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RICO's Lessons for Loss Causation

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In *Hemi Group, LLC v. City of New York*, the Supreme Court held that New York could not sue an online cigarette seller under the Racketeer Influenced and Corrupt Organizations Act (RICO) for failing to file certain tax-related information about its customers.[1]

The *Hemi* Court announced, as a matter of federal common law, that "proximate cause" must be established by "the directness of the relationship between the conduct and the harm," and does *not* turn on "foreseeability."[2] In so holding, the Court built upon two RICO precedents—*Anza v. Ideal Steel Supply Corp.*[3] and *Holmes v. SIPC*[4]—which similarly required "directness," as opposed to foreseeability, as the touchstone of proximate cause.

I have previously suggested that the Supreme Court's RICO cases should be of interest to securities litigators, because many of the factors bearing on causation in RICO cases are also present in securities cases.[5] In particular, "*Anza* instructs that 'the central question [a court] must ask is whether the alleged violation led directly to the plaintiff's injuries.'"[6] *Hemi* reinforces that instruction.

This article expands on that observation to suggest that the "loss causation" element of a securities-fraud action should be construed congruently with the proximate cause standard articulated by the Supreme Court in its RICO decisions, most recently *Hemi*. That is, if a RICO plaintiff must show a "direct" relationship between the wrongdoing and harm alleged, and not merely that the harm was foreseeable, why should a securities-fraud plaintiff be allowed to prevail on any lesser showing?

Background

In a trio of cases—*Holmes*, *Anza*, and (most recently) *Hemi*—the Supreme Court has significantly tightened the "proximate cause" element of a RICO violation.

RICO authorizes "[a]ny person injured in his business or property by reason of" racketeering activity, which is defined to

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include a number of predicate acts such as mail or wire fraud, to bring a civil action.[7] RICO's civil-suit provision "require[s] a showing that the defendant's violation not only was a 'but for' cause of [the plaintiff's] injury, but was the proximate cause as well."[8]

In *Holmes*, after concluding that proximate cause is a "required" element of a civil RICO claim, the Court explained that it was using the term "'proximate cause' to label generically the judicial tools used to limit a person's responsibility for the consequences of that person's own acts."[9] "[A]mong the many shapes the concept took at common law," the Court continued, "was a demand for some direct relationship between the injury asserted and the injurious conduct alleged. Thus, a plaintiff who complained of harm flowing merely from the misfortunes visited upon a third person by the defendant's acts was generally said to stand at too remote a distance to recover."[10]

The *Holmes* Court offered three justifications for requiring "directness of relationship" as a "central element[]" of the proximate-cause inquiry.[11] First, more attenuated injuries are more likely to be caused by factors independent of the alleged wrongdoing. Second, recognizing indirect injuries would require apportionment of damages among wrongdoers. And third, "the need to grapple with these problems is simply unjustified by the general interest in deterring injurious conduct, since directly injured victims can generally be counted on to vindicate the law as private attorneys general, without any of the problems attendant upon suits by plaintiffs injured more remotely."[12]

In *Anza*, the Court explained that its "analysis begins—and, as will become evident, largely ends—with *Holmes*."[13] The Court reiterated "[t]he requirement of a direct causal connection" between the wrongdoing and harm alleged by the civil plaintiff.[14]

The *Anza* Court, building upon *Holmes*, offered five reasons for enforcing the directness requirement: First, the direct victim of the purportedly illegal conduct (defrauding the tax authority) was the State of New York, not the plaintiff; second, the facts presented in *Anza* made it difficult to "ascertain the damages caused by some remote action"; third, other intervening events could have resulted in the plaintiff's asserted injury; fourth, if the Court permitted the plaintiff to maintain its claim, the proceedings that would follow would be inherently speculative; and fifth, the facts presented by the plaintiff raised the specter of duplicative recovery, because "the immediate victims" of the alleged violation could "be expected to vindicate the laws by pursuing their own claims."[15]

Hemi followed directly from *Holmes* and *Anza*. The City of New York sued an online cigarette vendor, arguing that its failure to file certain tax-related customer information constituted a RICO violation. The Court held that RICO's proximate-cause requirement was not satisfied.[16]

The *Hemi* Court first stressed that "as we reiterated in *Holmes*, '[t]he general tendency of the law, in regard to damages at least, is not to go beyond the first step'" in the causal chain.[17] The plaintiff's theory, in contrast, postulated multiple steps between wrongdoing and harm: "Here, the conduct directly responsible for the City's harm was the customer's failure to pay their taxes. And the conduct constituting the alleged fraud was Hemi's failure to file [customer] reports. Thus, as in *Anza*, the conduct directly causing the harm was distinct from the conduct giving rise to the fraud."[18]

The *Hemi* Court also rejected the City's theory of liability because it "rests not just on separate *actions*, but separate actions carried out by separate *parties*."[19] "We have never before stretched the causal chain of a RICO violation so far," the Court explained, "and we decline to do so today."[20]

