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Deliberately Defrauding Investors: The Scope of Liability Comment.

Andrew R. Simank

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COMMENT

DELIBERATELY DEFRAUDING INVESTORS: THE SCOPE OF LIABILITY

ANDREW R. SIMANK

I. Introduction 254
II. Background 259
  A. The Special Reason-to-Expect Standard in Texas . . . 259
  B. Negligent Misrepresentation in Texas 268
III. A National Perspective on the Reason-to-Expect Standard 272
  A. The Especial-Likelihood Provision Can Be Broadly Interpreted 274
  B. General Industry Practice of Reliance on Financial Reports 276
IV. Application of Section 536 Satisfies the Reason-to-Expect Standard 279
  A. Decisions by Jurisdictions that Apply Section 536 Are Instructive for the Future of Texas Jurisprudence 284
  B. The Availability of Federal Remedies Does Not Preempt State Tort Law 285
V. A Comparison of the Scopes of Liability for Fraudulent and Negligent Misrepresentation 288
VI. A Proposed Solution Based on the Policy Considerations for a Broad Scope of Liability 293
VII. Conclusion 296

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I. INTRODUCTION

The Enron scandal, along with similar corporate collapses that have followed in its wake,[1] exposed the distrust and corruption prevalent in the United States' securities market. Since the Enron debacle, shareholders and investors have increasingly filed suit in state and federal courts to recoup financial losses resulting from fraudulent representations made by failing corporations.[2] Specifically, these shareholders and investors have advanced, among others, common law misrepresentation claims against publicly traded companies for alleged fraudulent U.S. Securities and Exchange Commission (SEC) filings and other required public disclosures.[3] The scope of liability for common law fraud, other-

1. *See* Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 127–28 (2002) (explaining that the Enron collapse was only the beginning of a series of accounting scandals at Worldcom, Adelphia, Tyco, and many others that ultimately resulted in a reduction of investor net worth); Kathleen F. Brickey, *From Enron to Worldcom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 358–59 (2003) (noting that since the Enron-Andersen saga, "[f]ederal and state regulators have since initiated fraud investigations involving dozens of corporations, including Adelphia, HealthSouth, McKesson, Tyco, and Qwest").

2. *See* Herrmann Holdings Ltd. v. Lucent Techs., Inc., 302 F.3d 552, 556–57 (5th Cir. 2002) (asserting securities fraud claims, among others, for the company's failure "to use its reasonable best efforts" to register the transfer of its stock with the SEC under the merger agreement); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 540 F. Supp. 2d 759, 763 (S.D. Tex. 2007) (alleging, among other claims, common law fraud against corporate lenders for disseminating "false financial statements and ... information about [the corporation] ... through various media outlets"); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 388 F. Supp. 2d 780, 781 (S.D. Tex. 2005) (maintaining common law and statutory fraud claims against a brokerage firm for allowing the manipulation of annual financial reports relied on by investors); Bank of Am. Corp. v. Lemgruber, 385 F. Supp. 2d 200, 206–07 (S.D.N.Y. 2005) (bringing suit against a Brazilian bank for an alleged scheme to defraud stock investors through embezzlement and misrepresentation); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 235 F. Supp. 2d 549, 549–50 (S.D. Tex. 2002) (filing a securities fraud class action against accounting firms, law firms, and investment firms for orchestrating a "Ponzi scheme to artificially exaggerate earnings and hide corporate debt" in order to attract potential investors); Prospect High Income Fund v. Grant Thornton, LLP, 203 S.W.3d 602, 606–08 (Tex. App.—Dallas 2006) (advancing a common law fraud claim against corporation's outside auditor for erroneous financial filings after the issuer corporation was forced into bankruptcy), *rev'd in part*, 314 S.W.3d 913 (Tex. 2010).

3. *See* Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co., 313 F.3d 305, 322 (5th Cir. 2002) (asserting a claim of common law fraud for reliance on opinion letters that contained inaccurate financial information); *In re* Enron Corp. Sec., Derivative &

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wise known as deceit, was originally very narrow under the *Restatement (First) of Torts*.[4] Protection extended only to the person or limited class of persons whom the maker of the misrepresentation intended to have act in reliance on the misstatement.[5] Thus, a number of jurisdictions held that purchasers of stock in the open market could not be afforded protection for their reliance on statements made in a prospectus intended to induce investors to purchase the stock from the issuing corporation.[6] In an attempt to provide protection to individuals

"ERISA" Litig., 490 F. Supp. 2d 784, 820 (S.D. Tex. 2007) (alleging common law fraud against a financial analyst for concealing Enron's financial condition by filing financial reports that detailed erroneous and misleading earnings); Rogers v. Cisco Sys., Inc., 268 F. Supp. 2d 1305, 1311–12 (N.D. Fla. 2003) (claiming fraud because shareholders were induced to hold their stock when they relied on "quarterly and annual financial statements" filed with the SEC, "statements by [corporate] executives, and financial news reports"); Small v. Fritz Cos., 65 P.3d 1255, 1257 (Cal. 2003) (advancing a "holder claim" against a corporation and its officers after shareholders' relied on fraudulent financial reports that misrepresented corporate earnings and profits); Reisman v. KPMG Peat Marwick LLP, 787 N.E.2d 1060, 1062–66 (Mass. App. Ct. 2003) (citing, in part, fraud and negligent misrepresentation claims for shareholders' reliance on audit opinions certifying the company's financial reports in the acquisition of company stock); Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 575–76 (Tex. 2001) (alleging fraudulent representations included in three SEC-filed prospectuses, which noted Ernst & Young "as experts in auditing and accounting"); Tex. Capital Sec., Inc., v. Sandefer, 58 S.W.3d 760, 767 (Tex. App.—Houston [1st Dist.] 2001, pet. denied) (recognizing that stock purchasers maintained common law and securities fraud claims against a stock promoter and brokerage firm for materially misrepresenting the value of the company's stock to entice investors).

4. *See* 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 448–49 & n.2 (3d ed. 2006) (emphasizing that the *Restatement (First) of Torts* precluded protection to third persons who were not intended to rely upon the misrepresentation even when the original recipient was "substantial[ly] certain[]" to repeat the statement to a third person "'for the purpose of influencing his conduct in transactions with him'" (quoting RESTATEMENT (FIRST) OF TORTS § 533 cmt. b (1938))); *see also* Globe Commc'ns Corp. v. R.C.S. Rizzoli Periodici, S.p.A., 729 F. Supp. 973, 977–78 (S.D.N.Y. 1990) (stating the intent requirement under the *Restatement (Second) of Torts* has expanded by extending liability to those persons the maker of a misrepresentation has reason to expect will rely on the statement).

5. *See* RESTATEMENT (FIRST) OF TORTS §§ 525, 531 (1938) (stating that liability will extend to a defendant for "a misrepresentation of fact, opinion, intention or law" (1) to only those recipients to whom the misrepresentation is made with the intent to cause them "to act or refrain from action in reliance" in a business transaction and (2) only to such persons who suffered pecuniary harm by relying upon the misrepresentation "in the transaction or type of transaction in which the maker intended to influence their conduct").

6. 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 448 (3d ed. 2006); *see also* Cheney v. Dickinson, 172 F. 109, 111–13 (7th Cir. 1909) (denying a fraud claim for a third party's reliance on false representations made in a

who are commonly victimized by fraudulent behavior, section 531 of the *Restatement (Second) of Torts* extended the class of persons who may seek liability for a fraudulent misrepresentation to include those who the maker has "reason to expect" will act or refrain from acting on the misrepresentation,[7] "although such persons are beyond the range of [the] actual intent."[8]

The broad scope of the reason-to-expect standard has been subject to different interpretations by state and federal courts. Some jurisdictions have held there can be reason to expect reliance without inquiring into whether it was especially likely

prospectus because the plaintiff was not within the particular class to which the statement was addressed); Greene v. Mercantile Trust Co., 111 N.Y.S. 802, 803–08 (N.Y. Sup. Ct. 1908) (rejecting a fraud claim alleging reliance on a prospectus that induced plaintiff to purchase company stock), *aff'd*, 112 N.Y.S. 1131 (N.Y. App. Div. 1908); Peek v. Gurney, [1873] 6 L.R.E. & I. App. 377, 382 (denying plaintiff recovery under fraud claim because the misstatements made in a prospectus were not intended to influence the plaintiff, who was not the original stockholder that purchased the shares of stock from the corporation); W. Page Keeton, *The Ambit of a Fraudulent Representor's Responsibility*, 17 TEX. L. REV. 1, 5–6 (1938) (explaining that *Peek v. Gurney* promulgated a two-part rule that limited a defrauder's liability: "first, there must have been a desire or purpose to influence the action of the particular plaintiff or class of people to which the plaintiff belongs; and second, there must have been a desire or purpose to influence him in the manner that occasioned the damage"); Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 239 (1933) (stating the general proposition that statements in a prospectus are "addressed only to the initial buyers of the security" and not to subsequent or remote purchasers that the prospectus issuer does not intend to influence); *cf.* Hindman v. First Nat'l Bank, 112 F. 931, 941–43 (6th Cir. 1902) (recognizing that it is insufficient for purchasers of capital stock to claim reliance on statements in a bank certificate when a direct connection between the bank and plaintiff cannot be shown); Hunnewell v. Duxbury, 28 N.E. 267, 268–69 (Mass. 1891) (deciding that a false statement concerning the amount of paid-up capital stock issued by a defendant corporation was "not addressed to or intended for the public").

7. RESTATEMENT (SECOND) OF TORTS § 531 (1977).

8. 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 452–53 (3d ed. 2006); *see also* DAN B. DOBBS & ELLEN M. BUBLICK, CASES AND MATERIALS ON ADVANCED TORTS: ECONOMIC AND DIGNITARY TORTS—BUSINESS, COMMERCIAL AND INTANGIBLE HARMS 595 (2006) (explaining that actual intent is not required for the imposition of liability by third persons because a "reason to expect that the statement will influence a transaction or a class of persons is sufficient"); JAMES E. MEEKS ET AL., ADVANCED TORTS: CASES AND MATERIALS 244 (2004) (indicating that a defendant who did not make a misrepresentation directly to a third party is still subject to liability under the *Restatement (Second)* so long as the defendant had "'reason to expect'" the misrepresentation would reach the third party and influence the third party's conduct (quoting RESTATEMENT (SECOND) OF TORTS § 533 (1965))). In some cases, according to the *Restatement (Second)*, the expectation of reliance is a sufficient basis for prescribing liability, even if the maker of the misrepresentation does not intend to induce reliance. VINCENT R. JOHNSON, ADVANCED TORT LAW: A PROBLEM APPROACH 49 (2010).

reliance would occur.[9] On the other hand, Texas courts have gone to great lengths to ensure that the "expectation of influencing conduct"[10] requirement for common law fraud requires more than mere foreseeability before a third party can prevail on a claim of fraudulent misrepresentation.[11] Specifically, this tension stems from the text of section 531 and the language in the corresponding comment d.[12] In *Ernst & Young, L.L.P. v. Pacific Life Insurance*

9. *Compare* Hawkins v. Upjohn Co., 890 F. Supp. 609, 612 (E.D. Tex. 1994) (holding that a consumer's indirect reliance on a pharmaceutical company's misrepresentations was "sufficient to state a claim of fraud" under the reason-to-expect standard of section 533 of the *Restatement (Second)* without inquiring into whether there was an especial likelihood reliance would occur), Globe Commc'ns Corp. v. R.C.S. Rizzoli Periodici, S.p.A., 729 F. Supp. 973, 977–78 (S.D.N.Y. 1990) (ruling that a foreign publisher "knew or reasonably should have foreseen" some United States publishers would republish the misrepresentations made in the article because the defendant had reason to expect reliance without requiring any "special" reason for such an expectation), Prof'l Investors Life Ins. Co v. Roussel, 528 F. Supp. 391, 396–97 (D. Kan. 1981) (denying summary judgment for defendants by noting that the defendants' reasonable expectation of reliance was an issue of fact to be decided by the jury), *and* Habberman v. Wash. Pub. Power Supply Sys., 744 P.2d 1032, 1070 (Wash. 1987) (holding that the defendants may have had a duty to the plaintiffs, in accordance with section 531, when the maker of a misrepresentation has reason to expect the bondholders will receive the misrepresented information regardless of privity), *with* Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co., 313 F.3d 305, 324–27 (5th Cir. 2002) (stating the Texas-based holders failed to establish "that there was an especial likelihood that debenture holders would rely on [the defendant's] SEC filings"), United States v. Hawley, 544 F. Supp. 2d 787, 815 (N.D. Iowa 2008) (holding that insurance agents had information "that would lead a reasonable man to conclude that there was an especial likelihood that the false documents would reach the government, even though the government was a third party to the crop insurance contracts"), *rev'd on other grounds*, 619 F.3d 886 (8th Cir. 2010), Clark v. McDaniel, 546 N.W.2d 590, 593–94 (Iowa 1996) (ruling that a used-car salesman may have had a special reason to expect his misrepresentations would be passed on to third party purchasers when the buyer resold the car), *and* Rhee v. Highland Dev. Corp., 958 A.2d 385, 392–99 (Md. Ct. Spec. App. 2008) (relying on sections 531–33 of the *Restatement (Second)*, the appeals court held that developers had special reason to expect their misrepresentations of the property would induce reliance from subsequent purchasers).

10. *See* RESTATEMENT (SECOND) OF TORTS § 531 (1977) (stating that one who intends to induce reliance, as required under common law fraud, "is subject to liability to the persons or class of persons whom he intends or has reason to expect to act or to refrain from action in reliance upon the misrepresentation").

11. *See* Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 581 (Tex. 2001) (noting that an "obvious risk that a third person will rely on a representation is not enough to impose liability," even if it is "commonly known or expected in the investment community" that a third party would rely on such a misrepresentation (internal quotation marks omitted)); *see also In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 490 F. Supp. 2d 784, 824 (S.D. Tex. 2007) (holding that the reason-to-expect language under section 531 requires the plaintiff to show more than that the financial filings were generally available to the investment community and could foreseeably be relied upon).

12. *Compare* RESTATEMENT (SECOND) OF TORTS § 531 (1977) (providing the

St. Mary's Law Journal, Vol. 42 [2010], No. 1, Art. 3

Co.,[13] the Texas Supreme Court laid the foundation for the special reason-to-expect-reliance provision by requiring "*an especial likelihood*" that a misrepresentation will induce reliance.[14] The reasoning employed by the Texas Supreme Court has been followed and applied in subsequent securities fraud disputes by the Texas state appellate courts, federal district courts, and the United States Court of Appeals for the Fifth Circuit.[15]

This Comment reevaluates the special reason-to-expect-reliance requirement of Texas common law fraud claims as applied to defrauded shareholders and investors. When compared to the common law trend of expanding the scope of liability in deceit actions, Texas's imposition—or at least Texas's interpretation—of this "special" requirement comports more with the rigidity of the narrow limit on liability advanced by the *Restatement (First)*. Texas's desire to limit corporate liability in securities fraud cases is discordant with the policy of protecting investors through the imposition of liability for highly culpable conduct (e.g., fraudulent misrepresentations). Although federal securities statutes have provided additional avenues for securities investors and shareholders to recover financial losses,[16] common law fraud actions

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reason-to-expect standard), *with* RESTATEMENT (SECOND) OF TORTS § 531 cmt. d (1977) (stating the *especial-likelihood* requirement).

13. Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573 (Tex. 2001).

14. *See Ernst & Young*, 51 S.W.3d at 581 (requiring the tortfeasor have a special reason to expect reliance on "'*information* that would lead a reasonable man to conclude that there is *an especial likelihood*'" that investors would rely on the SEC-filed statements in evaluating the value and stability of the securities in dispute (quoting RESTATEMENT (SECOND) OF TORTS § 531 cmt. d (1977))).

15. *See* Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co., 313 F.3d 305, 326 (5th Cir. 2002) (upholding *Ernst & Young* by stating that the plaintiffs had to more than merely assert that "defendants knew or should have known that plaintiffs would rely on the Fairness Opinion in deciding whether to redeem their debentures"); *In re Enron Corp.*, 490 F. Supp. 2d at 822–25 (using the holding in *Ernst & Young* to accept the defendant's argument that the plaintiffs could not claim reliance simply because there was an obvious risk the misrepresentation would be repeated to a third party); Prospect High Income Fund v. Grant Thornton, LLP, 203 S.W.3d 602, 611–13 (Tex. App.—Dallas 2006) (distinguishing the present facts from *Ernst & Young* by noting that the plaintiff's reliance was disputably foreseeable and especially likely), *rev'd in part*, 314 S.W.3d 913 (Tex. 2010).

16. *See* 15 U.S.C. § 77k(a) (2006) (allowing certain classes of people to bring civil suit relating to securities fraud); 17 C.F.R. § 240.10b-5 (2008) (establishing liability for "employment of manipulative and deceptive devices" in federal securities and fraud litigation); 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.1, at 445 n.7, § 7.2, at 455 n.17 (3d ed. 2006) (emphasizing that increased legislation in the field of securities fraud has emerged to protect investors).

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should remain a viable claim in mitigating fraudulent behavior. Moreover, the special reason-to-expect standard, as interpreted by Texas courts, is as equally restrictive as the *Restatement (Second)* standard for negligent misrepresentation. This equivalence does not comport with the *Restatement (Second)*'s traditional policy that liability for negligent actions is more restrictive than liability for fraud.[17]

This Comment will first examine the emergence of the reason-to-expect standard and how Texas courts have used this requirement to defeat common law fraud claims. Next, this Comment will address how statutorily required filings and other required public disclosures satisfy the reason-to-expect standard under section 536 of the *Restatement (Second)*. Finally, this Comment will discuss the policy behind the requirement of these disclosures—holding corporations liable for their deceitful actions—and the differences between negligent and fraudulent misrepresentation in determining liability.

II. BACKGROUND

A. *The Special Reason-to-Expect Standard in Texas*

Common law fraud is one of the oldest tort claims recognized by every state and federal court in the United States.[18] The common law action for fraudulent misrepresentation in Texas generally consists of five elements, which require the plaintiff to prove that

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17. *See* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 856–57 (2008) (arguing that the "should know" standard of negligent misrepresentation applied by several Texas courts is not consistent with section 552 "because liability for negligent misrepresentation under the Restatement is more restrictive than liability for fraud").

18. VINCENT R. JOHNSON, ADVANCED TORT LAW: A PROBLEM APPROACH 11 & n.1 (2010); *see also* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 105, at 727 (5th ed. 1984) (delineating the history of the action for deceit, which was recognized as early as 1201). It was not until the late eighteenth century, in *Pasley v. Freeman*, (1789) 100 Eng. Rep. 450 (K. B.), that the action for deceit was held to impose liability where the plaintiff did not deal with the defendant directly but was induced by a misrepresentation made by the defendant to a third person. *See* 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.1, at 443–44 (3d ed. 2006) (noting that *Pasley* recognized the action for deceit, originally associated with a claim for breach of warranty, as a distinct tort for misrepresentations that misled another and that resulted in a financial loss); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 105, at 728 (5th ed. 1984) (stating that after *Pasley*, "deceit was recognized as purely a tort action, and not necessarily founded upon a contract").

St. Mary's Law Journal, Vol. 42 [2010], No. 1, Art. 3

the defendant: (1) made a material misrepresentation; (2) which was false or made with a reckless disregard of the truth; (3) which was "*intended to induce [the plaintiff] to act upon the representation*"; (4) which was "actually and justifiably relied upon" by the plaintiff; (5) who "thereby suffered injury."[19] For nearly a century, Texas courts have recognized these common law elements when analyzing an actionable fraud claim.[20] The intent element of common law fraud, as emphasized above, does not require that a defendant specifically know the identity of the recipient intended to rely on the misstatement.[21] It should also be noted that in some cases the expectation of reliance is a sufficient basis for liability, "even if the defendant does not intend to induce reliance."[22] Texas courts impose liability absent a showing of "a direct relationship between the alleged fraudfeasor and a specific

19. *Ernst & Young*, 51 S.W.3d at 577 (emphasis added); *see also* Oppenheimer v. Prudential Sec. Inc., 94 F.3d 189, 194 (5th Cir. 1996) (holding that a claim for common law fraud requires "a material misrepresentation, which was false, and which was either known to be false when made or was asserted without knowledge of its truth, which was intended to be acted upon, which was relied upon, and which caused injury" (quoting DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 688 (Tex. 1990))); *In re Enron Corp.*, 490 F. Supp. 2d at 792–93 (laying out the requirements for common law fraud under Texas law). Although "[c]ourts list anywhere from four to nine elements of the common law fraud[] claim," there is general agreement on the substantive elements the plaintiff must prove. DAN B. DOBBS, THE LAW OF TORTS 1345–46 (2000); *see also* VINCENT R. JOHNSON, ADVANCED TORT LAW: A PROBLEM APPROACH 12–13 (2010) (noting the generally agreed-upon common elements of fraud, "although courts vary in articulating the requirements"); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 105, at 728 (5th ed. 1984) (listing the traditional five elements for a cause of action in deceit).

20. *See* Trenholm v. Ratcliff, 646 S.W.2d 927, 930 (Tex. 1983) (stating the necessary elements for a common law fraud claim, as established in *Wilson v. Jones* by the Texas Commission of Appeals, in a suit initiated by a homebuilder against a real estate developer (citing Wilson v. Jones, 45 S.W.2d 572, 573 (Tex. Comm'n App. 1932, holding approved))). The traditional five common elements of fraud can be traced from the *Ernst & Young* opinion to a Fourth District Court of Civil Appeals decision in *Wortman v. Young*, where the court required (1) a material misrepresentation, (2) made with scienter, (3) intended to induce the recipient, (4) who justifiably relies, and (5) suffers damage. *See* Wortman v. Young, 221 S.W. 660, 662 (Tex. Civ. App.—San Antonio 1920, writ granted) (defining "actionable fraud" in regard to certain vendor lien notes executed by the defendant), *rev'd on other grounds*, 235 S.W. 559 (Tex. Comm'n App. 1921, judgm't adopted).

21. *See* RESTATEMENT (SECOND) OF TORTS § 533 (1977) (stating that a person is subject to liability for the making of a fraudulent misrepresentation when made to a third person "and the maker intends or has reason to expect that [the misrepresentation's] terms will be repeated or its substance communicated to the other").

22. VINCENT R. JOHNSON, ADVANCED TORT LAW: A PROBLEM APPROACH 49 (2010).

known person" in accordance with Texas case law applying the *Restatement (Second)*.[23] The Texas Supreme Court, Texas appellate courts, federal courts, and other courts around the country have adopted and followed the *Restatement (Second)* without reservation.[24]

Third party investor and shareholder security fraud claims, under both federal and state law, have an established history in Texas jurisprudence.[25] However, it was not until *Ernst & Young* that the Texas Supreme Court explicitly recognized the special reason-to-expect standard in Texas case law under section 531 of

23. *See Ernst & Young*, 51 S.W.3d at 573 (explaining that traditional Texas fraud jurisprudence has not focused on privity with the alleged fraudfeasor, but rather on whether the misrepresentation was intended to influence a third person's conduct, as is proscribed under section 531 of the *Restatement (Second) of Torts*). Dating back to 1890, Texas case law has recognized a fraud cause of action if a misrepresentation was made with the purpose of reaching a third person and influencing the person's conduct. *See id.* (recognizing that a firm's direct intent for subscribers of an agency to rely on its financial status was sufficient to satisfy a fraud claim); *see also* DAN B. DOBBS, THE LAW OF TORTS 1370 (2000) ("It has been settled since the 1700s that privity is not required to support an action for fraudulent misrepresentation." (citing Gainesville Nat'l Bank v. Bamberger, 77 Tex. 48, 13 S.W. 959, 960–61 (1890))).

24. *See* Response to Petition for Review at 3–4, Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573 (Tex. 2001) (No. 00-0232) (noting that various Texas courts that have adopted and applied the *Restatement (Second) of Torts*); *see also In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 490 F. Supp. 2d 784, 822–23 (S.D. Tex. 2007) (applying section 531 of the *Restatement (Second)* to an action of common law fraud); McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 791–92 (Tex. 1999) (adopting the *Restatement (Second)* as the official standard for negligent misrepresentation for courts applying Texas law); Prospect High Income Fund v. Grant Thornton LLP, 203 S.W.3d 602, 611–13 (Tex. App.—Dallas 2006) (following the Texas Supreme Court's use of section 531 for interpreting the validity of a common law fraud claim), *rev'd in part*, 314 S.W.3d 913 (Tex. 2010).

25. *See* Adams v. Reagan, 791 S.W.2d 284, 287–90 (Tex. App.—Fort Worth 1990, no writ) (affirming the certification of a class of former investors, who filed an action against the officers and directors of a financial investment company that filed for bankruptcy); Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408, 410–15 (Tex. App.—Dallas 1986, writ ref'd n.r.e.) (claiming negligent and fraudulent misrepresentation for erroneous financial reports prepared by an auditor shortly before the auditee declared bankruptcy). Plaintiffs will frequently allege federal securities violations in tandem with common law fraud and negligent misrepresentation claims. *See, e.g.*, Steiner v. Southmark Corp., 734 F. Supp. 269, 276–79 (N.D. Tex. 1990) (alleging securities fraud actions, including a Rule 10b-5 violation, against directors and auditors of the corporation). Actions for fraud by stockholders of corporations have been recognized in Texas courts for nearly a century. *See* Smith v. Smith, 213 S.W. 273, 274 (Tex. Civ. App.—Austin 1919, writ ref'd) (holding a scheme to defraud company stockholders through the sale of corporate property sufficient to impose liability).

the *Restatement (Second)*.[26] Although Texas case law was consistent with the *Restatement (Second)* by "focus[ing] on the defendant's knowledge and intent to induce reliance," the court referred to the law in other jurisdictions that "explicitly followed section 531 or adopted its approach."[27] Prior to *Ernst & Young*, Texas courts had resolved the intent element of common law fraud without inquiring into whether the maker of the misrepresentation had "special" reason to expect the recipient would act or refrain from action in reliance upon the statement.[28] In fact, proponents have argued the Texas common law interpretation of fraudulent misrepresentation claims, at one point, oscillated between a

26. *See Ernst & Young*, 51 S.W.3d at 579 ("While it is true that Texas courts have not used the words 'reason to expect' when discussing fraud's intent element, a defendant who acts with knowledge that a result will follow is considered to intend the result.").

27. *Ernst & Young*, 51 S.W.3d at 578–79 & nn.5, 6; *see also* Hines v. Riverside Chevrolet-Olds, Inc., 655 So. 2d 909, 920 (Ala. 1994) (ruling that the plaintiffs were part of the limited class of persons that the manufacturer had special reason to expect would rely on the nondisclosure of information pertaining to the damaged automobiles), *overruled on other grounds by* State Farm Fire & Cas. Co. v. Owen, 729 So. 2d 834 (Ala. 1999); Bily v. Arthur Young & Co., 834 P.2d 745, 773 (Cal. 1992) (holding that section 531 applies to the intentional misrepresentation of an electronics company's financial health for an investor's reliance on the accounting firm's audit opinion); Clark v. McDaniel, 546 N.W.2d 590, 593–94 (Iowa 1996) (applying and following the reason-to-expect standard under sections 531 and 533). Some jurisdictions have enforced the reason-to-expect standard by section 533 of the *Restatement (Second)* without mention of section 531 because the language in both sections is essentially the same. *See* Freeman v. Myers, 774 S.W.2d 892, 893–94 (Mo. Ct. App. 1989) (subjecting the defendant to liability because the misrepresentation of the car's mileage was expectedly relied upon by a third party); Epperson v. Roloff, 719 P.2d 799, 803 (Nev. 1986) (stating that the defendant may be found liable for fraud when the maker has reason to believe the misinformation will be communicated to a third party).

28. *See* Steiner v. Southmark Corp., 734 F. Supp. 269, 279–80 (N.D. Tex. 1990) (holding, without mention of a special reason-to-expect requirement, that the defendant could be liable to unknown third parties for creating misleading public filings); Custom Leasing, Inc. v. Tex. Bank & Trust Co., 516 S.W.2d 138, 143–44 (Tex. 1974) (stating that one is liable for affirmative misrepresentations "made and designed to be acted upon by another . . . regardless of his knowledge of falsity or intent to deceive"); Am. Indem. Co. v. Ernst & Ernst, 106 S.W.2d 763, 765 (Tex. Civ. App.—Waco 1937, writ ref'd) (upholding a fraud judgment when a false representation was made to another "with the intent or knowledge that it should be exhibited or repeated to a third party for the purpose of deceiving him"); King v. Shawver, 30 S.W.2d 930, 932 (Tex. Civ. App.—Fort Worth 1930, no writ) (declaring that liability is not dependent upon "special reliance upon [the] defendant individually," but rather when there is sufficient "reliance upon [the] defendant as one of a group or class"); Smith v. Smith, 213 S.W. 273, 277 (Tex. Civ. App.—Austin 1919, writ ref'd) (holding that a corporation may be liable for damages of a stockholder when the stockholder is induced to act to his detriment "by reason of . . . false and fraudulent statements" made by the corporation).

reason-to-expect and privity standard.[29] The scope of liability for common law fraud was open to a possible range of interpretations. This uncertainty in the law prompted the court to narrow the liability of corporations for fraud damages, which were supposedly subject to a potentially limitless class of investors.[30]

As noted by petitioner Ernst & Young, the Dallas court of appeals became the first Texas court to endorse section 531 of the *Restatement (Second)*.[31] The Texas Supreme Court accepted this

29. *Compare* Hawkins v. Upjohn Co., 890 F. Supp. 609, 612 (E.D. Tex. 1994) (asserting that a maker of a false representation is liable to a third person under the reason-to-expect language of section 533 of the *Restatement (Second) of Torts*), *with* Kanon v. Methodist Hosp., 9 S.W.3d 365, 371–72 (Tex. App.—Houston [14th Dist.] 1999, no pet.) (holding that an actionable fraudulent misrepresentation claim requires privity between the plaintiff and defendant where the alleged fraudfeasor "intend[s] to influence the very person to whom he makes the representation"), *abrogated by* Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573 (Tex. 2001).

