DIRECTORS AND OFFICERS
RICO'S PERSON-ENTERPRISE DISTINCTNESS REQUIREMENT

JOSEPH M. MCLAUGHLIN
SIMPSON THACHER & BARTLETT LLP

JUNE 26, 2000

The RICO statute[1] is a web of potential exposure to third parties for corporate directors and officers. The assertion of a RICO claim immediately raises the economic and publicity stakes for any corporate director or officer alleged to have undertaken, in the statute's adhesive phrase, a pattern of racketeering activity.

The aggressive expansion of RICO beyond its narrow beginnings as a tool to combat organized crime has been alternately deplored and encouraged by members of the legal and business communities with differing perspectives. The combination of the statute's broad language, the availability of treble damages and recovery of attorneys' fees by a successful civil RICO plaintiff entices many claimants to recast traditional commercial disputes as RICO violations. While the Supreme Court has recognized that most civil RICO claims are asserted against legitimate businesses and their employees, "rather than against the archetypal, intimidating mobster,"[2] it has resolved to leave to Congress any wholesale curtailment of the statute's reach. The high court has demonstrated greater willingness to reconcile conflicting interpretations of specific RICO provisions, most recently in *Beck v. Prupis*[3], in which the Court clarified that no civil RICO conspiracy claim arises from injury caused by an overt act that is not a RICO statutory racketeering act. The facts of *Beck* presented the Court with another opportunity to address a recurring RICO issue that has engendered conflicting results — whether corporate directors or officers may properly be sued as RICO "persons" when the alleged RICO "enterprise" is the company they serve -- but the Court bypassed the issue without comment.[4] This column examines the genesis of "the person-enterprise distinctness rule" and cases interpreting the rule, and seeks to extract practical guidelines from the often metaphysical inquiries the rule entails.

The Source of the Rule

Section 1962(c), the broadest and most frequently invoked civil liability provision of RICO, makes it unlawful "for any person employed by or associated with an enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering." The statute broadly defines "person" as including "any individual or entity capable of holding a legal or beneficial interest in property," and "enterprise" as including "any individual, partnership, corporation . . . and any union or group of individual associated in fact although not a legal entity."[5]

Few statutory provisions have been parsed as closely as section 1962(c), with the interplay between the terms "person" and "enterprise" receiving particular scrutiny.[6] Federal courts everywhere except the Eleventh Circuit require that the culpable "person" be separate and distinct from the "enterprise" it allegedly conducts through a pattern of racketeering activity.[7] The language of section 1962(c) and the stated purpose of the provision support the person-enterprise distinctness requirement. Section 1962(c)'s limitation of liability to persons "employed by or associated with" an enterprise suggests that the person should be distinct from the enterprise. In contrast, section 1962(a), which provides a narrower RICO claim for plaintiffs injured by an alleged investment of racketeering-derived income in the enterprise, does not contain any of the language in section 1962(c) which suggests that the culpable person and the enterprise must be distinct.[8] The person-enterprise distinctness rule under section 1962(c) also accords with Congress'objective under that provision of combating infiltration of innocent or passive corporations by RICO "persons," who either siphon off the company's money or manipulate it as a passive tool to extract money from third parties.[9]

Affiliated Entities

Several generally accepted rules have arisen from section 1962(c)'s person-enterprise distinctness requirement. Most fundamentally, the prohibition against an identity between the "enterprise" and the defendant "person" forecloses a section 1962(c) claim against a company that allegedly conducted itself as an enterprise.[10] Most courts, including the Second Circuit, accept as a corollary that a subsidiary or other corporate affiliate cannot constitute the "enterprise" through which a defendant-person parent company allegedly conducts racketeering activity. As one court summarized the law, "[m]erely pleading that the parent corporation set the proscribed policy and that the subsidiary subsequently acted on its behalf is not sufficient."[11] Thus, in *Discon, Inc. v. Nynex Corp.*,[12] the Second Circuit affirmed the dismissal of a section 1962(c) claim where the alleged "enterprise" comprised a parent company and two of its subsidiaries, and the same corporate entities, which the Court noted functioned within a "unified corporate structure," were sued as "persons" conducting the group's affairs.[13]

The Second Circuit has held, however, that the breadth of the statutory terms "person" and "enterprise" permits allegations that a single entity is the defendant "person" conducting the affairs of an "enterprise" in which the defendant is one of several members with no legal affiliation. For example, in *Cullen v. Margiotta*,[14] the Second Circuit held that as to an "enterprise" consisting of Town + Town Committee + County Committee, any one of those entirely separate entities could be a defendant "person" conducting the affairs of the enterprise of which it was a part. The lesson is that while an entity may not be deemed "associated with" only itself or entities sharing a common economic purpose, section 1962(c) permits suit against a defendant "person" associated with an "enterprise" of which it is only a part. Of course, the more unaffiliated entities a plaintiff argues combined to form an enterprise, the greater the difficulty it will encounter in pleading and proving that the "person" participated in the "operation or management of the enterprise itself."[15]

