RICO REPORT – 2ND COURT OF APPEALS RULING
RECORDED ON : *FEBRUARY 11, 2022*

[CAL STEIN]

Hello and thank you for joining me on this special installment of the RICO Report where we're going to talk about a recent and interesting RICO decision released by the 2nd Circuit Court of Appeals last month. My name is Cal Stein and I'm a partner in the White Collar and Litigation Practice Groups at Troutman Pepper. I represent clients in white collar criminal and government investigation matters as well as in complex civil lawsuits and in RICO litigation. I am very pleased to have my partner, Steve Rinehart here with me today to talk about this case. Steve is a commercial litigation partner out of Troutman's New York office. Steve, it's wonderful to have you here today. Why don't you tell us a little bit more about yourself.

[STEVE RINEHART]

Thanks, Cal. I'm glad to be here. I've been practicing law for longer than I care to admit but I can say that I started practicing about five years after the RICO statute was passed. That'll give you a sense of my longevity. I do a variety of commercial business disputes. I've done a fair amount of civil RICO cases, including trying civil RICO cases to a jury. So, it's an area in which I have a lot of interest and this particular case that we're going to talk about today I thought was rather unusual.

[CAL STEIN]

Well, thank you, Steve. And, with that, let's get in and start talking about that case. Do you want to give us a little bit of background of the facts, summary of the case?

[STEVE RINEHART]

Sure. I'd be happy to. So, this case involves a dispute between two of the major players in the high-end bankruptcy consulting area. And what that means is bankruptcies involving assets of at least a billion dollars in which the trustee or the bankruptcy estate retains the services of a restructuring consultant to deal with decisions about how to liquidate, spin-off or restructure assets. And these two players in this case are Alix Partners and McKenzie. A little bit of a background here, just by way of interest, the case was brought by Jay Alix who is the founder of Alix Partners. He got the claims assigned to him by Alix Partners because he has been single-handedly pursuing McKenzie through various bankruptcy courts for years to try to get them disqualified. And as I describe the Complaint you'll understand why. So, McKenzie is the dominant competitor in this base. It gets most of the engagements and high-end bankruptcy cases. Of the engagements that McKenzie does not get, there are a handful of other players who receive those assignments. And historically, over a period of many years, Alix received about 24% of the engagements that did not go to McKenzie. Now, to be eligible for an engagement and to be appointed by a bankruptcy court, a consultant has to submit a disclosure to the Court that is submit it, certified under oath, under penalty of perjury, indicating that it does not hold an interest adverse to the bankruptcy estate and for an entity like McKenzie with thousands of clients, you can imagine there's potential there for conflicts of interest. So, the advisor submits the verified statement, Alix alleges – and these are only allegations – that McKenzie violated these requirements by submitting inaccurate applications

in 13 bankruptcy proceedings where ultimately McKenzie did receive the engagement as consultant. And Alix claims further that because these applications were false, that they constituted violations of law which gives sort of the basis for the RICO claims that Alix included in his Complaint. And I think, Cal, you're gonna talk about those in particular.

[CAL STEIN]

So, based on those facts, Alix brought seven total counts against McKenzie and we're just gonna focus here today on the RICO counts of which there were several. And briefly, I'm gonna go through some of the allegations they made in those RICO counts. First, Alix identified McKenzie Recovery and Transformation Services, abbreviated RTS, as the RICO enterprise. Alix alleged it was formed for the purpose of facilitating and committing the alleged fraud that Steve just described. In terms of racketeering activity, Alix accused McKenzie of many schemes to defraud primarily focusing on those allegedly false applications to the bankruptcy courts including in violation of federal mail and wire fraud statutes and the federal false declarations statute among many other violations of racketeering activity that are alleged. And then finally causation. And this is the element that is of most interest in this case and in this decision and the one we're gonna spend the time talking about today. Alix alleged that if McKenzie had not engaged in the fraud that Alix alleged then McKenzie would not have received the 13 engagements identified in the Complaint and further, that Alix would have been appointed in at least some of those 13. And we're gonna talk a lot more about that soon. This case was originally brought in the Southern District of New York and, Steve, do you want to tell us a little bit about what happened in those proceedings?

[STEVE RINEHART]

Sure. So, what happened there was that McKenzie moved to dismiss the Complaint under Rule 12(b)(6) of the Federal Rules of Civil Procedure on the basis that the Complaint did not state a cause of action upon which relief could be granted and that the RICO claims in particular were legally deficient, among other reasons, because they failed to allege proximate causation which is an element of civil RICO. Alix opposed the motion claiming that, in fact, it did show causation and the District Court agreed with McKenzie in saying that there was an insufficient allegation of proximate causation because there were intervening events and decisions that would have, could have plausibly caused Alix not to get those engagements and that in essence, the actions of the trustees, the bankruptcy court, and other actors in the bankruptcy process intervened to reach the decision to engage McKenzie and not Alix. That Alix was basically really just speculating.