30. *See Ernst & Young*, 51 S.W.3d at 582 (rejecting Pacific Mutual's section 536 presumption claim by explaining the court's reluctance to subject market participants to unlimited liability when other remedies are available to protect investors). The potential unlimited range of economic harm is commonly mentioned as a problem when expanding the scope of liability. *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90 (D.R.I. 1968) (criticizing the rationale that an innocent party should be forced to suffer pecuniary loss in order to limit the liability of an accountant); Rozny v. Marnul, 250 N.E.2d 656, 660–61 (Ill. 1969) (identifying the problem of extending liability to an indeterminate class); *Ultramares* Corp. v. Touche, 174 N.E. 441, 444 (N.Y. 1931) (stating that the extension of liability to negligent actions would expose accountants "to a liability in an indeterminate amount for an indeterminate time to an indeterminate class"); 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.6, at 477 & n.13 (3d ed. 2006) (recognizing the continuous "source of doubt" to be "the potentially limitless range of economic harm"); William L. Prosser, *Misrepresentation and Third Persons*, 19 VAND. L. REV. 231, 246–50 (1966) (listing Cardozo's "host of terrifying spectres" that could result if the court extended "the liability of accountants who were merely negligent" and did not have a special reason to expect reliance upon the general use of certified balance sheets). The Texas Supreme Court seemed implicitly to endorse Ernst & Young's business impact argument, set forth in their appellate petition, where they claimed the potential negative impact on business in the state warranted the abolition or strict interpretation of the "reason-to-expect" standard as applied to unknown or unidentifiable purchasers of junk bonds. *See* Appellate Petition for Review at 11–12, *Ernst & Young*, 51 S.W.3d 573 (No. 00-0232) (arguing that the "expansion of liability for accounting firms and the detrimental spill-over effect on the industries they serve warrants the Court's review" because the "reason-to-expect" standard could balloon into liability for wholly unknown parties); Bonita A. Daly & John M. Gibson, *The Delineation of Accountants' Legal Liability to Third Parties:* Bily *and Beyond*, 68 ST. JOHN'S L. REV. 609, 612–13 (1994) (noting that the impact of litigation has forced auditing firms to restrict their auditing practices from high-risk categories and has substantially increased liability insurance premiums).

31. Appellate Petition for Review at 7, Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573 (Tex. 2001) (No. 00-0232) (arguing that "the Dallas Court of Appeals ignored [*Wilson*] and [*Westcliff*] and became the first Texas court ever to hold that intent

endorsement and subsequently applied the reason-to-expect standard to an allegedly false and misleading audit report filed by Ernst & Young, which was relied upon by an institutional investor in the purchase of securities from one bank in a two-bank merger.[32] In denying the common law fraud claim, the court determined the defendant company did not have a special reason to expect respondents, Pacific Mutual, would rely on the audit report because "what is commonly 'known' or 'expected' in the investment community" does not by itself establish fraudulent intent.[33] The court illustrated "the narrow scope of the reason-to-expect standard" by explaining:

> Even an obvious risk that a misrepresentation might be repeated to a third party is not enough to satisfy the reason-to-expect standard; rather, the alleged fraudfeasor must "have information that would lead a reasonable man to conclude that there is *an especial likelihood* that it will reach those persons *and will influence their conduct*."[34]

Based on this reasoning, the audited financial statements filed with the SEC were held by the court to be "insufficient to show that Ernst & Young possessed information of an especial likelihood" that would induce reliance from investors like Pacific

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extends to unknown and unidentified persons" through the court's acceptance of section 531 of the *Restatement (Second) of Torts*); *see also Ernst & Young*, 51 S.W.3d at 579 (recognizing that "Texas courts have not used the words 'reason to expect' when discussing fraud's intent element" but have generally followed the *Restatement (Second)*'s interpretation of intent as defined under section 531).

32. *See Ernst & Young*, 51 S.W.3d at 573, 578–80 (applying section 531 to erroneous financial statements contained in three prospectuses prepared by Ernst & Young and filed by RepublicBank Corporation).

33. *Ernst & Young*, 51 S.W.3d at 581. The Texas Supreme Court rejected Pacific Mutual's expert testimony "that investors like Pacific commonly rely on representations made in SEC-filed documents in evaluating securities backed by an entity." *Id.* (emphasizing that "[g]eneral industry practice or knowledge may establish a basis for foreseeability to show negligence, but it is not probative of fraudulent intent"); *see also* Reed Tool Co. v. Copelin, 689 S.W.2d 404, 406 (Tex. 1985) (rejecting a foreseeability approach to intentional conduct by requiring the risk or known danger sought to be avoided to be a substantial certainty (citing VerBouwens v. Hamm Wood Prods., 334 N.W.2d 874, 876 (S.D. 1983))); Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408, 415 (Tex. App.—Dallas 1986, writ ref'd n.r.e.) (holding that the "should have been known" standard for negligent misrepresentation does not apply to fraud because the intent element requires a "greater degree of purposeful conduct than does the 'foreseeability' element of a negligence action").

34. *Ernst & Young*, 51 S.W.3d at 580 (quoting RESTATEMENT (SECOND) OF TORTS § 531 cmt. d (1977)).

Mutual.[35] Subsequent decisions interpreting Texas law have upheld this precedent by ruling the generalized industry practice of disseminating financial statements throughout the investment community is insufficient to raise a fact issue as to whether the plaintiffs had reason to expect reliance.[36]

To combat the Texas Supreme Court's narrow interpretation of the reason-to-expect standard, plaintiffs alleging fraud have claimed that statutorily required SEC financial filings and other public disclosures pertaining to the business's economic state support a presumption that the defendant corporations had reason to expect reliance on the publicly available information.[37] Plaintiffs argue that section 536 of the *Restatement (Second)* establishes this presumption in common law fraud actions.[38]

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35. *Id.* at 581.

36. *See* Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co., 313 F.3d 305, 326–27 (5th Cir. 2002) (rejecting the plaintiff's claim of reliance on the fairness opinion prepared by Morgan Stanley, noting "*Ernst & Young* specifically held inadequate to meet the required standard evidence that investors commonly relied on representations made in SEC filings"); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 490 F. Supp. 2d 784, 820–25 (S.D. Tex. 2007) (applying *Ernst & Young* in the court's rejection of the plaintiffs' claims of reliance on "Enron's financial reports, SEC-filed documents, analyst reports and analyst recommendations," due to the plaintiffs failure to identify "particular misrepresentations by Enron arising out of its transactions with Merrill Lynch" in order to adequately plead reliance). Plaintiffs bringing a cause of action for fraudulent misrepresentation in federal court must satisfy Federal Rule of Civil Procedure 9(b), which requires a plaintiff to plead with particularity the various misrepresentations allegedly made by the defendants. *See In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 540 F. Supp. 2d 759, 764–65 (S.D. Tex. 2007) (holding that the plaintiff must identify specific facts that support an inference of fraudulent intent, including "statements contended to be fraudulent," identity of the speaker, location and time the statements were made, and an explanation as to "why the statements were fraudulent" (citing Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 362 (5th Cir. 2004))); VINCENT R. JOHNSON, ADVANCED TORT LAW: A PROBLEM APPROACH 13 (2010) (noting that federal courts and most state courts impose a heightened pleading requirement for fraud accusations because fraud can damage the reputation and goodwill of a corporation or professional person).

37. *See Ernst & Young*, 51 S.W.3d at 581 (citing section 536 and stating that the "one who complies with a statutory filing requirement is presumed to have reason to expect that the information will reach and influence the class of persons the statute is designed to protect"); *see also In re Enron Corp.*, 490 F. Supp. 2d at 824 (restating the section 536 presumption argument set forth in *Ernst & Young*). The Texas Supreme Court in *Ernst & Young* left open the possibility that section 536 would apply in other cases; therefore, the plaintiffs in *Great Plains* believed their case fell within that scenario because the debenture holders' actions and decisions regarding their investments directly "related to the entities that were the subject of the SEC filing." Brief for Petitioner-Appellant at 5–10, *Great Plains Trust*, 313 F.3d 305 (No. 01-21121).

38. *See Ernst & Young*, 51 S.W.3d at 581 (arguing that section 536 satisfies the

Section 536 provides:

> If a statute requires information to be furnished, filed, recorded or published for the protection of a particular class of persons, one who makes a fraudulent misrepresentation in so doing is subject to liability to the persons for pecuniary loss suffered through their justifiable reliance upon the misrepresentation in a transaction of the kind in which the statute is intended to protect them.[39]

The scope of liability is limited to the particular class the statute is designed to protect, which is determined by focusing "on the statute's purpose rather than the person furnishing the information."[40]

With the intent of "preventing the circumstances that led to the 1929 stock market crash," federal securities regulations emerged in an effort to protect investors and stockholders from fraudulent practices by publicly traded companies.[41] As a result, Congress

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reason-to-expect standard because "the SEC documents were filed under [federal] statutes designed to protect investors like Pacific"). Texas courts that cite *Ernst & Young* in support of the special reason-to-expect standard quote extensively from the opinion's reason-to-expect section. *See Great Plains Trust*, 313 F.3d at 324–26 (quoting and citing the facts and reasoning set forth in *Ernst & Young* for three pages of support for the court's holding that the plaintiffs failed to state a claim for fraud); *In re Enron Corp.*, 490 F. Supp. 2d at 822–24 (citing the reason-to-expect section from *Ernst & Young* for three pages in the district court's denial of the common law fraud claim); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 235 F. Supp. 2d 549, 604–06 (S.D. Tex. 2002) (detailing the Texas Supreme Court's narrow interpretation of sections 531 and 536 in *Ernst & Young*).

39. RESTATEMENT (SECOND) OF TORTS § 536 (1977).

40. *See Ernst & Young*, 51 S.W.3d at 581 (citing RESTATEMENT (SECOND) OF TORTS § 536 cmts. c & d (1977)) (setting forth Pacific's argument claiming reliance upon Form S-3 and Form 10-K registrations filed under federal regulations pursuant to the Securities Exchange Act of 1933).

41. *See* Ginger E. Margolin, Case Note, *Securities—Fraud—Private Plaintiffs May Not Maintain Aiding and Abetting Suits Under Securities Exchange Act Section 10(b) and Securities and Exchange Commission Rule 10b-5*, 26 ST. MARY'S L.J. 601, 604–05 (1995) (recognizing that securities regulation consists of seven federal legislative acts, including the first two federal securities laws, known as the Securities Act of 1933 and the Securities Exchange Act of 1934, which were intended by Congress "to restore faith in the nation's economy"); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194–95 (1976) (providing that in the aftermath of the 1929 market crash, the "Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce"); Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 582 (Tex. 2001) (declaring that the federal securities regulations of the 1933 and 1934 Acts were enacted after the 1929 market crash and "were generally designed to protect investors"); Brief for Petitioner-Appellant at 8–9, *Great Plains Trust*, 313 F.3d 305 (No. 01-21121) (arguing that the "fairness opinion" was filed pursuant to regulations of the 1933 Act, which was designed and promulgated to protect investors); Jeffrey A. Barrack, *Auditor Responsibility Under the Federal Securities Laws: A Note*

promulgated the Securities Act of 1933 and the Securities Exchange Act of 1934 (collectively, "the Securities Acts").[42] The 1933 Act requires these companies, in part, to deliver "a prospectus to an investor upon the distribution of securities,"[43] while the 1934 Act mandates the periodic filing of financial disclosure documents.[44] Although the passage of this legislation

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from the WorldCom Securities Litigation, 29 AM. J. TRIAL ADVOC. 1, 5–6 (2005) ("Section 11 of the Securities Act [of 1933] 'was designed to assure compliance with the disclosure provisions . . . by imposing a stringent standard of liability on the parties who play a direct role in a registered offering'" (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 381–82 (1983))); Carlos J. Cuevas, *The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court*, 13 J. CORP. L. 793, 795–96 (1988) (asserting that "[t]he stock market crash of 1929 was the catalyst for the enactment of federal legislation regulating the securities markets," which prompted Congress to enact the Securities Act and Exchange Act in order "to alleviate the problems that produced the 1929 securities market crash"); Zathrina Perez et al., *Securities Fraud*, 45 AM. CRIM. L. REV. 923, 924 (2008) (noting that although the 1933 Act and 1934 Acts target different markets, the objective of both is "to ensure vigorous market competition by mandating full and fair disclosure of all material information in the marketplace").

42. *See* 15 U.S.C. §§ 77a–77aa (2006) (providing the current amended version of the Securities Act of 1933); 15 U.S.C. §§ 78a–78oo (2006) (setting forth the current amended version of the Securities Exchange Act of 1934); *Ernst & Ernst*, 425 U.S. at 194–95 (discussing Congress's intent to protect investors when Congress enacted the Securities Act of 1933 and Securities Exchange Act of 1934); 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.1, at 445 & n.7 (3d ed. 2006) (detailing the "pioneer legislation" that dealt with the sale of securities); Harry Shulman, *Civil Liabilities and the Securities Act*, 43 YALE L.J. 227, 227 (1933) (analyzing the Securities Act's purpose of securing "accuracy in the information that is volunteered to investors"); Note, *Implied Liability Under the Securities Exchange Act*, 61 HARV. L. REV. 858, 858–59 (1948) (emphasizing that the Securities Act and Securities Exchange Act have incorporated "policies of disclosure and fair play into the law of securities transactions" by imposing criminal penalties, injunctions, and civil liability for violations of the respective Acts).

43. *See Ernst & Young*, 51 S.W.3d at 581 (describing Pacific's claim of reliance on the Form S-3 registration statements, which also contained the audit opinion and financial information prepared by Ernst & Young, filed with the SEC pursuant to 17 C.F.R. § 239.13 to register the securities described in the prospectuses); Brief for Petitioner-Appellant at 8–9, *Great Plains Trust*, 313 F.3d 305 (No. 01-21121) (providing that "[t]he 'fairness opinion' was attached as an exhibit to the Form F-4 filed pursuant to" 17 C.F.R. § 239.34, which mandates the opinion "be filed with the SEC and delivered to the investors"). Fairness opinions are typically issued to shareholders in a proxy statement, in accordance with prospectus filing requirements, and they state whether a proposed transaction is fair "from a financial point of view." Michael W. Martin, Note, *Fairness Opinions and Negligent Misrepresentation: Defining Investment Bankers' Duty to Third-Party Shareholders*, 60 FORDHAM L. REV. 133, 137 (1991).

44. *See* Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 581–82 (Tex. 2001) (detailing the three prospectuses, filed pursuant to 17 C.F.R. § 249.310 and incorporated in RepublicBank's Form 10-K, which stated that the corporation financials were included in the prospectuses in reliance upon Ernst & Young's "expert" opinion as

identifies Congress's intent to provide "the public with more protection and better remedies than were available at common law," it is unclear to what extent this legislation expanded common law liability.[45] An analysis of federal statutes governing securities transactions is beyond the scope of this Comment, but recognizing the intent behind the disclosure requirements is necessary when analyzing liability under section 536 of the *Restatement (Second).*

B. *Negligent Misrepresentation in Texas*

Defining the scope of liability for fraudulent misrepresentation requires an understanding of the traditional ambit of permissible complaints recognized against a negligent misrepresentor.[46] The traditional approach of negligent misrepresentation developed through the privity bar, which precluded actions by injured parties who were not in contractual privity with the provider of information.[47] Most jurisdictions, including Texas courts, have abandoned the "strict-privity" standard and adopted one of three

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indicated in the audit report); *see also In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 490 F. Supp. 2d 784, 825 (S.D. Tex. 2007) (analyzing the specificity needed to satisfy a common law fraud claim by review of Merrill Lynch's "awareness that the Nigerian Barge and Power Transactions were being used to help Enron cook its books and manipulate its 1999 SEC 10-K and 10-Q reports").