Directors, Officers and Employees

The person-enterprise distinctness rule has been applied less consistently when individuals are introduced into the mix. Of particular significance to the corporate director or officer are the divergent approaches courts have adopted to whether a plaintiff can overcome the distinctness requirement by alleging (a) a corporation as the enterprise and (b) the same corporation's directors, officers or employees as culpable RICO persons who conduct the business of the enterprise-corporation through a pattern of racketeering activity.

Corporations, unlike natural persons, can act only through employees and agents. This principle underlies the Second Circuit's baseline formulation that a plaintiff cannot circumvent the distinctness rule "by alleging a RICO enterprise that consists merely of a corporate defendant associated with its own employees or agents carrying on the regular affairs of the defendant."[16] *Riverwoods Chappaqua Corp. v. Marine Midland Bank, N.A.*,[17] is illustrative. There, plaintiffs alleged that the defendant bank and two of its officers were "persons" conducting the affairs of the bank's Restructuring Group as a RICO enterprise. Reasoning that the Restructuring Group was not distinct from the defendant bank itself and that the activities of the Group were nothing more than activities of company representatives conducting the business of the bank, the Second Circuit held that "where employees of a corporation associate together to commit a pattern of predicate acts in the course of their employment and on behalf of the corporation, the employees in association with the corporation do not form an enterprise distinct from the corporation."

Even if the regular business affairs of the company are alleged to be conducted for an illegitmate purpose, including fraud, the distinctness rule forecloses allegations under section 1962(c) that a company conducted itself (or its directors, officers or employees conducted the company) as an "enterprise."[18] In the Second Circuit, "an individual corporate officer is distinct from his employer only if he acts in a manner inimical to, or at least divorced from, the corporation's interest," which is a difficult showing.[19] Applying these principles, courts in the Second Circuit generally have dismissed section 1962(c) claims alleging (1) corporate directors and officers as the "persons" conducting the affairs of the company they serve as an "enterprise,"[20] and (2) partners and employees of an accounting firm as the "persons" conducting the affairs of the firm and its affiliates as an "enterprise."[21]

The bar imposed by the person-enterprise distinctness requirement has not entirely disabled plaintiffs able to posit meaningful differentiations between defendant "persons" and "enterprises" from alleging section 1962(c) claims. In *Securitron Magnalock Corp. v. Schnabolk*,[22] the Second Circuit sustained allegations of an "association in fact" enterprise consisting of two corporations that shared office space and an individual who was an officer and the controlling shareholder of both corporations. The same three entities were named as defendant "persons" allegedly conducting the "enterprise." Rejecting a challenge under the distinctness rule to the enterprise formulated, the Second Circuit de-emphasized the centrality of the common officer and controlling shareholder and found dispositive that the two companies were in different

lines of business and each legally was "an independent entity that could benefit from [the common officer's] nefarious activities." Some courts have permitted section 1962(c) claims to proceed by adopting a sharply limited intepretation of the person-enterprise distinctness rule. In *Mirman v. Berk & Michaels, P.C.*,[23] the Southern District of New York deemed an individual defendant to be a separate and distinct entity from the accounting firm defendants in which he was a partner so that plaintiffs could allege the individual as the "person" conducting an "enterprise" consisting of the individual and the accounting firms at which he was a partner. This result seems questionable; it applies *Cullen*'s "partial overlap" rule, *i.e.*, an individual may be both the RICO "person" and "enterprise" if he is merely a part of the enterprise and not its sole member, but extends it beyond its proper limitation to an enterprise that includes at least one member separate and legally unaffilated with any defendant "person."[24]

