Editorial Analysis

THE HOBBS ACT AND RICO IN TAKEOVER LITIGATION

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"In 1984, American corporations spent over $3.5 billion to repurchase their securities from unwanted shareholders at premiums totalling over $600 million above market prices."[1] The student comment in the Harvard Law Review from which this quote was taken is rich in citations and discussion. The authors are, however, unable to think of a cogent theory to attack the practice. Their vision was too limited.

Powerful Weapon

RICO is a powerful weapon in the corporate takeover wars. It can be used by almost any of the players, depending on how the contest is going. This brief note suggests that civil RICO is available to shareholders in a derivative action against a "shark" who demands either a targeted repurchase or the sale to him of a "crown jewel" asset at a rhinestone price.[2]

I am not here concerned with direct shareholder actions, nor with directors' liability for violation of fiduciary duty. This memo focuses upon the Hobbs Act, 18 U.S.C. §1951, to the exclusion of other RICO predicates that might apply. Among these other predicates are the mail and wire fraud statutes, 18 U.S.C. §§1341, 1343, and ITAR (interstate travel in aid of racketeering).

Mail or wire fraud would be committed by directors who breached their fiduciary duty (or and by an outsider who aided, abetted or caused such a breach, 18 U.S.C. §2) to treat all shareholders fairly and to safeguard the corporation's assets. If such an allegation were made, the plaintiff would be required to prove that the corporation's management passed golden parachute resolutions or otherwise sought to protect its position even against an outside offer that was favorable. Also, because the fraud need not be successful in order for liability to attach, the outsider would be liable to the corporation (and perhaps its shareholders) for *attempting* (the statutory word is "schem(ing)") to induce the directors to commit a fiduciary breach.

Mail fraud might also be committed by the "shark" scheming to defraud the investment community of its right to have proper and truthful Hart-Scott-Rodino filings made. Often a shark will falsely claim in the initial stages of a run that his stock transactions are for investment.[3]

Hobbs Act

Section §1952 makes it a crime to use interstate facilities with intent to promote or carry on an unlawful activity. The latter term includes "bribery," which the U.S. Supreme Court has construed to include state law commercial bribery, *Perrin v. United States*, 444 U.S. 37 (1979). Thus, if the outsider in effect offers directors and officers the chance to keep their jobs (by foregoing the takeover bid) in exchange for a preferential repurchase or asset spinoff, the elements of commercial bribery might be present. This would, of course, depend upon state law.[4]

In focusing upon a derivative action premised upon the Hobbs Act[5] as a RICO predicate, it is important to be clear about the identities of the wrongdoer, the victim(s), the innocent bystanders, and the damages. It might be argued that the shareholders are the "real" victims, based upon the evidence (*e.g.*, in the Harvard Note) that they suffer a loss in value of their shares. Note that unlike a 10b-5 plaintiff, they would be saying that they can collect for the harm without selling at a loss.

However, the analysis that follows is premised upon the proposition that a shark with a history of takeover activity has sought (and perhaps obtained) a targeted repurchase or preferential asset spinoff, and has achieved this result by threatening the corporation with a bitter takeover battle that will disrupt its normal business activity, cause qualified management personnel to desert the company, and cause suppliers and customers to hesitate to enter into long-term business relationships. These elements of harm are vital to the success of the claim, but can be developed through discovery from management ("Now, tell us please what adverse consequences you expected for the company from a takeover battle.") and by expert testimony. The damages may be particularly easy to show when a company is engaged in somewhat speculative high-tech expansion efforts requiring the continued confidence of contract partners, joint venturers, and financing sources.

Now for the Hobbs Act. The Act proscribes obstruction or delay of commerce, or an attempt or conspiracy to do so (note the built in conspiracy provision) by (among other means) extortion, the definition of which includes "fear."

Second Circuit Decision

The Second Circuit recently decided an important case for our purposes. In *U.S. v. Capo*, 791 F.2d 1054 (2d Cir. 1986), defendants allegedly sought and obtained payments from several victims in ex-

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change for inducing Kodak to give preferential treatment to the victims' applications for employment. This, the court held, in an opinion by Judge Kearse, violated the Hobbs Act prohibition of conspiracy to commit extortion by fear. The case goes as far as or farther than any court of appeals has gone, and provides a useful backdrop to consideration of the authorities on which Judge Kearse relies.

