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THE PROPOSED FEDERAL SECURITIES CODE: TIME TO RECOGNIZE THAT FINANCIAL INFORMATION BECOMES STALE

I. Introduction

The American Law Institute ("ALI") has completed the Federal Securities Code ("Code") and it will be introduced to Congress shortly.¹ The Code is the product of more than eleven years of work² and has received the endorsement of both the Securities and Exchange Commission ("SEC")³ and the American Bar Association ("ABA").⁴ Interested members of the legal profession⁵ have been active in the drafting process directed by the Code's Reporter, Professor Louis Loss. Legislative enactment, however, is not guaranteed.⁶

1. *Loss Letter on Changes in Revised SEC Code Proposal*, Legal Times of Wash., Sept. 22, 1980, at 21, col. 1 [hereinafter cited as *Loss Letter*]. The Code consolidates an area referred to generally as securities law. It is currently governed by several statutes which the Code will supercede if enacted. See Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976) [hereinafter cited as *1933 Act*]; Securities Exchange Act of 1934, 15 U.S.C. §§ 77b-77e, 77j, 77k, 77m, 77o, 77s, 78a-78o, 78o-3-78hh (1976) [hereinafter cited as *1934 Act*]; Public Utility Holding Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1976); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1976); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (1976). Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1976). Amendments to the Investment Company Act and the Investment Advisers Act were effected by the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (codified at scattered sections of 80, 15 U.S.C. (1976)). Amendments to the 1933 and 1934 Acts were effected by the Securities Act Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (codified at scattered sections of 77, 78, 15 U.S.C. (1976)). Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified at scattered sections of 77, 78, 80, 15 U.S.C. (1976)).

2. Huffman, *Negotiators Savor Securities Code Agreement*, Legal Times of Wash., Sept. 22, 1980, at 1, col. 1 [hereinafter cited as Huffman].

3. *Id.*

4. *Id.* Although the ABA endorsed the original version of the Code, *Loss Letter*, *supra* note 1, at 21, it has decided not to take any action with regard to the SEC-approved version. Meeting of the ABA Corporation, Banking and Business Law, Section Committee, Federal Regulation on Securities (Oct. 18, 1975).

5. Huffman, *supra* note 2.

6. Professor Loss, has acknowledged that difficulties may arise once the Code is submitted to Congress. *Loss Letter*, *supra* note 1, at 23. In addition, commentators have called for an extensive review of the Code at the congressional level. Benston, *Required Periodic Disclosure Under the Securities Acts and Under the Proposed Federal Securities Code*, 33 U. MIAMI L. REV. 1471, 1471-2 (1979) [hereinafter cited as *Required Disclosure Under the Proposed Federal Securities Code*]; Wolfson, *Comments on the Proposed Federal Securities*

One area which will be the subject of congressional debate is the underlying policy of continuous disclosure implemented by the Code.⁷ Companies will register once⁸ and then continuously disclose to the securities marketplace important developments which affect their financial position.⁹ This Note poses a question which bears directly upon the disclosure requirement: at what point does financial information become stale?¹⁰ If disclosure is to be required on a continuous basis, recognition should be given to the fact that financial information loses its probative value.¹¹

The nature of stale financial information is discussed in Section II by reviewing the treatment of staleness in common law fraud and bankruptcy cases. Section III analyzes the approach taken with regard to stale financial information in existing securities law. This Note concludes by proposing that an objective definition of staleness should be incorporated into the Code, thereby placing reasonable limits on the liability created under the Code's continuous disclosure requirements.¹²

Code: Transformation of the Securities Act of 1933, 33 U. MIAMI L. REV. 1495, 1517-18 (1979) [hereinafter cited as *Comments on the Proposed Federal Securities Code*].

7. Loss, *Keynote Address: The Federal Securities Code*, 33 U. MIAMI L. REV. 1431, 1451 (1979) [hereinafter cited as *Keynote Address*]. See also *Required Disclosure Under the Proposed Federal Securities Code*, *supra* note 6, at 1472, 1483; *Comments on the Proposed Federal Securities Code*, *supra* note 6 at 1497-9.

8. *Required Disclosure Under the Proposed Federal Securities Code*, *supra* note 6, at 1472. See ALI FED. SEC. CODE §§ 402, 403 (1980) [hereinafter cited as CODE]; See also notes 201-05 *infra* and accompanying text.

9. See CODE, *supra* note 8, § 602; notes 201-05 *infra* and accompanying text.

10. For the purposes of discussion, "financial information" is intended to include press releases and interim reports relating to earnings and financial data although reference primarily is made to audited financial statements. "Stale" or "staleness" refers to the point at which information, because of elapsed time or subsequent events, ceases to provide a reliable basis for decision making.

11. Professor Loss has stated as one of the Code's aims, "[the] reexamination of the entire scheme of investor protection with a view to increasing its efficiency and doing so, in President Roosevelt's words, 'with the least possible interference to honest business.'" Loss, *ALI Federal Securities Code: A Program*, 34 BUS. LAW. 347 (Nov. 1978 - Feb. 1979).

12. The purpose of this Note is to review and comment upon the treatment of stale financial information in specific areas of the law. Nevertheless, brief consideration should be given to the ongoing debate within the financial community between a majority of academicians engaged in empirical research and professional money managers. Shapiro, *Letter from Wall Street — Random Walk*, ACROSS THE BOARD, Nov. 1977, at 8 [hereinafter cited as *Random Walk*]. See also Frankfurter, *Index Funds: Fad or Foe?* J. ACCT., AUDITING & FINANCE, 116-17 (1978) [hereinafter cited as *Index Funds*]. Essentially the debate is between those who believe that stock prices follow a random walk and those who argue that although

II. The Nature of Stale Financial Information

At common law, in an action alleging fraud (misrepresentation and deceit), the staleness of financial information is often considered in determining whether reliance was reasonable. Although some courts have had difficulty formulating a standard for determining when financial information becomes stale,¹³ few have challenged the notion that at some point staleness occurs.¹⁴ Further, many courts have been willing to apply objective criteria, such as

stock market prices will not increase or decrease at a fixed rate, by charting past price movements (trend analysis), discernible patterns can be used to predict future movements. *Random Walk, supra* at 8. Movements are random in the sense that history does not repeat itself, "[k]nowing the course of a stock's past price movements is of no value in predicting its future course" *Random Walk, supra*, at 8. See also FINANCIAL ACCOUNTING STANDARDS BOARD, FASB DISCUSSION MEMORANDUM 7 (July 31, 1979) (random walk and trend analysis theories discussed in relation to corporate earnings rather than stock prices) [hereinafter cited as FASB MEMO].

The random walk is a well established theory of finance supported by a significant amount of empirical research. See Chant, *On the Predictability of Corporate Earnings Per Share Behavior*, J. FINANCE, 13 (March 1980) [hereinafter cited as *Corporate Earnings*] and articles cited therein. Under the random walk theory, an efficient stock market is dominated by "competing, rational, profit-maximizing buyers and sellers . . . quick to obtain new information and act on it." *Random Walk, supra*, at 8. Inherent in the theory, therefore, is the assumption that financial information becomes stale as more recent developments reach the marketplace. See FASB MEMO, *supra*, at 7.

Trend analysis, espoused by professional money managers referred to as chartists (analysts who seek to predict future stock market prices by charting past price movements), assumes that financial information will remain a predictive tool. Although current information becomes available, prior financial statements are necessary to an accurate assessment of future earnings. FASB MEMO, *supra*, at 7. Trend analysis, therefore, is not consistent with an objective definition of staleness.

Empirical evidence tends to support the random walk theory. In addition, the investment community (traditionally a random walk opponent) has created "index funds" which rely on a random walk assumption and allow individuals to invest in the market as opposed to a particular company. *Index Funds, supra*, at 116. No definitive choice, however, has been made within the financial community between the random walk and trend analysis theories. See generally *Corporate Earnings, supra*; FASB Memo, *supra*; *Index Funds, supra*; E. Miller, *A Simple Counter Example to the Random Walk Theory*, FINANCIAL ANALYSTS J., 55 (July-Aug. 1979).

13. *Reeve v. Dennett*, 145 Mass. 23, 29, 11 N.E. 938, 944 (1887); *Newark Live Poultry Co. v. Fauer*, 118 N.J.L. 556, 558, 194 A. 270, 272 (Sup. Ct. 1937), *aff'd*, 120 N.J.L. 187, 199 A. 12 (Ct. Err. & App. 1938); *Duncan v. Stoneham*, 253 N.Y. 183, 186-87, 170 N.E. 571, 572 (1930); *Zabriskie v. Smith*, 13 N.Y. 322, 332 (1855); *De Swarte v. First Nat'l Bank*, 188 Wis. 455, 457, 206 N.W. 887, 890 (1926).

14. *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. 437, 440, 528 P.2d 188, 191 (1974); *Fetherston v. National Republic Bancorp.*, 280 Ill. App. 151, 159 (1935); *Von Bruck v. Peyser*, 25 N.Y. Super. Ct. 468, 478 (1864).

prevailing economic conditions and business customs, in evaluating staleness.¹⁵

The general notion that information may become stale has been recognized in several areas of law.¹⁶ With regard to financial infor-

15. *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. at 440-41, 528 P.2d at 191; *Fetherston v. National Republic Bancorp.*, 280 Ill. App. at 159; *Newark Live Poultry Co. v. Fauer*, 118 N.J.L. at 558, 194 A. at 272; *Macullar v. McKinley*, 49 N.Y. Super. Ct. 5, 10-11 (1882), *aff'd*, 99 N.Y. 353, 2 N.E. 9 (1885).

The common law torts of misrepresentation and deceit are relevant to judicial interpretations of the Securities Acts. See *Holdsworth v. Strong*, 545 F.2d 687, 693-94 (10th Cir. 1976) *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)). Cf. *McClellan v. Alexander*, 599 F.2d 1190, 1202 (3rd Cir. 1979) ("[T]he standard of liability for common law fraud under Delaware law is the same as that for liability in an action implied from [§ 10b, 1934 Act, 15 U.S.C. § 78j(b) (1977)].").

