Ideal Steel Supply Corp. v. Anza (July 2, 2004): The Second Circuit Determines that No Reliance is Necessary When a Defendant's Alleged Acts of Mail and Wire Fraud Directly Cause Injuries to a Competitor or to the Target of the Scheme to Defraud.

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FACTS

Ideal Steel Supply Corp. ("Ideal") brought a civil RICO claim against its direct competitor, National Steel Supply Co. ("National"). Ideal and National were the only substantial competitors for steel products in their geographic area. According to Ideal's complaint, customers generally chose between National and Ideal on the basis of price. Ideal alleged that National had gained a competitive advantage by not charging customers state sales tax on cash transactions. Further, National allegedly did not pay any state tax on these cash transaction but, instead, submitted fraudulent state sales tax reports that intentionally omitted information concerning National's cash transactions. Thus, by defrauding the state tax authority , National was able to maintain its profit margin while undercutting Ideal's prices on cash transactions. Ideal alleged that national violated RICO section 1962(c) in that National's false state sales tax reports were transmitted to the state tax authority in violation of the federal mail and wire fraud statutes. Ideal further claimed that, under section 1964(c), it was injured "by reason of" National's scheme to avoid state sales taxes and to gain a competitive advantage over Ideal.

Ideal also brought a claim under section 1962(a), alleging that National had earned profits by its "cash, no tax" scheme and used the profits to open an outlet in close proximity to Ideal's sales facility. Ideal claimed that National's second location further caused significant business losses.

The district court dismissed Ideal's suit, holding that Ideal lacked standing because it did not rely on National's fraudulent tax reports. Because only the state tax authority relied on the fraudulent sales tax reports, Ideal could not satisfy RICO's direct causation requirement that a plaintiff be injured "by reason of" National's alleged RICO violation. Ideal appealed to the United States Court of Appeals for the Second Circuit.

MAIL AND WIRE FRAUD: COMPETITORS / TARGETS NEED NOT RELY

The Second Circuit noted that under section 1964(c) of the RICO Act, a plaintiff must show that it was injured in its business or property "by reason of" the defendant's RICO violation, i.e., "the plaintiff must plead and prove that the violation not only was the logical, or 'but for', cause of the injury but also was its

legally cognizable, or proximate cause." The district court relied on a long line of Second Circuit authority concerning RICO's proximate cause standard in the context of mail and wire fraud and dismissed the claim on the basis of the following general principle:

> In complaints predicated on mail and wire fraud, a plaintiff must plead "'loss causation,' meaning that the misrepresentation must be both the actual and a proximate source of the loss that the plaintiffs suffered," [citation omitted], *and* "transaction causation," which requires a plaintiff to demonstrate that [plaintiff] relied on defendants' misrepresentations. (Court's emphasis.)

The Second Circuit, however, distinguished this line of authority. First, the Second Circuit stated that in every case relied upon by the district court "we noted that the plaintiffs were not competitors of the racketeering enterprises or targets of alleged racketeering activity . . . . The view that a competitor alleging an injury to its business resulting from racketeering activity of a defendant competitor adequately pleads proximate cause within the meaning of section 1964(c) is consistent with the Supreme Court's . . . [standard for proximate causation]." Second, in the cases relied upon by the district court and requiring reliance, the plaintiffs claimed that they were parties to fraudulently induced transactions and that they were the person(s) deceived by the defendant's fraud. Because none of the cases relied upon by the district court concerned a plaintiff who claimed to have been directly harmed by means of fraud perpetrated on another person, the district court's reasoning was flawed.

The Second Circuit held that Ideal's allegations were sufficient to establish injury "by reason of" National's alleged RICO violations:

> . . . the principle governing the present case is that where a complaint contains allegations of facts to show that the defendant engaged in a pattern of fraudulent conduct that is within the RICO definition of racketeering activity and that it was intended to and did give the defendant a competitive advantage over the plaintiff, the complaint adequately pleads proximate cause, and the plaintiff has standing to pursue a civil RICO claim. This is so even where the scheme depended on fraudulent communications directed to and relied upon by a third party rather than plaintiff.
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> [National's] mailings or electronic transmissions of fraudulent sales tax reports to the State Tax Department were an essential part in the "cash, no tax" scheme, for without the fraudulent reports, and the State's reliance on them, defendants would have had to pay the uncollected sales taxes out of their own assets. The principal

> intended victim of the scheme was Ideal, over which defendants sought to secure competitive advantage by giving certain cash customers an unlawful benefit, and by concealing that unlawful conduct and retaining the resulting profits by means of racketeering activity. Accordingly, we conclude that Ideal, as a competitor directly targeted by defendants for competitive injury, has standing to assert its RICO claims against defendants for violations of section 1962(c) based on the alleged predicate acts of mail and wire fraud.