45. *See* Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law,* 9 B.C. INDUS. & COM. L. REV. 137, 154 (1967) (questioning the scope of the duties imposed on accountants under the Securities Act of 1933 and the Securities Exchange Act of 1934).

46. *See* Response to Petition for Review at 3–4, *Ernst & Young,* 51 S.W.3d 573 (No. 00-0232) (arguing the defendant's position "that the scope of permissible complainants against a fraudfeasor should be as limited as those against a negligent misrepresenter" is misled because the *Restatement (Second)* and Texas cases have rejected this contention); 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.3, at 459–60 (3d ed. 2006) (noting the scienter requirement of fraud and analyzing cases that afford a remedy for negligent or innocent misrepresentations in the absence of scienter).

47. *See* DAN B. DOBBS, THE LAW OF TORTS 1370–72 (2000) (explaining the problems associated with the dispensing of the privity requirement in negligent misrepresentation); JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 29–30 (1995) (noting that the first stage of "virtual nonliability" in the modern tort of negligent misrepresentation developed through the privity doctrine in the nineteenth century); VINCENT R. JOHNSON & ALAN GUNN, STUDIES IN AMERICAN TORT LAW 939–40 (4th ed. 2009) (evaluating the *Ultramares* "privity" doctrine as one of three views on liability to third parties for negligent misrepresentation); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 107, at 746–47 (5th ed. 1984) (citing Justice Cardozo's opinion in *Glanzer v. Shepard* in order to reinforce the main point that liability was imposed on a contractual basis).

alternatives to the privity doctrine.[48] The "significant expansion of liability to third parties" includes the near-privity standard,[49] the foreseeability standard,[50] and the standard promulgated in

48. *See* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 848 (2008) (concluding that most jurisdictions, including Texas and New York, moved away from the *Ultramares* privity standard by allowing "parties not in privity of contract to assert negligent misrepresentation claims against information providers" through the evolution of three different standards). In *Ultramares*, the plaintiff was barred from recovering for negligent misrepresentation "in the absence of privity with [the] defendants, even though" the claimant could have reasonably been expected to rely on the financial statements in the normal course of business. Darrell D. Hallett & Thomas R. Collins, Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 159 (1968).

49. *See, e.g.*, VINCENT R. JOHNSON, MASTERING TORTS: A STUDENT'S GUIDE TO THE LAW OF TORTS 296–99 (3d ed. 2008) (surveying a group of courts that held information providers "are liable for negligent preparation of financial reports only to those in privity of contract with them" or in an equivalent relationship very similar to privity). According to the New York State Court of Appeals, under the near-privity standard, "three elements must be established" in order for the relationship "'to be equated with privity:'"

> (1) the information provider must have been aware that the misinformation would be used in a specific transaction or for a specific purpose; (2) the information provider must have known that the misinformation would be relied on by the third party; and (3) there must have been some conduct by the information provider linking it to the third party that evinces the provider's understanding that the third party would rely on the misinformation.

Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 849 (2008) (quoting Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110, 112 (N.Y. 1985)); *see also* JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 55–56 (1995) (declaring that the *Ultramares* principle was revitalized by the decision in *Credit Alliance* by limiting the duty owed to third parties who rely on representations if the three conditions listed above are met).

50. *See* DAN B. DOBBS, THE LAW OF TORTS 1373 (2000) (noting that "two states, Mississippi and Wisconsin," moved away from the *Restatement (Second)*'s position and adopted the foreseeability approach where liability was enforced "to the extent of reasonably foreseeable reliance"); JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 130–34 (1995) (reiterating that the foreseeability analysis imposes liability only "'where both the plaintiff and the risk are foreseeable to a reasonable person'" (quoting Donnelly Constr. Co. v. Oberg/Hunt/Gilleland, 677 P.2d 1292, 1295 (Ariz. 1984))); VINCENT R. JOHNSON, MASTERING TORTS: A STUDENT'S GUIDE TO THE LAW OF TORTS 296–99 (3d ed. 2008) (presuming some courts enforce the foreseeability standard because "foreseeability of harm is the ordinary test for negligence liability"); Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 850–51 (2008) (explaining that only three states have adopted the foreseeability standard, while the majority of states have opted in favor of the near-privity or *Restatement (Second)* standards because of the crippling liability that

section 552 of the *Restatement (Second)*.[51]

Texas and the majority of states have adopted section 552 of the *Restatement (Second)* as the standard for deciding negligent misrepresentation actions.[52] Despite Texas courts' repeated following of the *Restatement (Second)* standard, confusion has persisted "among courts, commentators, and practitioners" as to whether Texas follows a strict or expansive reading of section 552.[53] The Dallas court of appeals' decision in *Blue Bell, Inc. v.*

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could potentially result from the foreseeability standard's enforcement).

51. *See* DAN B. DOBBS, THE LAW OF TORTS 1372–73 (2000) (stating that the *Restatement (Second)* standard "recognizes a limited kind of liability to third persons" where "[t]he defendant has no general liability to the public; at most he is liable to a small group" or limited class of persons of which the plaintiff is a member); JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 161–63 (1995) (summarizing the *Restatement (Second)* section 552 standard as applied by the majority of courts); Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 851–52 (2008) (noting that the majority of jurisdictions have adopted the intermediate standard of section 552). One who supplies false information in the course of business and fails to exercise reasonable care "in obtaining or communicating the information" is liable to the person or "limited group of persons" to whom the representor intended to supply the information or to those who "the recipient intends to supply it." Liability is limited to a loss suffered when the plaintiff justifiably relies "upon [the information] in a transaction that [the representor] intends the information to influence or knows that the recipient so intends or in a substantially similar transaction." RESTATEMENT (SECOND) OF TORTS § 552 (1977).

52. *See* DAN B. DOBBS, THE LAW OF TORTS 1372 (2000) ("Most courts adopt the *Restatement (Second)*'s position or something close to it."); JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 161 (1995) (declaring that virtually all jurisdictions use the *Restatement (Second)*'s "standard to measure the duty to third" persons); John S. Dzienkowski, Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759, 776 (1982) (noticing that the modern trend of liability for audit engagements "indicates that most courts are rejecting the *Ultramares* rule and adopting the *Restatement of Torts* position"). The Texas Supreme Court implicitly rejected the foreseeability standard in *Blue Bell* through the court's whole adoption of section 552 in Fed. Land Bank Ass'n v. Sloane, 825 S.W.2d 439 (Tex. 1991), and McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787 (Tex. 1999). Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 857–60 (2008). It is accurate to state that the court "impliedly" adopted section 552 because the language in *Blue Bell* is contrary to the *Restatement (Second)* and, additionally, because section 552 requires a defendant "to have actual knowledge of a third party's reliance" on the supplied information. Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 860 (2008) (quoting Abrams Ctr. Nat'l Bank v. Farmer, Fuqua & Huff, P.C., 225 S.W.3d 171, 177 (Tex. App.—El Paso 2005, no pet.)).

53. *See* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 854 (2008) (explaining that the

Peat, Marwick, Mitchell & Co.[54] applied a less restrictive interpretation of section 552 by extending the liability of a misrepresentor to those whom the defendant "should know" would rely on the representation;[55] however, the majority of Texas courts have declined to follow this interpretation and have strictly applied the *Restatement (Second)* as written.[56] In other words, the as-written interpretation acts as an intermediate standard, where the section's restrictiveness lies between the narrow near-privity approach and the expansive foreseeability approach.[57] Under the *Restatement (Second)* standard, the information provider is not required to know the precise identity of the third party who relied upon the information provider's misrepresentation.[58] Section 552 extends liability for negligent

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confusion of the interpretation of section 552 stems from conflicting interpretations by Texas courts, with some applying "a more expansive reading of the *Restatement*'s standing requirements").

54. Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408 (Tex. App.—Dallas 1986, writ ref'd n.r.e.).

55. *See id.* at 412 (holding, based upon the circumstances of the case, that "an accountant preparing audited financial statements [who] knows *or should know* that such statements will be relied upon by a limited class of persons . . . may be liable for injuries to members of that class relying on [the] certification of the audited reports"); Jordan H. Leibman & Anne S. Kelly, *Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle*, 30 AM. BUS. L.J. 345, 350 (1992) (recognizing that "in the 1980s[,] several state courts virtually eliminated the privity barrier" by adopting the negligence foreseeability rule, which holds "that accountants are potentially liable to any third party who reasonably might be expected to rely on the audited financial statements"). The Dallas court of appeals' foreseeability or "should know" standard stood in contrast to the *Restatement (Second)* drafters' intent of extending "a legal duty only to those persons who the information provider actually intends or knows will rely on the provider's information." Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 856 (2008).

56. *See* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 854–60 (2008) (explaining the Texas Supreme Court's adoption of section 552 as written in *McCamish*, 991 S.W.2d 787).

57. *Id.* at 852. Under the *Restatement (Second)* standard, Feinman states "the central issue is the degree of knowledge" that the information provider must have of the potential plaintiffs or the intended use of the information. JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 167 (1995).

58. *See* JAY M. FEIMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 170 (1995) (stating that the required knowledge of a defendant under the *Restatement (Second)* does not necessarily require "knowledge of the identity of the particular relying plaintiff[] when the defendant knows that the members of an identifiable group will rely" on a misrepresentation); Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The*

misrepresentations made to the limited class of persons who the misrepresentor intends or knows will receive and be influenced by the information, regardless of whether the specific identity of the recipient is unknown to the information provider.[59] The *Restatement (Second)*'s intermediate standard is traditionally based upon the difference between the liability standards of fraudulent and negligent misrepresentation, which has developed from the policy consideration of placing greater liability on more culpable conduct.[60]

III. A NATIONAL PERSPECTIVE ON THE REASON-TO-EXPECT STANDARD

While Texas courts have used the reason-to-expect standard to limit liability in common law fraud claims brought by shareholders and investors, a substantial number of states have failed to recognize or, in some cases, even address the especial-likelihood provision of section 531 of the *Restatement (Second)*.[61] Many

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Misunderstood Tort, 40 TEX. TECH L. REV. 845, 852, 874–75 (2008) (noting that the *Restatement (Second)* standard does not require the supplier of information to know the exact identity of any third party who relies on the supplier's information "or the existence of any link between the provider and the third party").

59. *See* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 852 (2008) (analyzing the extent of liability imposed under section 552 when an information supplier knows or intends to guide a recipient's decision making with the information); *see also* RESTATEMENT (SECOND) OF TORTS § 552 (1977) (limiting liability for loss suffered to the persons who the information provider "intends to supply the information or knows that the recipient intends" to rely on the information by supplying it to another). The limited group of persons articulated in section 552(2)(a) can include thousands of potential users if the information provider intends or knows the misinformation could potentially be circulated to such a large group. Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 876 (2008).

60. *See* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 853 (2008) (explaining that "[s]ection[] 552's intermediate standard is based [upon] (1) the difference between fraud and negligent misrepresentation and (2) the reasonable expectations of commercial information users"); *see also* RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (stating that the restrictiveness of section 552 differs from fraudulent misrepresentation stated in section 531); JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 167 (1995) (commenting on the drafter's intent of limiting the scope of liability for negligent misrepresentation); VINCENT R. JOHNSON, ADVANCED TORT LAW: A PROBLEM APPROACH 115 (2010) (noting that actions for negligent misrepresentation and fraud have some of the same requirements but mainly differ in the scope of liability imposed by each).

61. *See* Rogers v. Cisco Sys., Inc., 268 F. Supp. 2d 1305, 1313–14 (N.D. Fla. 2003)

jurisdictions, including New York, Massachusetts, New Jersey, California, and Florida, have not hesitated to recognize common law securities claims where shareholders and investors were fraudulently induced to buy, sell, or hold shares of corporate stock to their financial detriment.[62] Unlike Texas's strict interpretation of section 531, these courts either implicitly or expressly acknowledge that shareholder reliance satisfies the reason-to-expect language to constitute a valid common law fraud claim.[63] The proximate causation requirement of a third-party claim is satisfied with the recognition of sufficient intent to induce reliance when using the reason-to-expect standard; however, in many instances, courts refuse to grant relief because of the inadequacy of the plaintiffs' pleadings of reliance due to the absence of specific

(holding that shareholders sufficiently pled a fraud claim with particularity under section 525 of the *Restatement (Second)* but failed to plead specific damages); Prof'l Investors Life Ins. Co v. Roussel, 528 F. Supp. 391, 396–97 (D. Kan. 1981) (holding that under section 531 and section 536 of the *Restatement (Second)*, the plaintiff's claim for common law fraud stated a genuine issue of fact because there was enough evidence to infer that the defendants made the representations with the purpose of influencing the plaintiff's conduct); Small v. Fritz Cos., 65 P.3d 1255, 1258–59 (Cal. 2003) (recognizing a cause of action for stockholders induced by fraud to hold their stock under section 531 of the *Restatement (Second)*, but not requiring a specific showing of an especial likelihood that such reliance would occur). Furthermore, these claims are frequently based upon fraudulent misrepresentations made in certified financial documents that falsely state the corporation's financial condition. *See Rogers*, 268 F. Supp. 2d at 1313–14 (noting that the plaintiffs reviewed and relied upon various financial reports filed with the SEC and statements made by the defendants); *Small*, 65 P.3d at 1257–58 (explaining that shareholders allegedly relied upon quarterly financial reports that grossly overstated earnings).

62. *See* Primavera Familienstifung v. Askin, 130 F. Supp. 2d 450, 494 (S.D.N.Y. 2001) (recognizing common law fraud claims for investors when they are induced to sell or retain their investments); Gutman v. Howard Sav. Bank, 748 F. Supp. 254, 262–68 (D.N.J. 1990) (allowing investors in a bank to state a common law fraud claim for misrepresentations that induced the plaintiffs to hold securities they would have otherwise sold); Murphy v. BDO Seidman, LLP, 6 Cal. Rptr. 3d 770, 781 (Cal. Ct. App. 2003) (recognizing investors' fraud action that claimed that plaintiffs were induced to purchase stock in the defendant's company because of misstatements contained in financial filings); Haberman v. Wash. Pub. Power Supply Sys., 744 P.2d 1032, 1070–71 (Wash. 1987) (holding that bondholders can state a claim for fraud when the defendant corporation has reason to expect the holders will receive the misinformation).

63. *Compare Rogers*, 268 F. Supp. 2d at 1313 (positing, without expressly stating the reason-to-expect language, that one recent Florida decision and "numerous other state courts have recognized that inducing another to refrain from action is sufficient to state a cause of action in fraud"), *with Small*, 65 P.3d at 1259 (recognizing a cause of action by holders of securities that claimed fraud when induced "'*to refrain from action* in reliance upon the misrepresentation'" (quoting RESTATEMENT (SECOND) OF TORTS § 531 (1977))).

St. Mary's Law Journal, Vol. 42 [2010], No. 1, Art. 3

damages.[64] Although a valid fraud cause of action requires proving both causation and damages, the reason-to-expect language is a pure causation issue to be decided by state courts. The reluctance to grant third-party shareholder claims is a state's individual prerogative; however, shareholder "liability has become a settled principle of liability in those state jurisdictions encompassing the heart of the country's financial services industry."[65] Thus, other states have chosen to allow third party shareholder and investor causes of action by simply recognizing a fraudulent inducement to buy, sell, or hold shares of corporate stock satisfies the reason-to-expect standard.

