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Client Alert

International Arbitration Practice Group

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International Litigation Update: Second Circuit Clarifies Rules Governing Extraterritorial Application of RICO and Definition of "Foreign State" Under Foreign Sovereign Immunities Act

In a series of recent decisions, the U.S. Supreme Court has sought to restrict plaintiffs' ability to apply U.S. law to, and to bring claims in the U.S. courts based on, extraterritorial conduct. In *Morrison v. National Australian Bank*,[1] the Court established a presumption that U.S. statutes do not apply extraterritorially unless Congress has, in the text of the statute, clearly indicated that they do. More recently, the Court held in *Kiobel v. Royal Dutch Petroleum*[2] that the Alien Tort Statute, which had in recent years been used by non-U.S. plaintiffs to bring large class action claims in U.S. courts against companies operating abroad based on alleged violations of customary international law, did not confer U.S. court jurisdiction over tort claims involving conduct abroad. In addition, recent rulings have sought to restrict U.S. courts ability to exercise personal jurisdiction over foreign defendants, including under the "stream of commerce" theory of jurisdiction.[3] Viewed collectively, the Court's rulings appeared to reflect a view that plaintiffs, likely encouraged by plaintiff-friendly U.S. rules including liberal discovery, the availability of jury trials, and the "American Rule" requiring parties to presumptively bear their own litigation costs regardless of the outcome of a case, were bringing cases to U.S. courts that should properly have been brought under foreign law and/or before foreign tribunals.

Lower federal courts have struggled to apply these rulings; those struggles have focused specifically on (a) whether particular statutes evidence a clear congressional intent to apply extraterritorially, and (b) in what is perhaps an even more vexing factual inquiry, whether particular allegations (or established facts) create a sufficient nexus with the United States to render a case domestic, as opposed to extraterritorial.

In *European Community v. RJR Nabisco Inc., et al.*,[4] a decision issued on April 23, 2014, the U.S. Court of Appeals for the Second Circuit considered these issues. Specifically, the court considered the extraterritorial effect of the Racketeer Influenced and Corrupt Organizations Act (RICO), and specifically whether civil RICO claims could be maintained against an alleged enterprise whose operations took place largely, though not entirely, outside the United States. The Court also considered whether the European

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Community (EC), a federal entity formed by treaty and comprised of the majority of individual nations in Europe, is a "foreign state" for purposes of the Foreign Sovereign Immunities Act (FSIA). The Second Circuit held that the plaintiffs' RICO case was not impermissibly extraterritorial and that the EC is a foreign state for purposes of U.S. law; each of these rulings is important to companies operating abroad, and particularly those that are operating in, or that having dealings with, the European Union.

I. Extraterritoriality of RICO

In European *Community*, the EC alleged that an extensive and widespread enterprise worked together to facilitate illegal narcotics trafficking and to launder the resulting proceeds through legal businesses; the plaintiffs alleged, specifically, that U.S.-based executives traveled regularly from the United States to foreign nations to facilitate the scheme, that the U.S. members of the alleged enterprise received their profits in the United States, and that the U.S. members of the alleged enterprise filed false documents with the U.S. government in furtherance of the scheme. Based on these allegations, the plaintiffs alleged violations of RICO (based upon alleged predicate acts of mail fraud, wire fraud, money laundering, violations of the Travel Act, and providing material support to terrorist organizations) and several common law torts under New York law.

The U.S. District Court for the Eastern District of New York dismissed the case. As to the RICO claims, the district court held that because the activities of the "enterprise" underlying the RICO claim (which it found consisted of a "loose association of Colombian and Russian drug-dealing organizations and European money brokers") were directed outside the United States, the enterprise must be considered foreign.[5] Finding a lack of clear congressional intent that RICO could be applied to foreign enterprises, the district court dismissed the case for failure to state a cause of action. Specifically, the district court based its ruling on the Second Circuit's prior decision in *Norex Petroleum v. Access Industries*, in which the circuit rejected an argument that because RICO requires the plaintiff to prove the existence of an enterprise whose activities affect interstate or foreign commerce, the RICO statute reflected a clear Congressional intention that it apply extraterritorially. The district court found that this language from *Norex* erected a comprehensive bar against RICO claims that were based on the existence and activities of a foreign RICO enterprise.

The Court of Appeals disagreed, finding that the district count had erred in finding that *Norex* held that RICO could never be applied extraterritorially. The Court of Appeals clarified its rule and held, as a matter of first impression, that a RICO claim involving extraterritorial conduct is cognizable where that claim depends upon violations of a predicate statute that **itself** manifests an unmistakable congressional intent to apply extraterritorially. The court held that "[b]y explicitly incorporating these statutes [*i.e.*, the statutes whose violation constitutes a RICO predicate act] into RICO as predicate racketeering acts, Congress has clearly communicated its intention that RICO apply to extraterritorial conduct to the extent that extraterritorial violations of those statutes serve as the basis for RICO liability."[6]

Applying this rule, the Court determined that two of the predicate acts in the complaint—money laundering and material support of terrorism—were intended to apply extraterritorially, while three others—wire fraud, mail fraud, and the Travel Act—were not.[7]

