

1991

An Issuer's Duty under Rule 10b-5 to Correct and Update Materially Misleading Statements

Robert H. Rosenblum

Follow this and additional works at: <https://scholarship.law.edu/lawreview>

Recommended Citation

Robert H. Rosenblum, *An Issuer's Duty under Rule 10b-5 to Correct and Update Materially Misleading Statements*, 40 Cath. U. L. Rev. 289 (1991).

Available at: <https://scholarship.law.edu/lawreview/vol40/iss2/5>

This Article is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized editor of CUA Law Scholarship Repository. For more information, please contact edinger@law.edu.

AN ISSUER'S DUTY UNDER RULE 10b-5 TO CORRECT AND UPDATE MATERIALLY MISLEADING STATEMENTS

*Robert H. Rosenblum**

To the uninitiated, the general antifraud provisions of the federal securities laws might appear to be reasonably straightforward in their application. Loosely translated, after all, those provisions say "tell the truth and don't leave out anything important."¹ The initiated know better. Countless cases, treatises, and law review articles have examined, re-examined, and disagreed on when a participant in the securities markets has violated these provisions by telling a half-truth, by telling an outright lie, or by saying nothing at all.²

This Article focuses on when an issuer of securities can say nothing at all. It examines the still murky areas of when an issuer has a duty to correct a statement that it discovers was misleading when made (a "duty to correct"), and when an issuer has a duty to update a statement that was accurate when made, but later became misleading (a "duty to update"). Both duties arise under section 10(b)³ ("section 10(b)") and rule 10b-5 ("rule 10b-5")⁴ of the Securities Exchange Act of 1934.⁵

* Mr. Rosenblum is with the Washington, D.C. office of Fulbright & Jaworski. The author gratefully acknowledges the helpful comments of Jean W. Gleason, Esq. during the preparation of this Article.

Mr. Rosenblum prepared a portion of this Article while legal counsel to then-Commissioner Joseph A. Grundfest of the Securities and Exchange Commission. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are the author's and do not necessarily reflect the views of the Commission, of the Commission staff, or of Mr. Grundfest.

Except when referring to actual people, all gender specific language applies equally to both men and women.

1. See 15 U.S.C. § 78j(b) (1988); 17 C.F.R. § 240.10b-5 (1990).
2. Cf. *Blue Chips Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.")
3. 15 U.S.C. § 78j(b).
4. 17 C.F.R. § 240.10b-5.
5. This Article refers to the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1988), as the "Exchange Act." This Article refers to the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1988), as the "Securities Act."

The concept that an issuer has a duty to correct its own statements gained widespread judicial and academic acceptance following the decision of the United States District Court for the Southern District of New York in *Ross v. A.H. Robins Co.*⁶ *Ross* involved statements made by the A.H. Robins Company ("Robins") in two annual reports and a prospectus which indicated that the Dalkon Shield, a contraceptive device it manufactured, was safe and effective.⁷ Shareholders of Robins alleged that the company violated rule 10b-5 by failing to correct these statements after an unpublished research report concluded that the Dalkon Shield was not as safe or as effective as the earlier statements indicated.⁸ The court concluded that Robins' failure to correct its earlier statements was within the purview of rule 10b-5.⁹

An issuer's duty to update its own statements is in some respects similar to, but analytically is distinct from, its duty to correct its statements. Requiring an issuer to correct a statement that it discovers was wrong when made is somewhat different from requiring an issuer to continuously review the many true statements it makes, and to update those statements if and when they become inaccurate.¹⁰ The question of when such a duty might arise was presented as a central issue to the United States Court of Appeals for the First Circuit in *Backman v. Polaroid Corp.*¹¹ *Backman* involved a statement that allegedly became materially misleading after it was made in Polaroid's quarterly report.¹² A three-judge panel initially ruled that Polaroid breached a duty to update the statement.¹³ On rehearing *en banc*, however, the court essentially side-stepped the duty to update issue by holding that the statement in the quarterly report never became materially misleading.¹⁴

6. 465 F. Supp. 904, 908 (S.D.N.Y.), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

7. *Id.* at 907.

8. *Id.*

9. *Id.* Nonetheless, the district court concluded that plaintiffs could not maintain an action under rule 10b-5, holding instead that section 18 of the Exchange Act, 15 U.S.C. § 78r, which provides an express private right of action for misleading statements made in documents filed with the Commission, was the shareholders' exclusive remedy. 465 F. Supp. at 910-13. The court of appeals reversed the district court on this point, and held that the shareholders' rule 10b-5 claim was not precluded. 607 F.2d at 551-55.

10. Interestingly, the *Ross* court stated that "[i]t is now clear that there is a duty to correct or revise a prior statement which was accurate when made but which has become misleading due to subsequent events." 465 F. Supp. at 908. This statement literally recognizes a duty to update, although the factual situation in *Ross* involved a duty to correct. *Id.*

11. [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,899, at 94,937-3 (1st Cir.), *rev'd en banc*, 910 F.2d 10, 16-18 (1st Cir. 1990).

12. *Id.* at 94,938-39.

13. *Id.* at 94,943-45.

14. *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990).

Related to the question of whether an issuer has a duty to correct or update its own statements is the question of whether an issuer has a duty to correct or update misleading statements made about it by third parties, such as reporters and financial analysts. The nearly unanimous view of courts that have considered this question is that issuers ordinarily have no such duty.¹⁵

Courts that have considered whether an issuer has a duty to correct or update statements have done so without establishing a generally accepted framework for their analysis. Several United States Supreme Court decisions, however, particularly in the insider trading context, have created an analytical framework addressing the more general question of when defendants violate rule 10b-5 by failing to disclose material information. This Article applies this framework to the specific question of when defendants violate rule 10b-5 by failing to disclose material information necessary to correct or update misleading statements.

This Article concludes that rule 10b-5 imposes a general duty on issuers to correct their statements upon discovery that the statements were misleading when made. The Article also concludes that rule 10b-5 imposes on issuers a duty to update certain statements upon discovery that they became misleading at some time after they were made. This duty, however, applies only to statements that are “forward-looking”—statements that by their terms purport to continue to be valid beyond the date they are made. The Article then discusses certain limitations on when an issuer’s failure to correct or update misleading statements violates rule 10b-5. Next, the Article reviews some special considerations involving an issuer’s duty to update statements it made in a document it was required to prepare under rules or regulations of the Securities and Exchange Commission (“SEC or Commission”). Finally, this Article examines whether an issuer has a duty to correct or update rumors or misleading statements made by third parties. The Article endorses the nearly unanimous view of the courts that an issuer has no such duty unless the third party’s statements can be attributed to the issuer.

I. THE FRAMEWORK—WHEN IS THERE A DUTY TO DISCLOSE MATERIAL INFORMATION UNDER RULE 10B-5?

A. Background

Rule 10b-5 prohibits fraudulent conduct in connection with the purchase or sale of securities.¹⁶ Among the types of fraudulent conduct rule 10b-5

15. See *infra* notes 158-64 and accompanying text.

16. Rule 10b-5 provides that:

prohibits are the outright manipulation of securities prices,¹⁷ the making of statements that are materially misleading,¹⁸ and the omission of certain material information.¹⁹

If a defendant's failure to correct or update a misleading statement violates rule 10b-5, it does so because it constitutes an "omission" of material information.²⁰ By way of illustration, a plaintiff alleging a breach of a duty to correct or update a misleading statement alleges, in substance, that the defendant failed—or omitted—to disclose corrected or updated information, and that this omission violated rule 10b-5. Stating the same concept in customary securities law parlance, a defendant in such a case violated rule 10b-5 only if he had, and breached, an affirmative "duty to disclose" the corrected or updated information.

To date, the United States Supreme Court has not considered the circumstances under which an issuer acquires a duty to disclose corrected or updated information. Other federal courts have considered these duties,²¹ but have not provided a generally accepted framework for determining when such duties arise. However, the Supreme Court and lower federal courts have established, in other contexts, a framework to determine when a duty

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 or to omit to state 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.

17 C.F.R. § 240.10b(5) (1990).

17. *E.g.*, *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 474 (1977). "'Manipulation' is 'virtually a term of art when used in connection with securities markets.' The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Id.* at 476 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)).

18. *Id.* at 474-76.

19. *Id.* In addition to rule 10b-5, other antifraud provisions of the federal securities laws, such as Securities Act section 12(2), 15 U.S.C. § 77(j)(2) (1988), Securities Act section 17(a), 15 U.S.C. § 77q(a) (1988), and Exchange Act section 18(a), 15 U.S.C. § 78r(a) (1988), prohibit misleading statements in specified securities transactions and documents.

20. *See, e.g.*, *Ross v. A.H. Robins Co.*, 465 F. Supp. 904, 907 (S.D.N.Y.), *rev'd*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *see also Fischer v. Kletz*, 266 F. Supp. 180, 183-84 (S.D.N.Y. 1967) (accounting firm violated rule 10b-5 and the common law tort of deceit by remaining silent when it discovered financial statements it certified were materially misleading).

21. *See infra* notes 59-61 and accompanying text.

to disclose arises under rule 10b-5. This framework provides guidance in determining when a duty to disclose corrected or updated information arises.