A. *The Especial-Likelihood Provision Can Be Broadly Interpreted*

Courts that discuss the especial-likelihood language subject the section to varying degrees of scrutiny. One Massachusetts court held that shareholder reliance on falsely certified audit opinions satisfied the "special" reason-to-expect standard because such "reliance is *especially predictable* where the accounting firm affirms or reaffirms the substance of its audit opinion contemporaneously with its knowledge" that the financial statements would be relied upon by foreseen or specific investors.[66] In the appellate court's opinion, the defendant's issuance of audit

64. *See Rogers*, 268 F. Supp. 2d at 1314 (denying recognition of a fraud action because of the plaintiff's failure to "allege specific reliance on the defendants' representations" (quoting *Small*, 65 P.3d at 1256)); Hunt v. Enzo Biochem, Inc., 471 F. Supp. 2d 390, 411–12 (S.D.N.Y. 2006) (requiring a plaintiff to plead specific reliance by demonstrating a causal connection between the alleged misrepresentation and resulting harm); *Small*, 65 P.3d at 1257 (rejecting the recognition of a fraud cause of action because plaintiff shareholder failed to "make a bona fide showing of actual reliance"). In holder actions, the courts often require specificity in the allegations of reliance; this requires plaintiffs to allege how many shares of the stock they would have sold and when the sale would have taken place. *Rogers*, 268 F. Supp. 2d at 1314.

65. *See* Samuel T. Brannan, *Arguments and Authorities Supporting the Viability of Holder Claims*, *in* 1615 PLI CORP. L. & PRAC. COURSE HANDBOOK SERIES 329, 336 (2007) ("Since the 1890s, courts in New York, Massachusetts, New Jersey, California and Illinois have recognized common law liability based on the fraudulently induced retention of securities.").

66. *See* Reisman v. KPMG Peat Marwick LLP, 787 N.E.2d 1060, 1067–68 (Mass. App. Ct. 2003) (emphasis added) (referencing section 531 comments c, d, e, and illustration 4 when holding that the defendant corporation had reason to expect reliance upon their misstatements "both when the financial reports were first issued and when they were reaffirmed").

opinions for falsified financial reports warranted greater liability considering the defendants knew the audited reports were likely to be used and relied upon by the plaintiffs.[67]

Furthermore, the Dallas court of appeals allowed public bondholders to state a common law fraud claim, reasoning that an indenture filing requirement raised a genuine issue of material fact regarding whether the defendant company had reason to expect the information was especially likely to be received and relied upon.[68] The court attempted to distinguish *Ernst & Young*, but its analysis is unpersuasive because the same court decided a fact issue existed in both cases regarding an especial likelihood of reliance on the financial disclosures filed with the SEC.[69] Indeed,

67. *See id.* at 1067 (explaining that the plaintiffs did not have to prove the defendants made the misstatements with the specific purpose of inducing reliance, as fraudulent misconduct is subject to a lesser standard of culpability). The appellate court also based its decision on the settled principle in Massachusetts law that "where reliance on a fraudulent misstatement is a substantial factor in the decision to purchase and/or retain stock," the fraudfeasor is liable for the "loss in the value of stock suffered" by one who relies on the misrepresentation. *Id.* at 1068.

68. *See* Prospect High Income Fund v. Grant Thornton, LLP, 203 S.W.3d 602, 611–12 (Tex. App.—Dallas 2006) (noting that the plaintiffs demonstrated sufficient intent to induce reliance by showing the defendants "had information that would cause a reasonable man to conclude that the existing bondholders would be especially likely to rely upon . . . audited financial statements"), *rev'd in part*, 314 S.W.3d 913 (Tex. 2010). The court of appeals concluded that a material issue of fact existed as to whether the plaintiffs relied on the information for the decision to invest and when they continued to hold the bonds even after their purchase. *Id.* at 612–13.

69. *Compare id.* at 612 (concluding a fact issue existed as to whether the defendant had reason to expect that plaintiffs would rely on its audited financial statements filed with the SEC), *with* Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 576–77 (Tex. 2001) (noting the Dallas court of appeals held that the plaintiff's affidavits created a fact issue as to whether the defendant had reason to expect that an institutional investor would rely on its representations in SEC filings). In *Prospect High Income*, the appeals court reasoned that some evidence indicated the plaintiffs' reliance was foreseeable and especially likely, whereas the plaintiff's reliance in *Ernst & Young* was foreseeable but not especially likely. *Prospect High Income*, 203 S.W.3d at 612. The court emphasized the fact that the filing requirement required the issuing bond company to furnish "*each Securityholder*" with copies of the quarterly and annual reports pursuant to § 13 of the Exchange Act. *Id.* While the disclosure requirements in *Ernst & Young* did not require each individual shareholder be provided with a copy of the company's financial report, investors in that case were apparently expected to rely on the statements regardless of whether the statements were personally served or registered with the SEC for viewing by the public. *See Ernst & Young*, 51 S.W.3d at 575–76 (describing how, with the consent of Ernst & Young, RepublicBank issued prospectuses that incorporated their Form 10-K "in reliance upon" Ernst & Young's audit report and "authority . . . as experts," and also how the prospectuses were included in Form S-3 registration statements filed with the SEC). Notably, federal securities law requires information contained in registration statements

St. Mary's Law Journal, Vol. 42 [2010], No. 1, Art. 3

this case was recently overturned by the Texas Supreme Court for similar reasons.[70] However, from this decision and the decision in *Reisman*, it appears that courts can apply a broad interpretation to the reason-to-expect standard through the especial-likelihood provision. The difference between a foreseeable result and one that is especially likely is just a matter of degree, and this result is dependent on the unique circumstances of each individual case.[71]

B. *General Industry Practice of Reliance on Financial Reports*

Generalized industry practice or knowledge, as held by Texas courts, is insufficient to demonstrate that the maker of a misrepresentation possessed information especially likely to influence recipient conduct.[72] The Texas Supreme Court treats general industry knowledge as information that can be reasonably foreseen, instead of as a basis for judgments on narrower grounds through use of the reason-to-expect standard.[73] Further analysis

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be made available to the public and copies of the statements "be furnished to every applicant at such reasonable charge as the Commission may prescribe." 15 U.S.C. § 77f(d) (2006).

70. *See generally* Grant Thornton LLP v. Prospect High Income Fund, 314 S.W.3d 913–15 (Tex. 2010) (holding the law does not impose "an obligation on [an] auditor to provide an accurate accounting . . . to anyone who reads and relies on it").

71. The degree of knowledge that separates foreseeable reliance from reliance that is especially likely to occur is quite minimal. The degree of difference is subject to the discretion of the court. *Compare* Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co., 313 F.3d 305, 324–26 (5th Cir. 2002) (holding that Morgan Stanley's opinion letters were insufficient to determine that the debenture holders' reliance was especially likely and justifiable because the plaintiffs failed to plead facts that conclusively established that the defendants knew the opinion letters were for persons other than the Board of Directors), *with Reisman*, 787 N.E.2d at 1067–68 (determining that, based on the facts in record, the defendants had sufficient knowledge to conclude plaintiffs would rely on the audited financial statements and SEC filings, advice given by the defendants on the pooling transaction, and the common knowledge that the financials had been used in past transactions).

72. *See, e.g.*, *Ernst & Young*, 51 S.W.3d at 581 (stating Pacific's affidavits, which spoke in terms of common knowledge and expectation, were insufficient to show that investors like Pacific would rely on the defendants' statements "in purchasing securities . . . issued years earlier").

73. *Id.* Many courts have expressed an explicit willingness to extend the scope of liability for negligence, and this expression "suggests an equivalent willingness so to expand the scope of liability for intended misrepresentation." 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 455 n.18 (3d ed. 2006); *see also* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90–92 (D.R.I. 1968) (stating that an intentional misrepresentor "is liable to all those persons whom he should reasonably have foreseen would be injured by his misrepresentation"); Fischer v. Kletz, 266 F. Supp. 180, 184–88 (S.D.N.Y. 1967) (finding no reason to bar the plaintiff's common law action for deceit

of section 531 of the *Restatement (Second)* reveals that obvious risks differ between that of common knowledge and that of expectation in the investment community.[74] Any misrepresentation can be communicated to third persons and these transmissions create an obvious risk of reliance,[75] but falsely certified financial reports will be relied upon by investors and shareholders, particularly when the sole purpose of the reports is to disclose the financial condition of the corporation.[76]

The revelation of a corporation's financial condition is directly implicated in the intraday trading of the corporate stock.[77] The

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because the certification of financial statements by accountants is similar to a business transaction where the information "is naturally and justifiably relied upon by individuals for decisional purposes"); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 364–66 (Wis. 1983) (holding that liability will be imposed on accountants for injuries to third parties that are foreseeable from their negligent acts).

74. As previously mentioned, several states confirm this point through their recognition of shareholder and investor actions for fraud when the plaintiffs were induced to retain, sell, or buy shares of stock based upon fraudulent misrepresentations. *See* Hunt v. Enzo Biochem, Inc., 471 F. Supp. 2d 390, 392–93, 410–13 (S.D.N.Y. 2006) (recognizing the viability of common law holder claims, after certain corporate officers and directors made misrepresentations about the company in an effort to inflate share prices); *Reisman*, 787 N.E.2d at 1067–68 (allowing common law securities claim when investors rely on fraudulent misstatements by the filing corporation).

75. RESTATEMENT (SECOND) OF TORTS § 531 cmt. d (1977). Illustrations one through three of the commentary to section 531 note instances where the transmission of a misrepresentation to a third party does not impose liability on the misrepresentor. *Id.* § 531 illus. 1–3 (1977). In the examples given, the fraudulent statements were not intended to reach and influence unknown third parties. *Id.* § 531.

76. The common practice of investor reliance on certified financial reports can be traced back to the late 1800s. *See* Hunnewell v. Duxbury, 28 N.E. 267, 268 (Mass. 1891) (stating a cause of action for deceit by shareholders for false representations filed with the commissioner of corporations); Gerner v. Mosher, 78 N.W. 384, 387–88 (Neb. 1899) (upholding claim brought by shareholders for reliance on falsely certified financial reports that pertained to the bank's financial condition). In the initial decision of *Ernst & Young*, the Dallas court of appeals rejected the defendant's contention that the alleged misrepresentations were not material and determined that the opinion of the plaintiff's expert established that investors considered it important to rely on SEC-filed documents when deciding to invest in the defendant corporation. Pac. Mut. Life Ins. Co. v. Ernst & Young & Co., 10 S.W.3d 798, 803–04 (Tex. App.—Dallas 2000), *rev'd*, 51 S.W.3d 573 (Tex. 2001). Although the decision was reversed, the reasoning is still instructive and persuasive for future application. *See* Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 575, 580–81 (Tex. 2001) (rejecting expert opinions by a certified public accountant and a former dean of the Southern Methodist University School of Business, who both testified to the commonly accepted practices).

77. *See* Expert Report & Affidavit at 25, Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & "ERISA" Litig.), 490 F. Supp. 2d 784 (S.D. Tex. 2007) (No. 4:01-CV-03624), 1999 WL 34747790 (concluding that earnings announcements are "quickly incorporated into both the bond and stock prices within that day"); *see also*

maker of the misrepresentation could assume this information is substantially certain to affect the trading decisions of a reasonable investor.[78] Expert opinion confirms what is already commonly known in the investment community—earning reports immediately control market price behavior of the underlying stock.[79] This knowledge goes beyond a mere obvious risk because corporations have reason to expect third-party investors will use the filed information in their investment decisions.[80]

William O. Fisher, *The Analyst-Added Premium As a Defense in Open Market Securities Fraud Cases*, 53 BUS. LAW. 35, 39–41 (1997) (providing examples for sudden stock price fluctuations "on minimum variance between the estimated and actual reported [corporate] earnings"); James J. Park, *Assessing the Materiality of Financial Statements*, 34 J. CORP. L. 513, 514 (2009) (noting that the inaccuracy of financial reports can cause the value of the stock to be overstated, and that purchasing shareholders will suffer resulting losses from the ownership of a stock that does "not reflect the underlying economic value of [the] compan[y]").

78. Comment c of section 531 states: "one who believes that another is substantially certain to act in a particular manner as a result of a misrepresentation intends that result, although he does not act for the purpose of causing it and does not desire to do so." RESTATEMENT (SECOND) OF TORTS § 531 cmt. c (1977); *cf.* Reisman v. KPMG Peat Marwick LLP, 787 N.E.2d 1060, 1067 & n.12 (Mass. App. Ct. 2003) (explaining that an auditor's falsely certified company report will be relied upon by potential investors when the defendant is "aware that there is a limited subgroup of investors—those whose companies its client company wishes to acquire—to whom such financial reports will, in all likelihood, be furnished").

79. *See* Expert Report & Affidavit at 25, Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & "ERISA" Litig.), 490 F. Supp. 2d 784 (S.D. Tex. 2007) (No. 4:01CV03624), 1999 WL 34747790 (explaining how earnings information is incorporated in a stock's price within hours of an announcement). Analysts will often publish earnings forecasts for publicly traded companies, and when the actual earnings of companies do not meet the projected forecasts, the stock market prices will drop and investors will sue. William O. Fisher, *The Analyst-Added Premium As a Defense in Open Market Securities Fraud Cases*, 53 BUS. LAW. 35, 35–36 (1997). Corporations have become obsessed with their reported quarterly earnings because these reports have such a substantial impact on their short-term stock price. *See* David Millon, *Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. 890, 892–94 (2002) (noting that the Enron scandal provides a textbook example of how corporations will engage in fraudulent tactics to achieve projected earnings in order to maintain their short-term stock price).

80. *See* Citizens State Bank v. Timm, Schmidt & Co., 335 N.W.2d 361, 365 & n.10 (Wis. 1983) (explaining that an information provider can reasonably expect a third party to rely upon the reviewed financial statements because "'the primary intended user for most reviewed financial statements is a third party'" (quoting John S. Dzienkowski, Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759, 813 (1982))). The review of financial statements is often "the only feasible level of assurance available to small businesses seeking to provide reliable financial data to third parties." John S. Dzienkowski, Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759, 813 n.295 (1982).

IV. APPLICATION OF SECTION 536 SATISFIES THE REASON-TO-EXPECT STANDARD

The Texas Supreme Court has declined to broadly apply section 536.[81] The court's narrow application results from the court's understanding that the section "effectively alleviates a [shareholder or investor's] burden to show intent to induce reliance" in common law fraud causes of action.[82] Even though section 536 does presume the information provider always has reason to expect the class of persons the statute is designed to protect will rely upon the information provided, the purpose of the section is to provide protection and security to those persons who intend to rely on the truthfulness of the filed information.[83] According to the court in Ernst & Young and the *Restatement (Second)*, a statute requiring corporations to report their financial condition to the public serves the purpose of making the information available to those who consider the knowledge important.[84] Commentary under the section clearly indicates the controlling factor is the purpose of the legislature and not the person or corporate entity who furnishes the required information.[85] Logically, an information provider would always deny intent to induce any type of reliance on the falsified

81. *See Ernst & Young*, 51 S.W.3d at 582 (declining to apply section 536 after Pacific argued that the federal regulatory enforcement mechanism of Rule 10b-5 is designed to protect members of the public such as Pacific and that, therefore, section 536 presumes the defendant had reason to expect the plaintiff's reliance on the SEC-filed documents).

82. *See id.* (reasoning the intent-to-induce-reliance element cannot be negated when other federal and state remedies are available).

83. *See* RESTATEMENT (SECOND) OF TORTS § 536 cmt. c (1977) (explaining that when information is required to be filed by statute, "one who complies with the requirement always has reason to expect that the information will reach the class of persons and influence their conduct").