The dissenters in *Hemi* did not dispute that the City's claim failed the "directness" standard of proximate causation; rather, they argued that proximate cause should turn on "foreseeability" rather than directness.[21] The majority pointed out that the same argument had been advanced, unsuccessfully, by the dissent in *Anza*.[22] The majority concluded:

> **The concepts of direct relationship and foreseeability are of course two of the "many shapes [proximate cause] took at common law." Our precedents make clear that in the RICO context, the focus is on the**

directness of the relationship between the conduct and the harm. Indeed, *Anza* and *Holmes* never even mention the concept of foreseeability.[23]

Discussion

In a private securities-fraud action, the plaintiff must prove "'loss causation,' *i.e.*, a causal connection between the material misrepresentation and the loss."[24] Or, as Congress has put it: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages."[25]

The Supreme Court's leading decision on loss causation (*Dura*) describes this as a "proximate[] cause" requirement.[26] It cited with approval "the need to prove proximate causation" in securities cases.[27]

The *Dura* Court rejected an attenuated theory of loss causation for reasons that echo those underlying the RICO decisions. As in *Holmes*, the *Dura* Court rejected a "but-for" test for causation.[28] As in *Anza*, the *Dura* Court noted that a "tangle of factors" that could impact price (and hence loss) counsels against a causation finding.[29] And as in *Hemi*, the *Dura* Court explained that the securities laws are designed "to protect [investors] against those economic losses that misrepresentations *actually cause*."[30]

This is not to pretend that *Dura* and *Hemi* are on all fours—if for no other reason than Justice Stephen Breyer, the author of *Dura*, wrote the dissent in *Hemi*. But there are intriguing parallels between the two cases. And, interestingly, *Dura* nowhere mentions foreseeability as an element of loss causation under the securities laws.[31]

Both RICO and the securities laws (after the Private Securities Litigation Reform Act of 1995) are federal statutes in which Congress has authorized civil fraud suits but left many of the details to the courts. In the absence of contrary congressional direction—and there is none—it would make sense to construe the "cause" requirements congruently.

And both RICO and securities cases raise the specter of expensive yet baseless civil litigation, as the Supreme Court has recognized in many cases.[32] The "directness" standard adopted for RICO cases can be enforced on a motion to dismiss, as in *Anza* and *Hemi*. The Supreme Court has stressed the importance of motions to dismiss in securities cases, too.[33] Indeed, 0the Court's recent jurisprudence has favored rules that allow early judicial resolution of the merits of complex federal cases.[34]

The proximate cause standard announced in *Hemi* and the other RICO cases, which requires a direct relationship between the wrongdoing and harm alleged, could also be applied in private securities-fraud actions. In a brief recently filed in the Supreme Court, the federal government (without reference to the RICO cases) took the position that "a private plaintiff must establish a direct causal link between the defendant's violation and injury to himself."[35]

The Supreme Court has made clear that a civil plaintiff cannot merely recite in its complaint the legal elements of its causes of action; rather, it must plead facts that, if proved, would allow a reasonable fact-finder to conclude that those legal elements are met.[36] In *Hemi*, the Court held that an allegation that conduct "directly caused" the plaintiff's harm "is a legal conclusion about proximate cause."[37] The Court held that the plaintiff is required to allege *conduct* that led directly to its injuries.[38]

In a securities case, a civil plaintiff must plead and prove that the defendant's misconduct caused economic loss.[39] A mere allegation of "causation" will not suffice; yet an allegation of "foreseeability" does not add much to the mix.[40] As *Hemi* demonstrates, in contrast, the directness requirement can be evaluated at the motion-to-dismiss stage.[41]

Moreover, securities plaintiffs frequently bring claims that rely on an attenuated sequence of events to connect the alleged wrongdoing with a decline in the stock price, particularly when someone other than the issuer is named as a defendant. The concerns expressed in *Dura* mirror those in the RICO cases: The absence of a meaningful cau-

sation requirement will allow speculative or non-meritorious claims to proceed.

Accordingly, the following statements from the RICO trilogy would appear—at least as a working hypothesis—equally applicable in private securities-fraud cases:

- "[T]he focus is on the directness of the relationship between the conduct and the harm."[42]
- "[T]he central question [a court] must ask is whether the alleged violation led directly to the plaintiff's injuries."[43]
- "Thus, a plaintiff who complained of harm flowing merely from the misfortunes visited upon a third person by the defendant's acts was generally said to stand at too remote a distance to recover."[44]

At minimum, this intersection between RICO and securities cases should be fertile ground for securities litigators.

Conclusion

In RICO cases, the Supreme Court has definitively rejected "foreseeability" as the test for proximate causation, adopting instead a "directness" standard. The foregoing suggests that the same standard should be applied to the loss causation element of private securities-fraud claims.