16. The relevant cases may be categorized as follows: (a) *Banking*: In *Asbury Park & Ocean Grove Bank v. National City Bank*, 35 N.Y.S.2d 985 (Sup. Ct. 1942), *aff'd*, 268 A.D. 984 (1st Dep't 1944), the defendant bank issued a letter of credit at the plaintiff's request. In order to protect itself, the defendant required the plaintiff to deposit certain securities as collateral. Drafts were then submitted by the beneficiary of the credits and despite the plaintiff's request that the drafts not be honored, the defendant found that the drafts complied with the terms of the credits and paid the money. The defendant asserted ownership over the collateral and the plaintiff sued the bank for conversion of the securities.

The court in *Asbury Park* focused on whether the drafts and shipping tickets conformed with the requirements of the letter of credit. "Plaintiff argues that a point might be reached where the shipping tickets would be considered to be too old to satisfy the credit although there was no condition as to the date of shipment." *Id.* at 989-90. The court held that the "documents were not stale in this case," *id.* at 990, because the shipping tickets related to the transactions which were the subject of the letters of credit. "[T]here is nothing *stale* about a shipping ticket representing goods shipped within this period, but eighteen months before the draft was presented." *Id.* (emphasis added).

(b) *Fair Credit Reporting Act*: In *McPhee v. Chilton Corp.*, 468 F. Supp. 494 (D. Conn. 1978), an action was brought charging that the Fair Credit Reporting Act had been violated when a credit reporting agent indicated that the plaintiff had filed a bankruptcy petition, but not that the petition was later withdrawn. The court held that "[t]he statute does prohibit the publication of reports containing stale information about bankruptcies, those whose adjudication antedates a report by more than fourteen years. 15 U.S.C. § 1681c(a)(1) (1976)." *Id.* at 497. The court noted that all of the provisions of § 1681c concern staleness of information (fourteen years for a bankruptcy and seven years for suits and judgments, paid tax liens, accounts placed for collection or charged to profit and loss, criminal records and any other adverse item of information). However, "[c]ompliance calls for a review of dates already recorded, rather than a new investigation or [verification of matter outside the file]." *Id.* at 497 n.6.

(c) *Fourth Amendment Law*: The most extensive discussion of stale information is found in cases construing the requirement that a search warrant be based on probable cause.

In *U.S. v. Weinrich*, 586 F.2d 481 (5th Cir. 1978), *cert. denied*, 441 U.S. 927 (1979), the defendants were convicted of importing and distributing marijuana and hashish. On appeal, the defendants asserted that information relied on in the application for a wiretap was fa-

mation, however, the discussion has been limited. In common law fraud, where transactions are primarily at arms length,¹⁷ staleness is viewed as an objective limitation on the liability imposed for the issuance of financial information.¹⁸ Bankruptcy law, however, involves face to face transactions between a debtor and creditor.¹⁹ In this context staleness is determined according to the intent of the parties.²⁰ Objective criteria, however, such as the length of time between the issuance of a financial statement and reliance thereon, are still used to evaluate whether credit was extended within the period intended.²¹

A. Common Law Fraud

One element of an action for misrepresentation and deceit is justifiable reliance by the plaintiff upon the defendant's representation.²² In deciding whether a plaintiff's reliance is justifiable, either an objective or subjective standard may be used. While a majority

tally *stale* since the first informant's tip was given 100 days prior to the application and the second tip was given 30 days prior to the application. The court noted that staleness is an issue to be decided on the facts of each case. It then held that since the information indicated the presence of an extensive on-going enterprise, "[i]t certainly was not unreasonable for the judge to conclude that the activity was continuing as of the date of the application." *Id.* at 492. *See also* United States v. Williams, 603 F.2d 1168, 1172 n.4 (5th Cir. 1979) *cert. denied*, 444 U.S. 1024 (1980) ("We need not address the issue whether a six-month-old tip is too stale, however, because the magistrate was not limited to that single piece of information in his determination of probable cause.").

In *United States v. Solario*, 577 F.2d 554 (9th Cir. 1978), the defendant appealed a conviction of receiving and possessing an unregistered firearm, contesting the validity of the warrant issued to search his home. The court found that the likelihood the object would be moved together with the fact that the information provided was at least four months old, left the information too stale to support a finding of probable cause. In addition, other "information contained in the affidavit [was] insufficient to cure the staleness of the primary information." *Id.* at 556.

17. *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. at 439, 528 P.2d at 190-91.

18. *Id.* at 440, 528 P.2d at 191.

19. *Gerdes v. Lustgarten*, 266 U.S. 321, 326 (1924).

20. *Id.*

21. *Id.*

22. W. PROSSER, *LAW OF TORTS* 685-86 (4th ed. 1971) ("a false representation made by the defendant . . . [k]nowledge or belief on the part of the defendant that the representation is false . . . [a]n intention to induce the plaintiff to act or refrain from action in reliance upon the misrepresentation . . . [j]ustifiable reliance upon the representation on the part of the plaintiff, in taking or refraining from it [and] damage to the plaintiff, resulting from such reliance."). *See Vanderboom v. Sexton*, 460 F.2d 362, 366 (8th Cir. 1972); *Madison Fund, Inc. v. Charter Co.*, 406 F. Supp. 749, 752 (S.D.N.Y. 1975).

of courts apply an objective (reasonable man) standard,²³ others have held that justifiable reliance is dependent upon a subjective determination of whether a particular individual had the ability and right to rely.²⁴ In the context of business transactions, however, an objective standard has been consistently applied.²⁵ It has been expressed as a function of time and/or subsequent events.²⁶

1. Subsequent Events

In *Aldrich v. Scribner*,²⁷ the defendant's agent made a representation to the plaintiff (buyer) regarding the number of items to be sold.²⁸ The court held that where the defendant had apprised the plaintiffs of the actual number of items involved before the sale was consummated, the plaintiffs were no longer justified in relying upon the original representation of the defendant's agent.²⁹

23. See note 15 *supra*.

24. *Monte Verde v. Moore*, 539 P.2d 1362, 1365 (Colo. Ct. App. 1975). *Accord*, *Berg v. Xerxes-Southdale Office Building Co.*, 290 N.W.2d 612, 616 (Minn. 1980). In *Cheever v. Schramm*, 577 P.2d 951 (Utah 1978), it was held that the buyers had not established that the sellers had misrepresented the status of the business to be sold. The court stated that reliance is a question to be determined under the circumstances, taking into account the age, intelligence, experience, mental condition and knowledge of both parties. *Id.* at 954.

25. "If [the plaintiff] failed to do those things . . . it failed to exercise the care and prudence that would seem to be required of persons, firms, or corporations engaged in a business involving such great financial risks." *General Fin. Co. v. Nelson*, 180 La. 287, 288, 156 So. 355, 356 (1934). *Accord*, *McClellan v. Alexander*, 420 F. Supp. 1057, 1086 (D. Del. 1976), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979) ("At common law as well as under the securities law, the plaintiff has a duty to act with reasonable prudence in his business dealings."); *National Republic Bank v. National Homes Constr. Corp.*, 63 Ill. App. 3d 920, 925, 381 N.E.2d 15, 19 (1978). See *Johnson v. Lockman*, 41 N.C. App. 54, 58, 254 S.E.2d 187, 189 (1979); *Harris v. Dunham*, 203 Va. 760, 765, 127 S.E.2d 65, 70-71 (Ct. App. 1962).

The objective (reasonable man) standard is not imposed where there have been face to face transactions and "positive intentional fraud [was] successfully practised upon the single minded or unwary." *Prather v. Colorado Oil & Gas Corp.*, 218 Kan. 111, 119, 542 P.2d 297, 304 (1975) (quoting *Wolf v. Brungardt*, 215 Kan. 272, 283, 524 P.2d 726, 735 (1974)). *Accord*, *Fleetwood Corp. v. Mirich*, 404 N.E.2d 38, 45 (Ind. Ct. App. 1980).

26. *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. at 440-41, 528 P.2d at 191. See note 33 *infra*.

27. 146 Mich. 609, 109 N.W. 1121 (1906).

28. *Id.* at 610, 109 N.W. at 1122.

29. *Id.* at 612, 109 N.W. at 1122. See *Des Brisay v. Foss*, 264 Mass. 102, 112, 162 N.E. 4, 7 (1928); *cf.* *Levin v. Zeeman*, 94 N.Y.S.2d 441, 444 (City Ct. 1949) ("[P]reliminary statements made by a broker which are superseded by plaintiff's direct dealing with the principals, cannot constitute a basis for fraud."). *But see* *Nodak Oil Co. v. Mobil Oil Corp.*, 533 F.2d 401, 409-10 (8th Cir. 1976) (defendant has a duty to see that the misrepresentation was

Subsequent events which will preclude a showing of justified reliance include a course of dealing between the parties. For instance, in *Phillips v. Hebden*,³⁰ the parties continued to do business with each other for nearly three years after the alleged misrepresentation. The plaintiff (creditor) claimed to have been deceived by the defendant's false representations as to the ownership of property.³¹ In addition, the defendant had made his monthly credit payments for nearly one year.³² The court held that the plaintiff's reliance was based upon the credit established by the defendant through the prompt payment of his account rather than upon any representations defendant may have originally made.³³

2. Time

Staleness as a function of time is a well recognized principal at common law.³⁴ Most recently, in *Herz & Lewis, Inc. v. Union Bank*,³⁵ the court used the length of time which had elapsed between the issuance of financial information and reliance thereon as the objective criteria to evaluate the plaintiff's reliance on financial information.³⁶

In *Herz & Lewis*, a wholesale jeweler brought suit against a bank and its agent for damages allegedly caused by the bank's misrepre-

fully retracted).

30. 65 A. 266 (R.I. 1906).

31. *Id.* at 267.

32. *Id.*

33. *Id.* In addition, reliance will be precluded as a matter of law where the parties enter into a subsequent agreement. See *Woodmont, Inc. v. Daniels*, 274 F.2d 132, 140 (10th Cir. 1959), *cert. denied*, 362 U.S. 968 (1960) ("[T]he contractor could not recover damages for the period following the March 17 amendment . . . because they then had no right to rely on the original misrepresentations."). *Accord*, *Anderson v. General Motors Corp.*, 154 F. Supp. 927, 931 (W.D. Wash. 1957) ("[T]he signing of this last agreement of November 1, 1952, operated as a matter of law to deny plaintiff any right to recover by reason of any alleged misrepresentation made on November 9, 1951.").

