' has standing." Id. at 259 (brackets in original; internal citation omitted). However, this statement seemingly contradicts *Holmes*, which disfavored "[a]llowing suits by those injured only indirectly" and concluded that permitting a RICO claim to be brought by the "conspiracy's *secondary victims*…runs afoul of proximate-causation standards."[8]

Conclusion

In *Ideal*, the Second Circuit preserved the common law rubric of "proximate cause" as the test for causation under RICO, but found the traditional transaction causation requirement unnecessary because the plaintiff was an "intended target" of the RICO misconduct. *Ideal* thus substituted the RICO defendant's "targeting" of the plaintiff for the conventional requirement in fraud cases that a plaintiff rely on the defendant's misrepresentations. This holding, an evident application of the panel's "rough sense of justice," clearly expands potential liability in civil RICO cases involving fraud. *Ideal* now allows RICO plaintiffs to survive motions to dismiss by artfully portraying themselves as "intended targets"—even if not the primary targets—of a competitor's fraud against others (including tax authorities).[9] Consequently, *Ideal* demonstrates that Justice William S. Andrews' axiom of practical politics still infuses causation analysis. Of course, the Supreme Court may soon have a final word on this subject, in *Ideal* or otherwise.[10] Meanwhile, in the context of causation in federal litigation, the search for "rough justice" continues.

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1. Justice John Paul Stevens once wrote that it is "virtually impossible to announce a black-letter rule [of proximate cause] that will dictate the result in every case." Associated General Contractors of CA, Inc. v. CA State Council of Carpenters, 459 U.S. 519, 536, 103 S.Ct. 897, 908 (1983) (emphasis added). Justice Clarence Thomas, citing Palsgraf, more recently noted that "[t]his Court has been less than clear with respect to the requirements for establishing proximate cause." Archer v. Warner, 538 U.S. 314, 326, 123 S.Ct. 1462 (2003)(dissenting opinion).

2. Lentell, 396 F.3d at 172 ("We have described loss causation in terms of the tort-law concept of proximate cause . . .."); Emergent, 343 F.3d at 197 ("We have often compared loss causation to the tort law concept of proximate cause, 'meaning that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission.'") (internal citation omitted); AUSA Life Insurance Company v. Ernst & Young, 206 F.3d 202, 210 (2d Cir. 2000) ("… loss causation is causation in the traditional 'proximate cause' sense….") (emphasis added); Manufacturers Hanover Trust Co. v. Drysdale Securities Corp., 801 F.2d 13, 20 (2d Cir. 1986) ("The requirement of 'loss causation' derives from the common law tort concept of 'proximate causation.'") (internal citation omitted).

3. The Court has acknowledged "arguably inconsistent threads in our prior case law." Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 179, 187 (2d Cir. 2001).

4. The mail fraud and wire fraud sections are virtually identical. "The . . . statutes [both] prohibit the use of those means of communication in furtherance of 'any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises.' 18 U.S.C. §§1341, 1343." Ideal, 373 F.3d at 256.

5. The authors have found little or no support for Judge Winter's proposition in his cited reference to the Court's opinion in *Holmes*, although Justice Antonin Scalia's solo concurring opinion seems to support it. 503 U.S. at 286. Moreover, the proposition itself stands in marked contrast to an earlier Supreme Court opinion directly on point: "[A requirement] that the plaintiff must seek redress for an injury caused by conduct that RICO was designed to deter is unhelpfully tautological." Sedima, S.P.R.L. v. Imrex Co., Inc., 473 U.S. 479, 494 (1985). It also appears that Judge Winter's foray into the realm of "statutory intent" ultimately disregards *Holmes'* determination that the "by reason of" language in the RICO statute means the defendant's conduct must "proximately cause" harm to the plaintiff in the common law sense.