B. *When is There a Duty to Disclose?*

The most significant Supreme Court cases addressing when a duty to disclose material information arises under rule 10b-5 are two insider trading cases, *Chiarella v. United States*²² and *Dirks v. SEC*.²³ These cases, among others, stress that rule 10b-5 does not itself impose a general affirmative duty to disclose material information.²⁴ Rather, according to the *Chiarella* and *Dirks* Courts, a defendant has an affirmative duty to disclose material information only if the defendant has a fiduciary or similar relationship that gives rise to an affirmative duty to disclose the omitted information, and if the defendant's failure to disclose that information would be fraudulent.²⁵

At first glance, this framework appears to be circular—it seems to suggest that an affirmative duty to disclose exists when there is a relationship giving rise to an affirmative duty to disclose, and that a breach of such a duty is fraudulent if it is fraudulent. Nonetheless, the framework suggests that

22. 445 U.S. 222 (1980).

23. 463 U.S. 646 (1983). It is not surprising that insider trading cases provided the Court with the opportunity to consider when rule 10b-5 imposes affirmative disclosure duties. A defendant in an insider trading case violates rule 10b-5 by breaching a duty to disclose material, nonpublic information prior to trading while in possession of that information. See, e.g., *Chiarella v. United States*, 445 U.S. 222 (1980); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). Thus, the question of when a defendant has such an affirmative disclosure duty is central to determining insider trading liability.

24. *Dirks*, 463 U.S. at 654; *Chiarella*, 445 U.S. at 235; see also *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5.").

25. *Dirks*, 463 U.S. at 653-54; *Chiarella*, 445 U.S. at 228-30. The *Chiarella* Court derived this holding in large part from the common law principle that an affirmative duty to disclose material information "arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" *Chiarella*, 445 U.S. at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)) (alteration supplied by Court). As an interesting aside, comment e to section 551(2)(a) states that "[i]t is not within the scope of this Restatement to state the rules that determine the duty of disclosure which under the law of business associations the directors of a company owe to its shareholders." RESTATEMENT (SECOND) OF TORTS § 551(2)(a) comment e (1976). The *Chiarella* Court did not address this disclaimer.

The *Chiarella* Court also relied heavily on the Commission's decision in *Cady, Roberts*, in which the Commission established that the relationship between a corporation's insiders and the corporation's shareholders, coupled with the unfairness of allowing insiders to trade in the corporation's stock while in possession of confidential corporate information, requires a corporation's insiders to abstain from trading in that corporation's shares unless they have first disclosed all material, nonpublic information of which they are aware. *Chiarella*, 445 U.S. at 227-28; *Cady, Roberts*, 40 S.E.C. at 911-12.

three issues must be addressed to determine when a duty to disclose arises: first, when does a fiduciary relationship exist; second, under what circumstances does that relationship give rise to an affirmative disclosure duty; and third, when is a breach of that duty fraudulent for purposes of rule 10b-5?

C. *A Closer Look at the Elements of the Chiarella and Dirks Test*

1. *When Does a Fiduciary Relationship Exist?*

According to the framework established in *Chiarella* and *Dirks*, the first question in determining if a defendant has a duty to disclose for purposes of rule 10b-5 is whether the defendant has a fiduciary or similar relationship with the plaintiff.²⁶ Neither *Chiarella* nor *Dirks* expressly addresses when such a relationship arises. In both cases, however, the Court appeared to agree with the formulation adopted by the United States District Court for the Southern District of New York in *United States v. Reed*,²⁷ an insider trading case. *Reed* held that, to determine whether a person has a fiduciary relationship with purchasers or sellers of a corporation's securities, a court should, among other considerations, look to whether " 'confidence is reposed on one side and there is resulting superiority and influence on the other.' "²⁸

Language from *Chiarella* strongly supports this formulation:

[A] duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or similar relationship of trust and confidence between them." . . . [In the insider trading context, which involves an affirmative duty to dis-

26. *Dirks*, 463 U.S. at 653-54; *Chiarella*, 445 U.S. at 228-30.

27. 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985). In *Reed*, the court held that a son who misappropriated information concerning a takeover from his father, a corporate director, might have had a confidential or fiduciary relationship with his father sufficient to support 10b-5 liability. *Id.* at 705.

As this Article went to press, the United States Court of Appeals for the Second Circuit, in an *en banc* decision, also agreed with the *Reed* formulation for determining when a fiduciary or similar relationship arises. *United States v. Chestman*, No. 89-1276, 1991 U.S. App. LEXIS 23242, at *51-*53 (2d Cir. Oct. 7, 1991) (*en banc*). The *Chestman* court, however, limited the *Reed* court's holding that a son and his father had a fiduciary or similar relationship to the facts of that case. *Id.* at *54-*55.

28. *Reed*, 601 F. Supp. at 706 (quoting 36A C.J.S. *Fiduciary*, at 384 (1961)).

The Supreme Court also appears to have employed the *Reed* formulation, in substance, outside the insider trading context. *See infra* note 57 (discussing *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972)). Other federal courts have employed the *Reed* formulation in various non-securities law contexts. *See, e.g.*, *Commodity Futures Trading Comm'n v. Heritage Capital Advisory Services, Ltd.*, 823 F.2d 171, 173 (7th Cir. 1987); *United States v. Margiotta*, 688 F.2d 108, 122 (2d Cir. 1982); *Francois v. Francois*, 599 F.2d 1286, 1292 (3d Cir. 1979), *cert. denied*, 444 U.S. 1021 (1980); *Roberts v. Sears, Roebuck & Co.*, 573 F.2d 976, 983 (7th Cir.), *cert. denied*, 439 U.S. 860 (1978); *Steinbrugge v. Haddock*, 281 F.2d 871, 874 (10th Cir. 1960).

close material, non-public information about a company prior to trading in that company's stock, such a duty arises from] a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the "necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders."²⁹

Moreover, both the *Chiarella* and *Dirks* Courts used the considerations identified in *Reed* to decide whether the defendants had a fiduciary or similar relationship with a corporation's shareholders that led to an affirmative duty to disclose confidential corporate information prior to trading. The *Chiarella* Court held that Mr. Chiarella, an employee of a financial printer who gleaned the identity of takeover targets from documents delivered to the printer, had no duty to publicly disclose this information prior to trading:³⁰

No duty could arise from [Mr. Chiarella's] relationship with the sellers of the target company's securities, for [he] had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.³¹

Similarly, in *Dirks*, the Court held that Mr. Dirks, a financial analyst who learned, from a former company official, that a company was engaged in a massive fraud, had no duty to publicly disclose this information prior to disclosing it to his clients, who then sold stock of the company.³² According to the Court, Mr. Dirks "was a stranger to [the company], with no pre-existing fiduciary duty to its shareholders. He took no action, directly or indirectly, that induced the shareholders or officers of [the company] to repose trust or confidence in him."³³

29. *Chiarella*, 445 U.S. at 228-29 (quoting *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956)) (footnotes omitted).

30. *Id.* at 225, 235.

31. *Id.* at 232-33. Some of the members of the Court would have found Mr. Chiarella liable on a "misappropriation" theory. See *infra* notes 51-56 and accompanying text.

32. *Dirks v. SEC*, 463 U.S. 646, 648-52 (1983).

33. *Id.* The *Dirks* Court also concluded that Mr. Dirks was not a tippee, because the corporate insiders who provided the confidential information to him "were motivated by a desire to expose the fraud" and "received no monetary or personal benefit for revealing [the fraud], nor was their purpose to make a gift of valuable information to [Mr.] Dirks." *Id.* at 666-67. See also *infra* note 49 and accompanying text (discussing tippee liability). Thus, the Court's decision in this regard can be read as concluding that Mr. Dirks had no fiduciary relationship with the insiders (and therefore had no fiduciary relationship with the corporation or its shareholders), because the insiders' disclosure to him was not a "confidence" and did not result in Mr. Dirks obtaining "superiority" or "influence" over those insiders.

2. *Under What Circumstances Does a Given Fiduciary Relationship Give Rise to a Particular Affirmative Disclosure Duty?*

Determining that a defendant has a fiduciary relationship with a plaintiff is only the first step in evaluating whether the defendant has an affirmative disclosure duty. As Justice Frankfurter observed in *SEC v. Chenery Corp.*:³⁴

But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?³⁵

There does not appear to be a generally accepted test to determine the scope of a particular fiduciary's affirmative disclosure duties. Instead, the Supreme Court has looked to a number of factors, such as the language of section 10(b) and rule 10b-5, the legislative history of the Exchange Act and of section 10(b), common law notions of fraud, and Commission interpretations of section 10(b) and rule 10b-5.³⁶

The *Chiarella* Court, for example, considered many of these sources when it concluded that a duty to disclose material, nonpublic information prior to trading arises from the fiduciary relationship between corporate insiders and the corporation's shareholders.³⁷ The Court first observed that neither the language nor the legislative history of section 10(b) discussed whether insiders had such a duty.³⁸ The Court, however, found that under both common law and Commission interpretations of section 10(b) and rule 10b-5, insiders

Indeed, the *Dirks* Court implicitly incorporated the considerations identified in *Reed* in its tests for determining when "tippees" (*see infra* note 49 and accompanying text) and "temporary insiders" (*see infra* note 50 and accompanying text) have fiduciary relationships giving rise to a duty to disclose confidential information prior to trading. Both tippees and temporary insiders (such as underwriters, accountants, and lawyers hired by the corporation) stand in a position of confidence with a corporate insider or with the corporation, and therefore indirectly with the corporation's shareholders: a tippee receives, albeit improperly, confidential information from a corporate insider (the "tipper"), and a temporary insider receives confidential information from the corporation to assist it in achieving corporate purposes. Both tippees and temporary insiders also must be in a position to influence a corporate insider or the corporation. A tippee must be able to influence his tipper, because the tipper must "benefit, directly or indirectly, from his disclosure" to the tippee. *Dirks*, 463 U.S. at 662. A temporary insider receives the confidential information from a corporation precisely so that he can assist, and thus presumably influence, the corporation.