34. The fact that financial information will at some point become stale does not appear to ever have been disputed. The controversy which continues in the common law courts is whether a time limit can be objectively determined. See *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. at 441, 528 P.2d at 191; *Fetherston v. National Republic Bancorp.*, 280 Ill. App. at 159; *Reeve v. Dennett*, 145 Mass. at 29, 11 N.E. at 944; *Bradley v. Seaboard Nat'l Bank*, 167 N.Y. at 430, 60 N.E. 771 at 772; *Macullar v. McKinley*, 49 N.Y. Super. Ct. at 10-11; *Von Bruck v. Peyser*, 25 N.Y. Super. Ct. at 478.

35. 22 Ariz. App. 437, 528 P.2d 188.

36. *Id.* at 440-41, 528 P.2d at 191.

sentations as to the reliability of a customer who failed to repay credit the jeweler extended.³⁷ The misrepresentation³⁸ involved financial information which was given to the plaintiff more than two years earlier by the bank.³⁹ This information included a false statement as to the amount of credit the defendant was "presently extending . . . to [the customer]."⁴⁰ The defendant averred to the falsity of the statement but argued in a motion for summary judgment that, because of the lapse of time between issuance and reliance, the plaintiff had no right to rely.⁴¹ The lower court granted the motion. On appeal, the Arizona Court of Appeals noted that because the case had been dismissed by way of summary judgment in favor of the defendant (bank), it "would review the facts in a light most favorable to [the plaintiff (jeweler)]."⁴² Adhering to the concept that financial information becomes stale, the court held that, as a matter of law, the jeweler's reliance was unreasonable and that given the lapse of time, he had no right to rely on the alleged misrepresentation.⁴³

The finding that the misrepresentation had become stale was based on several objective criteria.⁴⁴ First, the court looked to the "general capacity for rapid economic change,"⁴⁵ and second, to "the specific transaction involved."⁴⁶ This is consistent with common law cases which examined the nature of the trade or industry and any customs regarding the issuance of financial information, as well as the condition of the economy as a whole, in an attempt to objectively define staleness.⁴⁷

37. *Id.* at 437-38, 528 P.2d at 190.

38. The bank did not deny that there was a misrepresentation. It argued that the jeweler must still prove justifiable reliance or the existence of a confidential relationship. *Id.* at 438, 528 P.2d at 190.

39. *Id.* at 439, 528 P.2d at 191.

40. *Id.*

41. *Id.* at 437, 528 P.2d at 189.

42. *Id.*

43. *Id.* at 441, 528 P.2d at 191.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Fetherston v. National Republic Bancorp.*, 280 Ill. App. at 159; *Macullar v. McKinley*, 49 N.Y. Super. Ct. at 10-11. Some courts have attempted to define staleness subjectively by looking to the intent of the parties. See *Duncan v. Stoneham*, 253 N.Y. 183, 187, 170 N.E. 571, 572 (1930) (defendants placed no limitation upon the use of their representation); *Bradley v. Seaboard Nat'l Bank*, 167 N.Y. at 430, 60 N.E. at 772 ("The firm cannot be heard

In *Fetherston v. National Republic Bancorporation*,⁴⁸ the defendant bank had formed a banking syndicate composed of banks in outlying districts.⁴⁹ Plaintiffs, depositors in certain of the outlying banks, brought an action alleging that the defendant bank had fraudulently induced them into leaving their deposits in the outlying banks by advertising that they were part of a system supported by enormous combined resources.⁵⁰ The court held that in light of the changing conditions in the banking industry, no depositor would be justified in relying on a statement made a year earlier.⁵¹

The court in *Herz & Lewis*⁵² considered the length of delay following the misrepresentation the most important factor in evaluating the reasonableness of the plaintiff's reliance.⁵³ The possibility that staleness might be expressed as a function of time was first articulated in the nineteenth century. In *Von Bruck v. Peyser*,⁵⁴ a seller of goods brought an action alleging that the defendant falsely and fraudulently induced him to sell goods to a third party on credit.⁵⁵ The court held that whether the plaintiffs were influenced in making sales to a third person by representations made by the defendant two years and four months previously, was a question of fact.⁵⁶ The court determined that "the length of time intervening between the receipt of the defendant's letter . . . and the sales . . . in the judgment of law [could operate] to prevent any supposed influence."⁵⁷ While concluding that staleness under

to say that the mischievous force was operative longer than it expected it to be.").

48. 280 Ill. App. 151.

49. *Id.* at 154.

50. *Id.* at 154-55.

51. *Id.* at 159. See *Macullar v. McKinley*, 49 N.Y. Super. Ct. at 10-11 ("[W]hen the plaintiffs received the statement of February, they could not be justified in assuming that it was made by the defendant, as something which he meant they should sell goods upon for all future time, but only for that space of time that, according to the custom of the agency, would elapse, before another application be made, and another statement procured."). See also *Newark Live Poultry Co. v. Fauer*, 118 N.J.L. at 558, 194 A. at 272 (a suit was brought for purchases made in June charging the defendant with false representations: the court noted that the defendant had offered no proof of custom in the trade to support his argument that the period of time in question negated a showing of justified reliance).

52. *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. 437, 528 P.2d 188.

53. *Id.* at 441, 528 P.2d at 191.

54. *Von Bruck v. Peyser*, 25 N.Y. Super. Ct. 468.

55. *Id.* at 477-78.

56. *Id.* at 478. *Accord*, *Zabriskie v. Smith*, 13 N.Y. at 332.

57. *Von Bruck v. Peyser*, 25 N.Y. Super. Ct. at 478. *Cf.* *Snow v. Hogan*, 312 Ill. App. 636,

the circumstances should be resolved as a question of fact, the court postulated that the law would not give representations which are acted upon a continuing influence for all time,⁵⁸ stating that "[t]here probably must be some limit" to the length of time financial information can be relied upon.⁵⁹

The court in *Herz & Lewis* criticized the *Von Bruck* decision because it failed to distinguish between actual reliance (a question of fact) and the right to rely (a matter of law).⁶⁰ Instead it felt that the concurring opinion was better reasoned.⁶¹ The concurrence in *Von Bruck* noted that

the plaintiffs, as persons of ordinary prudence, could not be presumed to have believed that circumstances of a party would necessarily remain the same [for two years and four months].⁶²

Herz & Lewis, therefore, utilized a common law principle that was more than one hundred years in the making.⁶³ The liability imposed on those who release financial information will be limited to that period of time for which it remains accurate and reliable.⁶⁴ In order to define staleness, the courts will use objective criteria such as the nature of the economy and the type of transaction involved.⁶⁵

640, 38 N.E.2d 934, 937 (1942) ("[The representation] [h]aving been made on June 21, 1929, it does not prove fraud on October 18th and November 13th, when [reliance is alleged to have occurred]."); *De Swarte v. First Nat'l Bank*, 206 N.W. 887, 890 (Wis. 1926) ("One of the transactions took place in January. We see no reason why the plaintiff could not then rely on the representations made in October.").

58. *Von Bruck v. Peyser*, 25 N.Y. Super. Ct. at 478.

59. *Id.* In *Reeve v. Dennett*, 145 Mass. 23, 11 N.E. 938, allegedly false representations were made by the defendant to the plaintiff regarding the value of corporate stock. The court reasoned that it could not rule as a matter of law whether the representations continued to operate in the plaintiff's mind in April, 1881 even though they had been made in May, 1880. *Id.* at 29, 11 N.E. at 944-45. The case was relied upon by the same court in *Joseph v. Tata*, 161 N.E.2d 763 (Mass. 1959), where the court refused to rule as a matter of law that a conversation on or about March 16th had ceased to serve as a ground for reliance on April 12th or 15th. *Id.* at 161 N.E.2d at 765.

60. *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. at 441-42, 528 P.2d at 192.

61. *Id.*

62. *Von Bruck v. Peyser*, 25 N.Y. Super. Ct. at 482.

63. 22 Ariz. App. at 441-42, 528 P.2d at 191-92.

64. "[T]he real issue in this case is how far into the future can the information be relied upon?" *Id.* at 440, 528 P.2d at 191.

65. *Id.*

B. Bankruptcy Law

The discussion of staleness in bankruptcy law supports the use of objective criteria to evaluate the conduct of parties involved in the issuance of financial statements.⁶⁶ Creditors usually obtain a signed agreement from their debtors stating that the financial statement may be relied upon until such time as the debtor notifies the creditor of material changes.⁶⁷ As a result, courts in the context of a bankruptcy proceeding look to the intent of the parties in determining whether the statements should have been relied upon by the creditor at some point in time after their issuance.⁶⁸

Detailed analysis of the staleness of financial statements in bankruptcy law began in the 1920's with litigation that resulted in the Supreme Court decision of *Gerdes v. Lustgarten*.⁶⁹ Because these cases involve face to face transactions between a debtor and creditor, subjective criteria are more important than they are in common law fraud cases or in the area of securities law, where transactions often lack an ongoing relationship.

In *Gerdes*, a debtor submitted a financial statement on January 5, 1920 which stated that the creditor could continue to rely upon the statement until notified by the debtor of material changes in his financial condition.⁷⁰ Funds were advanced to the debtor in October and November of 1920 and in February of 1921. Upon the debtor's subsequent bankruptcy, the creditor moved to avoid discharge of the debt pursuant to section 14(b) of the Bankruptcy Act of 1910.⁷¹

The bankruptcy referee allowed the discharge, holding that even if the creditor had relied on the statement, reliance was not rea-

66. *Gerdes v. Lustgarten*, 266 U.S. at 326; see notes 80-85 *infra* and accompanying text.

67. *Gerdes v. Lustgarten*, 266 U.S. at 326.

68. *Id.*

69. *Id.* at 321.

70. *Id.* at 323.