84. *Ernst & Young*, 51 S.W.3d at 582. Commentary under section 536 states that those individuals who find knowledge of the corporation's financial position important in determining their actions and decisions can use the acquired information "in any type of transaction with the corporation in question." RESTATEMENT (SECOND) OF TORTS § 536 cmt. e (1977).

85. *See* RESTATEMENT (SECOND) OF TORTS § 536 cmt. d (1977) (stating it is "immaterial that the information is not furnished voluntarily but under compulsion of the statute" because the intent of protection for a particular class of persons is a question of statutory construction and should not be decided by those who are required to furnish the information); 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 451 (3d ed. 2006) ("And where misrepresentations occur in reports required by statute, the class of persons who may take advantage of them is defined by the intent or purpose of the legislature rather than that of the person who makes the report.").

information in order to limit the provider's liability. Deceptive and irresponsible securities practices such as these prompted the adoption of federal legislation to better protect the investing public,[86] thus exemplifying the legislative intent under section 536.[87]

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86. *See* Lloyd Alan Levitin, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L.J. 436, 460 (1964) (noting that common law liability to third parties has been greatly expanded for misrepresentations under the Securities Act of 1933); Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 154 (1967) (identifying the legislative intent of protecting "the investing public from fraudulent and irresponsible securities transactions [that] arose from the speculative and unorthodox financing of the 1920's and the resultant stock market crash of 1929"); Darrell D. Hallett & Thomas R. Collins, Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 163–66 (1968) (commenting on the extension of liability for misrepresentations under the Securities Acts of 1933 and 1934); Note, *The Accountant's Liability—For What and to Whom*, 36 IOWA L. REV. 319, 328 (1951) (emphasizing that the Securities Act of 1933 expanded the liability of public accountants by holding them liable for untrue statements or omissions of material fact "necessary to avoid misleading subscribers"). The Securities Acts recognize that there are certain persons with expertise and knowledge of the securities being offered, which thereby requires imposing a duty on these persons to disclose "an honest representation of the facts" to the investing public. *See* Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 154–55 (1967) (providing that the purpose of the Securities Act of 1933 is to supply full and fair information on the character of securities sold).

87. Case law existing at the time Congress enacted the Securities Acts indicated that those who relied upon false information, found in statements required to be filed by statute, were entitled to recover when the misrepresentation did not accurately reflect the company's financial condition. *See, e.g.*, Warfield v. Clark, 91 N.W. 833, 834–35 (Iowa 1902) (holding that the company's false financial statement filed under state code warranted recovery under action of deceit for the plaintiff's reliance on the misrepresentation). *But see* Hindman v. First Nat'l Bank, 112 F. 931, 932–33, 941–43 (6th Cir. 1902) (noting that a license issued by an insurance company to do business based upon a falsely certified bank certificate did not give a right of action for fraud by a stock purchaser who allegedly relied on the fact that the bank had been licensed to do business). Even then, as now, differences in construing statutory intent occurred because courts can apply "a broad or a narrow judicial interpretation of the scope of the legislative purpose." 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 451 n.11 (3d ed. 2006). *Compare* Merchants' Nat'l Bank v. Armstrong, 65 F. 932, 936–37 (C.C.S.D. Ohio 1895) (holding that statements filed pursuant to the National Bank Act were not filed for the purpose of protecting stockholders, and therefore, these stockholders could not recover against the bank for shares of stock they accepted as collateral for a loan), *with* Gerner v. Mosher, 78 N.W. 384, 387 (Neb. 1899) (holding that statutorily required reports made to the comptroller of currency were intended for the protection of persons entering into business transactions in which the financial condition of the bank is a crucial factor).

Congress articulated its intent to protect investors and shareholders by imposing civil liability through the Securities Act of 1933 and the Securities Exchange Act of 1934.[88] The Securities Act of 1933 was enacted to provide investors and shareholders with certain minimal protections by ensuring that "the full disclosure of truthful information regarding the character of the securities [is] offered to the public."[89] The Securities Exchange Act of 1934 expanded upon the disclosure requirements of the 1933 Act and amplified the discretion of the SEC "to effectuate the broad legislative purpose" of providing investor and shareholder protection through the regulation of market transactions.[90]

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88. *See* Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 330, 342–45, 347–51 (1988) (stating that the Securities Acts were administered under the SEC as a regulatory scheme designed "to restore public confidence in the symbols and the basic currency of the industrial era"); Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 153–55 (1967) (commenting on Congress's new "comprehensive scheme for regulating securities transactions" through the passage of the Securities Acts).

89. Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 329–31 (1988) (addressing the key regulatory laws that were put into place during the Great Depression, including the Securities Act, Exchange Act, and four additional statutes); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (recognizing that the 1933 Act was promulgated "to protect investors against fraud and . . . promote ethical standards of honesty and fair dealing"). Congress's overriding objective with the 1933 and 1934 Acts included "protecting investors by mandating (1) equal access to information and bargaining power, (2) full disclosure, and (3) effective enforcement." Ginger E. Margolin, Case Note, *Securities—Fraud—Private Plaintiffs May Not Maintain Aiding and Abetting Suits Under Securities Exchange Act Section 10(b) and Securities and Exchange Commission Rule 10b-5*, 26 ST. MARY'S L.J. 601, 604–05 (1995).

90. *See* Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 155 (1967) (emphasizing that the Exchange Act was intended to correct fraudulent and irresponsible practices not covered by the previous act). The 1934 Act was enacted by Congress to regulate market manipulation of stock prices, which were not covered by the 1933 Act. *Id.* at 155 n.83. The Securities Act was concerned with the misconduct of investors as individuals in connection with the sale of securities, while the Exchange Act was concerned with the misconduct of individual investors in relation to the market. *Id.*; *see also* Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 659 (1965) (stating that the 1933 Act imposes civil liability "only for misconduct in connection with the *sale* of a security," while the 1934 Act was drafted primarily "to protect the investor against manipulation of stock prices through regulation of transactions upon securities exchanges and over-the-counter markets and to impose regular reporting requirements on companies whose stock is listed on a national securities exchange").

Under the Securities Acts, responsible parties are subject to liability for misrepresentations or omissions contained in a registration statement,[91] a prospectus,[92] or any report filed with the SEC,[93] and are also liable for "the use of manipulative or deceptive devices in the purchase or sale of any security."[94] Specifically, liability for misrepresentations or omissions contained in a registration statement or prospectus does not require the claimant to prove actual knowledge of the statement's falsity, privity of contract, damages resulting from the particular statement, or even the defendant's negligence in making the false representations.[95] This great expansion of liability denotes

91. *See* Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 156–57 (1967) (explaining that "§ 11 of the Securities Act of 1933 imposes civil liability only for misrepresentations or omissions of material facts in the registration statement filed with the commission"); Darrell D. Hallett & Thomas R. Collins, Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 163 (1968) (stating that "§ 11 extends relief to any purchaser of securities covered by a registration statement"). A registration statement is intended to include "any report, document, or memorandum filed as part of such statement or incorporated therein by reference." 15 U.S.C. § 77b(a)(8) (2006).

92. *See* Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 159 (1967) (imposing liability under § 12(2) for "one who offers or sells securities by means of a prospectus that includes a misrepresentation ... or fails to disclose a material fact").

93. *See* Roberta S. Karmel, *When Should Investor Reliance Be Presumed in Securities Class Actions?*, 63 BUS. LAW. 25, 33–35 (2007) ("Nevertheless, the cases that permit recovery to plaintiffs for indirect reliance outside of the section 18 context are consonant with the idea expressed in section 18 that companies should be liable for false or misleading statements in SEC filed documents."); Darrell D. Hallett & Thomas R. Collins, Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 165–66 (1968) (noting that § 18 of the Securities Exchange Act of 1934 "extends liability to any person who causes a misleading statement to be made in any report filed with the SEC"). A prospectus refers to any "notice, circular, advertisement, letter, or communication ... which offers any security for sale or confirms the sale of any security." 15 U.S.C. § 77b(a)(10) (2006).

94. *See* Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 161–62 (1967) (providing that civil liabilities can be implied under Rule 10b-5 by enforcing a duty of disclosure where any person "'engage[s] in any act, practice, or course of business which would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security'" (quoting 17 C.F.R. § 240.10b-5 (1964))).

95. *See* Roberta S. Karmel, *When Should Investor Reliance Be Presumed in Securities Class Actions?*, 63 BUS. LAW. 25, 28 (2007) (explaining that § 11 of the Securities Act does not require proof of reliance in order to impose "civil liability for false

Congress's broad remedial purpose of exercising reasonable control over the national securities markets.

When publicly traded companies intentionally file a falsified registration statement, prospectus, or any other report with the SEC, an investor's decision to buy, sell, or hold a corporation's securities in reliance upon such statements is clearly a transaction of the kind the filing statutes are intended to protect.[96] The Texas Supreme Court conceded the possibility that section 536 could apply in situations where an investor's actions and decisions regarding his or her securities related to the corporate actions that were subject to the SEC filing.[97] Though the court wishes to limit liability by restricting the pool of potential plaintiffs, the reason-to-

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or misleading statements in a prospectus used in a registered securities offering"); Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 157–59 (1967) (stating § 11 eliminated any requirement of scienter, privity, or reliance, thus implying it imposes absolute liability). Liability under the federal securities statutes extends to ultimate investors and persons who acquired a "*registered* security" based on misstatements or omissions contained in a registration statement without requiring proof that the misstatements were intended to influence particular plaintiffs. 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 451–52 (3d ed. 2006) (quoting 9 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4250 (3d ed. 2004)). Similarly, the fraud-on-the-market doctrine allows investors to recover their losses under the theory that a company's stock price is determined by the financial information available, and therefore, fraudulent statements will defraud stock purchasers "even if the [stock] purchasers do not directly rely on the misstatements." Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988) (quoting Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986)). This distinction separates common law fraud claims from federal securities fraud claims because common law actions require proof of actual reliance. Rogers v. Cisco Sys., Inc., 268 F. Supp. 2d 1305, 1314 n.18 (N.D. Fla. 2003).

96. *See* RESTATEMENT (SECOND) OF TORTS § 536 cmt. d (1977) (noting that whether the statute "is intended to give protection only in a particular type of transaction, or in all transactions in which the information furnished may be material, is a question of statutory construction"). The statutory filing requirements are specifically designed for the protection of shareholders and investors. *See* Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 154–55 (1967) (stating the purpose of the Securities Acts was to protect the public from fraudulent practices).

97. *See* Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 582 (Tex. 2001) ("While section 536's presumption might apply to purchasers of securities in the merged entity or to RepublicBank shareholders who relied on the filed information in voting to approve the merger, which we do not decide, we cannot say its reach extends to open-market purchases of unrelated securities."); Reply Brief for Petitioner-Appellant-Plaintiff at 9–10, Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co., 313 F.3d 305 (5th Cir. 2002) (No. 01-21121), 2002 WL 32104206, at *9–10 (distinguishing *Ernst & Young* in asserting that the debenture holders' actions were sufficiently related to the SEC filing, the defendant corporations, and the proposed merger entity).

St. Mary's Law Journal, Vol. 42 [2010], No. 1, Art. 3

expect standard merely promotes responsible financial reporting and disclosure requirements.

A. *Decisions by Jurisdictions that Apply Section 536 Are Instructive for the Future of Texas Jurisprudence*

The Texas Supreme Court reasoned section 536, unlike section 531 (which does apply in Texas fraud jurisprudence), "has no counterpart in Texas common law and other courts have rarely applied it."[98] The failure of Texas courts to impose liability under section 536 should not deter a re-examination of the presumption created by the section. Other states' adoption of the section is instructive for future application in Texas jurisprudence. In a shareholder claim for fraudulent misrepresentation, a federal court in Florida recognized the filing requirements in the federal securities laws "exist to protect *all* investors, including those who decide to hold their stock based on such information."[99] Likewise, courts in Kansas, North Carolina, Oregon, and Pennsylvania have adopted section 536 as it pertains to fraudulent misrepresentations.[100]

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98. *See Ernst & Young*, 51 S.W.3d at 582 (stating section 536's presumption of compliance when the filing requirement is fulfilled does not extend to purchases of securities unrelated to the entity for which the filing was made at the time of the misstatements).

99. *See* Rogers v. Cisco Sys., Inc., 268 F. Supp. 2d 1305, 1313 n.17 (N.D. Fla. 2003) (paraphrasing section 536 and noting that the filing requirements in the federal securities laws required Cisco to file its quarterly and annual financial reports with the SEC).

100. *See* Wysong & Miles Co. v. Emp'rs of Wausau, 4 F. Supp. 2d 421, 428–29 (M.D.N.C. 1998) (reasoning section 536 applied because the Supreme Court of North Carolina had already adopted the *Restatement (Second)*'s position for negligent misrepresentation and there was no reason to think its courts would not adopt section 536 as it pertained to fraudulent misrepresentation); Prof'l Investors Life Ins. Co. v. Roussel, 528 F. Supp. 391, 396–97 (D. Kan. 1981) (rejecting defendant's argument that the plaintiffs were not a part of the class the statutes were intended to protect under section 536, and deciding liability for violation of the state's Insurance Holding Company Act was to be determined by the jury); Handy v. Beck, 581 P.2d 68, 69, 73–74 (Or. 1978) (applying section 536 for a false report filed with the state engineer in compliance with a state statute regulating water wells); Woodward v. Dietrich, 548 A.2d 301, 304–05, 307–11 & n.8 (Pa. Super. Ct. 1988) (applying section 536 for misrepresentation made by a contractor to the county's municipal authority regarding the improper installation of a sewer connection). Of the jurisdictions that have cited section 536, only Texas has affirmatively stated a reluctance to apply it. *See* Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co., 313 F.3d 305, 326 (5th Cir. 2002) (acknowledging the *Ernst & Young* Court's decision to apply section 536 "narrowly if at all"); *Ernst & Young*, 51 S.W.3d at 581–82 ("Because section 536 effectively alleviates a claimant's burden to show intent to induce reliance in fraud actions, it should be applied narrowly if at all.").

Section 536 is an extension of the reason-to-expect standard.[101] At common law, liability has traditionally flowed from a falsified statement to members of the class of persons whom the maker of the misrepresentation reasonably intends or has reason to expect will act in reliance on the statement.[102] Accordingly, states seeking to adopt a reasonable reliance standard, as most have done under section 531,[103] would extend the prohibition against fraudulent practices through enforcement of section 536. Thus, Texas courts' adoption of section 531 and rejection of section 536 are counterintuitive to the state's objective of curtailing fraudulent and deceptive behavior.

B. *The Availability of Federal Remedies Does Not Preempt State Tort Law*

The Texas Supreme Court partly rejected the application of section 536 because, in the court's estimation, "[i]nvestors already have remedies for securities violations under Rule 10b-5 and other federal and state securities laws."[104] Two useful points of reference when dealing with the preemption of tort law consist of the preemption of state law by federal law and the displacement of the common law by statutes.[105] Federal law does not preempt state

101. Very few commentators mention section 536 when discussing liability for fraudulent misrepresentation, but when the section is mentioned, it is discussed in connection with the reason-to-expect standard of section 531. *See, e.g.*, John P. Freeman, *Current Trends in Legal Opinion Liability*, 1989 COLUM. BUS. L. REV. 235, 262 & n.108 (1989) (explaining and examining the reason-to-expect standard under section 531). Section 536 is regarded as a special application of the rule stated in section 531 because it "does not limit or restrict liability under the rule stated in [section] 531, apart from the statute." RESTATEMENT (SECOND) OF TORTS § 536 cmt. c (1977).

