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"Heard It Through the Grapevine": Fraud Action may be Based on Third Party Information

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In fraud and negligent misrepresentation cases, **reliance** is often a crucial issue. Frequently, clients have not actually read or directly heard information from an alleged wrongdoer in connection with the purchase of an investment. Instead, clients may have heard information from their stockbroker, who in turn had read a financial report about a company or may have read information in a report or brochure prepared for the client's benefit.

The issue is whether this **indirect reliance** is sufficient to legally satisfy the reliance element for fraud or negligent misrepresentation claims. Recently, a California appellate court in *Murphy v. BDO Seidman, LLP*, (2003) 113 Cal.App.4th 687 answered this question in the affirmative.

Murphy follows cases which dealt with issues of liability in the securities law context. In 1992, before the stock market boom of the late 1990s and the corporate scandals that followed, the California Supreme Court had placed limitations on the liability of accounting firms involved in securities actions. See, *Bily v. Arthur Young & Co.* (1992) 3 Cal.4th 370.

In *Bily*, investors in a manufacturer of portable personal computers brought action against an accounting firm alleging fraud, misrepresentation, and professional negligence. After a jury trial, the judge entered judgment in plaintiffs' favor with respect to professional negligence, but against plaintiffs on all other claims. Both parties appealed.

On appeal, the Supreme Court limited liability of accounting firms, holding that an accounting firm that prepared a general audit for a computer manufacturer is not liable to third-party investors under a theory of general negligence, even if the investors relied on the audit report. The Court was concerned that holding accountants liable under such circumstances could result in unlimited liability out of proportion with fault and that such a ruling could have a significant impact on the cost and availability of such audits. *Id.* at 398. *Bily* also held, however, that **"an auditor may be held liable for negligent misrepresentation to third parties who are known to the auditor and for whose benefit the auditor has rendered the audit report."** *Id.* at 370.

In recent years, with all of the corporate scandals in the news, the courts appear to have shifted policy to expand, rather than contract, the reach of liability in securities cases. A California Supreme Court case entitled *Small v. Fritz Cos., Inc.* (2003) 30 Cal.4th 167 is one such case. In *Small*, plaintiff alleged fraud and negligent misrepresentation against a corporation that falsely reported earnings and profits to shareholders in its quarterly financial reports. Plaintiff alleged the misrepresentations induced him to **hold** his stock. When the truth came out, the stock dropped in value causing damage to plaintiff and other investors. The trial court sustained defendant's demurrer.

The California Supreme Court in *Small* held that defendants who make misrepresentations may be liable not only to investors who are induced to purchase stocks, but also to those investors who are induced to **hold** stocks. *Id.* The Court based its ruling on:

> **[California's] compelling interest in preserving a business climate free of fraud and deceptive practices. Denying a cause of action to persons who hold stock in reliance upon corporate misrepresentations reduces substantially the number of persons who can enforce corporate honesty.**

Id.

Murphy v. BDO Seidman, supra, further opens the door to potential liability to investors. It reflects the present environment following Enron and other corporate scandals.

The Facts of *Murphy*

In *Murphy v. BDO Seidman, supra*, a group of investors sued accountants, alleging "fraud in preparation of financial statements in connection with a corporate merger." *Murphy, supra*, 113 Cal.App.4th 687. Defendants demurred to plaintiffs' fifth amended complaint. The trial court granted defendants' demurrer without leave to amend, in part on the grounds that plaintiffs failed to plead they **relied** on the financial statements prepared by the accountants. The court of appeal reversed, finding reliance was sufficiently stated even though some plaintiffs failed to allege that they actually read the financial statements in question.

Plaintiffs alleged the defendant accounting firm Logan, Throop & Company ("Logan") prepared financial statements for a privately held company called World Interactive Networks, Inc. ("WIN") in which Logan significantly overstated the value of WIN's assets. Plaintiffs included some investors who claimed to have directly relied upon Logan's misrepresentations when they invested in WIN. However, other investors did not allege that they **directly** relied upon the financial statements. Rather, these "*Grapevine Plaintiffs*" relied "on what others told them the statements said." Logan challenged this form of reliance. It argued that "such indirect reliance by those [investors] . . . does not constitute legal reliance and is thus not actionable." *Murphy, supra,* at 702-703.

In rejecting Logan's arguments, the *Murphy* court of appeal expanded upon *Bily's* holding regarding an accounting firm's liability for intentional or negligent misrepresentation, as set forth above, finding that:

> **Indirect reliance is actionable if Logan [] had reason to know others would convey their misrepresentations to appellants. Under *Bily*, respondents are liable for (1) negligent misrepresentation if they knew it was substantially certain that appellants would receive the misstatements and (2) intentional misrepresentation if it was reasonably foreseeable appellants would receive the statements. Thus, nothing in *Bily's* formulation of negligent or intentional misrepresentation precludes indirect reliance.**

Murphy, supra, at 702-703 (citations omitted). The *Murphy* court concluded that, ". . . the 'grapevine' [investors] stated claims for negligent and intentional misrepresentation notwithstanding their indirect reliance on Logan's misstatements" because investors plead sufficiently that Logan knew it was substantially certain, and reasonably foreseeable, that investors would receive the statements indirectly from third parties. *Murphy, supra,* at 703.

The *Murphy* court noted an important policy shift that has developed with respect to the securities markets and the desire of the courts to broaden the reach of existing laws in reaction to what it called an "awareness that all is not right with the securities markets and the accountants who are supposed to police them." *Murphy, supra,* at 703 at n. 12. The court quoted the California Supreme Court in *Small, supra*:

> **The last few years have seen repeated reports of false financial statements and accounting fraud, demonstrating that many charges of corporate fraud were neither speculative nor attempts to extort settlement money, but were based on actual misconduct. To open the newspaper today is to receive a daily dose of scandal, from Adelphia to Enron and beyond. Sadly, each of us knows these newly publicized instances of accounting-related securities fraud are no longer out of the ordinary, save perhaps in scale alone. . . Eliminating barriers that deny redress to actual victims of fraud now assumes an importance equal to that of deterring non-meritorious suits.**

Murphy, supra, at 703 at n. 12 (citations omitted).

What We Have Learned from *Murphy*

Murphy is an important case. As plaintiffs' attorneys are aware, individuals who directly communicate to victims of fraud often may not have insurance or the financial means to pay damages. As a consequence, victims of fraud may seek recovery from law firms, accountants and other professionals whose behind-the-scenes conduct has caused substantial harm, even when the professional did not **directly** communicate the fraudulent or misleading information to victims.

The *Murphy* and the *Small* decisions may signal the beginning of the end for many of the limitations of liability for accountants involved in defrauding investors. The courts appear to be taking a broader view toward auditor liability in securities cases given the current environment of corporate scandal.

After *Murphy*, plaintiffs should be encouraged to pursue claims against professionals who make misrepresentations when it was foreseeable or substantially certain that investors or other victims of fraud would rely on the information, albeit indirectly.