71. Bankruptcy Act of 1910, § 14(b), ch. 412, 36 Stat. 839 (amending Bankruptcy Act of 1898, § 14(b), ch. 541 30 Stat. 550) (codified at 11 U.S.C. § 32(b) (1976)) (repealed 1978). Section 32(b) was incorporated into the new Bankruptcy Act. See Bankruptcy Act of 1978, 11 U.S.C. §§ 727(a)(10), 1141(d)(4) (Supp. III 1979). The section had provided that the applicant be discharged unless he has "(2) with intent to conceal his financial condition . . . failed to keep books of account or records from which such condition might be ascertained; or (3) obtained money or property on credit upon a materially false statement in writing, made by him to any person or his representative for the purpose of obtaining credit from such person. . . ." 11 U.S.C. § 32(b) (1976).

sonable, "since in view of the financial depression prevailing in 1920, the 'reasonable time' for which the statement remained a 'continuing statement' had expired."⁷² The district court reversed the referee's objective determination and found that reliance was justified.⁷³ The Second Circuit reversed the district court and affirmed the referee's finding that the lapse of time rendered the statement stale.⁷⁴

The Supreme Court, acknowledging divisions among the circuits,⁷⁵ resolved the question as one of intent. The Court held that if the written statement was made for the purpose of obtaining credit and was materially false, "the vice inherent in the original falsity of the statement is not remedied by the lapse of time."⁷⁶ It reasoned that within the time the debtor intended the statement to be effective he could not argue that extrinsic circumstances made the creditor's reliance unreasonable. The Court explained that "the lapse of time is only material in determining whether credit was extended within the period intended."⁷⁷ Although the Supreme Court rejected an objective determination of staleness, it is important to note that the debtor had expressly recited to the creditor that the statement be regarded as continuous and binding and relied upon until changed or recalled.⁷⁸

In a case factually similar to *Gerdes v. Lustgarten*, the Fourth Circuit utilized the test set forth by the Supreme Court and looked to the intent of the parties in order to determine how long a financial statement could be relied upon.⁷⁹ In *International Shoe Co. v. Kahn*,⁸⁰ three years elapsed between the issuance of the statement and the extension of credit thereon.⁸¹ There was an express provision in the credit agreement that the financial statement would stand good for subsequent purchases signed by the debtor, but another clause indicated that financial statements

72. *Gerdes v. Lustgarten*, 266 U.S. at 324.

73. *Id.* at 324-25.

74. 289 F. 481, 483 (2d Cir. 1923), *rev'd*, 266 U.S. 321 (1924).

75. 266 U.S. at 325.

76. *Id.* at 326.

77. *Id.*

78. *Id.*

79. *International Shoe Co. v. Kahn*, 22 F.2d 131 (4th Cir. 1927).

80. 22 F.2d 131.

81. *Id.* at 133.

should be issued at least once a year.⁸² Although the Fourth Circuit applied the *Gerdes* test, it took into account several objective factors including the exigencies of business affairs, current business practises and the request by the creditor (signed by the debtor) that financial statements be issued each year.⁸³ The court held that it would be unreasonable to construe the statement as continuing indefinitely.⁸⁴ The statement was viewed as a representation of the debtor's financial condition only for the year which followed its issuance.⁸⁵

The most recent decision to follow *Gerdes* is *Northern Trust Co. v. Garman*.⁸⁶ In *Northern Trust*, the creditor, in making a series of loans, relied on three financial statements issued separately by the debtor.⁸⁷ The creditor filed a complaint to prevent the discharge of a debt pursuant to section 17(a)(2) of the Bankruptcy Act of 1938⁸⁸ alleging that the debtor used materially false financial statements to secure various loans. Although the most recent loan was approved based on a seven month old financial statement,⁸⁹ the

82. *Id.*

83. *Id.* The objective criteria are similar to those used in *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. 437, 528 P.2d 188 (1975). See notes 44-47 *supra* and accompanying text.

84. *International Shoe Co. v. Kahn*, 22 F.2d at 133.

85. *Id.* Cf. *In re Simon Weltman & Co.*, 2 F.2d 759, 760 (S.D.N.Y. 1924) (Judge Learned Hand, in an opinion decided while *Gerdes v. Lustgarten* was pending before the Supreme Court, wrote that, "[a]ssuming that [the clause calling for the financial statement's continuing reliability], was not to be read literally yet it meant something, . . . it was natural within the year for a seller who had heard nothing from the buyer, nor of any catastrophic change, as in 1920, [to rely].") (emphasis added).

86. [Current Transfer Binder] BANKR. L. REP. (CCH) ¶ 67,417 (7th Cir. 1980).

87. *Id.* at 77,710-11.

88. Bankruptcy Act of 1938, § 17(a)(2) (codified at 11 U.S.C. § 523(a)(2) (Supp. III 1979)). The section provides that an individual debtor is not discharged from any debt—

(2) for obtaining money, property, services, or an extension, renewal, or refinancing (footnote omitted) of credit, by—

(A) false pretenses, false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) or use of a statement in writing—

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for obtaining such money, property, services or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive.

Id.

89. *Northern Trust Co. v. Garman*, [Current Transfer Binder] BANKR. L. REP. CCH

bankruptcy and district court judges found that reliance was unreasonable.⁹⁰ The Seventh Circuit, however, held that the time lapse between the date of financial statements and the granting of loans by the creditor in reliance on them was not "so unreasonable as not to be reliance in fact."⁹¹ Citing *Gerdes*,⁹² the court noted that the debtor had included a statement agreeing to notify the creditor of any material changes in its financial position.⁹³ Just as in *Gerdes*, the Seventh Circuit resolved the question of staleness in terms of the intent of the parties given the continuing reliability clause.⁹⁴

III. Staleness in Securities Law

In order to determine the extent to which staleness has been recognized in securities law, the civil liability sections of the Securities Act of 1933 and the Securities Exchange Act of 1934⁹⁵ will be discussed with particular emphasis on section 11(a) of the 1933 Act⁹⁶ and section 10(b) of the 1934 Act.⁹⁷ Although securities law as it presently exists prevents the application of a uniform approach to staleness,⁹⁸ the concept has been viewed as a limitation on liability under both the 1933 and 1934 Acts.⁹⁹

A. The 1933 Act

The securities statutes were enacted for the purpose of avoiding

¶ 67,418 at 77,711 n.2, 77,715.

90. *Id.* at 77,715.

91. *Id.*

92. *Gerdes v. Lustgarten*, 266 U.S. 321 (1924).

93. *Northern Trust Co. v. Garman*, [Current Transfer Binder] BANKR. L. REP. (CCH)

¶ 67,417 at 77,715.

94. *Id.* "[The debtor] clearly filed the financial statements for the purpose of obtaining credit . . . [and] the creditor extended credit upon the faith of the statements." Whether a continuing reliability clause exists in an agreement or words by the debtor from which such assurance can be found, a financial statement speaks as of the date it is issued. *Monier v. Guaranty Trust Co.*, 82 F.2d 252, 254 (2d Cir. 1936).

95. See note 1 *supra*.

96. 1933 Act, 15 U.S.C. § 77k(a) (1976).

97. 1934 Act, 15 U.S.C. § 78k(b) (1976).

98. See note 1 *supra*.

99. See text accompanying notes 101-06 (1933 Act) and 121-28 (1934 Act) *infra*. Similar to common law fraud, in securities law cases, transactions normally lack an on-going relationship between the parties. In fact, under the 1933 and 1934 Acts, transactions take place in an impersonal market. Objective limitations on liability, therefore, are more appropriate than where the parties are engaged in a continuing relationship.

frauds by substituting a "philosophy of full disclosure for the philosophy of *caveat emptor*,"¹⁰⁰ and Congress intended that the legislation be construed "flexibly to effectuate [this] remedial purpose."¹⁰¹ The liability established by section 11, however, is more than a simple expansion of common law principles to achieve a remedial purpose. Section 11 imposes near absolute liability for the issuance of a false registration statement.¹⁰² As a result of the stricter liability, Congress imposed the burden of proving reliance upon certain plaintiffs bringing an action pursuant to section 11. The plaintiffs that were singled out in an amendment to section 11(a) are those who purchase securities in reliance on a stale registration statement.¹⁰³

Section 11(a) of the 1933 Act was amended during the joint House-Senate Conference on the 1934 Act.¹⁰⁴ The amendment placed the burden to show reliance on any plaintiff who purchased a security subsequent to the issuance of an earnings statement covering a period of at least twelve months after the effective date of

100. Securities and Exchange Comm'n v. Capital Gains Bureau, 375 U.S. 180, 186 (1963).

101. *Id.* at 195. See also Securities and Exchange Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968), cert. denied, 404 U.S. 1004 (1971). ("[T]he securities laws should be interpreted as an expansion of common law . . . to effectuate the broad remedial design of Congress." (footnote omitted)).

102. R. JENNINGS & H. MARSH, SECURITIES REGULATION 825 (4th ed. 1977) [hereinafter cited as JENNINGS & MARSH]; Kripke, *Securities Law Reform and the ALI Federal Securities Code*, 33 U. MIAMI L. REV. 1453, 1462-63 (1979); *Keynote Address*, supra note 7, at 1446-47.

103. Section 11(a), 1933 Act, 15 U.S.C. § 77k(a) (1976) reads in pertinent part:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue. . . .

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

Id.

104. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934).

the registration statement and made generally available to shareholders.¹⁰⁵ Acknowledging that a financial statement (specifically a registration statement) may become stale and that staleness can be objectively defined, the conference committee explained that "[t]he basis of this provision is that in all likelihood the purchase and price of the security purchased after publication of such an earning statement will be predicated on that statement rather upon the information disclosed upon registration."¹⁰⁶

Under both the amended and original versions of section 11 liability is imposed for material statements in a registration statement which are false or misleading and for material omissions of facts required to be stated therein.¹⁰⁷ "Materiality" must be proven in order to establish liability under the section.¹⁰⁸ Reliance, however, is not generally required.¹⁰⁹ Because section 11 is in the nature of a negligent misrepresentation statute,¹¹⁰ there is no requirement that the plaintiff plead and prove scienter.¹¹¹ In addition, section 11 expressly eliminates any requirement of privity of contract between the plaintiff and the issuer and between the plaintiff and collateral defendants (such as directors and officers) so that "[a]ny purchaser in the market . . . may sue."¹¹² Finally,

105. 1933 Act, 15 U.S.C. § 77k(a) (1976). Proof of reliance "may be established 'without proof of the reading of the registration statement'; but since at that point the prospectus need no longer be delivered to anyone (unless there is an unsold allotment), proof of such reliance would appear to be very difficult." JENNINGS & MARSH, *supra* note 102, at 833.

106. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934).

107. 1933 Act, U.S.C. § 77k(a) (1976). See JENNINGS & MARSH, *supra* note 102, at 825; *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 568 (E.D.N.Y. 1971).

108. *Escott v. Barchris Construction Corp.*, 283 F. Supp. 643, 681 (S.D.N.Y. 1968) (materiality defined as "matters which [an average prudent investor should reasonably] know before he can make an intelligent informed decision whether or not to buy the security"). The Supreme Court in *TSC Indus., Inc. v. Northway*, 426 U.S. 438 (1975), defined materiality in the context of an action brought pursuant to § 14 of the 1934 Act which may be applicable to § 11 of the 1933 Act as well. JENNINGS & MARSH, *supra* note 102, at 826. The Court in *TSC Industries* defined materiality as follows: "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important." 426 U.S. at 449.