[CAL STEIN]

Got it.

[STEVE RINEHART]

Otherwise would have received those engagements. So in essence the causation alleged was too remote, contingent, and indirect to sustain a RICO claim. And in making that decision the District Court was really relying on pretty much tried and true RICO juris prudence with respect to proximate causation. You do have to show or at least allege a plausible direct connection between the injury and the offense that's being alleged. Alix appealed to the Second Circuit Court of Appeals.

[CAL STEIN]

And that's what's really interesting about this case is that Alix did appeal it and ultimately the Second Circuit Court reversed the District Court. The Second Circuit found that Alix's theory of proximate cause was sufficient at least at the motion to dismiss stage. The Second Circuit found that the injuries Alix alleged, the loss of its engagements, or the theoretical loss of engagements at least, was sufficient and sufficiently directly connected to the alleged RICO violations of McKenzie's submission of the fraudulent applications. And baked into this decision is the Second Circuit's determination that all of those intervening events cited by the District Court and which Steve just mentioned, did not break the causal chain. And this is where I really want to start our discussion about this case. This concept of intervening events. So, Steve, the District Court's decision relied heavily on the presence of intervening events, most notably the decisions by the trustees and the Court not to choose Alix. That seemed like it made some sense to me but the Second Circuit had a different view. It wrote: "We agree that these might have been intervening events if Alix had somehow learned before the assignment had been made that McKenzie had been filing false statements and then sued for the fees it anticipated it would have received if McKenzie had told the truth. However, this is not such a case. Alix sued after the assignments had already been awarded." So, here, the Second Circuit seems to be focusing on the timing of the alleged fraud in the suit. What do you make of this?

[STEVE RINEHART]

Well, it looks like the Court was really addressing a specific objection that McKenzie had raised as reflected in the District Court's decision which is, not only are there these sort of intervening judgments and activities by other parties, that may break the chain of causation, but you can't even say that any consultant would have been retained in these cases because remember, the trustee of the debtor-in-possession makes the decision about whether or not it's appropriate to hire a third-party consultant to help restructure their business. So some bankruptcy cases no one is hired. So McKenzie argues how can you possibly say, Alix, that you would have gotten something that may not have existed and no one would have gotten that fee. So the Court was really addressing that particular argument by saying we're not there. The 13 cases in which Alix claims McKenzie wrongfully obtained the engagements were obviously 13 cases in which McKenzie had been appointed because the trustee had decided there should be a consultant. So that element of the causal chain was satisfied by the, if you want to call it, the timing of the case that Alix brought after a consultant had been appointed.

[CAL STEIN]

I also want to talk about what I've been referring to and, Steve, what we've been referring to when we discuss this case as the "market share theory" or the market share analysis that the Court went through. One of the most interesting aspects, I think, is that the Second Circuit adopted Alix's market share theory of causation which addressed the idea that the bankruptcy trustees and the Court would have selected them in a certain portion of the cases if McKenzie had been disqualified. This is summarized quite well in the following line from the opinion where the Court said: "It is also a reasonable inference that in making another selection they would have awarded assignments to eligible firms in approximately the same ratio they had been using in the past." So it's not just that they would have assigned someone else, it's that they would have assigned them in approximately the same ratio. And this is one way the

Second Circuit got around the intervening event argument offered by McKenzie. What are your thoughts on this?

[STEVE RINEHART]

Well, we can talk further about what was really the underlying concern of the Court throughout this piece of litigation, but to talk about the market share in particular. There are cases, including some RICO cases, that talk about market share. The Court in particular was referring to a couple of Seventh Circuit decisions, more specifically by Judge Posner whose approach to a juris prudence is at times eccentric.

[CAL STEIN]

[Laughing]

[STEVE RINEHART]

And memorable. And there are a couple of cases where he talks about probabilistic analysis as well as market share and lotteries and roulette wheels and stuff like that to sort of get his point across. But the cases aren't nearly as clear as the Second Circuit here would make you think. So market share is not gonna get you across the line on causation. And I think the Court here is doing a little bit of what it criticized the District Court about which is conflating causation and damages. Market share may be highly relevant to damages. Assuming you were wronged, how do you figure out what you would have gained absent the misconduct? You might look at market share. But the caselaw is not nearly that clear. So I think it was one of the paths that the Court took to get where it ended up but I'm not sure that particular analysis would have a lot of legs going forward.