102. John P. Freeman, *Current Trends in Legal Opinion Liability*, 1989 COLUM. BUS. L. REV. 235, 262 n.108 (1989).

103. Over one-hundred cases from more than thirty states are exemplified in the court citations of section 531. *See generally* RESTATEMENT (SECOND) OF TORTS § 531 app. (1977) (listing courts that cite to section 531). This majority of states has extended the class of persons who may take advantage of actions for deceit to those whom the reason-to-expect standard applies. *See* 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 452–53 (3d ed. 2006) (discussing the judicial tendency to extend the class of persons in addition to the "legislative expansion of the scope of defendant's duty in fraud").

104. *Ernst & Young*, 51 S.W.3d at 582.

105. *See* Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 571–72 (2009). If tort law affords plaintiffs protection by recognizing an independent duty for purely economic losses, liability should be imposed for a breach of the defined duty unless the plaintiff entered into a contract with

tort law unless there is "evidence that preemption 'was the clear and manifest purpose of Congress.'"[106] Federal statutes can expressly indicate the intent of preemption.[107] Where a provision is ambiguous, the language and structure of the statute can preempt state law by implication.[108] However, case law indicates there is a general presumption against preemption.[109] Similarly,

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the defendant that specifically waived that protection. *Id.* at 571.

106. Betsy J. Grey, *Make Congress Speak Clearly: Federal Preemption of State Tort Remedies*, 77 B.U. L. REV. 559, 569 (1997) (quoting Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947)); *see also* Marin R. Scordato, *Federal Preemption of State Tort Claims*, 35 U.C. DAVIS L. REV. 1, 21–22 (2001) (noting that "if Congress is clear in expressing its intent, then there should be no controversy over the preemptive scope of the federal law," and Congress has the power to correct the courts' interpretation of an ambiguous statute by simply amending the statute). Professor Vincent Johnson recognizes courts are reluctant in voiding state statutes and common law decisions through federal preemption because such an occurrence would disrupt the balance between the freedom of action and liability that defines tort obligations. Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 572 (2009).

107. *See* Betsy J. Grey, *Make Congress Speak Clearly: Federal Preemption of State Tort Remedies*, 77 B.U. L. REV. 559, 566 (1997) (noticing courts that find express preemption typically focus on "the plain meaning of the language at issue, the context of the provision, and the relevant legislative history"); *cf.* Marin R. Scordato, *Federal Preemption of State Tort Claims*, 35 U.C. DAVIS L. REV. 1, 22–23 (2001) (suggesting one possible approach for determining congressional intent is a bright-line rule where the Supremacy Clause only provides preemptive effect to those provisions that expressly and unequivocally set forth such a legislative intent).

108. Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 572 (2009). Implied preemptions are normally classified as either an implied field preemption or conflicts preemption. Betsy J. Grey, *Make Congress Speak Clearly: Federal Preemption of State Tort Remedies*, 77 B.U. L. REV. 559, 566–67 (1997). Implied field preemption occurs when a scheme of pervasive federal regulation is comprehensive and displaces all state regulation, while conflicts preemption arises when state law prevents compliance with federal law or impairs some federal objective. *Id.*

109. *See* Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 572 & n.235 (2009) (identifying a Third Circuit decision that "[found] the presumption against preemption applicable" (citing Colacicco v. Apotex Inc., 521 F.3d 253 (3d Cir. 2008))); Marin R. Scordato, *Federal Preemption of State Tort Claims*, 35 U.C. DAVIS L. REV. 1, 29–30 (2001) (providing that although there is no textual support in the Supremacy Clause for a presumption against federal preemption, in cases where the court finds against preemption, the presumption is frequently cited). Cases citing the presumption allude to state autonomy and the assumption that state powers are not to be superseded by federal statutes unless there is clear intent by Congress. *See* Colacicco v. Apotex Inc., 521 F.3d 253, 262–63 (3d Cir. 2008) (explaining that congressional legislation "'in a field which the States have traditionally occupied, we start with the assumption that the historic police powers of the States'" are not to be preempted (quoting Medtronic, Inc. v. Lohr, 518 U.S. 470, 485 (1996))), *vacated on other grounds*, 129 S. Ct. 1578 (2009) (vacating and remanding "for further consideration in light of *Wyeth v. Levine*, 129 S. Ct. 1187 (2009)); Munoz v. Fin. Freedom Senior Funding Corp., 567 F. Supp. 2d 1156, 1159 (C.D. Cal. 2008) (finding the

the statutory displacement of state common law principles only exists when the legislative implication is obvious and plainly abrogates a common law right.[110]

The purpose behind the enactment of federal securities laws arose from the perceived inadequacies in common law remedies and state legislation.[111] Federal securities laws were intended to expand upon the protection granted to investors under the common law and are not limited to situations traditionally governed by common law causes of action.[112] Nonetheless, federal legislation was implemented to add protection and not to replace existing state remedies.[113] As recognized by the United States Supreme Court, any disadvantages under federal law were attenuated to the extent that investors and shareholders retained remedies in state courts.[114] Although common law liability was

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presumption against preemption inapplicable when state regulation occurs "'in an area where there has been a history of significant federal presence'" (quoting United States v. Locke, 529 U.S. 89, 108 (2000))).

110. Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 WASH. & LEE L. REV. 523, 573 & n.236 (2009). A statute should not be construed as to amend the common law beyond the words and circumstances of the particular act. *See* Meade v. Freeman, 462 P.2d 54, 59–60 (Idaho 1969) ("'[W]here the implication is obvious it cannot be ignored. No statute is to be construed as altering the common law farther than its words and circumstances import.'" (quoting Moon v. Bullock, 151 P.2d 765, 771 (Idaho 1944))), *overruled on other grounds by* Alegria v. Payonk, 619 P.2d 135 (Idaho 1980).

111. *See* Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 546–48 (1999) (explaining that Congress enacted the federal securities laws after investigative hearings, where it found that common law remedies provided insufficient investor protection against fraud "'in the issuance of securities and in postissuance trading'" (quoting Robert A. Prentice, *The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5*, 47 EMORY L.J. 1, 58 n.266 (1998))).

112. *Id.* at 547–48 (1999). Welle notices that federal securities laws promote uniformity and reduce aggregate cost of enforcement and compliance by allowing "investors to predict what the law requires." *See id.* at 548–49 (proposing securities reform efforts aim at cooperation and coordination to reduce regulatory burdens, instead of suggesting measures to deregulate securities laws).

113. *See* Basic Inc. v. Levinson, 485 U.S. 224, 244 n.2 (1988) ("Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law . . . ."). It is important to note the availability of an express remedy under one particular section of the Securities Acts does not preclude defrauded purchasers from maintaining an action under another section as well. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382–83 (1983) (allowing plaintiffs to bring § 10(b) catchall claims even though liability could also be imposed under the stricter pleading requirements of § 11).

114. *See* Small v. Fritz Cos., 65 P.3d 1255, 1260–61 (Cal. 2003) (explaining that federal courts denied recognition of holder actions but "'[o]bviously this disadvantage is

not "especially molded" for the regulation of securities fraud, general tort law still provides avenues for recovery by imposing severe liability when the circumstances permit.[115] One must remember the common law provided important precedent for the federal securities laws, and a final analysis of these provisions requires a look back to the common law canons.[116]

V. A COMPARISON OF THE SCOPES OF LIABILITY FOR FRAUDULENT AND NEGLIGENT MISREPRESENTATION

The adoption of section 552 by the Texas Supreme Court expanded the scope of liability for negligent misrepresentation claims.[117] As previously explained, the *Restatement (Second)*

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attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law'" (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 n.9 (1975))).

115. *Cf.* Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 241–42 (1933) (noting that actions for false statements were available under fraud and negligence, but very few investors brought suit because "the men empowered to decide cases made many allowances for the practices of the time" prior to the adoption of the Securities Acts). Schulman explains that a deceit action does not require knowledge of falsity under this limited doctrine. *Id.* The claim is sufficient if the statement was made without any knowledge of its truth, whether intentionally falsified or not. *Id.*; *see also* 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 457 & n.20 (3d ed. 2006) (asserting that there is no requirement for the plaintiff to prove intent to deceive as an element for fraud as long as the defendant intended the recipient to act on the misrepresentation). Knowledge and intent of a valid fraud claim are dependent on circumstances "[a]nd circumstances may damn where conscience is pure." Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 241–42 (1933).

116. *See Legislation: Federal Regulation of Securities: Some Problems of Civil Liability*, 48 HARV. L. REV. 107, 108 (1934) (noticing that an evaluation of the civil provisions of the federal securities statutes necessitates a look back at the common law, but the federal provisions differ greatly in regard to reliance, materiality, and damages); Robert A. Prentice, Stoneridge, *Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611, 620–21 (2008) (emphasizing that the common law plays an important role in the Securities Acts because "Congress was injecting federal statutory law into an area that for a hundred years or more had been governed primarily by the common law of fraud").

117. *See* McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 791 (Tex. 1999) (noting that the court had already adopted the tort of negligent misrepresentation per section 552 in *Sloane*); Fed. Land Bank Ass'n of Tyler v. Sloane, 825 S.W.2d 439, 442 (Tex. 1991) (agreeing with the *Restatement (Second)*'s definition of the scope of an information provider's duty for negligent misrepresentations). Commentators and legal scholars often note the expanding scope of permissible negligent misrepresentation actions. *See* DAN B. DOBBS, THE LAW OF TORTS 1345–46 (2000) (explaining the evolution of the privity, foreseeability, and *Restatement (Second)* approaches for negligent misrepresentation); Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV.

standard for negligent misrepresentation allows complaints against an alleged fraudfeasor by plaintiffs whose identity is unknown. Plaintiffs can prevail on these claims if the information provider intends a limited group, of which the plaintiff is a member, to receive the provider's information.[118] In comparison, the reason-to-expect language of section 531 creates a more expansive scope by subjecting fraudfeasors to liability for misrepresentations they have reason to expect will influence the recipient's conduct.[119] Texas courts circumvent the broad scope of section 531 through a narrow interpretation of the especial-likelihood provision, derived solely from commentary under the section.[120] The courts' use of the especial-likelihood provision requires claimants to prove the maker of the misrepresentation actually intended to influence or knew reliance would occur.[121] If common knowledge and practice

845, 847–53 (2008) (analyzing the different standards for negligent misrepresentation in general).

118. *See* RESTATEMENT (SECOND) OF TORTS § 552(2) (1977) (limiting liability by requiring intent or knowledge of the potential recipients).

119. *See id.* § 531 (stating the general rule of liability for fraudulent misrepresentations); 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 452–53 (3d ed. 2006) (noting the judicial tendency to relax the old law and extend the range of potential persons who can impose liability "to include those who the defendant has reason to expect will act in reliance on the statement").

120. *See* Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 581 (Tex. 2001) (rejecting plaintiff's fraud claim because the common practice of reliance on representations made in SEC-filed documents did not make the information especially likely to reach and influence third parties); *see also* Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co., 313 F.3d 305, 323–26 (5th Cir. 2002) (applying the especial likelihood provision, and finding that the "[p]laintiffs were therefore obligated to do more than posit conclusory assertions in an attempt to broaden the class of intended recipients"); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 490 F. Supp. 2d 784, 822–24 (S.D. Tex. 2007) (agreeing that under Texas law, the plaintiffs could not establish intent to induce reliance from the application of the reasoning set forth in *Ernst & Young*).

121. Actual intent and knowledge under section 552 differ from the reason-to-expect language of section 531. RESTATEMENT (SECOND) OF TORTS § 552 cmt. h (1977). The reason-to-expect standard is not equivalent to the intent-to-influence requirement for negligent misrepresentation. *Id.* Because the reason-to-expect standard is clearly an intentional tort, the degree of knowledge relating to who would rely on the false statements is relaxed to allow greater imposition of liability for highly culpable conduct. *See* Response to Petition for Review at 7–8, *Ernst & Young*, 51 S.W.3d 573 (No. 00-0232) (noting the reason-to-expect standard "is clearly an intentional tort formulation"); RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (commenting on the culpability of conduct in deceit actions and how intent to deceive warrants greater liability). Both sections 552 and 531 expressly state that knowledge of the specific identity of a relying plaintiff is not required; however, liability under section 531 is more expansive because it incorporates protection to persons who reasonably could rely on a misrepresentation. *See*

is not a sufficient reasonable expectation, liability is limited to those the misrepresentor intends or knows will receive and rely on the provided statement.[122] Accordingly, the Texas Supreme Court's analysis of the reason-to-expect standard necessarily restricts liability exposure and has a similar scope of liability as that imposed under the *Restatement (Second)*'s standard for negligent misrepresentation.

RESTATEMENT (SECOND) OF TORTS § 531 cmt. d (1977) (explaining if "a reasonable man would conclude that the result will follow or would govern his conduct," one has reason to expect reliance will occur). While courts disagree over the degree of intent or knowledge required for negligent misrepresentation claims, "[m]any courts require that a defendant know of the potential user of the information it provides and of the potential use of the information." JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 169–70 (1995); *see also* First Fla. Bank v. Max Mitchell & Co., 558 So. 2d 9, 15 (Fla. 1990) (holding reliance from the ever present possibility of repetition of the misstatement to any third party insufficient to satisfy a negligent misrepresentation action). *But see* Bily v. Arthur Young & Co., 834 P.2d 745, 773 (Cal. 1992) (holding that a defendant intends to influence in a transaction with the plaintiff "whenever [the] defendant knows with substantial certainty that [the] plaintiff, or the particular class of persons to which [the] plaintiff belongs, will rely on the representation in the course of the transaction"). Feinman recognizes that the standard requiring a defendant know of the potential user and know of the use of the information follows the knowledge requirement stated in section 552 and, therefore, acts as a middle ground between the intent standard of *Bily* and the broader foreseeability rule. JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 170 (1995).

122. *See* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 852–53 (2008) (providing that section 552(2) "limits an information provider's liability for negligent misrepresentation to those third parties who the provider actually intends or knows will receive the information" and in substantially similar transactions where "the provider actually intends or knows [the third parties] will be influenced by the information"). Once a court restricts liability by requiring a strong nexus (otherwise known as the especial likelihood provision) between the information provider and those who will be influenced, a misrepresentor must have more than a reasonable assumption concerning the identity of potential recipients. *See Ernst & Young*, 51 S.W.3d at 581 (explaining that, from the court's interpretation of section 531, there must be something special in the situation known to the information provider that would prompt a reasonable man to govern his conduct based on the expectation that the information will reach certain persons and influence their conduct). This degree of knowledge is typically required by the majority of courts for negligent misrepresentation. *See* JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 170 (1995) (commenting on the intermediate approach that requires general knowledge of a potential user of the information); *see also* Reisman v. KPMG Peat Marwick LLP, 787 N.E.2d 1060, 1067 (Mass. App. Ct. 2003) (stating that "actual knowledge of the specific claimant . . . and of the specific transaction . . . at the times the false statements were made" implicates the standard of negligent misrepresentation and not fraudulent inducement).