SECTION 1962(a): INVESTING RACKETEERING INCOME – CAUSATION REQUIRED

The Second Circuit also held that Ideal stated a claim under section 1962(a) of the RICO Act for injury sustained as a result of National's investment of racketeering income. Under section 1962(a), a "complaint must allege injury 'by reason of defendants' investment of racketeering income in an enterprise,' as distinct from injury traceable simply to the predicate acts of racketeering alone or to the conduct of the business of the enterprise." *Ouaknine v. MacFarlane*, 897 F.2d 75, 82-83 (2d Cir. 1990).

The Second Circuit determined that National used its business profits to open a second retail outlet closer to Ideal's retail store. Because at least some of National's profits could properly be attributed to its racketeering activity, the Second Circuit held that Ideal adequately stated a claim for which relief may be granted under section 1962(a).

GOOD LAW vs. BAD LAW

Good Law: The Second Circuit's opinion in *Ideal Steel* affirms the elementary concept that RICO's proximate cause standard may be established by a plaintiff's reliance on fraudulent statements, but reliance is not the ***only*** means to establish proximate cause. *Ideal Steel's* holding that proximate cause is established by victims who experience competitive injury or who are targets of a scheme to defraud, even though the false statements are made to and relied upon by others, also corresponds with the case law in other jurisdictions and avoids an unnecessary split in authority. *See, e.g., Procter & Gamble Co. v. Amway Corp.*, 242 F.3d 539, 565-566 (5th Cir.), *cert. denied*, 534 U.S. 945 (2001). Courts must be mindful that although reliance is an element of common law fraud claims, it is not an element of a RICO claim. RICO requires injury "by reason of" the RICO violation, and a RICO plaintiff may experience direct harm even when reliance is absent. For example, a defendant who uses the mails to knowingly negotiate a forged check induces the bank's (not the victim's) reliance when authorizing the funds to be transferred. In the context of RICO, proximate

cause – not reliance – is the relevant issue. Reliance is one way to establish proximate cause, but not the only way. The Second Circuit maintained the appropriate focus in *Ideal Steel*.

Bad Law: In its opinion, the Second Circuit stated in dicta that "[g]enerally, two or more related acts of racketeering activity may be considered a 'pattern' of racketeering." This statement is based on the definition of "pattern" set forth in the RICO Act, section 1961(5).

Since the Supreme Court's decision in *H.J. Inc. v. Northwestern Bell*, 492 U.S. 229 (1989), the statutory definition of "pattern" has – for all practical purposes – become meaningless. In *H.J. Inc.*, the Supreme Court stated that there is "something to a RICO pattern beyond simply the number of predicate acts involved" and held "that to prove a pattern of racketeering activity a plaintiff or prosecutor must show that the racketeering predicates are related, and that they amount to or pose a threat of continued criminal activity." In glossing over the "pattern" requirement, and referring only to the statutory definition, the Second Circuit created confusing dicta that obviously ignores the operative "pattern" standard set forth by the Supreme Court in *H.J. Inc.* If this confusion was unintentional, the Second Circuit should be more careful in the future and avoid such short-hand commentary. If this confusion was intentional, one can only hope that *Ideal Steel* does not signal the Second Circuit's intention to whittle-away at *H.J. Inc.* Although *H.J. Inc.* is not the epitome of unambiguous judicial expression, it has proven to be a workable standard.

Bad Law: The Second Circuit held that Ideal had adequately pled a section 1962(a) claim by alleging that National had used its ill-gotten profits to open a new store closer to Ideal's location. In doing so, the Second Circuit correctly stated that a section 1962(a) "complaint must allege injury 'by reason of defendants' investment of racketeering income in an enterprise,' as distinct from injury traceable simply to the predicate acts of racketeering alone or the conduct of the business of the enterprise." *Ouaknine*, 897 F.2d at 82-83.