34. 318 U.S. 80 (1943).

35. *Id.* at 85-86.

36. *See, e.g., Chiarella v. United States*, 445 U.S. 222, 226-29 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, 201, 212-14 (1976); *cf. Dirks*, 463 U.S. at 660-63. (relying in part on a SEC Commissioner's concurring opinion in a Commission administrative decision).

37. *Chiarella*, 445 U.S. at 226-30.

38. *Id.* at 226.

have a duty to disclose material, nonpublic corporate information prior to trading.³⁹

The Court has identified other considerations that may be used in appropriate instances. For example, a "longstanding acceptance by the courts [of a reasonable interpretation of section 10(b)], coupled with Congress' failure to reject [that interpretation], . . . argues significantly in favor of [its] acceptance."⁴⁰ In addition, it is appropriate to consider "what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance."⁴¹

3. *When is the Breach of an Affirmative Disclosure Duty Fraudulent for Purposes of Rule 10b-5?*

Not every breach of a fiduciary duty constitutes a violation of rule 10b-5. The breach must also involve fraud or deception.⁴² This requirement, however, generally should not be an issue in actions involving a breach of an affirmative disclosure duty by a fiduciary. *Chiarella* and *Dirks* make it clear that a fiduciary's omission in breach of an affirmative disclosure duty involves fraudulent conduct within the meaning of rule 10b-5.⁴³ The fraud requirement becomes an issue when, for example, the alleged breach of a

39. *Id.* at 226-29; see *supra* note 23 and accompanying text.

40. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975).

41. *Id.* at 737.

Until recently, the Ninth Circuit also employed a test, referred to as the "flexible duty standard," that was intended to determine the scope of an affirmative disclosure duty under rule 10b-5. The flexible duty standard required a court to consider five non-exclusive factors: the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transactions in question.

White v. Abrams, 495 F.2d 724, 735-36 (9th Cir. 1974) (footnotes omitted). The Ninth Circuit, however, "put to rest the 'flexible duty standard'" in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1570 (9th Cir. 1990). The *Hollinger* court stated that the flexible duty standard is a negligence test, and the Supreme Court, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), rejected a negligence test in favor of a scienter requirement for rule 10b-5 cases. *Hollinger*, 914 F.2d at 1570.

42. *Dirks v. SEC*, 463 U.S. 646, 654 (1983); see *Chiarella*, 445 U.S. at 234-35 ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."); *Santa Fe Industries v. Green*, 430 U.S. 462, 472-73 (1977) (violation of section 10(b) and rule 10b-5 must involve more than just a breach of a fiduciary duty, it must also involve deception).

43. *Dirks*, 463 U.S. at 653; *Chiarella*, 445 U.S. at 228-29; see also *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972) (bank and its officers violated rule 10b-5 by breaching a duty to members of an Indian tribe to disclose that a better price was available for sales of shares held by the Indians).

fiduciary duty involves fully disclosed conduct that unfairly benefits majority shareholders at the expense of minority shareholders.⁴⁴

Also, although not expressly at issue in *Chiarella* or *Dirks*, there are other elements that must be present for any conduct, including a fiduciary's breach of an affirmative disclosure duty, to violate rule 10b-5). Some of the more significant elements include the requirements that the defendant must have acted with scienter, the undisclosed information must have been material, the failure to disclose the information must have caused some harm to the plaintiff, the plaintiff must have relied on the omission, and the fraudulent conduct must have been in connection with the purchase or sale of a security.⁴⁵ Several of these elements impose significant limitations on when an issuer's failure to correct or update information violates rule 10b-5.

D. Examples of Affirmative Disclosure Duties

Before applying the test set forth in *Chiarella* and *Dirks* to determine when an issuer has a duty to correct and a duty to update misleading statements, it may be helpful to identify some of the other affirmative disclosure duties that courts have established, and the fiduciary or similar relationships giving rise to those duties. Perhaps the best-known example of an affirmative disclosure duty is the duty of corporate insiders to publicly disclose material, nonpublic information prior to trading while in possession of that information. This duty not to engage in "insider trading" arises from the fiduciary relationship corporate insiders, such as officers and directors⁴⁶ and

44. *E.g.*, *Santa Fe*, 430 U.S. at 474. In *Santa Fe*, minority shareholders alleged that they had received an inadequate price from a majority shareholder who employed a "short-form merger," a Delaware state law procedure that allows shareholders owning 90% or more of an issuer's outstanding stock to purchase the remaining stock at an announced price. Instead of exercising their statutorily authorized right to obtain a court appraisal, the minority shareholders brought an action under rule 10b-5 to set aside the merger. *Id.* at 465-67. The Court held that the complaint did not state a cause of action under rule 10b-5 because it did not involve deception or manipulation. *Id.* at 474. Rather, the Court characterized the complaint as alleging only "internal corporate mismanagement." *Id.* at 479 (quoting Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971)).

45. *See infra* notes 113-27 and accompanying text.

46. *See Dirks*, 463 U.S. at 654-55; *Chiarella*, 445 U.S. at 232; *see also* Exchange Act § 16(b), 15 U.S.C. § 78p (1988) (including officers and directors, among others, as insiders for purposes of the prohibition against insiders profiting from purchasing and selling the same security within a six-month period).

majority or controlling shareholders,⁴⁷ have with the non-controlling shareholders of the corporation.⁴⁸

“Corporate outsiders” also may have fiduciary relationships with a company’s shareholders that give rise to a duty to disclose confidential corporate information prior to trading. Among the corporate outsiders who may have such relationships are people who knowingly have improperly received confidential corporate information (so-called “tippees”),⁴⁹ and people who, while performing work for a corporation, legitimately receive confidential information (so-called “temporary insiders”).⁵⁰

47. *Superintendent of Ins.*, 404 U.S. at 12; *Pepper v. Litton*, 308 U.S. 295, 307 (1939); *List v. Fashion Park, Inc.*, 340 F.2d 457, 461 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951), *aff’d*, 235 F.2d 369 (3d Cir. 1956); 3 LOSS, SECURITIES REGULATION 1450 (2d ed. 1961); *see also* *Strong v. Repide*, 213 U.S. 419 (1909) (majority shareholder committed common law fraud by purchasing stock from another shareholder without disclosing material information); Securities Act Section 15, 15 U.S.C. § 77o (1988), and Exchange Act § 20(a), 15 U.S.C. § 78t(a) (1988) (imposing liability on certain controlling persons); *cf.* Exchange Act § 16(b), 15 U.S.C. § 78p (1988) (including 10% shareholders, among others, as insiders for purposes of the prohibition against insiders profiting from purchasing and selling the same security within a six-month period).

48. *See supra* notes 23, 25; *supra* note 29 and accompanying text. As the *Chiarella* Court put it, the fiduciary relationship that gives rise to the obligation not to trade while in possession of inside information prior to publicly disclosing it is “a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.” *Chiarella*, 445 U.S. at 228 (summarizing the Commission’s decision in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)).

49. *Dirks* discussed when tippees are liable for trading while in possession of confidential information received from a corporate insider.

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing [material, nonpublic] information to the tippee and the tippee knows or should know that there has been a breach.

Dirks, 463 U.S. at 660 (footnote omitted). An insider’s disclosure of material, nonpublic information breaches his fiduciary duty to the shareholders only if “the insider personally will benefit, directly or indirectly, from his disclosure.” *Id.* at 662; *accord Chiarella*, 445 U.S. at 230 n.12 (“‘Tippees’ of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider.”).

50. The *Dirks* Court specifically identified underwriters, accountants, lawyers, and consultants as examples of people who might acquire such a relationship. The basis for recognizing a fiduciary relationship on the part of temporary insiders is

that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. . . . For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

Dirks, 463 U.S. at 655 n.14 (citations omitted); *see, e.g.*, *SEC v. Tome*, 638 F. Supp. 596, 616-17 (S.D.N.Y. 1986); *SEC v. Lund*, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983).