[CAL STEIN]

We've talked a lot about the 13 cases that Alix identified in its Complaint. The Second Circuit spent some time focusing on one of those cases in particular. It was an engagement where Alix alleges that McKenzie should have been disqualified and it's the Jennon example. Basically, Alix alleged that Jennon's parent company against whom Jennon had a fraudulent transfer claim was a McKenzie client and Alix argues that if McKenzie had disclosed that, Jennon never would have hired McKenzie because it would not have wanted McKenzie investigating the fraudulent transfer claim against another of its own clients. That seemed to make some sense to me and this seemed like if true, a particularly egregious example assuming Alix could prove it. Did you get the sense that the seriousness of this particular conflict mattered to the Second Circuit?

[STEVE RINEHART]

I think it did. Certainly that's one reason why they called it out in their opinion and also, it presents a particularly right-line set of facts where it's easy to determine or to perceive that there was a serious and irreconcilable conflict going on here. Again, it's got to be proven ultimately before the Court, but those are the allegations and I think it's reflective of the Court's concern about the integrity of the bankruptcy process and it really pervades the opinion. So, there are several spots where the Court goes out of its way to say: "You know what? This case is different because it implicates our supervisory responsibility for the integrity of the bankruptcy courts." So by bringing this case kind of up front, it's really defining

– if you want to call it the moral problem – the Court's discussion of the Jennon example just indicates to me that as a litigator, you need to not only think about the law, but think about what story you're telling, because even appellate judges sitting on the bench in the Second Circuit are alert to the rights and the wrongs of the situation. So clearly the Court was concerned about this and I think that informs their ultimate determination to let this go back to the District Court for further development.

[CAL STEIN]

I think that's a really good point and really good advice as well. And, of course, while the Court did focus on the Jennon example, it applied the same rationale to the other 12. It specifically wrote: "Although proximate cause is most clearly alleged with respect to Jennon, the remaining 12 engagements also meet the proximate cause requirement." And in so stating that, the Court again focused on the facts that Alix was competing with McKenzie for these engagements. Do you think that under the reasoning here the fact of competition is enough or do you think there has to be more? For example, strong evidence that the plaintiff would have actually gotten the work but for the allegedly bad activity?

[STEVE RINEHART]

And I think that mere competition is not enough. In fact, you know, one of the kind of lessons of the development of RICO over decades is that, you know, the courts don't want competitors using this statute as a cudgel against each other and it's really not intended to solve that kind of a dispute. You really gotta show that there is in fact a pattern of criminal activity. And not just unfair competition. So, competition is not enough, but it certainly helps when you're looking at these issues of causation and damages. The evidence or at least plausible allegation that Alix, because of historical trends, because of the peculiar way the bankruptcy courts work, they could show statistically yes, we get 24% or thereabouts. Year in and year out it's really not a matter of speculation. So, yes, that certainly helps, but it ultimately can only go so far. You know, one of the cases that the Court and Alix relied on was this Bridge case that had to do with purchasing tax liens at auction. Well, in Bridge, the system worked so that if there were two equally qualified competing bidders who bid the same amount, that the County would automatically award the lien in order. So if you didn't get it on Tuesday, you'd get it on Wednesday. So the amount of discretion at play was very, very limited. And in fact the Supreme Court said in its opinion there really were no intervening factors here. So the Second Circuit relies on that but it doesn't really grapple, I think, sufficiently, with the degree of discretion and happenstance that affects proceedings in bankruptcy court as in all proceedings in court.

[CAL STEIN]

Steve, I want to pivot now and talk about some lessons that practitioners may be able to take out of this case. And the first issue I want to discuss is the scope of this decision and the scope of its applicability. You had mentioned earlier some language in the case the Court utilized about fraud on the bankruptcy court. There was also some language about invoking its supervisory authority. In reading that, it seemed like the Court was trying to limit somewhat the application of this decision perhaps for the reason you just mentioned of not wanting to allow competitors to use RICO as a cudgel against each other. But, how do you think those efforts are gonna play out in the future? Do you think the Court did enough here to narrow its applicability in the way it wanted?

[STEVE RINEHART]

Well, one of the things that was surprising in reading the opinion is that the Court didn't use its usual tool chest for limiting the precedential value of decisions. In other words, the Second Circuit may explicitly indicate that an opinion is not for publication which limits its precedential value and the ability to cite it in the courts below. Secondly, they could have arguably disposed of this case by a summary order and just sent it back for further proceedings. They didn't do that. And even when they sort of qualified by saying well, this is an unusual case and implicates the integrity of the courts, they didn't as explicitly limit it as I've seen in other opinions, which in essence say we are deciding the issues of the peculiar facts of the case before us and this should not be considered to be applicable beyond the peculiar bounds of this situation. They weren't quite that restrictive. And whether that's inadvertence or intentional, I don't know, but it does leave a little wiggle room and a crack in the door for a broader interpretation and application.