Given that the action was at the pleading stage, it is unclear whether National's investment of the proceeds of racketeering activity in a new store closer to Ideal constituted injury "by reason of" the investment. There is a long line of authority holding that when a defendant "reinvests" the proceeds of racketeering activity back into the enterprise and, thus, perpetuates the enterprise's existence, the proximate cause requirements under section 1962(a) are not met. For example, in *Westways World Travel v. AMR Corp.*, 182 F. Supp.2d 952 (C.D. Cal. 2001), the court held:

> Although the Ninth Circuit has not yet ruled directly on this issue, the majority of courts hold that mere reinvestment of racketeering

proceeds into a corporation is not sufficient under section 1962(a). *See Vicom, Inc. v. Harbridge Merchant Services, Inc.*, 20 F.3d 771, 779 n.6 (7th Cir. 1994). As the Third Circuit in *Brittingham* explained, "[a] plaintiff must allege . . . more than a remote connection between the use or investment of racketeering income and the injury suffered." 943 F.2d at 304. The *Brittingham* court concluded that the reinvestment of racketeering proceeds is too remote a connection. *See id.* at 305.

> If this remote were to suffice, the use-or-investment injury requirement would be almost completely eviscerated when the alleged pattern of racketeering activity is committed on behalf of a corporation . . . Over the long term, corporations generally reinvest their profits, regardless of the source. Consequently, almost every racketeering act by a corporation will have some connection to the proceeds of a previous act. Section 1962(c) is the proper avenue to redress injuries caused by the racketeering acts themselves. If plaintiffs' reinvestment injury concept were accepted, almost every pattern of racketeering activity by a corporation would be actionable under section 1962(a), and the distinction between section 1962(a) and section 1962(c) would become meaningless.

Id.; *see also Fogie v. THORN Americas, Inc.*, 190 F.3d 889, 896 (8th Cir. 1999) (holding that a plaintiff must allege an injury that is separate and distinct from injuries allegedly caused by the defendant's engaging in the predicate acts, and that allegations of reinvesting racketeering income do not suffice); *Kaczmarek v. International Business Machines Corp.*, 30 F.Supp. 2d 626, 628-29 (S.D.N.Y. 1998) (concluding that reinvestment of racketeering income is not an "injury" under section 1962(a) because the real cause of injury would be the predicate racketeering acts, not the investment of the proceeds of the enterprise). This Court agrees that allegations of reinvesting the racketeering income are insufficient to state an injury arising from a defendant's use or investment of racketeering income under section 1962(a).

Here, Plaintiffs allege that the money [Defendants] received from its alleged racketeering activities were invested into its Debit Memo development and into ARC, Sabre, American Eagle and AMR to increase the volume of Debit Memos issued. Plaintiffs further allege that investing this money has enabled [Defendants] to increase its issuance of Debit Memos and the collection of the

> alleged unlawful penalties from travel agents including Plaintiffs. These allegations fail to state facts which amount to an injury to Plaintiffs arising from Defendants' use or investment of racketeering income, as opposed to injury from the predicate acts themselves. *See Nugget Hydroelectric*, 981 F.2d at 437. Plaintiffs merely allege Defendants reinvested the proceeds obtained from its alleged predicate racketeering acts, which then enabled Defendants to increase the same racketeering activities. The real injury allegedly suffered by Plaintiff is from the racketeering activity, not from the investment of the proceeds. *See Kaczmarek*, 30 F.Supp. 2d at 628-629. Therefore, the Court will grant Defendants' motion to dismiss Plaintiffs' section 1962(a) claim without prejudice.

Id. at 960-961.

The obvious issue presented by *Ideal Steel* is whether National's opening of a second store simply constituted the reinvestment of the proceeds of racketeering back into the enterprise or whether Ideal experienced some unique injury by virtue of National's new store. At first glance, it does not appear as though the opening of a second store would cause any unique harm, separate from the harm being caused by the acts of racketeering. Ideal was allegedly injured "by reason of" National's failure to charge sales tax to cash paying customers. The additional store enabled National to engage in its racketeering activity at two locations, rather than one. The fact remains, however, that regardless of whether National is doing business at one or two locations, Ideal is injured "by reason of" the alleged "cash, no tax" scheme. The fact that National opened a second store imposed no unique injury. The second store simply increased the amount of harm being caused by the alleged acts of racketeering. Perhaps discovery will reveal some unique injury to Ideal, but the courts must be careful not to all a section 1962(a) claim to proceed merely on the basis of a reinvestment injury.

The Second Circuit's full opinion is published at *Ideal Steel Supply Corp. v. Anza*, 373 F.3d 251 (2d Cir. 2004). The Second Circuit's decision in *Ideal Steel* was subsequently reversed in part and vacated in part by the United States Supreme Court. *See Anza v. Ideal Steel Supply Corp.*, 547 U.S. 451 (2006).