109. JENNINGS & MARSH, *supra* note 102, at 833. See also 1933 Act, 15 U.S.C. § 77k(a) (1976).

110. *Beecher v. Able*, 374 F. Supp. 341, 346 (S.D.N.Y. 1974) (citing 3 L. LOSS, SECURITIES REGULATION 1729-30 (2d ed. 1961)).

111. *Id.*

112. JENNINGS & MARSH, *supra* note 102, at 832-33. But see *Barnes v. Osofsky*, 373 F.2d 269, 273 (2d Cir. 1967) (plaintiff must still show that he is a purchaser of one of the securi-

section 11 imposes absolute liability on the issuer.¹¹³ The amendment to section 11(a) was intended to limit this liability.

The section 11(a) staleness provision has not been the subject of extensive judicial construction.¹¹⁴ In *Rudnick v. Franchard Corp.*,¹¹⁵ however, consideration of the staleness provision was necessary. In *Rudnick* the plaintiffs purchased stock which was registered under two separate offerings.¹¹⁶ An additional purchase of stock by one of the plaintiffs occurred after an annual financial statement covering a twelve-month period subsequent to the second offering had been issued.¹¹⁷ The court held that "[u]nder the terms of section 11(a), in order for [the plaintiff] to recover on this claim, it would be necessary for him to prove that he relied upon the . . . registration statement. [Although] [r]eliance may be established without proof that he actually read the statement."¹¹⁸ By imposing proof of reliance, the staleness provision served to limit the liability of the defendant with regard to the additional purchase of stock.

B. The 1934 Act

The staleness of financial information is not expressly provided for under the 1934 Act. Recognition of the concept is implicit, however, in judicial decisions construing section 10(b) of the 1934

ties issued in the registered offering).

113. 1933 Act, 15 U.S.C. § 77k(a) (1976). An issuer may plead as a defense, however, that the plaintiff knew of the untruth or omission at the time of his acquisition. JENNINGS & MARSH, *supra* note 102, at 828-29. Section 11(a) imposes liability subject only to a due diligence defense upon all directors of the issuer, all who sign the registration statement, all underwriters of the offering and any expert who is named as having prepared or certified any part of the registration statement. The due diligence defense calls for a "reasonable" investigation and a "reasonable" belief in the accuracy and completeness of the registration statement. *Id.*

114. Section 11 itself has not been the focus of much litigation. See JENNINGS & MARSH, *supra* note 102, at 825 ("This was a tribute both to the care with which the Securities and Exchange Commission processed registration statements and to the ability and integrity of the corporate bar.").

115. 237 F. Supp. 871 (S.D.N.Y. 1965).

116. *Id.*

117. *Id.* at 872-73.

118. *Id.* at 873 (footnote omitted). See also *Emmi v. First Mfrs. Nat'l Bank*, 336 F. Supp. 629, 634 n.5 [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,330 at 91,783 n.5 (D. Me. 1971) (The element of reliance added by amendment to § 11(a) in 1934 is applicable only in the event an intervening financial statement had been issued).

Act¹¹⁹ and SEC Rule 10b-5 promulgated thereunder.¹²⁰ In order to restrict the liability imposed by the private right of action created under section 10(b), the courts have required a showing of causation in fact between the fraudulent misrepresentation and a plaintiff's injury.¹²¹ In *List v. Fashion Park, Inc.*¹²² causation was defined as a function of materiality — an essentially objective determination and reliance — a subjective element.¹²³ Courts fol-

119. The 1934 Act, 15 U.S.C. § 78j (1976) reads in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. A private cause of action was created under § 10(b) "in order to provide a right of recovery for fraudulent misrepresentations in connection with the purchase or sale of securities." *Beecher v. Able*, 435 F. Supp. 397, 412 (S.D.N.Y. 1977).

120. 17 C.F.R. § 240.10b-5 (1980) reads in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id. ("[T]he Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.") *Securities and Exchange Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d at 848.

121. *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 238-39 (2d Cir. 1975).

122. 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

123. *Id. Materiality: Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489 (9th Cir. 1974) ("The applicable test of materiality is essentially objective . . . 'whether a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.'") (quoting *List v. Fashion Park, Inc.*, 340 F.2d at 462) (citation omitted).

Reliance: List v. Fashion Park, 340 F.2d at 462 (Requiring the "misrepresentation [to be] a substantial factor in determining the course of conduct" of the individual plaintiff.) (quoting Restatement of Torts § 546 (1938)); *Accord, Chelsea Assocs. v. Rapanos*, 527 F.2d 1266, 1271 n.2 (6th Cir. 1975); *Marbury Mgmt., Inc., v. Kohn*, 470 F. Supp. 509, 514 (S.D.N.Y. 1979). Proof of reliance is not required in cases involving a failure to disclose. *Affiliated Ute*

lowing *List*, however, borrowed the term "justifiable reliance" from the common law torts of misrepresentation and deceit.¹²⁴ The effect has been to create a judicial hybrid which utilizes objective as well as subjective criteria.¹²⁵

Just as at common law, staleness is viewed under the 1934 Act as a limitation on liability for the release of financial information. At common law, however, courts are concerned with actual reliance (subjective) and the right to rely (objective).¹²⁶ Staleness affects a plaintiff's right to rely.¹²⁷ Under the 1934 Act, the courts are concerned with reliance (subjective) and materiality (objective).¹²⁸ While staleness at common law affects only the plaintiff's right to rely, under the 1934 Act, it has been considered in conjunction with plaintiff's burden to show both materiality and reliance.

1. Materiality

In *Tucker v. Arthur Andersen & Co.*,¹²⁹ the defendant was charged with material misrepresentations and omissions in financial statements for the fiscal year ending June 30, 1968 published in an annual report and proxy statement in violation of section 10(b) of the 1934 Act and Rule 10b-5.¹³⁰ Plaintiffs were purchasers of stock in the corporation which defendant audited and sought to represent a class of all purchasers of stock between September 26, 1968 and November 1, 1969.¹³¹

On a motion of the plaintiffs for class action certification the defendant argued that materiality was not a common issue to the

Citizens v. United States, 406 U.S. 128, 153-54 (1972). See also *Williams v. Sinclair*, 529 F.2d 1383, 1389 (9th Cir. 1975); *Chelsea Assocs. v. Rapanos*, 527 F.2d 1266, 1271 (6th Cir. 1975); *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 238-39 (2d Cir. 1975). Where reliance is required, it cannot be determined solely through subjective analysis. Although the original formulation spoke in terms of a subjective test of reliance, *List v. Fashion Park*, 340 F.2d at 462, "[a] . . . study strongly suggests that [the Second Circuit] has been loath to modify the reliance requirement to account for characteristics, peculiar to the individual plaintiff." *Gordon v. Burr*, 366 F. Supp. 156, 166 (S.D.N.Y. 1973) (footnote omitted) (citing 72 COLUM. L. REV. 562, 567 (1972)).

124. See *Holdsworth v. Strong*, 545 F.2d 687, 695-97 (10th Cir. 1976).

125. See note 123 *supra*.

126. *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. at 440, 528 P.2d at 191.

127. *Id.*

128. See notes 122, 123 *supra*.

129. 67 F.R.D. 468 (S.D.N.Y. 1975).

130. *Id.* at 471-72.

131. *Id.*

class.¹³² In anticipation of the court's finding that materiality was a common issue, the defendant argued that "plaintiffs cannot present a homogeneous class because materiality would vary over time."¹³³ Essentially, the argument presented to the court was that information made available to the public through a number of sources, would gradually negate the materiality of any alleged misrepresentations or omissions in the June 30, 1968 financial statements.¹³⁴ As financial information (including interim earnings reports and public announcements relating to corporate affairs) became publicly available, the audited financial statement would become stale.¹³⁵ The defendant asserted that because the "alleged misrepresentations and omissions would depend at what point during the class period the purchase of . . . stock was made,"¹³⁶ class action certification should be denied. The court did not question or find fault with the staleness argument and expressly stated that the argument might succeed.¹³⁷ Instead of denying certification,

132. *Id.* at 474-75. On this question, the court found that materiality was "a common issue to be analyzed on an objective basis." *Id.* at 475.

133. *Id.* at 475. See *Tucker v. Arthur Andersen & Co.* 67 F.R.D. 468 (S.D.N.Y. 1975), Brief for Defendant, at 46-58. *Id.*

134. *Id.* at 475-76. "The public information alluded to . . . consisted of interim earnings reports issued on November 8, 1968, February 14, May 15, 1969 and the report for the fiscal year ended June 30, 1969 which was issued October 21, 1969. In addition, there were public announcements that: (1) the SEC had required Black Watch to register its herd program as a security under the Securities Act of 1933; (2) Bermec would be acquiring several new companies; (3) Congress would be enacting tax reform legislation which might effect Black Watch's operations; and (4) Black Watch would be sold to State Mutual Life Assurance Company." *Id.* at 476 (footnotes omitted).

135. *Id.* at 476. "[The defendant argued] that . . . assuming [the 1968 financials] were material at the beginning of the class period, they would subsequently become immaterial as each bit of information or combination of information became known to the public." *Id.*

136. *Id.* But see *James v. Gerber Products Co.*, 587 F.2d 324, 327 (6th Cir. 1978) ("The undisclosed information in dispute . . . is comprised of interim earnings figures. . . [which] only rise to the level of materiality when they can be calculated with substantial certainty [that is, when they are finalized a month or so after the end of a business quarter].")