NOTES

1. *Hemi Group, LLC v. City of New York*, ___ U.S. ___ (Jan. 25, 2010), slip op. 1, available online at 2010 WL 246151.
2. *Hemi*, slip op. 10.
3. Anza v. Ideal Steel Supply Corp., 547 U.S. 451, 126 S. Ct. 1991, 164 L. Ed. 2d 720 (2006).
4. Holmes v. Securities Investor Protection Corp., 503 U.S. 258, 112 S. Ct. 1311, 117 L. Ed. 2d 532, Fed. Sec. L. Rep. (CCH) P 96555, R.I.C.O. Bus. Disp. Guide (CCH) P 7968 (1992).
5. Mark A. Perry, "Stoneridge and the Continued Reconceptualization of Implied Private Rights of Action", 12 *Wall St. Lawyer* 1, 9 (Feb. 2008).
6. Perry, *supra*, at 9 (quoting *Anza*, 547 U.S. at 460).
7. 18 U.S.C.A. § 1964(c).
8. *Holmes*, 503 U.S. at 268 (citing *Associated General Contractors of California, Inc. v. California State Council of Carpenters*, 459 U.S. 519, 534, 103 S. Ct. 897, 74 L. Ed. 2d 723, 112 L.R.R.M. (BNA) 2753, 96 Lab. Cas. (CCH) P 14028, 1983-1 Trade Cas. (CCH) ¶ 65226 (1983)).
9. *Holmes*, 503 U.S. at 268.
10. *Holmes*, 503 U.S. at 268-269.
11. *Holmes*, 503 U.S. at 269.
12. *Holmes*, 503 U.S. at 269-270.
13. *Anza*, 547 U.S. at 456.
14. *Anza*, 547 U.S. at 460.
15. *Anza*, 547 U.S. at 458-460.

16. The Court divided 5-3, with Justice Sotomayor recused. Justice Ginsburg joined the majority opinion "in part," without specifying which "part" she was (or was not) agreeing with. *See Hemi*, slip op. 1-2 (Ginsburg, J., concurring).
17. *Hemi*, slip op. 7 (quoting *Holmes*, 503 U.S. at 271-272).
18. *Hemi*, slip op. 8 (citing *Anza*, 547 U.S. at 458).
19. *Hemi*, slip op. 8.
20. *Hemi*, slip op. 8.
21. *Hemi*, slip op. 6 (Breyer, J., dissenting).
22. *Hemi*, slip op. 9.
23. *Hemi*, slip op. 10.
24. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005).
25. 15 U.S.C.A. § 78u-4(b)(4).
26. *Dura*, 544 U.S. at 342.
27. *Dura*, 544 U.S. at 344-345.
28. *Dura*, 544 U.S. at 343.
29. *Dura*, 544 U.S. at 343.
30. *Dura*, 544 U.S. at 345 (emphasis added).
31. Although some courts of appeals have adopted a foreseeability standard for loss causation (*see, e.g., In re Flag Telecom Holdings, Ltd. Securities Litigation*, 574 F.3d 29, 40, Fed. Sec. L. Rep. (CCH) P 95295 (2d Cir. 2009)), the Supreme Court never has.
32. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741, 95 S. Ct. 1917, 44 L. Ed. 2d 539, Fed. Sec. L. Rep. (CCH) P 95200, 1975-1 Trade Cas. (CCH) ¶ 60351 (1975); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 163, 128 S. Ct. 761, 169 L. Ed. 2d 627, Fed. Sec. L. Rep. (CCH) P 94556 (2008).
33. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324, 127 S. Ct. 2499, 168 L. Ed. 2d 179, Fed. Sec. L. Rep. (CCH) P 94335 (2007).
34. *Ashcroft v. Iqbal,* 129 S. Ct. 1937, 1949-1950, 173 L. Ed. 2d 868, 2009-2 Trade Cas. (CCH) ¶ 76785, 73 Fed. R. Serv. 3d 837 (2009).
35. Brief for the United States as Amicus Curiae, *Morrison v. National Australia Bank Ltd.*, No. 08-1191 (U.S. filed Oct. 27, 2009).
36. *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 557-563, 127 S. Ct. 1955, 167 L. Ed. 2d 929, 2007-1 Trade Cas. (CCH) ¶ 75709, 68 Fed. R. Serv. 3d 661 (2007).
37. *Hemi*, slip op. 11.
38. *Hemi*, slip op. 11.
39. 15 U.S.C.A. § 78u-4(b)(4).
40. *See, e.g., Pension Committee of University of Montreal Pension Plan v. Banc of America Securities LLC*, 568 F.3d 374, 382, 47 Employee Benefits Cas. (BNA) 1011 (2d Cir. 2009) (concluding that allegation of "foreseeability" satisfied the *Twombly* standard).
41. *See also McBrearty v. Vanguard Group, Inc.*, 2009 WL 4019799 (2d Cir. Nov. 23, 2009) (pre-*Hemi* case affirming dismissal of RICO claim, even assuming loss was "foreseeable").
42. *Hemi*, slip op. 10.
43. *Anza*, 547 U.S. at 460.
44. *Holmes*, 503 U.S. at 268 (citing 1 J. Sutherland, *Law of Damages* 55-56 (1882)).