Corporate outsiders also may have fiduciary relationships with third parties, such as their clients or employers, that serve as the basis for a duty to disclose confidential corporate information prior to trading. This is the case when a corporate outsider "misappropriates," or steals, confidential information about a company from a third party, if trading while in possession of that information would breach a duty created by a fiduciary or similar relationship with the third party.⁵¹ For example, investment bankers,⁵² lawyers,⁵³ employees of financial printers,⁵⁴ and newspaper reporters⁵⁵ who misappropriate material, nonpublic information about a company from their clients or employers, in breach of a duty created by a fiduciary relationship with their clients or employers, violate rule 10b-5 when they trade, or participate in schemes to trade, while in possession of that information.⁵⁶

51. *E.g.*, SEC v. Clark, 915 F.2d 439, 442-52 (9th Cir. 1990); United States v. Carpenter, 791 F.2d 1024, 1026, 1031-32 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981); United States v. Willis, 737 F. Supp. 269, 271-76 (S.D.N.Y. 1990); United States v. Elliott, 711 F. Supp. 425, 430-31 (N.D. Ill. 1989); United States v. Reed, 601 F. Supp. 685, 699-703, 719-20 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); SEC v. Musella, 578 F. Supp. 425, 438 (S.D.N.Y. 1984); *see also* United States v. Grossman, 843 F.2d 78, 79-82 (2d Cir. 1988) (lawyer found to have misappropriated information of a client's capitalization plan), *cert. denied*, 488 U.S. 1040 (1989); Rothberg v. Rosenbloom, 771 F.2d 818, 822-23, 824-25 (3d Cir. 1985) (Higginbotham, J., concurring) (directors of a corporation have a duty to disclose information concerning a potential merger).

Chief Justice Burger first suggested the misappropriation theory in his dissent in *Chiarella*. Chief Justice Burger would have imposed 10b-5 liability on Mr. Chiarella, who "misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence." *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting). The majority in *Chiarella* did not address the misappropriation theory because they did "not believe that a 'misappropriation' theory was included in the jury instructions." *Id.* at 237 n.21. In addition to Chief Justice Burger's dissent, however, four other Justices, in three separate opinions, expressed varying degrees of support for the misappropriation theory. *See id.* at 238 (Stevens, J., concurring); *id.* at 239 (Brennan, J., concurring); *id.* at 245 (Blackmun and Marshall, JJ., dissenting).

52. *E.g.*, *Newman*, 664 F.2d at 17.

53. *E.g.*, *Elliott*, 711 F. Supp. at 430-31; *see also* *Musella*, 578 F. Supp. at 438 (office manager of law firm found liable for misappropriating information regarding targets of tender offers).

54. *E.g.*, *Materia*, 745 F.2d at 203; *see also* *Chiarella*, 445 U.S. at 239-45 (Burger, C.J., dissenting) (misappropriation theory should apply to printer who acquires securities after acquiring inside information on his job).

55. *E.g.*, *United States v. Carpenter*, 791 F.2d 1024, 1026, 1031-32 (2d Cir. 1986); *see also* *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1266-71 (9th Cir. 1979) (newspaper reporter was required to disclose that he was writing favorably about a company whose stock he purchased cheaply to increase the value of that stock).

56. *See also* *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990) (refusing to dismiss charge that a psychiatrist misappropriated information from his patient); *SEC v. Clark*, 699 F. Supp. 839, 843-45 (W.D. Wash. 1988) (misappropriation theory applied to the president of a company's subsidiary who purchased stock in the target of a takeover by the company); *United States v. Reed*, 601 F. Supp. 685, 699-703, 719-20 (S.D.N.Y.) (misappropriation theory may

Corporate insiders and outsiders may have other affirmative disclosure duties that also stem from fiduciary relationships. For example, the Supreme Court has indicated that a fiduciary relationship may give rise to a duty to disclose material, nonpublic information when the fiduciary knows that purchasers or sellers of a corporation's securities are justifiably relying on him for their investments,⁵⁷ or when the fiduciary secretly is taking advantage of the confidential information at the expense of the shareholders.⁵⁸

II. AN ISSUER'S DUTY UNDER RULE 10B-5 TO CORRECT AND TO UPDATE ITS OWN STATEMENTS

A. Introduction

Those courts that have considered the issue generally have concluded that rule 10b-5 requires issuers to correct statements that they later learn were materially misleading at the time they were made.⁵⁹ Several courts have

apply to the son of a corporate director), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985). *Cf.* *United States v. Chestman*, No. 89-1276, 1991 U.S. App. LEXIS 23242, at *61 (2d Cir. Oct. 7, 1991) (en banc) (because a husband did not have a fiduciary or similar relationship with his wife, and thus could not misappropriate confidential information from her, a broker who learned of the confidential information from the husband was not liable under Rule 10b-5 for trading while in possession of that information).

57. For example, in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), officers of a bank acted as market makers in shares of a corporation that was formed by a group of American Indians. Because the value of the shares of the corporation was difficult to measure, the corporation asked the bank, its transfer agent, to stress to the Indian stockholders the importance of not selling the stock. *Id.* at 146. The bank officers knew that the stock was traded in two separate markets: a primary market of Indians selling to non-Indians and a resale market consisting entirely of non-Indians. The stock was traded at a higher price in the resale market than in the primary market. The Court found that the bank had assumed a duty to act on behalf of the Indian shareholders and that those shareholders relied on the bank when they sold their stock. *Id.* at 152-53. The Court held that this required the bank's officers to disclose to the Indian shareholders the existence of the more favorable non-Indian market prior to acting as market makers and inducing the Indians to sell their stock. *Id.*

58. For example, in *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963), the Court examined the fiduciary relationship that, by statute, investment advisers have with their clients. The Court held that this relationship requires an adviser to disclose to his clients his practice of purchasing securities for his own account shortly before recommending those securities to his customers, and then selling his securities at a profit following the increase in the market price resulting from the recommendation. *Id.* at 195-97.

59. *See, e.g.,* *Backman v. Polaroid Corp.*, 910 F.2d 10, 16-17 (1st Cir. 1990); *Ross v. A.H. Robins Co.*, 465 F. Supp. 904, 908 (S.D.N.Y.), *rev'd on other grounds*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Financial Industrial Fund v. McDonnell Douglas Corp.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,004, at 90,700-701 (D. Colo. 1971); *see also* *Craftmatic Securities Litig. v. Kraftsow*, 890 F.2d 628, 641 n.17 (3d Cir. 1989) ("[W]hen defendants voluntarily disclose information, they have a duty to disclose additional material facts only to the extent that the volunteered disclosure was misleading as to a material fact."); *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987) (misleading prior disclosures can create a duty to correct); *Rudolph v. Arthur Anderson & Co.*, 800 F.2d 1040, 1043

been more reluctant to conclude that an issuer has a duty to update statements that, while true when made, have become materially misleading,⁶⁰ although other courts have readily accepted that issuers have such a duty.⁶¹ Commentators generally have accepted that rule 10b-5 imposes on issuers a duty to correct, and on occasion have suggested issuers have a duty to update as well.⁶² There have been few attempts, however, to explain the basis for the imposition of these duties.

(11th Cir. 1986) ("Where a defendant's failure to speak would render the defendant's *own* prior speech misleading or deceptive, a duty to disclose arises." (emphasis in original)), *cert. denied*, 480 U.S. 946 (1987); *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 238 (6th Cir. 1985) (rule 10b-5 prohibits omissions of material facts necessary to make other statements not misleading), *cert. denied*, 475 U.S. 1015 (1986); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1317 (5th Cir. 1977) (defendant may have had a duty to disclose information that renders a prior statement misleading), *cert. denied*, 435 U.S. 952 (1978); *Rose v. Arkansas Valley Env't & Util. Auth.*, 562 F. Supp. 1180, 1207-08 (W.D. Mo. 1983) (defendant had a duty to disclose when he learned that his earlier statement was misleading when made); *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243 (S.D.N.Y. 1962) ("Fraud may be accomplished by . . . a failure to correct a misleading impression left by statements already made."); *cf. In re Apple Computer Securities Litig.*, 696 F. Supp. 490, 494-95 (N.D. Cal. 1987) (even if some of an issuer's statements in an article were misleading, the same article included corrective disclosure, thus there was no duty to correct those statements), *aff'd in part and rev'd in part*, 886 F.2d 1109 (9th Cir. 1989), *cert. denied*, 110 S. Ct. 3229 (1990).

60. *See, e.g., Backman*, 910 F.2d at 16-17; *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 758, 760 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985); *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 93-94 (2d Cir. 1981); *Shattuck Denn Mining Corp.*, 297 F. Supp. 470, 476 (S.D.N.Y. 1969); *see also Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989) (issuer not required to update projections in its periodic reports based on tentative internal estimates generated by its employees); *Panther v. Marshall Field & Co.*, 646 F.2d 271, 291-93 (7th Cir. 1981) (issuer not required to update projections to reflect new tentative estimates), *cert. denied*, 454 U.S. 1092 (1981).