137. 67 F.R.D. at 476. "If at a subsequent point in litigation [the defendant] is able to demonstrate that the misrepresentations and omissions, in light of other information, were not material . . ." But see cases cited by plaintiffs in support of their argument that actions have been permitted to proceed on behalf of a person who purchased securities over an extended period of time. *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), cert. denied, 395 U.S. 977 (1969); *Werfel v. Kramarsky*, 61 F.R.D. 674 (S.D.N.Y. 1974); In re *Caesars Palace Sec. Litigation*, 360 F. Supp. 366 (S.D.N.Y. 1973); *Grad v. Memorex Corp.*, 61 F.R.D. 88 (N.D. Cal. 1973); *Siegel v. Realty Equities Corp.*, 54 F.R.D. 420 (S.D.N.Y. 1972); In re *Penn Central Sec. Litigation*, 347 F. Supp. 1327 (E.D. Pa. 1972), aff'd, 494 F.2d 528 (3d Cir. 1974); *Rosenblatt v. Omega Equities Corp.*, 50 F.R.D. 61 (S.D.N.Y. 1969); *Fogel v. Wolfgang*, 47

however, the court determined that the flexibility of the Federal Rules of Civil Procedure¹³⁸ would allow it to "alter or amend any class certification order to narrow the class to those who purchased during the period when there was materiality."¹³⁹

2. Reliance

In *Mitchell v. Texas Gulf Sulphur Co.*,¹⁴⁰ an action was brought pursuant to section 10(b) of the 1934 Act and Rule 10b-5 for the issuance of alleged fraudulent press releases by the defendant.¹⁴¹ The district court found that on April 12, 1964, the defendant had issued a materially "inaccurate, misleading and deceptive" press release.¹⁴² The defendant argued in its appeal, however, that once a curative press release was issued on April 16, 1964, and received by the brokerage houses, reliance upon the April 12 press release would be precluded as a matter of law.¹⁴³ In other words, as soon as the April 16 press release was disseminated publicly, the April 12 release became stale.

The Tenth Circuit acknowledged the validity of the argument determining that "[a]t some point in time after the publication of a curative statement such as that of April 16, stockholders should no longer be able to claim reliance on the deceptive release."¹⁴⁴ The court then proceeded to review the conduct of each plaintiff finding that by April 22 and April 23, due to the wide publicity given to the April 16 statement, "the *reasonable investor* would have become informed of the April 16 release and could no longer rely on the earlier release in selling TGS stock."¹⁴⁵

F.R.D. 213 (S.D.N.Y. 1970); *Dolgow v. Anderson*, 43 F.R.D. 472 (E.D.N.Y. 1968); *Kronenberg v. Hotel Governor Clinton, Inc.*, 41 F.R.D. 42 (S.D.N.Y. 1966). See also *Tucker v. Arthur Andersen & Co.*, 61 F.R.D. 468 (S.D.N.Y. 1975), Brief for Plaintiff at 17-22.

138. FED. R. CIV. P. 23(c)(1).

139. *Id.* The fact that financial information may lose materiality in light of other available information has been discussed in nondisclosure cases where the issue is whether the failure to disclose involved a material fact. See *Chelsea Assocs. v. Rapanos*, 376 F. Supp. 929, 941 (E.D. Mich. 1974), *aff'd*, 527 F.2d 1266 (6th Cir. 1975) ("[I]n light of all the information available to them through published material . . . [the undisclosed fact] neither would or might have affected the action of a reasonable person in the plaintiff's position.").

140. 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

141. *Id.* at 92.

142. *Id.* at 97.

143. *Id.* at 102.

144. *Id.* at 103.

145. *Id.* (emphasis added).

Reliance has also been considered with regard to the liability of accountants given their continuing duty to disclose under section 10(b) of the 1934 Act and Rule 10b-5.¹⁴⁶ In *Fischer v. Kletz*,¹⁴⁷ the plaintiffs asserted that the defendant accounting firm was liable for its failure to disclose subsequent to its certification of the financial statement and the corporation's issuance of interim statements, facts which revealed that the statements were false and misleading.¹⁴⁸ On a motion to dismiss by the defendant, the court reviewed potential common law liability and liability under the 1934 Act. The *Fischer* court held as against a motion to dismiss that accountants who had certified a financial statement may be liable under section 10(b) of the 1934 Act for failure to disclose after-acquired information which reveals that the statement was false when issued.¹⁴⁹

Subsequent decisions have construed *Fischer* as imposing a "continuing duty to disclose . . . where the auditor learns facts revealing that a certification believed correct when issued was actually unwarranted."¹⁵⁰ Unfortunately, the courts have not defined the limitations of an auditor's liability: at what point in time does a financial statement become stale so that reliance thereon would be unreasonable and the duty to correct the prior statement unnecessary.

The American Institute of Certified Public Accountants ("AICPA"), recognizing the need for guidelines concerning its continuing duty to disclose,¹⁵¹ issued No. 41 of the Statements on Auditing Procedures entitled *Subsequent Discovery of Facts Existing At The Date of the Auditor's Report*.¹⁵² It acknowledged that due to a variety of conditions specific actions to be taken may vary "in

146. *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967).

147. *Id.*

148. *Id.* at 183. Staleness, in this context, occurs as a result of both a lapse of time and subsequent events.

149. *Id.* at 194. The defendant's motion to dismiss for liability arising out of an alleged failure to disclose facts which revealed that the interim statement issued by the corporation was false and misleading was also denied. *Id.* at 197.

150. *Gold v. DCL, Inc.*, 399 F. Supp. 1123, 1127 (S.D.N.Y. 1973).

151. The need for guidelines was recognized in direct response to the *Fischer* decision. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AICPA Internal Memorandum from D. J. Schneeman to Miss Melcher (Sept. 19, 1980).

152. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS VOLUME 1, AU § 561.01-.10 (1980) (Statements on Auditing Standards).

light of the circumstances."¹⁵³ The standard requires that subsequently discovered information be acted upon if the auditor's opinion would have been affected had the information been known to the auditor when he was preparing it, and if he believes that there are persons currently relying or likely to rely on the prior statement.¹⁵⁴ In addition, it advises the auditor to consult with his attorney because of the legal implications that may be involved.¹⁵⁵

With respect to reliance, the auditing standard expressly notes that "consideration should be given . . . to the time elapsed since the financial statements were issued," an objective criterion.¹⁵⁶ Implicit in the language of the standard is the view that once a new audited financial statement is issued, prior statements become stale and need not be corrected or reissued.¹⁵⁷

IV. The Proposed Federal Securities Code

The purpose of the Code is not only to consolidate the securities statutes,¹⁵⁸ but to require disclosure on a continuous basis.¹⁵⁹ Liability for the release of financial information should be limited to the period of time for which it remains accurate and reliable.¹⁶⁰

In common law fraud cases staleness is a function of objective criteria — most importantly, the length of time between the release of financial information and reliance thereon.¹⁶¹ Although reliance may be held unreasonable as a matter of law because of elapsed time,¹⁶² the common law courts have had difficulty defining the period for which those who release financial information will continue to be liable.¹⁶³ Some courts, however, have favored a one

153. *Id.* § 561.02.

154. *Id.* § 561.05.

155. *Id.* § 561.02. Because there is no objective standard in the 1934 Act, attorneys would have difficulty advising clients with regard to subsequently discovered information.

156. *Id.* § 561.05.

157. *Id.* § 561.06(a) ("Generally, only the most recently issued audited financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years."); § 561.06(b) ("[A]ppropriate disclosure of the revision can be made in [the new financial statement] instead of reissuing the earlier statements.")

158. *See* note 1 *supra*.

159. *See* note 7 *supra*.

160. *See* notes 201-05 *infra* and accompanying text.

161. *See* notes 52-62 *supra* and accompanying text.

162. *Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. at 441, 528 P.2d at 191.

163. *See* note 34 *supra*.

year period.¹⁶⁴ Staleness has also been objectively viewed as a function of time under the 1933 and 1934 Acts.¹⁶⁵ In the one section where it was foreseeable to do so, Congress defined staleness in terms of a one year period.¹⁶⁶ Staleness, both at common law and in securities law cases, has been used as an objective limitation on liability for the release of financial information. Much of the value inherent in such a limitation,¹⁶⁷ however, is lost when an express guideline is not provided.¹⁶⁸

A registration statement is stale under section 11(a) of the 1933 Act when a financial statement covering a twelve month period be-

164. *Fetherston v. National Republic Bancorp.*, 280 Ill. App. at 159 ("But whatever may have been the facts concerning these items . . . the bank statement was published approximately a year before the bank was closed and was therefore too remote."); *See also Herz & Lewis, Inc. v. Union Bank*, 22 Ariz. App. at 442, 528 P.2d at 192 ("[I]n *Brown*, the delay in reliance was only three months.") (distinguishing *Brown v. Lobdell, Farwell & Co.*, 51 Ill. App. 574 (1894)). Decisions construing staleness in the bankruptcy context also support a one year period. *See generally International Shoe Co. v. Kahn*, 22 F.2d at 133 ("[N]otwithstanding the express provision that it should stand good for subsequent purchases," the viability of the financial statement was limited to one year.); *In re Simon Weltman & Co.*, 2 F.2d 759, 760 (S.D.N.Y. 1924) (Judge Learned Hand wrote that "[a]ssuming [the continuing reliability clause], was not to be read literally, yet it meant something, and it was natural within the year for a seller . . . [to rely].").

165. *See* notes 101-06 (1933 Act) and 121-28 (1934 Act) *supra* and accompanying text.

166. 1933 Act, 15 U.S.C. § 77k(a) (1976).

167. As the Supreme Court recently noted in *United States v. Kubrick*, 444 U.S. 111, 117 (1979):

Statutes of limitation which are found and approved in all systems of enlightened jurisprudence, . . . represent a pervasive legislative judgment that it is unjust to fail to put the adversary on notice to defend within a specified period of time and that the right to be free from stale claims in time comes to prevail over the right to prosecute them. . . . These enactments are statutes of repose; and although affording plaintiffs what the legislature deems a reasonable time to present their claims, they protect defendants and the courts from having to deal with cases in which the search for truth may be seriously impaired by the loss of evidence, whether by death or disappearance of witnesses, fading memories, disappearance of documents, or otherwise.

Id. (citations omitted).