An equivalent scope of liability covered by fraudulent and negligent misrepresentation is problematic because the *Restatement (Second)* intended the tort of fraudulent misrepresentation to impose "greater liability exposure than the tort of negligent misrepresentation."[123] Texas case law has rejected the argument that the scope of permissible complaints should be as limited for fraudulent inducement as they are for negligent misrepresentations.[124] The reason for a narrower scope of liability in negligent misrepresentations is derived from the difference in the standard of conduct required by the rule and the reasonable expectations of the users of commercial information.[125] In other words, the standard of honesty and care

123. *See* Response to Petition for Review at 4, *Ernst & Young*, 51 S.W.3d 573 (No. 00-0232) (emphasizing the Texas Supreme Court's adoption of section 540 further highlights the fact that fraudulent inducement imposes greater liability than the narrow scope of negligent misrepresentation); RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (providing the rationale for the narrower scope of liability under the section); JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 167 (1995) (explaining that the drafters of the *Restatement (Second)* "intended that the scope of liability in negligent misrepresentation under § 552(2) be narrower than for intentional misrepresentation"); Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 853 (2008) (suggesting that a foreseeability standard for negligent misrepresentation is inconsistent with the reason-to-expect standard because liability for negligent misrepresentation is more restrictive than liability for fraud).

124. *See* D.S.A., Inc. v. Hillsboro Indep. Sch. Dist., 973 S.W.2d 662, 664 (Tex. 1998) (providing that "[t]he rationale for fixing a narrower scope of liability for negligent misrepresentation than for fraudulent inducement 'is to be found in the difference between the obligations of honesty and of care'" (quoting RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977))); Fed. Land Bank Ass'n of Tyler v. Sloane, 825 S.W.2d 439, 442–43 (Tex. 1991) ("The Restatement advances several policy reasons for limiting damages [for negligent misrepresentation], including a lower degree of fault indicated by a less culpable mental state and the need to keep liability proportional to risk."); Kajima Int'l, Inc. v. Formosa Plastics Corp., USA, 15 S.W.3d 289, 294 (Tex. App.—Corpus Christi 2000, pet. denied) (commenting on the Texas Supreme Court's analysis in *D.S.A.*, and concluding the tort of negligent misrepresentation has a narrower scope of liability than fraud). Any court that adopts the tort of negligent misrepresentation through section 552 implicitly recognizes the difference in the liability covered by each action because the reasoning for the distinction is found in the commentary of the section. *See* RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (stating that liability under the section is more restricted than in section 531); *see also* McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 791 (Tex. 1999) (providing an example of an implicit acknowledgment, where "the Court endorsed section 552 to define the scope of a lender's duty to avoid negligent misrepresentations to prospective borrowers").

125. *See* RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (explaining that the reason the scope of liability for negligent misrepresentation is narrower than liability

St. Mary's Law Journal, Vol. 42 [2010], No. 1, Art. 3

required for intentional misrepresentation "does not depend on the nature of the transaction in which the representation was made."[126] And unlike actions for deceit, the standard of care imposed by section 552 is purely situational and dependent upon the balancing of circumstances of which the information provider is clearly aware.[127] The purpose of considering the individual circumstances is to limit liability for less culpable conduct and encourage the flow of commercial information, which is necessary for the proper function of the economy.[128]

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for deceit "is to be found in the difference between the obligations of honesty and of care, and in the significance of this difference to the reasonable expectations of the users of information that is supplied in connection with commercial transactions"); Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845, 853 (2008) (commenting on the basis for section 552's intermediate standard by quoting comment a verbatim).

126. JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 167 (1995). Commentary to section 552 explains that honesty requires an information provider to speak or communicate in good faith and without any doubt in the truth or accuracy of the information being communicated. RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977). The standard of honesty is not dependent upon the circumstances of the particular claim, and every information provider is obligated to observe this standard. *See id.* ("The standard of honesty if unequivocal and ascertainable without regard to the character of the transaction in which the information will ultimately be relied upon or the situation of the party relying upon it.").

127. *See* JAY M. FEINMAN, ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS 167 (1995) (offering the idea that the authors of the *Restatement (Second)* adopted a Learned Hand-style balancing formula for negligent misrepresentation); *see also* RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (setting forth the balancing test for negligent misrepresentation as "a relative standard, which may be defined only in terms of the use to which the information will be put, weighed against the magnitude and probability of loss that might attend that use if the information proves to be incorrect").

128. *See* RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (intending to promote commercial transactions by limiting the liability of a negligent commercial information supplier in transactions in which the supplier intends "to supply the information for the sort of use in which the plaintiff's loss occurrs," but only if the supplier offers the information in good faith); William A. Sinacori, Bily v. Arthur Young & Co.*: An Unnecessary Return to Privity in Cases of Auditor Negligence*, 6 HOFSTRA PROP. L.J. 243, 281–82 (1993) (explaining that where there is good faith and no intent to deceive, the *Restatement (Second)* encourages the flow of commercial information). When negligence is involved, the scope of duty for liability is regulated to control the range of economic harm. Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90 (D.R.I. 1968); *see also* William L. Prosser, *Misrepresentations and Third Persons*, 19 VAND. L. REV. 231, 248–50 (1966) (quoting from the *Ultramares* case, Prosser recognizes actions for negligence should not subject persons to liability from an indefinite number of potential third parties).

VI. A PROPOSED SOLUTION BASED ON THE POLICY CONSIDERATIONS FOR A BROAD SCOPE OF LIABILITY

"The policy reasons for limiting liability for merely negligent misrepresentations totally disappear when dealing with an intentional tort such as common law fraud."[129] Where a defendant intends to deceive another through his misrepresentations, there is much less reason to limit liability for pecuniary harm caused to the recipient of the information.[130] The risk of loss and potential harm should be placed on an intentional tortious defendant rather than on an innocent injured plaintiff.[131] Because the *Restatement (Second)* places a greater degree of responsibility on fraudfeasors, the societal interest in the free flow of information cannot be strongly advocated when dealing with intentional misrepresentations.[132] The elimination of fraud and

129. Response to Petition for Review at 4–5, Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573 (Tex. 2001) (No. 00-0232); *see also* RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (noting the policy reasons for limiting the scope of liability for negligent misrepresentation); VINCENT R. JOHNSON & ALAN GUNN, STUDIES IN AMERICAN TORT LAW 7–10 (4th ed. 2009) (identifying the general public policy considerations for tort law, which are regularly invoked and cannot be ignored); Vincent R. Johnson & Shawn M. Lovorn, *Misrepresentation by Lawyers About Credentials or Experience*, 57 OKLA. L. REV. 529, 567–68 (2004) (reasoning "the scope of liability for negligence will not extend as far as in an action for fraud" because negligent conduct is less culpable).

130. *See* W. Page Keeton, *The Ambit of a Fraudulent Representor's Responsibility*, 17 TEX. L. REV. 1, 4 (1938) (commenting on the less culpable conduct of negligent acts and how "[t]he extent of an intentional wrongdoer's responsibility is much greater than that of a negligent wrongdoer").

131. *Levin*, 284 F. Supp. at 90; *see also* Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 143 (1967) (explaining that the choice between imposing liability on a fraudfeasor or an innocent relying party "is usually made in favor of the innocent party, unless some compelling policy factor dictates otherwise"). *See generally* VINCENT R. JOHNSON & ALAN GUNN, STUDIES IN AMERICAN TORT LAW 7–10 (4th ed. 2009) (noting that liability should be based on fault, and if the defendant's conduct is blameworthy, liability should be imposed). Johnson further notes that additional policy considerations for tort law include the promotion of individual responsibility, the establishment of predictability in human affairs, and spreading the cost of accidents to those parties responsible. *Id.*

132. *See* RESTATEMENT (SECOND) OF TORTS § 552 cmt. a (1977) (stating that no societal interest is served by encouraging the flow and communication of information not believed to be true); W. Page Keeton, *The Ambit of a Fraudulent Representor's Responsibility*, 17 TEX. L. REV. 1, 8 (1938) (suggesting that the social goal of economic progress "is a much stronger argument to limit a negligent representor's liability than to limit the liability of dishonest people"). However, commentators fear the broad application of liability risks violating the proportionality principle, which seeks to limit liability

St. Mary's Law Journal, Vol. 42 [2010], No. 1, Art. 3

deceptive practices from the corporate climate is a legitimate and substantial interest because corporate fraud has devastating consequences on a state's economy.[133] Additionally, holding fraudfeasors liable for all consequences resulting from a deliberate false representation would not likely deter an honest corporation from conducting ordinary business.[134] In fact, limiting the scope of liability for fraudulent misrepresentation "reduces substantially the number of persons who can enforce corporate honesty."[135] By forcing corporations who engage in fraudulent filing practices to bear the losses suffered by deceived investors and shareholders, fear of liability would deter future misconduct and promote diligent financial analysis of the reports released by the corporation.[136]

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in proportion to fault. Vincent R. Johnson & Shawn M. Lovorn, *Misrepresentation by Lawyers About Credentials or Experience*, 57 OKLA. L. REV. 529, 567–68 (2004).

133. *See* Small v. Fritz Cos., 65 P.3d 1255, 1264 (Cal. 2003) (noting that the filing of false or misleading corporate financial statements "may extend well beyond the particular investors who receive those statements"). The harm resulting from the misleading financial statements may cause financial institutions to hesitate in loaning money to corporations "if they cannot trust the corporate books, and the refusal of lenders to advance funds can doom a corporation, harming its stockholders, creditors, and employees." *Id.* Securities scholars agree that fraud destroys investor confidence and makes it difficult for investors to determine if they are buying high quality securities, thus allowing bad firms to flood the market with worthless securities. Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 713 (1996).

134. *Cf.* W. Page Keeton, *The Ambit of a Fraudulent Representor's Responsibility*, 17 TEX. L. REV. 1, 8 (1938) (noting that accountants will not be deterred from conducting normal business activity because of "the possibility that although they may act honestly, the courts will mistakenly find that they acted dishonestly"); John S. Dzienkowski, Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759, 813–14 (1982) (asserting that the accounting profession "is mature and able to spread the risk of negligence liability," and that the substantial profits made by auditing firms lessens the chance accounting firms will be deterred from certifying a publicly traded company's financial statements).

135. *Small*, 65 P.3d at 1265. Private litigation is needed to act as a useful deterrent because government regulation through the SEC "alone is not sufficient to keep markets honest." *Id.* at 1264 (quoting Edward Labaton, *Consequences, Intended and Unintended, of Securities Law Reform*, 29 STETSON L. REV. 395, 401 (1999)); *see also* Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438, 456 (1994) (suggesting that private civil litigation can effectively curtail the government's inability to enforce its mandatory disclosure system).

136. *See Levin*, 284 F. Supp. at 90 (stating "a broad rule of liability may deter future misconduct"); Joseph Goldberg & Walter F. Kelly, Jr., Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137, 143 (1967) (explaining the modern rule, which has extended the ambit of liability for an intentional misrepresentor to recipients whom the information provider

As most tort commentators suggest, a publicly traded company should not be liable to every individual investor and shareholder upon the filing of a falsely certified financial statement.[137] A heightened pleading standard that requires claimants to prove damages with specificity would effectively limit the class of persons who could take advantage of common law securities claims, while at the same time extending protection to those persons who justifiably relied on a company's fraudulent misrepresentations.[138] Fear that investors and shareholders will initiate a common law fraud action anytime a stock price fluctuates would be unwarranted because fraud causes of action are only concerned with those limited groups of investors who actually relied on the corporation's false statements.[139]

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reasonably expects will be injured by his misrepresentation, "may have some deterrent effect on future misconduct"). Corporations typically outsource financial auditing to accounting firms, and a firm's potential profit for review services encourages the oversight of potential third-party liability in deciding whether to conduct business. John S. Dzienkowski, Note, *Accountants' Liability for Compilation and Review Engagements*, 60 TEX. L. REV. 759, 813 (1982). Subjecting a corporation to broad liability under the common law would further prompt auditors to report any cases of material fraud to the client's audit committee, as required under existing auditing standards. *See* Andrew W. Reiss, Note, *Powered by More Than GAAS: Section 10a of the Private Securities Litigation Reform Act Takes the Accounting Profession for a New Ride*, 25 HOFSTRA L. REV. 1261, 1307–10 (1997) (analyzing the "Fraud Standard" issued by the Auditing Standards Board, which "provide[s] enhanced operational guidance on the consideration of fraud in conducting a financial statement audit").

137. *See* 2 FOWLER V. HARPER ET AL., HARPER, JAMES AND GRAY ON TORTS § 7.2, at 452 & n.15 (3d ed. 2006) (discussing the application of the reason-to-expect standard as a means of limiting liability in common law fraud actions); W. Page Keeton, *The Ambit of a Fraudulent Representor's Responsibility*, 17 TEX. L. REV. 1, 8 (1938) (listing methods for limiting a representor's liability to include those intended to rely, those reasonably expected to rely, or those who the representor believed would rely on the misrepresentation); Darrell D. Hallett & Thomas R. Collins, Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139, 161 (1968) (explaining that liability for intentional misrepresentation will extend to persons "who could reasonably expect to rely" on the misstatements).

138. *See Small*, 65 P.3d at 1266 (suggesting that plaintiffs who sufficiently plead actual reliance through proof of specific damages "stand out from the mass of stockholders who rely on the market"); *see also* Hunt v. Enzo Biochem, Inc., 471 F. Supp. 2d 390, 411–12 (S.D.N.Y. 2006) (discussing the heightened pleading standard enforced by California, Florida, and Massachusetts courts); Rogers v. Cisco Sys., Inc., 268 F. Supp. 2d 1305, 1314 n.18 (N.D. Fla. 2003) (noting that the Supreme Court of California in *Small* applied a heightened pleading burden which separates those plaintiffs "who actually and justifiably relied upon the misrepresentations from the general investing public, who, though they did not so rely, suffered the loss due to the decline in share value").

139. *See Small*, 65 P.3d at 1265 (rejecting the overstated assumption that if stock

St. Mary's Law Journal, Vol. 42 [2010], No. 1, Art. 3

VII. CONCLUSION

The *Restatement (Second) of Torts* extends liability to those who have reason to expect reliance upon misrepresentations communicated to third parties. Although this common law standard is subject to varied interpretations by different state courts, the Texas Supreme Court's narrow application of section 531 through the especial-likelihood provision effectively limits the ability of claimants to bring common law securities claims. This application equates to the same standard of liability imposed for neg-ligent misrepresentation and therefore does not conform to the traditional tort principle of further extending liability for fraudulent-inducement claims. The reason-to-expect standard can be broadly interpreted to allow plaintiffs to state a claim of fraud whether or not a misrepresentation is especially likely to induce recipient reliance. Alternatively, recognition of section 536 of the *Restatement (Second)* creates the presumption that investors and shareholders are expected to rely on corporate financial statements filed with the SEC because the statutory purpose of the financial disclosure system is to provide protection to those persons who find the use of filed financial statements important in the decision to buy, sell, or trade corporate stock. Policy considerations suggest the rise in corporate fraud warrants greater protection for investors and shareholders. Fraud victims should not be forced to bear the losses resulting from highly culpable conduct.

prices went up or down, investors could allege they either elected not to purchase or sell additional shares of the company stock in reliance upon the supposed misleading financial statements because the court is not concerned with the range of potential investors who could buy or sell the stock). Persons opposed to expanding the scope of potential claimants suggest that there will not be a way to rebut false claims of reliance when shareholders testify they read and relied upon the company's financial statements without further corroboration. *Id.* at 1264. However, these claims deal with credibility and are "routinely resolved by triers of fact in civil litigation." *Id.*

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