Despite finding that mail fraud, wire fraud, and Travel Act statutes did not cover extraterritorial conduct, the Court of Appeals held that the RICO claims based on alleged violations of those statutes could nonetheless proceed, because the court found that the complaint alleged domestic, as opposed to extraterritorial, conduct. Specifically, the court found that the U.S.-based defendant communicated with alleged co-conspirators on a virtually daily basis by means of U.S. interstate and international wires, that it utilized U.S. interstate and international mail to send bills and to arrange sales, and that the U.S. defendant's revenues from the scheme were ultimately repatriated to the United States. The court also found that the scheme was "directed at the United States and had substantial domestic effects." In sum, the court concluded that "[w]e need not now decide precisely how to draw the line between domestic and extraterritorial

applications of the wire fraud statute, the mail fraud statute, and Travel Act, because wherever that line should be drawn, the conduct alleged here clearly states a domestic cause of action," and held further that "[i]f domestic conduct satisfies every essential element to prove a violation of a United States statute that does not apply extraterritorially, that statute is violated even if some other conduct contributing to the violation occurred outside the United States."[8]

II. The EC as a "Foreign State"

In addition to deciding whether the plaintiffs' RICO allegations were sustainable, the Second Circuit was required to determine whether the plaintiffs' state law claims were supported by diversity jurisdiction. The district court had found that EC was not a "foreign state," and that, accordingly, complete diversity was lacking. The Court of Appeals disagreed, and found that the EC is an "organ of a foreign state," and thus an instrumentality of a foreign state for purposes of the FSIA. The EC's status as a foreign state instrumentality created diversity jurisdiction under the FSIA, and the state law claims survived the defendants' motion to dismiss.

In determining whether the EC was an organ of a foreign state, the Court of Appeals applied the test it established in *Filler v. Hanvitt Bank*,[9] which established five non-exclusive guiding factors to determine whether an entity is an organ under the FSIA. The factors are (1) whether the foreign state created the entity for a national purpose, (2) whether the foreign state actively supervises the entity, (3) whether the entity requires the hiring of public employees whose salary is paid by the foreign state, (4) whether the entity holds exclusive rights to some right, and (5) how the entity is treated under the foreign state's law. Finding that the EC satisfied four, and likely all five, of the factors, it held that the EC was indeed an organ. The Court of Appeals also rejected the defendants' argument that it is impossible for an international organization created by multiple states to be an "organ" of a foreign state. In this regard, the court noted that while the EC member states ceded primary [authority?] in certain areas of government to the EC, those states retained their sovereignty and retained the vast majority of governmental control within their borders. As a result, the court found that the EC "exercise[s] its powers by the sufferance of the member states, and was both subordinate to and smaller than the nation states that created it."[10]

III. Conclusions

The Court of Appeals' decision is meaningful from several perspectives. The Second Circuit, which covers the federal courts in New York, is a key forum for international litigation and cases involving foreign sovereigns. The court's ruling on the RICO claims demonstrates that the court will look carefully at cases involving allegations of foreign conduct, and examine both the applicable statutes and the facts to see (a) whether the statute at issue may be applied extraterritorially, and (b) whether facts, as alleged or, presumably, as proved after issue has been joined, show a nexus with the United States sufficient to conclude that the conduct at issue is domestic as opposed to extraterritorial. Given that the decision provides unmistakable guidance to plaintiffs in drafting complaints to avoid *Morrison*'s presumption against extraterritorial application of U.S. statutes, the decision in *European Community* likely ensures that complaints alleging extraterritorial torts may be less susceptible to dismissal at the pleading stage, and will require discovery to determine whether they are subject to dismissal under *Morrison*.

The Court of Appeals' conclusion that the EC is a "foreign state" under the FSIA also represents an important clarification; as the European Union continues to take action as a federal unit, disputes involving it and the private entities with whom it comes into contact are likely to arise, and to the extent those disputes can be brought in the U.S. courts, they will be resolved more efficiently with a clear understanding of the EC's sovereign status under U.S. law.[11] Interestingly, under the Second Circuit's ruling, the EC – whose form is more in the nature of a sovereign federal government than a subordinate state actor – is an instrumentality, and thus will be entitled in the Second Circuit to the (slightly) less robust immunities afforded to state instrumentalities than those afforded to states themselves.

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[1] 130 S. Ct. 2869 (2010).

[2] 133 S. Ct. 1659 (2013).

[3] *See J. McIntyre Machinery, Ltd. v. Nicastro*, 131 S. Ct. 2780 (2011).

[4] No. 11-2475-CV (2d Cir. Apr. 23, 2014).

[5] The RICO statute is codified at 18 U.S.C. § 1961 *et seq.*

[6] *European Community*, at *12.

[7] *Id.* at *17-22

[8] *Id.* at *24.

[9] 378 F.3d 213, 217 (2d Cir. 2004).

[10] *European Community*, at *35.

[11] The Court of Appeals noted that, subsequent to the commencement of the case, the EC had been incorporated into the European Union. Accordingly, it, not the European Union, remained the relevant entity for purposes of determining immunity, since jurisdictional determinations are made at the time a case is commenced. The decision of course remains noteworthy for the Court of Appeals' conclusion that a federal entity formed by several states can constitute an instrumentality of a foreign state. *European Union*, at *25 n. 14.