61. *See, e.g., Good v. Zenith Electronics Corp.*, 751 F. Supp. 1320, 1322 (N.D. Ill. 1990); *Wenzel v. Patrick Petroleum Co.*, 745 F. Supp. 211, 220 (D. Del. 1990); *D & N Financial Corp. v. RCM Partners Ltd. Partnership*, 735 F. Supp. 1242, 1252 (D. Del. 1990); *In re Gulf Oil/Cities Service Tender Offer Litig.*, 725 F. Supp. 712, 746 (S.D.N.Y. 1989); *Kirby v. Cullinet Software, Inc.*, 721 F. Supp. 1444, 1450-51, 1454-55 (D. Mass. 1989); *In re Kulicke & Soffa Indus., Inc. Securities Litig.*, 697 F. Supp. 183, 185, 189-91 (E.D. Pa. 1988); *Kammerman v. Steinberg*, 123 F.R.D. 66, 72 (S.D.N.Y. 1988); *Fry v. Trump*, 681 F. Supp. 252, 258 (D.N.J. 1988); *In re Warner Communications Securities Litig.*, 618 F. Supp. 735, 752 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986); *Brascan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773, 787-88 (S.D.N.Y. 1979); *Thomas v. Duralite Co.*, 386 F. Supp. 698, 716 (D.N.J. 1974), *modified*, 524 F.2d 577 (3d Cir. 1975), *aff'd*, 559 F.2d 1209 (3d Cir. 1977); *SEC v. Century Investment Transfer Corp.*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,232, at 91,443 (S.D.N.Y. 1971).

62. *See, e.g.,* 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 9.27, at 9-137 to -138 (1990); GOELZER, SANGER, SUMMERGRAD & BERUEFFY, DISCLOSURE ISSUES, 19TH ANNUAL INSTITUTE ON SECURITIES REGULATION 9, 23 (1987); 5A A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 88.04[b], at 4-18 to -21 (1988); M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 2.02, at 2-4 to -6 (1988); Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935, 963-66 (1979); Block, Barton & Garfield, *Affirmative Duty to Disclose Material Informa-*

Under the framework suggested by *Chiarella* and *Dirks*, rule 10b-5 should impose on an issuer a duty to correct or update its own statements only if it has a fiduciary relationship, presumably with its shareholders, that gives rise to those duties. Thus, in determining whether rule 10b-5 imposes a duty to correct or update, the central issues are whether an issuer has a fiduciary relationship with its shareholders, whether that relationship gives rise to a duty to correct or update, and what limitations rule 10b-5 imposes on the scope of those duties.

By way of summary, the *Chiarella* and *Dirks* framework appears, on balance, to support the view of many courts that the privilege of raising money by selling securities should result in concomitant duties on the part of issuers to correct and update their own statements under appropriate circumstances. Most significant in this regard is that an issuer's relationship with its shareholders should give rise to duties to correct and update to prevent issuers from deceiving their shareholders into paying too much, or receiving too little, for their securities. This could occur if an issuer, to maintain an artificially high or low price for its securities, intentionally failed to correct or update a statement it made after learning that statement was, or had become, materially misleading.

tion Concerning Issuer's Financial Condition and Business Plans, 40 BUS. LAW. 1243, 1251 (1985); Brown, *Corporate Secrecy, the Federal Securities Laws, and the Disclosure of Ongoing Negotiations*, 36 CATH. U.L. REV. 93, 100 (1986); Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5*, 62 N.Y.U. L. REV. 1218, 1248-49 (1987); Goelzer, *Disclosure of Preliminary Merger Negotiations—Truth or Consequences?*, 46 MD. L. REV. 974, 977-78 (1987); Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U.L. REV. 1473, 1530 n.238 (1986); Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 787 n.168 (1985); Note, *Rule 10b-5 and the Corporation's Duty to Disclose Merger Negotiations: A Proposal for a Safe Harbor from the Storm of Uncertainty*, 55 FORDHAM L. REV. 731, 741-43 (1987); Comment, *Duty to Correct, a Suggested Framework*, 46 MD. L. REV. 1250, 1253 (1987); Note, *Corporate Officers' Duty to Speak Truthfully in Response to Market Rumors: Levinson v. Basic, Inc. Holds Preliminary Merger Negotiations to be Material Facts*, 18 TOLEDO L. REV. 627, 634 (1987); cf. Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 749-50 n.72 (1989) (discussing whether there is a duty to update); Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1366 (1966) (stating that "it would require no great extension of existing trends to read [rule 10b-5] as providing a general sanction for an issuer's failure to disclose where previous disclosures have become . . . misleading"); Schneider, *The Uncertain Duty to Update—Polaroid II Brings a Welcome Limitation*, 4 INSIGHTS, Oct. 1990, at 9 (supporting the *en banc* Backman decision); Schneider, *Duty to Update: Does a Snapshot Disclosure Require the Commencement of a Motion Picture?*, 3 INSIGHTS Feb. 1989, at 3 (proposing the Commission adopt a "safe harbor" rule allowing issuers not to update statements); Schneider, *Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?*, 23 REV. SEC. AND COMMODITIES REG. May 9, 1990, at 83 (proposing the Commission adopt a "safe harbor" rule allowing issuers not to update statements).

The *Chiarella* and *Dirks* framework does, however, reveal an important limitation on an issuer's duty to update that often was not identified by courts prior to the First Circuit's *en banc* decision in *Backman v. Polaroid Corp.*⁶³ An issuer should have a duty to update only "forward-looking" statements—statements that by their terms purport to continue to be valid beyond the date they were disseminated. An example of forward-looking statements to which a duty to update should attach are financial projections, which attempt to predict the issuer's financial condition in a future period.⁶⁴ By contrast, ordinary financial statements, which report an issuer's current or historical financial position, are an example of disclosures that are not forward-looking, and to which a duty to update should not attach. A duty to correct, on the other hand, should attach to both forward-looking and non-forward-looking statements.

B. Applying the Chiarella and Dirks Framework to an Issuer's Duty to Correct and Duty to Update

1. An Issuer's Fiduciary Relationship with its Shareholders

An issuer almost undoubtedly has a fiduciary or similar relationship with its shareholders.⁶⁵ Among other things, the shareholders collectively own

63. Compare *Backman*, 910 F.2d at 17 ("We may agree that, in special circumstances, a statement, correct at the time, may have a forward intent and connotation upon which parties may be expected to rely. If this is a clear meaning, and there is a change, correction, more exactly, further disclosure, may be called for.") with *Greenfield*, 742 F.2d at 758 ("[I]f a corporation voluntarily makes a public statement that is correct when issued, it has a duty to update that statement if it becomes materially misleading in light of subsequent events."). In *Greenfield*, however, the court noted that the defendant had argued that the statement that allegedly became misleading was not subject to a duty to update because, by its terms, it "spoke" only as of the day it was issued and thus literally could not be rendered misleading by subsequent events. *Id.* at 759. The court did not reach that issue because it held that the statement never became misleading in any event. *Id.* at 759-60.

64. See, e.g., *Good*, 751 F. Supp. at 1322; *Kirby*, 721 F. Supp. at 1450-51; *In re Kulicke*, 697 F. Supp. at 185, 189-91.

65. A number of courts and the Commission have suggested that an issuer must disclose material, non-public information prior to purchasing its own securities, thus implying that an issuer has a fiduciary or similar relationship with its shareholders that gives rise to such a duty. See, e.g., *Levinson v. Basic, Inc.*, 786 F.2d 741, 746 (6th Cir. 1986), vacated on other grounds, 485 U.S. 224 (1988); *Arber v. Essex Wire Corp.*, 490 F.2d 414, 418 (6th Cir.), cert. denied, 419 U.S. 830 (1974); *Green v. Hamilton International Corp.*, 437 F. Supp. 723, 728-29 (S.D.N.Y. 1977); *In re Carnation Co.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595 (July 8, 1985); *Disclosure of the Impact of Possible Fuel Shortages on the Operation of Issuers Subject to the Registration and Reporting Provisions of the Federal Securities Laws*, Securities Act Release No. 5447, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,607, at 83,629 (Dec. 20, 1973); *SEC Comment on Timely Disclosure of Material Corporate Developments*, Securities Act Release No. 5092, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,915, at 80,035 (Oct. 15, 1970). Other courts also have indicated that an issuer has a fiduciary or similar relationship with its shareholders for purposes of rule 10b-5. See, e.g.,

the issuer. The issuer's officers, directors, and controlling shareholders, through whom or at whose direction the issuer acts, have a fiduciary or similar relationship,⁶⁶ and it is difficult to understand how these individuals could acquire this relationship solely as a result of their affiliation with the issuer if the issuer itself did not have such a relationship. Further, the federal securities laws imply a fiduciary duty on behalf of issuers, subjecting them to, among other things, various registration and reporting requirements for the benefit of their public shareholders.⁶⁷

Stated more formally, a fiduciary relationship is suggested by the considerations expressly identified by the *Reed* court, and implicitly adopted by the Supreme Court, for determining when such a relationship exists.⁶⁸ An issuer's shareholders have reposed confidence in the issuer by virtue of having risked their money to purchase an ownership interest in it. This confidence results in superiority and influence on the part of the issuer, because the issuer's shareholders effectively delegate the conduct of most of the issuer's affairs to the issuer (operating, of course, under the direction of its officers and directors, who are also fiduciaries of the shareholders).

2. *Does an Issuer's Fiduciary Relationship with Its Shareholders Give Rise to a Duty to Correct or a Duty to Update its Own Statements?*

As previously discussed, the Supreme Court has identified a number of factors to assist in determining whether a given fiduciary relationship gives rise to a particular affirmative disclosure duty.⁶⁹ Taken together, these fac-

Staffin v. Greenberg, 672 F.2d 1196, 1203-04 (3d Cir. 1982); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 863 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *Kohler v. Kohler Co.*, 319 F.2d 634, 638 (7th Cir. 1963).