6. As to divining statutory "purpose," in Gorris, there was a specific preamble in the statute that announced what the "mischief" was that the statute sought to avoid, thus making its purpose manifest. See Abrahams, 79 F.3d at 237; Moore, 189 F.3d at 178 n.7 (Calabresi, J., concurring). Determining the "purpose" of RICO, with its myriad predicates, which include many criminal statutes of 50 states, would not be as easy an exercise. See 18 U.S.C. § 1961(1). See also Lerner v. Fleet Bank, N.A., 318 F.3d 113, 120 (2d Cir. 2003).

7. In Lerner, 318 F.3d at 122 n.7 (emphasis added), the court "encourage[d] district courts" to use only the rubric of proximate causation to decide RICO standing, and in Baisch v. Gallina, 346 F.3d 366, 373 (2d Cir. 2003)(emphasis added), it "clarif[ied] that it is inappropriate to apply a [statutory intent] test independent of this circuit's proximate cause analysis." In the securities fraud context, the Supreme Court has recently endorsed the common law causation test, although it recognized that statutory intent is an important consideration, as well. Dura, 125 S.Ct. at 1633.

8. *Holmes*, 503 U.S. at 274 (bracketed material in original; emphasis added). Furthermore, to the extent Ideal indicates that a RICO plaintiff may recover for some "racketeering injury" that is distinct from the injury caused by the alleged predicate acts, it contravenes the Supreme Court's unambiguous determination that "[t]here is no room in [RICO's] statutory language for an additional, amorphous 'racketeering injury' requirement." Sedima, 473 U.S. at 495 (emphasis added). See also *Holmes*, 503 U.S. at 269 n.15 (confirming that there is no "analogue" in RICO jurisprudence to the Clayton Act's required showing of an "antitrust injury").

9. After remand, the District Court granted Ideal's motion to file an amended complaint adding further RICO mail fraud predicates based on defendants' filing of allegedly false income tax returns. The amended complaint alleges that defendants caused injury to Ideal's business by passing on to National's customers lower prices—thereby increasing National's sales and customer base—made possible by the false income tax returns, as well as by the false sales tax returns that were the subject of the earlier complaint. 2005 WL 911470 (S.D.N.Y. April 19, 2005).

10. The certiorari petition in *Ideal* is still pending. However, the Court has granted certiorari in *Bank of China, NY Branch v. NBM L.L.C.*, 73 U.S.L.W. 3745, 3749 (U.S. June 27, 2005)(No. 03-1559), limiting the question for review to whether a civil RICO plaintiff alleging mail and wire fraud as predicate acts must establish reliance. In *Bank of China*, the Second Circuit, citing *Holmes*, held that the requirement of showing that the defendant's RICO violation (consisting in part of mail and wire fraud predicates) was the "proximate cause" of the plaintiff's injury includes the requirement of showing "reasonable reliance."

Because the Court found that the jury was not properly instructed on this point, it reversed the judgment for the plaintiff. *Bank of China, NY Branch v. NBM L.L.C.*, 359 F3d 171 (2d Cir. 2004)(Scheindlin, D.J., sitting by designation). *Bank of China* was decided by the Second Circuit before *Ideal*, and *Bank of China* did not deal with the factual situation in *Ideal*, where the complaint alleged reliance by a third party, not the RICO plaintiff.

In its certiorari petition, the bank argued that several circuits have held that reliance is not a required element of a civil RICO claim based on predicate acts of mail and wire fraud. 2004 WL 1123366 at *13. In an amicus brief in *Bank of China*, the Solicitor General opposed granting certiorari, contending that *Bank of China* was correctly decided, that civil RICO based on mail and wire fraud does require reliance—at least by a third party (citing *Ideal*)—and that there was no conflict among the circuits. 2005 WL 1240076.

To what extent proximate cause in civil RICO based on mail and/or wire fraud requires reliance—by anybody—may well be answered by the Court next term in *Bank of China*. Either way, it appears that *Ideal* is likely to continue to allow civil RICO plaintiffs in the Second Circuit to allege mail and wire fraud predicate acts, with reliance by a third party, as long as the plaintiff was thereby "proximately" damaged.