More significantly, a growing number of courts outside the Second Circuit have rejected the person-enterprise distinctness rule as a bar section 1962(c) claims against corporate directors and officers.[25] In *Jaguar Cars, Inc. v. Royal Oaks Motor Car Co.*,[26] the Third Circuit parted with the Second Circuit and held that because "a corporation is a legally distinct entity from its officers or employees," the corporation's directors, officers or employees "may properly be held liable [under section 1962(c)] as persons managing the affairs of their corporation as an enterprise." The Third Circuit interpreted two Supreme Court decisions, neither of which expressly addressed the distinctness rule, to require overruling prior decisions barring allegations that directors or officers could conduct the affairs of their company as an enterprise. *Jaguar Cars* reasoned that the Supreme Court's holding in *Reves v. Ernst & Young*[27] that section 1962(c) liability does not extend beyond those who participate in the operation or management of an enterprise, "undermined the use of § 1962(c) to hold liable 'outsiders' who have no official position with the enterprise." In what has been questioned as a "leap of logic,"[28] the Third Circuit then interpreted *National Org. for Women v. Scheidler*'s[29] observation that the "enterprise" in section 1962(c) is "generally" viewed as the "vehicle through which . . . racketeering activity is committed, rather than the victim of that activity," to mean that corporate enterprises cannot be victims of racketeering activity undertaken by corporate insiders. In the Third Circuit's view, this meant that section 1962(c) would wither from disuse it did not authorize suit against the persons most likely to have the ability to use a company as a vehicle for racketeering activity.

The Third Circuit acknowledged that *Jaguar Cars* effectively means that, assuming the other requirements of RICO are met, "'a corporation may always be pled to be the enterprise controlled by its employees or officers.'" The court purported to ameliorate this result by noting that "the plaintiff can only recover against the defendant officers and cannot recover against the corporation simply by pleading the oficers as the persons controlling the corporate enterprise" -- a qualification providing limited comfort to corporate directors and officers and their insurers.

Conclusion

Jaguar Cars has not heralded the demise of the person-enterprise distinctness requirement. Expressly rejecting *Jaguar Cars*, courts in the Second Circuit have adhered to the requirement: when a director or officer "has acted in a corporation's behalf, he does not function as an entity distinct from that corporation, and should not be held liable under § 1962(c).[30] A viable section 1962(c) action requires allegations against defendant "persons" who are sufficiently distinct from the enterprise they purportedly conducted through a pattern of racketeering activity. If a corporate entity cannot associate with itself, logic and recognition of basic principles of corporate structure commend the conclusion that (1) directors and officers acting within the scope of their duties cannot be considered distinct from the company on whose behalf they act, and (2) affiliated companies, although legally separate, cannot constitute a valid enterprise because they operate within a unified corporate structure.

ENDNOTES

1 The Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-68.

2 *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 499 (1985).

3 120 S. Ct. 1608 (2000). Each of the defendants in the case when the matter reached the Supreme Court was a director or officer of an insurance holding company alleged to have conducted the company's business as an enterprise.

4 The Supreme Court had previously acknowledged but declined to address the issue of whether the alleged RICO enterprise must be separate and distinct from the person alleged to have engaged in a pattern of racketeering activity. *See H.J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 235 n.1 (1989).

5 18 U.S.C. § 1961(3) & (4).

6 For example, *Reves v. Ernst & Young*, 507 U.S. 170 (1993), in which the Supreme Court interpreted and limited the phrase "conduct or participate" in section 1962(c) to mean that no person can be liable under that provision unless it participated "in the operation or management of the enterprise itself," in turn sparked litigation concerning who is an operator or manager of a RICO enterprise under *Reves*. *See*, *e.g.*, *United States v. Viola*, 35 F.3d 37, 43 (2d Cir. 1994); *University of Maryland v. Peat, Marwick, Main & Co.*, 996 F.2d 1534, 1539 (3d Cir. 1993); *Clark v. Milam*, 847 F. Supp. 409, 416 (S.D. W.Va. 1994).

7 In *United States v. Hartley*, 678 F.2d 961 (11th Cir. 1982), *cert. denied*, 459 U.S. 1170 (1983), the court held that under section 1962(c) the same corporation could be alleged to be the enterprise and the person conducting the enterprise. *See also Cox v. Administrator U.S. Steel & Carnegie*, 17 F.3d 1386, 1398 (11th Cir. 1994), *cert. denied*, 513 U.S. 1110 (1995).

[8] Accordingly, a section 1962(a) "investment injury" claim may properly allege a corporation is the culpable "person" investing racketeering proceeds in the operation of its own corporate "enterprise." *Riverwoods Chappaqua Corp. v. Marine Midland Bank*, 30 F.3d 339, 345 (2d Cir. 1994); *Haroco, Inc. v. American National Bank & Trust Co.*, 747 F.2d 384, 401-02 (7th Cir. 1984), *aff'd on other grounds*, 473 U.S. 606 (1985).

[9] *Bennett v. U.S. Trust Co. of New York*, 770 F.2d 308, 315 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986).