Several common law cases decided by federal courts have concluded that issuers have a fiduciary relationship with their shareholders. *See, e.g.*, *Seymour v. National Biscuit Co.*, 107 F.2d 58, 63 (3d Cir. 1939), *cert. denied*, 309 U.S. 665 (1940); *Shewmake v. Badger Oil Corp.*, 654 F. Supp. 1184, 1188 (D. Colo. 1987); *see also Kohler v. Jacobs*, 138 F.2d 440, 442-43 (5th Cir. 1943) (corporations may not defraud shareholders while repurchasing their shares from those shareholders). Other federal courts have taken the opposite view. *See, e.g.*, *Jordan v. Global Natural Resources, Inc.*, 564 F. Supp. 59, 68 (S.D. Ohio 1983); *Ericksen v. Winnebago Industries, Inc.*, 342 F. Supp. 1190, 1193 (D. Minn. 1972); *DuVall v. Moore*, 276 F. Supp. 674, 680 (N.D. Iowa 1967). At least part of the reason for these different positions may be that, according to some courts, the law of the state of incorporation determines the extent and nature of a corporation's relationship with its shareholders. *See, e.g.*, *Glazer v. Glazer*, 374 F.2d 390, 407 (5th Cir.), *cert. denied*, 389 U.S. 831 (1967).

66. *See supra* notes 46-48 and accompanying text.

67. *See* 15 U.S.C. § 78m (1988).

68. *See supra* notes 27-33 and accompanying text.

69. *See supra* notes 34-41 and accompanying text.

tors indicate that an issuer's relationship with its shareholders should give rise to a duty to correct and a duty to update.

(a) *The Language of Section 10(b) and Rule 10b-5, and the Legislative History of the Exchange Act and Section 10(b)*

Even though neither the language of section 10(b) nor the language of rule 10b-5 expressly imposes on issuers a duty to correct or update, these provisions are broad enough to encompass such duties, just as they are broad enough to prohibit insider trading without expressly doing so.⁷⁰ An issuer's failure to correct or update a misleading statement may, under appropriate circumstances, constitute a "deceptive device or contrivance"⁷¹ within the meaning of section 10(b). Most notably, an issuer, by intentionally allowing the securities markets to continue to set the price of its securities based in part on information that the issuer provided and that it now knows is, or has become, materially misleading, may well deceive its shareholders into paying too much, or receiving too little, for its securities.⁷²

In this regard, despite occasional statements that issuers generally have no interest in their outstanding stock,⁷³ there are a number of reasons why an issuer might want to deceive its shareholders to maintain an artificially high or artificially low price for its stock. For example, an issuer may want its stock trading at an inflated price so that it or its insiders will receive a higher price in an offering of its securities⁷⁴ or in a third-party's tender offer for its shares.⁷⁵ Having its shares trading at a higher price also may act as an effec-

70. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 230 (1980); see also *supra* note 25 and accompanying text (discussing *Chiarella*).

71. 15 U.S.C. § 78j(b) (1988).

72. See, e.g., *Ross v. A.H. Robins Co.*, 607 F.2d 545, 547 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); see also *Ross v. A.H. Robins Co.*, 465 F. Supp. 904, 907 (S.D.N.Y.) (plaintiffs alleged that the issuer, by breaching a duty to correct, presented a false and inflated picture of its financial condition, which allowed its securities to trade at a higher price than if accurate disclosure had been made), *rev'd*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Fischer v. Kletz*, 266 F. Supp. 180, 185 (S.D.N.Y. 1967) (harm caused by failure to correct a statement that is, or has become, misleading is that investors are "induced to act in reliance upon a representation which the representor knows has become false"); cf. *Basic, Inc. v. Levinson*, 485 U.S. 224, 228 (1988) ("Respondents alleged that they were injured by selling [the issuer's] shares at prices artificially depressed by petitioners' misleading statements and in reliance thereon.").

73. See, e.g., *Treadway Co. v. Care Corp.*, 638 F.2d 357, 377 (2d Cir. 1980); *Etshokin v. Texasgulf, Inc.*, 612 F. Supp. 1212, 1216 (N.D. Ill. 1984).

74. See, e.g., *Financial Industrial Fund v. McDonnell Douglas Corp.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,004, at 90,699-700 (D. Colo. 1971).

75. See, e.g., *Emhart Corp. v. USM Corp.*, 403 F. Supp. 660, 662 (D. Mass. 1975).

tive deterrent to a hostile takeover bid.⁷⁶ Alternatively, the issuer may want its stock trading at an artificially low price for purposes of, among other things, a stock repurchase.⁷⁷

For the same reason that it may be “deceptive” conduct for purposes of section 10(b), an issuer’s failure to correct or update its misleading statements may constitute a “device, scheme, or artifice to defraud,” in violation of rule 10b-5(a), or an “act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,” in violation of rule 10b-5(c).⁷⁸ An issuer, by intentionally withholding corrected or updated information, may cause its shareholders to pay too much or receive too little for its securities, if the price of those securities reflects information the issuer provided, but now knows to be or to have become misleading. This may be deemed to “defraud,” or to “operate as a fraud” on, those shareholders.

An issuer’s failure to correct or update its statements also might come within the ambit of rule 10b-5(b), which prohibits omissions 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.”⁷⁹ It is arguable, though, that the use of the phrase “in the light of the circumstances under which [the statements] were made,” requires the statements that omitted the material fact to have been misleading at the time they were made.⁸⁰ If so, an issuer might not be liable under rule 10b-5(b) for omitting corrected or updated information.

76. See, e.g., *Electronic Specialty Co. v. Int’l Controls Corp.*, 409 F.2d 937, 941 (2d Cir. 1969).

77. See, e.g., *Thomas v. Duralite Co.*, 386 F. Supp. 698, 708-712, 716 (D.N.J. 1974), *aff’d in part, vacated in part*, 524 F.2d 577 (3d Cir. 1975), *aff’d*, 559 F.2d 1209 (3d Cir. 1977).

78. 17 C.F.R. § 240.10b-5(a), (c) (1990).

79. *Id.* § 240.10b-5(b).

80. *But see* *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 93 (2d Cir. 1981) (“In many instances, an omission to state a material fact relates back to an earlier statement, and if it is reasonable to think that prior statement still stands, then the omission may also be termed a misrepresentation.”); *Brascan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773, 787 (S.D.N.Y. 1979) (issuer’s failure to update a press release that became misleading after it was issued is within the ambit of rule 10b-5(b)); A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 88.04[b], at 4-20 (1988) (while clause 10b-5(b) “may have been intended to prohibit half truths in the same document, it is literally broad enough to force a corporation to correct its own prior statement”). In addition, other provisions of the federal securities laws are worded to prohibit only statements that were misleading at the time they were made. For example, Exchange Act section 18(a), 15 U.S.C. § 78r(a) (1990), prohibits in documents filed under the Exchange Act statements that were materially false and misleading “at the time and in light of the circumstances” under which they were made. The fact that section 18(a) is so limited suggests that other antifraud provisions that do not contain a similar express limitation, such as rule 10b-5, should not be read to imply such a limitation.

Similarly, the legislative history of the Exchange Act and section 10(b) suggests that section 10(b) is broad enough to support the imposition of duties to correct and update misleading statements. Even though the Supreme Court has observed that "the intended scope of § 10(b) . . . [is not] revealed explicitly in the legislative history of the [Exchange] Act, which deals primarily with other aspects of the legislation,"⁸¹ the Exchange Act's legislative history at least implicitly demonstrates that one of the original purposes of section 10(b) was to ensure accurate and prompt dissemination of material corporate information to the investing public so that market forces could determine the price of an issuer's securities based on that information.⁸² This purpose presumably can encompass a requirement that an issuer correct or update its own statements when it knows those statements are or have become misleading, and when it knows the market is continuing to rely upon those misleading statements in determining the price of its securities.

(b) *Common Law Fraud*

Certain common law principles and cases provide significant support for the imposition on an issuer of a duty to correct, and some support for the imposition of a duty to update. At common law, a party to a business transaction generally owes to other parties to that transaction, prior to the consummation of the transaction, a duty to correct and update statements he discovers are, or have become, materially misleading.⁸³ This principle sup-

81. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976).

82. *See, e.g.*, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 858-59 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 11 (1934); S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933); H.R. REP. NO. 85, 73d Cong., 1st Sess. 8 (1933); *see also* *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988) ("Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and hence, any material misrepresentations."); *Santa Fe Indus. v. Green*, 430 U.S. 462, 477-78 (1977) ("the Court repeatedly has described the 'fundamental' purpose of the [Exchange] Act as implementing a 'philosophy of full disclosure'"); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963) (federal securities laws were intended "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*") (emphasis in original). It also is noteworthy that the preamble to the Securities Act states that its purpose is "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, ch. 38, Pub. L. No. 73-22, 48 Stat. 74 (1933).

83. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 551(2)(c) (1977); W. PROSSER & R. KEETON, THE LAW OF TORTS § 106, at 738 (5th ed. 1984). As previously discussed, the *Chiarella* Court quoted from section 551 with approval. *See supra* note 25.