The court rejected the defendants' contention that the "mere selling of jobs" could not be extortion. The beginning point is the statutory language defining extortion as "the obtaining of property from another, with his consent, by wrongful use of . . . fear." The court recognized that no prior case had applied the Hobbs Act to "a job-selling scheme such as this one," but declined to characterize the defendants' conduct as "mere commercial bribery."

Fear

Fear "need not be fear of bodily harm but may be fear of a loss that is purely economic," the Second Circuit said, citing *Margiotta* and *Brecht*, discussed below. "While commonly the economic loss feared by the victim is the loss of an existing asset, . . . the scope of the Act is not so limited. Thus, the Act has been held to reach conduct threatening the loss of a status that would produce future assets [again citing *Margiotta*]. . . . Nor is the concept of economic loss under the Act limited to the loss of existing relationships, for that concept has been held to encompass the loss of an opportunity to enter into a business relationship." 791 F2d at 1061-62.

The court went on to say that the opportunity to enter into a long-term employment relationship is the sort of prospective advantage that would be considered "property" so as to bring the defendants within the Hobbs Act. The careful reader will note that the court treats extortion as a species of theft, which reflects the prevailing orthodox attitude embodied in, for example, the Model Penal Code. Second, the court is defining "property" broadly, another familiar device in modern writing on this subject.

Cautionary Note

The court sounded a cautionary note: "We recognize, of course, that fear of economic loss plays a role in many business transactions that are entirely legitimate; awareness of that fear and use of it as a leverage in bargaining, in which each side offers the other property, services, or rights it legitimately owns or controls, is not made unlawful by the Hobbs Act. What the Act reaches is not mere hard bargaining but the exploitation of the fear of economic loss in order to obtain property to which the exploiter is not entitled." 791 F.2d at 1062-63. Thus, the ordinary efforts of an employer to "bargain down the level of compensation to be paid" would not violate the Act. These defendants, however, behaved coercively in an unreasonable way, the court said.

In the setting of a corporate takeover attempt in which greenmail is exacted, one might ask whether the takeover "shark" was simply bargaining or coercively extorting. The answer will vary depending upon the shark's behavior — and perhaps its prior history of exacting tribute. By definition, payments in violation of the corporation's and shareholders' best interest are improper. Even if one did not wish to suggest that the directors and officers were violating their fiduciary duty, another analysis is possible. The *Capo* court seems to equate extortion with tortious interference with contract or with prospective advantage, in the familiar terminology of tort law. The pleader will take care to see that the threat of interference in the normal functioning of the business is set out precisely and in detail.

This leads to a discussion of power, the defendant's ability to convince the victim that the threat is "for real." The *Capo* court, having concluded that worry over not obtaining employment at Kodak was "fear" under the Act, discussed the defendants' actual power — as middlemen — to influence hiring decisions. "We note further that the government was not required to prove that the defendants actually had the power to control hiring at Kodak. It sufficed if those seeking jobs there had a 'reasonable fear the the defendants possessed such power and would use it if their demands were not met.' " 791 F.2d at 1064, quoting *United States v. Rastelli*, 551 F.2d 902, 905 (2d Cir.), *cert. denied*, 434 U.S. 831 (1977).

Using Influence

Analysis of the cases relied upon in *Capo* is instructive. In *United States v. Margiotta*, 688 F.2d 108 (2d Cir. 1982), *cert. denied*, 461 U.S. 913 (1983), the defendant was leader of the Nassau County and the Town of Hempstead Republican Party. He was convicted of having used his influence to compel an insurance agency to kick back insurance commissions and to make other payments or else risk losing its

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status as Broker of Record for the County and Town.