[10] *See Bennett*, 770 F.2d at 315 ("[A] corporate entity may not be simultaneously the 'enterprise' and the 'person' who conducts the affairs of the enterprise through a pattern of racketeering activity."); *accord Anatian v. Coutts Bank (Switzerland) Ltd.*, 193 F.3d 85, 89 (2d Cir. 1999), *cert. denied*, 120 S. Ct. 1241 (2000); *Riverwoods*, 30 F.3d at 344; *Haroco*, 747 F.2d at 400; *Rae v. Union Bank*, 725 F.2d 478, 481 (9th Cir. 1984).

[11] *Ewing v. Midland Finance Co.*, 1997 WL 627644, *5 (N.D. Ill. Sept. 26, 1997) (dismissing section 1962(c) claim against parent company that allegedly conducted subsidiary's affairs as an enterprise).

[12] 93 F.3d 1055 (2d Cir. 1996), *vacated on other grounds*, 525 U.S. 128 (1998).

[13] *Id.* at 1063; *see also Fogie v. Thorn Americas, Inc.*, 190 F.3d 889, 898 (8th Cir. 1999); *Bachman v. Bear, Stearns & Co.*, 178 F.3d 930 (7th Cir. 1999); *Odishelidze v. Aetna Life & Cas.*, 853 F.2d 21, 23-24 (1st Cir. 1988); *Abdullah v. Travelers Property & Cas. Corp.*, 83 F. Supp. 2d 289, 292 (D. Conn. 1999); *Kaczmarek v. IBM Corp.*, 30 F. Supp. 2d 626, 629-30 (S.D.N.Y. 1998); *Nebraska Security Bank v. Dain Bosworth Inc.*, 838 F. Supp. 1362, 1368 (D. Neb. 1993) (parent company and subsidiaries "cannot together or alone form a RICO enterprise for § 1962(c) purposes when one or both are also the defendant "person" because a parent corporation and a wholly owned subsidiary are, from an economic perspective, one and the same").

[14] 811 F.2d 698 (2d Cir.), *cert. denied*, 483 U.S. 1021 (1987).

[15] *Reves*, 507 U.S. at 185.

[16] *Riverwoods*, 30 F.3d at 344; *accord Anatian*, 193 F.3d at 89; *Lorentzen v. The Home Ins. Co.*, 18 F. Supp. 2d 322, 331-32 (S.D.N.Y. 1998).

[17] 30 F.3d 339 (2d Cir. 1994).

[18] *Cedric Kushner Promotions, Ltd. v. King*, 1999 WL 771366, *3 (S.D.N.Y. Sept. 28, 1999) *Mayfield v. General Electric Capital Corp.*, 1999 WL 182586, *8 (March 31, 1999); *Protter v. Nathan's Famous Systems, Inc.*, 925 F. Supp. 947, 955-56 (E.D.N.Y. 1996).

[19] *CPF Premium Funding , Inc. v. Ferrarini*, 1997 WL 15836, *12 (S.D.N.Y. Apr. 3, 1997).

[20] *See, e.g.*, *Cedric Kushner*, 1999 WL 771366 at *4; *Moy v. Terranova*, 1999 WL 158361, *12 (E.D.N.Y. Mar. 2, 1999); *Sartini v. Portofino Sun Center*, 1997 WL 400209 (S.D.N.Y. July 16, 1997); *Ferrarini*, 1997 WL 15836 at *13; *Protter*, 925 F. Supp. at 956.

[21] *See, e.g.*, *Department of Economic Development v. Arthur Anderson & Co.*, 924 F. Supp. 449, 471 (S.D.N.Y. 1996).

[22] 65 F.3d 256 (2d Cir. 1995), *cert. denied*, 516 U.S. 1114 (1996).

[23] 1994 WL 410881 (S.D.N.Y. Aug. 3, 1994).

[24] *See Cedric Kushner Promotions, Ltd v. King*, 1999 WL 771366, *3 (S.D.N.Y. Sept. 28, 1999).

[25] *See, e.g.*, *Khurana v. Innovative Health Care Systems, Inc.*, 130 F.3d 143, 156 (5th Cir. 1997); *Richmond v. Nationwide Cassel, L.P.*, 52 F.3d 640, 646 (7th Cir. 1995); *Sever v. Alaska Pulp Corp.*, 978 F.2d 1529, 1534 (9th Cir. 1992).

[26] 46 F.3d 258 (3d Cir. 1995).

[27] 507 U.S. 170 (1993).

[28] *LaSalle Bank Lake View v. Seguban*, 937 F. Supp. 1309, 1323 (N.D. Ill. 1996).

[29] 510 U.S. 249 (1994).

[30] *Ferrarini*, 1997 WL 15836 at *12.