Various federal and state cases have acknowledged that parties to business transactions have a common law duty to correct or update statements that later are found to be untrue or misleading. *E.g.*, *Robertson Oil Co. v. Phillips Petroleum Co.*, 871 F.2d 1368, 1373 (8th Cir. 1989) (applying Arkansas law); *Everman Nat'l Bank v. United States*, 756 F.2d 865, 869 (Fed.

ports, but only partially, imposing on an issuer a duty to its shareholders to correct or update materially misleading information. This support is qualified because an issuer generally is not a party to a "business transaction" with its shareholders. For the most part, once an issuer has sold its securities to the public, it is not a party to subsequent purchases or sales of those securities.⁸⁴ Frequently, an issuer strictly is not even a party to a business transaction with its shareholders when it sells its securities to the public. In a "firm commitment" public offering, for example, an issuer actually sells its securities to an underwriter, and it is the underwriter who (perhaps through additional intermediaries) sells those securities to the public.⁸⁵

Some common law courts have provided additional support for the imposition on issuers of a duty to correct. These courts have expanded the common law principle discussed above and have imposed on certain types of persons a duty to correct (but not a duty to update), even though those persons are not engaged in a business transaction—i.e., are not in "privity"—with defrauded purchasers or sellers of securities.⁸⁶ Perhaps the premier case in this regard is *Fischer v. Kletz*.⁸⁷ There, the United States District Court for the Southern District of New York held that an independent auditing firm owes a duty to the investing public to correct its certification of an issuer's financial statements when it learns that those statements were

Cir. 1985); *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 468 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981); *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453, 461 (2d Cir. 1968), *cert. denied*, 395 U.S. 920 (1969); *Fitzgerald v. McFadden*, 88 F.2d 639, 642-43 (2d Cir. 1937); *Loewer v. Harris*, 57 F.2d 368, 373-74 (2d Cir. 1893); *Fischer v. Kletz*, 266 F. Supp. 180, 184-86 (S.D.N.Y. 1967); *Mammas v. Oro Valley Townhouses, Inc.*, 131 Ariz. 121, 123, 638 P.2d 1367, 1369 (Ct. App. 1981); *St. Joseph Hosp. v. Corbetta Constr. Co.*, 21 Ill. App. 3d. 925, 953-54, 316 N.E.2d 51, 71-72 (1974); *U.S. Fidelity & Guar. Co. v. Black*, 412 Mich. 99, 127, 313 N.W.2d 77, 89 (1981); *Morykwas v. McKnight*, 37 Mich. App. 304, 306, 194 N.W.2d 522, 524 (Ct. App. 1971); *Bursey v. Clement*, 118 N.H. 412, 414, 387 A.2d 346, 348 (1978); *Bergeron v. DuPont*, 116 N.H. 373, 374, 359 A.2d 627, 628-29 (1976); *Susanoil, Inc. v. Continental Oil Co.*, 519 S.W.2d 230, 236 & n.6 (Tex. Ct. App. 1975).

84. An issuer engaged in repurchasing its shares from its shareholders would be a party to a business transaction with its shareholders. In such a case, though, the issuer has an independent duty to disclose material, nonpublic information, including material, nonpublic information correcting or updating previous statements, to avoid insider trading liability. See *supra* notes 65-68 and accompanying text.

85. For an explanation of an underwriter's role in firm commitment public offerings, see 1 L. LOSS & J. SELIGMAN, *SECURITIES REGULATION* 324-41 (3d ed. 1989).

86. This is consistent with rule 10b-5, under which plaintiffs need not prove privity; plaintiffs are not required to show that they sold their securities to, or purchased their securities from, the defendant. See, e.g., *Mount Clemens Indus., Inc. v. Bell*, 464 F.2d 339, 342-43 n.6 (9th Cir. 1972); *Herpich v. Wallace*, 430 F.2d 792, 805 n.12 (5th Cir. 1970); *Iroquois Indus., Inc. v. Syracuse China Corp.*, 417 F.2d 963, 968 (2d Cir. 1969), *cert. denied*, 400 U.S. 909 (1970); *Cochran v. Channing Corp.*, 211 F. Supp. 239, 245 (S.D.N.Y. 1962); A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10B-5* § 38.01[e][iv][H], at 2-114 (2d ed. 1990).

87. 266 F. Supp. 180 (S.D.N.Y. 1967).

materially misleading at the time of certification.⁸⁸ The *Fischer* court held that an auditing firm owes such a duty even though it is not in privity with the investors:

The common law has long required that a person who has made a representation must correct that representation if it becomes false and if he knows people are relying on it. This duty to disclose is imposed regardless of the interest of the defendant in the representation and subsequent nondisclosure.⁸⁹

According to a subsequent case, this duty derives from the auditor's relationship with the investing public:

Where it gives an opinion or certifies statements, an auditing firm publicly assumes a role that carries a special relationship of trust vis-a-vis the public. The auditor in such a case holds itself out as an independent professional source of assurance that the audited company's financial presentations are accurate and reliable. The importance of the act of certifying is such that a continuing duty to disclose has been imposed where the auditor learns facts revealing that a certification believed correct when issued was actually unwarranted.⁹⁰

Many cases following *Fischer* have emphasized, however, that an auditing firm's duty is limited to correcting its certification when it learns that the certification was misleading at the time it was made.⁹¹ An auditing firm generally has no duty to update a certification that was accurate at the time

88. *Id.* at 184-89. The court also held that plaintiffs' allegation that the auditing firm failed to correct its certification of the financial statements stated a claim under rule 10b-5. *Id.* at 189-94.

89. *Id.* at 188. *Fischer* is at odds with Judge Cardozo's well-known decision in *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), which held that an accounting firm owed no duty to persons with whom it was not in privity.

90. *Gold v. DCL Inc.*, 399 F. Supp. 1123, 1127 (S.D.N.Y. 1973) (citing *Fischer*, 266 F. Supp. at 180, other citations omitted).

91. See, e.g., *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1042-45 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987); *IIT, An Int'l Inv. Trust*, 619 F.2d 909, 927 (2d Cir. 1980); *Hirsch v. du Pont*, 553 F.2d 750, 761-62 (2d Cir. 1977); *United States v. Natelli*, 527 F.2d 311, 319 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976); *Robin v. Doctors Officenters Corp.*, 686 F. Supp. 199, 208 (N.D. Ill. 1988); *In re American Int'l Inc. Sec. Litig.*, 606 F. Supp. 600, 607 (S.D.N.Y. 1985); *Reingold v. Deloitte Haskins & Sells*, 599 F. Supp. 1241, 1257-59 (S.D.N.Y. 1984); *In re North Am. Acceptance Corp. Sec. Cases*, 513 F. Supp. 608, 635-36 (N.D. Ga. 1981); *Ingenito v. Bermec Corp.*, 441 F. Supp. 525, 548-50 (S.D.N.Y. 1977); *Kramer v. Scientific Control Corp.*, 365 F. Supp. 780, 789 n.10 (E.D. Pa. 1973), *dismissed in part and rev'd in part*, 534 F.2d 1085 (3d Cir. 1976); *In re Davy*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,482, at 86,559 (Jan. 25, 1984); see also *Latigo Ventures v. Lavenhol & Horwath*, 876 F.2d 1322, 1326-27 (7th Cir. 1989) (auditors are not under a continuing duty to disclose adverse financial information about a client; they may wait to report this information in their next audit report); *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 113, 15 N.E.2d 416, 419 (1938) (auditor's "business is to ascertain and state the true financial posi-

it was issued, but that subsequently became misleading.⁹² Instead, auditing firms may wait to report such updated financial information in their next audit reports.⁹³

At least one reason for this distinction between an auditing firm's duty to correct and its duty to update a certification is that the certification, by its terms, is not forward-looking. As opposed to predicting what an issuer's financial condition will be in the future, an auditor's certification states only that the issuer's financial statements fairly reflect the financial condition at the time of the issuance of those financial statements and the certification. Specifically, the standard auditor's certification, or report, states that the auditing firm has audited the issuer's balance sheet and other financial statements and that "[i]n our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [the issuer] as of (at) December 31, 19XX, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles."⁹⁴

tion of the company at the time of the audit, and his duty is confined to that' ") (quoting *In re London & Gen. Bank*, 2 N.Y. Ch. 673, 682 (1895)).

92. There are instances in which an auditing firm must update certifications that were true when made, but later were rendered misleading. For example, if an issuer is selling securities to the public, its auditor must conduct a reasonable inquiry to discover whether events subsequent to the audit period require it to update the certified financial statements appearing in the prospectuses. *E.g.*, *Ingenito*, 441 F. Supp. at 549 (citing *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643, 697-703 (S.D.N.Y. 1968)); *see also Rudolph*, 800 F.2d at 1044-45 (accounting firm had a duty to correct its certification of an issuer's financial statements, even though the certification had become misleading only after it was issued, because the accounting firm knew its certification was being used as part of a fraudulent scheme to raise money from investors).

Interestingly, the *Fischer* Court indicated that a distinction between certifications that initially were inaccurate and those that subsequently became inaccurate is unwarranted. According to the court, "the impact upon the person who relies on the representation is the same: he is induced to act in reliance upon a representation which the representer knows has become false." *Fischer*, 266 F. Supp. at 185.