The court held without dissent (Judge Winter dissented on the mail fraud convictions only) that the evidence supported a finding that the victim-broker was placed in fear of economic loss if it did not make the payments. See 688 F.2d at 134-36. (The court also held the evidence sufficient to support the government's alternative theory, that Margiotta committed extortion "under color of official right.") The court rejected Margiotta's argument that he was not guilty under the Hobbs Act because the broker had originally approached him to secure the position of Broker of Record. *Margiotta* relied upon dicta in *United States v. Brecht,* 540 F.2d 45 (2d Cir. 1976), *cert. denied,* 429 U.S. 1123 (1977), to the effect that extortion differs from bribery. This is true, but extortion crime can be committed even if the victim was induced by fear to make the initial approach.

The *Margiotta* court relied upon another case cited with approval in *Capo. United States v. Duhon,* 565 F.2d 345 (5th Cir.), *cert. denied,* 435 U.S. 952 (1972). In *Duhon,* two labor officials were convicted of extortion by fear under the Hobbs Act for accepting a $5,000 payment from a building contractor in order to promote "labor peace" and permit the contractor to use nonunion labor on the job sites. The contractor was afraid of economic loss if picketing continued at the job site, and also feared destruction of property by prounion activists.

Bribe Or Extortion

The payors had agreed amongst themselves, before they met with the defendants, that they would offer $5,000 to remove the pickets. The defendants claimed that at most they had accepted a bribe and had not committed extortion. The court's reasoning, rejecting this contention, is significant:

"The crucial issue is whether defendants intended to induct the $5,000 payment by exploiting . . . [the victim's] fear of economic loss. If not, then defendants merely accepted a bribe, which does not constitute extortion or violate the Hobbs Act. The distinction between extortion and bribery was discussed in *United States v. Hyde* [citation omitted]: '[t]he distinction from bribery is therefore the initiative and purpose on the part of the [defendant] and the fear and lack of voluntariness on the part of the victim.' Thus, the defendant must intend to exploit the fear of the victim. The defendant need *not* have originally caused the fear, nor need the cause of the fear itself be wrongful." 565 F.2d at 351.

Consent As Defense

This language is extraordinarily powerful. The *Capo* court's adoption of this rationale is significant. Consent is a defense to a Hobbs Act allegation. However, the consent must be "real," and not induced by wrongful pressure. Obviously, the courts do not mean that every purportedly consensual transaction agreed to because of economic pressure is extortionate. The term "wrongful" is contextual, and the context is the entire set of rules that determine reasonable commercial behavior. See also *United States v. Procaro,* 648 F.2d 753 (1st Cir. 1981)(settlement of claim after extortionate threat does not vitiate Hobbs Act case).

United States v. Brecht, supra, cited and distinguished in *Margiotta,* provides a useful clue to the distinctions we have been discussing. Brecht worked for Westinghouse. He demanded and received a $1,000 kickback from a subcontractor as payment for seeing that the latter was awarded a contract. He was convicted under the Hobbs Act and also under 18 U.S.C. §1952, the latter charge being premised upon violation of New York's commercial bribery and larcency by extortion statutes. N.Y. Penal Law arts. 155(2)(e)(ix), 180.05 (1976). The Second Circuit reversed the §1952 convictions, but only because it held (as later contradicted by the Supreme Court in *Perrin, supra*) that commercial bribery was not "bribery" within the meaning of the Travel Act.

Refusal To Limit

The Second Circuit refused to limit the Hobbs Act to labor racketeering and organized crime, although it recognized that most Hobbs Act cases involved one or both of these. Specifically, it held that extortion committed "solo" violates the act; there need not be "the presence of two individuals, as evidencing the participation of organized crime." The court recognized that no prior case had involved "a single incident of the use of economic fear by a private purchasing agent." But since the statutory language, literally read, embraced the defendant's conduct, and since "fear" includes "putting the victim in fear of economic loss," the Hobbs Act conviction was affirmed. 540 F.2d at 52.

The *Brecht* court relied upon *United States v. Addonizio,* 451 F.2d 49 (3d Cir.), *cert. denied,* 405 U.S. 1048 (1972), where contractors and other suppliers allegedly had to pay kickbacks to obtain contracts on municipal public works jobs in Newark. The defendants contended that the payments, if any, were bribes. The court's reasoning is echoed in *Brecht* and *Capo*, but is worthy of analysis. The court accepted the distinction between bribery and extortion: "bribery is a voluntary payment made in order to exert influence upon the performance of an official duty, [while] extortion involves payment

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in return for something *to which the payor is already legally entitled.*" 451 F.2d at 72 (emphasis in original). However, the court rejected an argument that the government had to prove that the payments were "induced by threatened interference with *then-existing* contract rights." 451 F.2d at 73 (emphasis in original). The defendants had argued that any payments were made in an effort to secure future rights.