[CAL STEIN]

Yeah, I think that's right. And I want to read the specific language, or at least some of the specific language that you were just referencing. The Second Circuit wrote: "The fact that this case invokes our supervisory responsibilities makes our resolution of it sui generis and of little, if any, application to ordinary RICO cases where these responsibilities are not front and center." So that's the language that you referenced and that I referenced as potentially being a limiting factor. Any other thoughts on that?

[STEVE RINEHART]

It is an attempt to limit it but it still leaves, as I said, a crack in the door because what's an ordinary RICO case? It seems to me that this decision provides some additional ammunition to a creative plaintiff if you can come up with some connection to the judicial system and you can invoke this kind of "unique" approach of flexible causation. There are, I think, plenty of cases out there where RICO plaintiffs have alleged that one way or the other defendants have messed around with the judicial system. Filing false affidavits, bringing actions of frivolous litigation, attorneys have been sued, in an effort to come up with creative RICO construct. And I think this decision gives them a little bit of light, a little bit of energy, to pursue that by saying that, well, whatever we say about causation in a customary RICO case, when you're talking about judges and courts and juries, it's a different analysis.

[CAL STEIN]

So let's turn to another lesson and it's one we've spoken about already. The lessons about RICO causation and how that might be affected here. We talked about how Alix relied on a market share analysis to prove causation, namely that historically it got X percentage of engagements that didn't go to McKenzie so therefore it would have gotten that exact same percentage of the engagements McKenzie allegedly should not have gotten. Have you seen many RICO cases that rely on that type of causation analysis or do you think there might be others coming in that same vein?

[STEVE RINEHART]

Well, I'd say I haven't seen that many successful RICO cases that rely on market analysis. The history of RICO is littered with competitors using RICO in an effort to address a perceived

grievance in the marketplace – somebody stole my employees, somebody stole my trade secrets, somebody's cheating on their taxes and they're doing better than me in the market – but there haven't been that many cases where that has been successfully deployed. And I think it's pretty clear that if you're reading this decision you're thinking, you know, maybe that analysis has more legs than we thought. And maybe we can – if we rely more heavily on statistical indicia – market share and a long-standing pattern of that market share, maybe you've got a chance to get past the motion to dismiss.

[CAL STEIN]

Yeah, I had the same thought. I mean, my first thought when reading this decision was: boy, what a slippery slope this could be in terms of causation allegations and creative causation theories by plaintiffs who may be trying to pursue their competitors. Let me flip to the third lesson, or third category of lessons that I want to talk about. It has to with the Second Circuit's reliance on the flexibility of causation. How important do you think it was here that the Second Circuit in particular relied on that concept?

[STEVE RINEHART]

I think it indicates a couple of things. First of all, in emphasizing flexibility the Court, I think, ended up muddying the waters on causation. It's somewhat ironic that at the beginning of their opinion, the Court says, you know, admittedly, the question of causation in RICO is less than pellucid. Well, I would argue that it's even less pellucid than it was before after this decision. And flexibility is a funny concept. It's in the eye of the beholder. And I think you and I both agree that a court will talk about liberal interpretation, flexibility when it's trying to get somewhere. And if the Court didn't believe that this is a case that for whatever reasons needed to be heard and not dismissed, flexibility is a good way to get there. And I think the problem is that it then becomes the horse that a lot of plaintiffs will want to ride, right? Look, the Second Circuit said let's be flexible, Judge. Get me past my motion to dismiss, let me take discovery, we'll figure this out later.

[CAL STEIN]

I think that's exactly right and I'll read in exactly what the Court said about this. It wrote: "As the Supreme Court has explained, proximate cause is a 'flexible concept' that is 'generally not amenable to bright line rules.'" And, I had the same thought that was really Alix benefitted from the Court's willingness to adopt that flexibility here, especially as it goes to causation, where Alix was offering a somewhat novel theory. And I agree. I think we may start seeing other RICO plaintiffs try to exploit our courts, whether it's the Second Circuit or another court, their willingness to be flexible on RICO causation in this way. So, Steve, we're about out of time here today, so I want to bring this discussion of this very interesting RICO case to a conclusion. I really want to thank you for joining me on this podcast. I also want to thank everyone for listening. I hope everyone will join us for our next regularly scheduled installment in which we'll be discussing RICO conduct. If you have any thoughts or any comments about this series I invite you to contact me directly at callan.stein@troutman.com. And if you have any thoughts or comments about this episode, you can contact Steve directly at stephen.rinehart@troutman.com, and that's Stephen with a "PH." You can subscribe and listen to other Troutman Pepper podcasts wherever you listen to podcasts, including on Apple, Google, and Spotify. Thank you for listening and stay safe.