168. The common law courts continue to have difficulty determining when financial information becomes stale. *See* note 34 *supra*. Under the 1934 Act, the accounting profession found it necessary to establish guidelines in response to *Fischer* which imposed liability for failure to disclose after-acquired information revealing that a prior financial statement was false when issued. *See* notes 151-57 *supra* and accompanying text. The court in *Tucker v. Arthur Andersen & Co.*, 67 F.R.D. 468 (S.D.N.Y. 1975), postponed the difficult question of narrowing the class of plaintiffs to those who purchased during the period of time when reliance was material. *See* notes 138-39 *supra* and accompanying text.

ginning after the effective date of registration has been issued.¹⁶⁹ This financial statement is presently included in the form 10-K annual report.¹⁷⁰ Given the comprehensive nature of the 10-K,¹⁷¹ the reasoning used to justify the imposition of a staleness provision in the 1933 Act is all the more appropriate today; "in all likelihood the purchase and price of such an earning statement will be predicated on that statement rather than upon [previously disclosed information]."¹⁷²

The 1933 Act staleness provision provides a guideline to the securities market¹⁷³ and to the courts as to what constitutes an unreasonable period of time between issuance and reliance. Staleness does not prevent a plaintiff from bringing an action, rather, it creates a presumption by placing the burden of proving reliance on those who purchase stock after the annual report has been released.¹⁷⁴ In addition, it allows a plaintiff to prove reliance without having read the statement.¹⁷⁵

Under the Code, a staleness provision would have uniform application.¹⁷⁶ Civil liability sections currently found in each of the securities statutes¹⁷⁷ are incorporated into part XVII of the

169. 1933 Act, 15 U.S.C. § 77k(a) (1976).

170. Securities and Exchange Comm'n Release Nos. 33-6231, 33-6232, 33-6233, 33-6234, 33-6235, 33-6236, 45 Fed. Reg. 63,630 (1980)(to be codified at 17 C.F.R. §§ 229, 231, 240, 241, 249).

171. 45 Fed. Reg. at 63,630-2.

172. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41. See notes 103-06 *supra* and accompanying text.

173. The term "securities market" is used to refer to potential plaintiffs as well as defendants.

174. 1933 Act, 15 U.S.C. § 77k(a) (1976).

175. This provides the plaintiff with an opportunity to argue the "fraud on the market theory." See *Blackie v. Barrack*, 524 F.2d 891, 905-08 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976) (Direct proof of reliance from each purchaser on a stock exchange is not necessary. "The statute [section 10(b) of the 1934 Act] and [Rule 10b-5] are designed to foster an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely."). *Id.* at 907. Cf. *Gold v. DCL Inc.*, 399 F. Supp. 1123, 1129 n.13 (S.D.N.Y. 1973) ("[Defendant] relies on the lack of market or media reaction to the annual report's disclosures to demonstrate the lack of materiality of the omitted notice of qualification. . . . [T]he remarkable steadiness of the market price for the defendant's common stock in the week before and after the annual report's issuance strongly suggests that the earlier omission may ultimately be found to have been lacking in materiality.").

176. CODE, *supra* note 8, Introduction xix-xx.

177. See note 1 *supra*.

Code.¹⁷⁸ By adopting a provision similar to that found in the 1933 Act, staleness would be applicable with regard to the release of all financial information, not just the registration statement. A staleness provision has the flexibility necessary to provide an objective guideline and still allow a defendant to show that because of subsequent events, staleness occurred prior to the expiration of a twelve month period.¹⁷⁹ In addition, because the previously disclosed information is only presumptively stale, a plaintiff is not forced out of court. He may recover so long as he proves reliance.¹⁸⁰

In its present form, the Code does not provide for the staleness of financial information. Although civil liability sections 1703 and 1704 cite the staleness provision added by Congress to section 11(a) of the 1933 Act as a source for the language used,¹⁸¹ they only provide the defendant with an affirmative defense and require him to have taken reasonable steps to correct the misrepresentation or omission.¹⁸²

Section 1703 of the Code imposes civil liability for sales and purchases of securities by fraud or misrepresentation.¹⁸³ Subsection (d) provides that a defendant to an action has a defense if he proves that the misrepresentation or omission was corrected by a

178. CODE, *supra* note 8, §§ 1701-09.

179. See notes 27-33 (common law fraud) and 140-45 (1934 Act) *supra* and accompanying text.

180. One clear example of justifiable reliance on otherwise stale financial information would be an investor who utilized a trend analysis in order to decide on which corporate stock to buy. See note 12 *supra*.

181. CODE, *supra* note 8, §§ 1703(d), Source, 1704(d), Source. See note 103 *supra*.

182. See notes 184, 187 *infra*.

183. CODE, *supra* note 8, § 1703 provides in pertinent part:

(a) TRANSACTIONS NOT EFFECTED IN THE MARKETS.—If the transaction is not effected in a manner that would make the matching of buyers and sellers substantially fortuitous, a seller or buyer who violates section 1602(a), 1602(b)(1)(A), 1603(a), or 1613 is liable to his buyer or seller for rescission or damages.

(b) TRANSACTIONS EFFECTED IN THE MARKETS.—If the transaction is effected in a manner that would make the matching of buyer and seller substantially fortuitous, a seller or buyer who violates section 1602(a)(1), 1602(b)(1)(A), 1603(a), or 1613 is liable for damages to a person who buys or sells during the period beginning at the start of the day when the defendant first unlawfully sells or buys, and ending at the end of the day when all material facts (or facts of special significance in the case of section 1603(a)) become generally available.

(c) RELATION TO SECTION 1704.—Section 1703 does not apply to the extent that section 1704 applies.

filing or press release.¹⁸⁴ The defense is not available, however, against a plaintiff who bought or sold securities before the corrected facts became available or before the plaintiff acted in justifiable reliance thereon.¹⁸⁵ Section 1704 imposes civil liability for false registration statements, offering statements and reports.¹⁸⁶

184. CODE, *supra* note 8, § 1703(d) provides:

A defendant has a defense to an action under section 1703(b) for violation of section 1602(a)(1), 1603(a), or 1613 if he proves that the misrepresentation or omission was corrected by means of a filing or press release or in any other manner reasonably designed to bring the correction to the attention of the investing public, except that this defense is not available against a plaintiff who bought or sold (1) before the facts as corrected became generally available, or (2) in justifiable reliance on the misrepresentation or omission. Reliance on an omission is proved by proof of reliance on the particular filing or document and ignorance of the omission; but reliance on either a misrepresentation or an omission may be proved without proof that the plaintiff read a particular filing or document.

Id.

185. *Id.*

186. CODE, *supra* note 8, § 1704 provides in pertinent part:

Alternative I: § 1704 Treatment for the "10-K"

[(a) SCOPE OF SECTION.—Section 1704 applies (whether or not the particular registration statement has terminated or been withdrawn) on proof that an effective registration statement, an effective offering statement as of the date specified in section 509(2) or (3), an annual report filed under section 602(a)(1), or any other so filed and incorporated by reference in any such filing (1) contained a misrepresentation, or (2) omitted a material fact or material document required.]

Alternative II: § 1705 Treatment for the "10-K"

[(a) SCOPE OF SECTION.—Section 1704 applies (* * *) on proof that an effective registration statement, an effective offering statement as of the date specified in section 509(2) or (3), or a report filed under section 602(a)(1) and incorporated by reference in any such filing (1) contained a misrepresentation, or (2) omitted a material fact or material document required.]

(b) DEFENDANTS.—The following persons are liable for damages under section 1704:

- (1) the registrant;
- (2) the principal executive officer or officers, the principal financial officer, and the principal accounting officer of the registrant, in each case as of the effective date of the registration statement, the date specified in section 509(2) or (3) with respect to the offering statement, or the filing date of the report, as the case may be;
- (3) every director of the registrant as of those respective dates;
- (4) every person named with his consent in the registration statement, offering statement, or report, as of these respective dates, as about to become a director;
- (5) every expert whose consent has been filed under section 2003(e), but only with respect to statements that purport to have been made by him; and
- (6) every underwriter in the case of an offering statement.

(c) PLAINTIFFS.—Section 1704 gives a right of action to a person who proves—

- (1) that, in the case of an offering statement, he bought a security of a class covered by the offering statement after its effectiveness; or

The defense of correction is provided in subsection (d) which incorporates language identical to that found in section 1703(d).¹⁸⁷

The Code refers to the 1933 Act staleness provision as a source for sections 1703(d) and 1704(d).¹⁸⁸ These sections, however, do not follow the approach chosen by Congress¹⁸⁹ in section 11(a) of the 1933 Act.¹⁹⁰ Congress could have amended the 1933 Act¹⁹¹ and placed the staleness provision in section 11(b) of the 1933 Act¹⁹² where affirmative defenses to liability for a false registration statement are set forth.¹⁹³ In addition, it could have left the question of what constitutes a stale registration statement up to the courts.¹⁹⁴ Instead, Congress attached the staleness provision to section 11(a) which sets forth the liability for a false registration statement¹⁹⁵ and defined staleness in terms of a twelve month period for which

(2) that, in the case of a registration statement or report, he bought or sold a security of the registrant after the effectiveness of the registration statement or the filing of the report.

Id. For an explanation as to the alternative § 1704(a) formulations see notes 206-10 *infra* and accompanying text.

187. CODE, *supra* note 8, § 1704(d) provides:

DEFENSE OF CORRECTION.—A defendant has a defense if he proves that the misrepresentation or omission was corrected by means of a filing or press release or in any other manner reasonably designed to bring the correction to the attention of the investing public; but this defense is subject to the exceptions in section 1703(d).

Id.

188. CODE, *supra* note 8, §§ 1703(d), 1704(d) Source.

189. Congress added the 1933 Act staleness provision to § 11(a) by amendment in 1934. See notes 104-06 *supra* and accompanying text.

190. The Code does make one important improvement, however, in that it refers to the 1933 Act staleness provision and provides for the defense of correction in § 1703(d). See CODE, *supra* note 8, § 1703(d) Source. Section 1703 replaces § 12(2) of the 1933 Act. See CODE, *supra* note 8, § 1703(a) Comment. Section 12(2) of the 1933 Act imposes civil liability for untrue statements of a material fact (or an omission of a material fact) in a prospectus or oral communication used to offer or sell a security. 1933 Act, 15 U.S.C. § 771(2). No reference was made in § 12(2) to the staleness of financial information. Staleness was only incorporated into § 11(a). Under the Code, the notion that an original statement might become stale, is applied not only to registration statements, but to § 12(2) situations as well.

191. See note 104 *supra*.

192. 1933 Act, 15 U.S.C. § 77k(b) (1976).

193. "Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof. . . ." *Id.*

194. Congress chose to define a stale registration statement as one issued prior to an earning statement covering a twelve month period beginning after the effective date of the registration statement. 1933 Act, 15 U.S.C. § 77k(a) (1976).