Two-Part Rejection

The court's rejection of this argument is in two parts, each of which is independently significant for the Hobbs Act analysis of greenmail. First, advance knowledge that kickbacks are expected raises at most a jury issue as to whether potential victims were simply aware of the pattern of extortion and "would succumb in advance of the contracting to the pressure which they knew would be forthcoming." *Id.* This standard clearly lessens the burden on a victim to show bluster and threats on the occasion in question, if a history of such conduct can be made out.

Second, the court considered the property rights that may be the subject of extortion:

"The second, and related, problem with appellants' argument is in its implicit assumption that *contractual* property rights are the only rights with which there could have been interference. In fact, contractual rights comprise only a part of the 'package' of rights which can form the basis of an extortion. Contractors, engineers, and suppliers, for example, have a right to expect that when they incur time and expense to bid on public projects, they will be awarded contracts when their bids are the lowest, and that they will subsequently enjoy the full financial benefits of their efficiency and industry." 451 F.2d at 73. Hence, "prospective advantage" is enough.

It is important to note that the contract or property interest involved in this discussion is not that extorted from the victim, but rather that that the victim fears to lose if the threat is carried out. Thus, there is not a perfect analogy to the cases involving theft (such as larceny) of intangibles. The "right" protected by making the extortionate payment has traditionally been broadly construed, even while the modern extortion statutes have limited the "payment" to parting with some recognized form of "property."

Two other cases cited with approval in *Capo* deserve mention. In *United States v. Tropiano,* 418 F.2d 1069 (2d Cir. 1969), *cert. denied*, 397 U.S. 1021 (1970), the defendants allegedly muscled into the refuse business and tried to prevent the victims from soliciting contracts for trash collection. The court rejected a contention that the "right to do business" in Milford, Conn. was not property that could be extorted. The statutory term "obtaining property" includes obtaining business concessions by putting the victim in fear. 418 F.2d at 1075-76. If one couples this holding with that in *Addonizio,* the Act's reach is quite broad. The defendant need not extort tangible goods (such as greenmail). He violates the Act if the obtains business concessions (such as refraining from competing) by threats, including threats of prospective economic harm.

Fear of Loss

In *United States v. Hathaway,* 534 F.2d 386, 395 (1st Cir.), *cert. denied,* 429 U.S. 819 (1976), the court held that "bribery and extortion are not mutually exclusive." Citing many of the cases we have been discussing, the court held that fear of loss of prospective economic advantage was "fear" within the meaning of the Act.

In sum, the Hobbs Act may provide a potent RICO predicate in the takeover situation. Corporate officers and directors who are considering paying greenmail should ask whether their agreement will end the dispute, as opposed to being the opening gun in the shareholders' race to the courthouse.

* Note: Professor Tigar has lectured on the topic of greenmail to a number of bar and professional audiences. He has been consulted by persons having an interest in such matters.

[1]Note, Greenmail: Targeted Stock Repurchases and the Management Entrenchment Hypothesis, 98 Harv. L. Rev. 1045 (1985).

[2]This note also does not deal with civil RICO generally. I refer the reader to the excellent ALI/ABA book, Civil RICO Litigation, published in 1985, and to the Buraff book by John Fricano, "RICO Strategies."

[3]A brief and critical excursion through the mail fraud precedents is my article "Mail Fraud, Morals and U.S. Attorneys," Litigation, Fall 1984, p. 22.

[4]For a discussion of securities laws claims in the greemail context, see *Pin v. Texaco, Inc.*, 793 F.2d 1448 (5th Cir. 1986).

[5]I am considering here only Hobbs Act violations based upon extortion through fear, and not those premised upon a public official's obtaining of property under color of official right. See generally *U.S. v. O'Grady*, 742 F.2d 482 (2d Cir. 1984)(en banc).