195. *Id.*

a financial statement was issued.¹⁹⁶

To the extent that the Code modifies the 1933 Act staleness provision and applies it only to those situations where the defendant affirmatively corrects a prior statement,¹⁹⁷ it fails to address the problem. In the context of financial information, staleness is an objectively determined limitation on liability which occurs as a function of time and/or subsequent events.¹⁹⁸ It may occur as the result of an affirmative correction, but it need not be so restricted.¹⁹⁹ The distinction is especially important given the Code's implementation of continuous disclosure.²⁰⁰

Under sections 402 and 403,²⁰¹ issuers will register once and continuously disclose to the market pursuant to section 602²⁰² and procedures promulgated by the SEC.²⁰³ The purpose of disclosure is "to keep reasonably current the information and documents contained in the registration statement or to keep investors reasonably informed with respect to the registrant."²⁰⁴ The Code's emphasis on current information should be combined with a recognition that information loses its reliability over time. As was observed more than a century ago, "[t]here probably must be some limit."²⁰⁵

The 1933 Act staleness provision imposes liability for false registration statements on "directors and everybody in sight unless they have affirmatively shown (at least in some cases) that they made a reasonable investigation."²⁰⁶ Under the Code this stricter form of liability may be extended to the form 10-K annual report.²⁰⁷ The ALI membership was unable to agree as to whether

196. See note 103 *supra*.

197. See notes 184, 187 *supra*.

198. *Time*: Tucker v. Arthur Andersen, 67 F.R.D. at 476; Herz & Lewis, Inc. v. Union Bank, 22 Ariz. App. at 441, 528 P.2d at 191. *Subsequent Events*: Mitchell v. Texas Gulf Sulphur Co., 446 F.2d at 103; see notes 27-33 *supra* and accompanying text.

199. An affirmative correction is but one type of subsequent event which renders the prior statement stale.

200. See notes 7-9 *supra* and notes 201-05 *infra* and accompanying text.

201. CODE, *supra* note 8, §§ 402, 403. See also *Required Disclosure Under the Proposed Federal Securities Code*, *supra* note 6, at 1472.

202. CODE, *supra* note 8, § 602 (1980). See also *Required Disclosure Under the Proposed Federal Securities Code*, *supra* note 6, at 1472.

203. *Id.*

204. CODE, *supra* note 8, § 602(a) (1980).

205. Von Bruck v. Peyser, 25 N.Y. Super. Ct. at 478.

206. *Keynote Address*, *supra* note 7, at 1446.

207. *Id.* at 1446-47.

the section 11-type liability or that imposed under Rule 10b-5²⁰⁸ where the plaintiff must establish scienter,²⁰⁹ should apply to the annual report. As a result, "it will be a wide open question that is presented to Congress."²¹⁰ Before Congress enacts the Code, it should carefully examine the difference between the staleness provision it placed in section 11(a) of the 1933 Act and the ALI formulation which speaks solely in terms of a reasonable correction.²¹¹ This is an especially important consideration given the question of whether the stricter section 11-type liability will be extended to the annual report on form 10-K.²¹²

The Code stresses uniformity as its *raison d'être*.²¹³ If a staleness provision is incorporated into the civil liability sections²¹⁴ it should provide a guideline by which the courts²¹⁵ will be able to apply the concept of staleness in the context of a misrepresentation action.²¹⁶

208. *Id.*

209. *Id.* at 1447.

210. *Id.*

211. The 1933 Act staleness provision applies in a context which includes, but is not limited to, a defendant's correction of a prior statement. In addition, the Code discusses the use of an objective standard to evaluate the plaintiff's reliance. CODE, *supra* note 8, §§ 1703(d), 1704(d). The Code's Commentary asserts that, "[t]here is nothing magic about the one year period [placed in section 11(a) of the 1933 Act]. Rather, [the Code provisions] provide an incentive for prompt correction. At the same time, the plaintiff who can prove justifiable reliance on the uncorrected misrepresentation is not out of court." CODE, *supra* note 8, § 1703(d) Comment (2).

While it is true that a correction or any subsequent event (including a lapse of time), may cause the original statement to be stale prior to the issuance of a financial statement covering a twelve month period. It is advantageous, however, to provide the courts and the investment community with objective standards. See notes 34-65 *supra* (common law), notes 66-94 *supra* (bankruptcy law) and notes 129-157 *supra* (securities law) and accompanying text.

212. See notes 206-10 *supra* and accompanying text.

213. CODE, *supra* note 8, Introduction xix-xx.

214. See notes 188-212 *supra* and accompanying text.

215. CODE, *supra* note 8, § 202(92). See note 216 *infra*.

216. *Id.* § 202(96). Part XVI of the Code, CODE, *supra* note 8, §§ 1601-1614, consolidates all the existing provisions that concern fraud, misrepresentation or manipulation. *Id.* Part XVI Comment. Specifically, § 1602(a) is the "basic, omnibus, residual provision on fraud and misrepresentation" from which the other sections of part XVI are particularizations. *Id.*

Section 1602(a) provides:

(a) GENERAL.—It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to buy or sell a security, or an inducement not to buy or sell a security, (2) a proxy solicitation or other circularization of security holders with respect to a security of a registrant, (3) a tender offer or a recommendation to security holders in favor of

Because reliance has been eschewed throughout the Code,²¹⁷ the only available means of incorporating staleness is through the definition of materiality.²¹⁸ A guideline as to what constitutes stale financial information could be incorporated into the commentary without interfering with the language of the section.²¹⁹

Staleness is an especially important concept within an action al-

or opposition to a tender offer, or (4) any activity or proposed activity by an investment adviser with respect to a client or a prospective client.

Id. § 1602(a).

Definitions for fraud and misrepresentation are found in §§ 202(61) and 202(96). Misrepresentation is defined solely in terms of materiality, an objective standard set out in § 202(92).

Section 202(61) provides in pertinent part:

(61) FRAUDULENT ACT.—

(A) GENERAL.—“Fraudulent act” includes an act, device, scheme, practice, or course of conduct that (i) is fraudulent, or (ii) operates or would operate as a fraud.

(B) INACTION OR SILENCE.—Inaction or silence when there is a duty to act or speak may be a fraudulent act.

(C) KNOWLEDGE OR RECKLESSNESS.—Notwithstanding section 202(61)(A), a person engages in a fraudulent act only if he acts with knowledge that his conduct is of a type specified in that section, or in reckless disregard of whether his conduct is of that type.

Id. § 202(61).

Section 202(96) reads in pertinent part:

(96) MISREPRESENTATION.—

(A) GENERAL.—“Misrepresentation” means (i) an untrue statement of a material fact, of (ii) an omission to state a material fact necessary to prevent the statements made from being misleading in the light of the circumstances under which they are made.

Id. § 202(96).

Section 202(92) reads in pertinent part:

(92) MATERIAL.—

(A) GENERAL.—A fact is “material” if there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining his course of action.

Id. § 202(92).

217. Loss, *supra* note 11, at 389. (“The common law requirement which is incorporated in some current securities law provisions . . . is abandoned throughout the Code.”).

Justified reliance is required, however, under the sections 1703(d) and 1704(d) where the defendant has made a reasonable correction. See notes 184, 187 *supra*. Under the 1934 Act, the staleness of financial information has been considered with regard to materiality and reliance. See notes 129-39 (materiality) and notes 140-57 (justifiable reliance) *supra* and accompanying text. Materiality is the objective element of causation under the 1934 Act while justifiable reliance is a judicial hybrid which combines objective and subjective criteria. See notes 121-25 *supra* and accompanying text.

218. See note 216 *supra*.

219. The language of the Code’s definition of materiality has been expressly approved by the Supreme Court. See *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 445 (1976).

leging fraud and misrepresentation because of the Code's duty to correct. Sub-section 1602(b)²²⁰ creates an express duty where a material fact becomes a misrepresentation by reason of a subsequent event which occurs before the consummation of a sale or purchase.²²¹ Although the only proscription among the current securities statutes is found in a proxy rule, the Code notes that the case law points to a general duty to correct.²²² One of the cases cited is *Fischer v. Kletz*²²³ which concerned an accountant's failure to disclose information subsequently acquired thus making certified financial statements false.²²⁴ Just as the accounting profession found it necessary to establish an objective guideline in response to the *Fischer* decision,²²⁵ the Code should provide some indication as to the extent of the duty to correct. Incorporating staleness into the Code's definition of materiality²²⁶ would serve to limit the liability created by the new duty to correct.²²⁷

V. Conclusion

The Federal Securities Code represents an unprecedented opportunity for reform in the area of securities law. Although the Code's authors have observed that "in an age of incredible legal proliferation . . . [a] sense of perspective and sense of balance . . . are sorely missing and overlooked,"²²⁸ no attempt has been made to reexamine the disclosure philosophy reflected in existing securi-

220. CODE, *supra* note 8, § 1602(b) provides in part:

Duty to Correct.—(1) It is unlawful for any person to fail to correct (by means of a filing or press release or in any other manner reasonably designed to bring the correction to the attention of the investing public) a statement of a material fact that was made by him or on his behalf and by his authority in a communication (other than a filing) with respect to a matter within section 1602(a), and that becomes a misrepresentation by reason of a subsequent event occurring before—

(A) the consummation of the sale or purchase, or the termination of the acts constituting the offer or inducement, referred to in section 1602(a)(1).

Id.

221. *Id.*

222. *Id.* § 1602(b) Comment.

223. 266 F. Supp. 180 (S.D.N.Y. 1967).

224. See notes 146-50 *supra* and accompanying text.

225. See notes 151-57 *supra* and accompanying text.

226. See note 216 *supra*.

227. Section 1703(a) establishes liability for the violation of section 1602(b). See note 183 *supra*.

228. *Keynote Address, supra* note 7, at 1451 (Professor Loss paraphrasing Professor Wechsler of Columbia, Director of the ALI).

ties statutes.²²⁹ While continuous disclosure may be a desirable policy, it is also necessary to consider "the need to avoid the adverse consequences of setting too low a threshold for civil liability."²³⁰ Since financial information should not be relied upon indefinitely, an objective definition of staleness would be valuable. Expressed as a function of time, such a standard would provide a guideline for the courts and the financial community. The creation of a presumption that stale financial information is unreliable, would strike the necessary balance between responsible disclosure and reasonable liability.

Scott V. Simpson

229. *Id.* ("[W]e have not even reexamined the disclosure philosophy [because] Congress is not going to change [it].").

230. *TSC Indus., Inc., v. Northway*, 426 U.S. 438, 449 n.10 (1976).