93. *Latigo Ventures*, 876 F.2d at 1327.

94. AM. INST. OF CERTIFIED PUBLIC ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS § 411.01 (1991). Generally accepted accounting principles also require an auditor's certification to reflect certain material events occurring after the date of the financial statements, but prior to the issuance of the certification. *See id.* §§ 530, 560.

Also, generally accepted accounting principles expressly require an auditor to correct a certification if he discovers it was materially false or misleading when issued. *See id.* § 561; *cf. Robin v. Arthur Young & Co.*, No. 87 C 6222 (N.D. Ill. Dec. 14, 1988) (1988 U.S. Dist. LEXIS 14083) (citing section 561); *Reingold v. Deloitte Haskins & Sells*, 599 F. Supp. 1241, 1259 (S.D.N.Y. 1984). The SEC has agreed. *See, e.g., In re Schulzetenberg*, Exchange Act Release No. 26,103, 41 SEC Dkt. 1260, 1284 (Sept. 23, 1988); *In re Jacobs*, Exchange Act Release No. 23,644, 36 SEC Dkt. 768, 769 (Sept. 24, 1986); *In re Anderson*, Securities Act Release No. 6586, 33 SEC Dkt. 410, 411 (June 11, 1985); *In re Davy*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,482, at 86,559 (Jan. 25, 1984).

The principle that an auditing firm generally has no duty to update its certifications, while not supporting the imposition on issuers of a duty to update their statements, also does not rule out imposing such a duty on issuers in certain circumstances. Unlike an auditor's certification, an issuer's statements do not necessarily report only existing or historical matters. Rather, some statements, such as financial projections, may by their terms purport to continue to be valid beyond the date the statements were made. To the extent that an issuer's shareholders continue to rely on the validity of such a forward-looking statement in determining the appropriate price to purchase or sell the issuer's securities, the imposition on the issuer of a duty to update that statement should not be inconsistent with *Fischer* and its progeny.

This distinction between forward-looking statements by an issuer and certifications by an auditor underscores an important point about an issuer's duty to update (but not its duty to correct): a duty to update attaches only to statements that are forward-looking. Statements that by their terms do not purport to have continuing validity are not subject to a duty to update.⁹⁵ More will be said on this point later.

(c) *Commission Interpretations*

Commission pronouncements concerning an issuer's duty to correct and to update its misleading statements generally support the imposition of those duties on issuers. In a few instances, the Commission has stated that issuers have such duties.⁹⁶ Also, on a number of occasions, the Commission has

Finally, policy considerations also support the distinction courts have drawn between an auditor's duty to correct and an auditor's duty to update its certification. As one court explained:

Relations of trust and confidence between accountant and client would be destroyed if the accountant were duty-bound to make continuous public disclosure of all the client's financial adversities. And the costs of auditing would skyrocket to compensate the accounting profession for the enormous expansion in potential liability, not to mention the increase in the costs of publication.

Latigo Ventures, 876 F.2d at 1327; see also *Rudolph*, 800 F.2d at 1044 ("It would be asking too much to expect accountants to make difficult and time-consuming judgment calls about the nature of routine facts and figures turned up after a report has been completed.").

95. See *infra* notes 111-12 and accompanying text.

96. See, e.g., *SEC v. Mesa Ltd. Partnership*, Litig. Release No. 12,637, Fed. Sec. L. Rep. (CCH) ¶ 95,492 (Sept. 27, 1990); *In re Carnation Co.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595-96 n.6 (July 8, 1985); Integrated Disclosure: Proposed Implementing Amendments to Rules, Forms and Schedules Under the Securities Exchange Act of 1934; Proposed Clarification of Safe Harbor Rules for Projections Under the Securities Acts, Securities Act Release No. 6338, 23 SEC Dkt. 428-29 (Aug. 18, 1981); Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,938, 81,943 (June 25, 1979); see also *In re Funeral Directors Manufac-*

“reminded” issuers of the importance of prompt and accurate disclosure of material information.⁹⁷ Nevertheless, the Commission has not accompanied its support of the duties to correct and update with as extensive an analysis as it employed in opinions such as *In re Cady, Roberts & Co.*,⁹⁸ the case in which the Commission first concluded that insider trading violates rule 10b-5,⁹⁹ and upon which the *Chiarella* Court relied heavily in establishing the existence and scope of insider trading liability.¹⁰⁰ Accordingly, courts might not rely as heavily on the Commission’s interpretations regarding an issuer’s duties to correct and update as the *Chiarella* Court relied on the Commission’s *Cady, Roberts* decision.¹⁰¹ Moreover, at least one Commissioner of

turing and Supply Co., 39 S.E.C. 33, 34 & n.3 (1959) (stop order proceedings under Securities Act section 8(d) can be instituted only if the registration statement was materially misleading when it became effective, but not if it was accurate when it became effective and subsequently became misleading; the antifraud provisions of the Securities Act, however, apply to vendors who omit to tell purchasers of the subsequent developments); *In re Howard*, 1 S.E.C. 6, 9-10 (1934) (same).

97. See, e.g., Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,943 (June 25, 1979); Disclosure of the Impact of the Wage and Price Standards for 1979 on the Operation of Issuers Subject to the Registration and Reporting Provisions of the Federal Securities Laws, Securities Act Release No. 6001, 16 SEC Dkt. 277 (Nov. 29, 1978); Notice of Adoption of an Amendment to Rule 14a-9, etc., Securities Act Release No. 5699, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461 (Apr. 23, 1976); Disclosure of the Impact of Possible Fuel Shortages on the Operation of Issuers Subject to the Registration and Reporting Provisions of the Federal Securities Laws, Securities Act Release No. 5447, [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,607, at 83,629 (Dec. 20, 1973); Notice to Registrants Engaged in Defense and Other Long Term Contracts and Programs of the Need for Prompt and Accurate Disclosure of Material Information Concerning Such Activities, Securities Act Release No. 5263, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,852, at 81,865 (June 22, 1972); Timely Disclosure of Material Corporate Developments, Securities Act Release No. 5092, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,915, at 80,035 (Oct. 15, 1970); see also Exchange Act Release No. 10,365, 2 SEC Dkt. 346 (Aug. 27, 1973) (announcing settlement of an action alleging in part that a company failed to disclose timely inaccuracies in projections previously given to securities analysts).

Also, stock exchanges and the NASD typically impose on companies listed with them a general duty to disclose promptly all material information. See, e.g., NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 202.05 [hereinafter COMPANY MANUAL]; AMERICAN STOCK EXCHANGE, COMPANY GUIDE § 401(a), 402(a) [hereinafter AMEX GUIDE]; NASD MANUAL, Schedule D, Part II § 1(c)(13). Accordingly, the exchanges and the NASD require disclosure beyond that which rule 10b-5 requires. The exchanges, but not the NASD, often allow companies to withhold material information for valid business purposes. See COMPANY MANUAL, *supra*, § 202.01; AMEX GUIDE, *supra*, § 402(a).

98. 40 S.E.C. 907 (1961).

99. *Id.* at 911.

100. See *supra* note 25.

101. See *Chiarella v. United States*, 445 U.S. 222, 226-28 (1990) (discussing the Commission’s decision in *Cady, Roberts*).

the SEC (at the time he was a Commissioner) publicly has criticized the imposition of a duty to update.¹⁰²

(d) *Longstanding Judicial Interpretations and Policy Considerations*

The continued acceptance of the duties to correct and update also finds some support from the near unanimity of courts in acknowledging an issuer's duty to correct, the substantial judicial recognition of an issuer's duty to update, at least under appropriate circumstances, and the failure of Congress and the Commission to reject the existence of those duties.¹⁰³ This is

102. See, e.g., *Carnation Revisited: Toward an Optimal Merger Disclosure and Rumor Response Policy*, 18 Sec. Reg. & L. Rep. (BNA) No. 15, at 521 (summary of then-Commissioner Joseph A. Grundfest's address to the Federal Regulation of Securities Committee, American Bar Association) (available through the Commission); cf. *Merger Negotiations, Tender Offers Taken Up by Panelists at "SEC Speaks"*, 18 Sec. Reg. & L. Rep. (BNA) No. 11, at 345 (March 14, 1986) (reporting then-Commissioner Peters' view that the *Carnation* release "does not amount to imposing an affirmative duty of disclosure").

In his *Carnation Revisited* speech, then-Commissioner Grundfest supported the concept of a safe harbor from the duty to update. Adoption of such a safe harbor also recently was proposed in Schneider, *Duty to Update: Does a Snapshot Disclosure Require the Commencement of a Motion Picture?*, 3 INSIGHTS, Feb. 1989, at 3. See Schneider, *Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?*, 23 REV. OF SEC. & COMMODITIES REG., May 9, 1990, at 83. Citing to Mr. Schneider's earlier article, a drafting committee, consisting of members of the subcommittees of the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law, presented the Commission with a proposed safe harbor rule. Letter from Richard E. Gutman to David S. Ruder, Chairman of the Securities and Exchange Commission (Apr. 28, 1989). Members of the Committee on Securities Regulation of the Philadelphia Bar Association also wrote to the Commission expressing that committee's support for Mr. Schneider's safe harbor proposal. Letter from Donald S. Morton to David S. Ruder, Chairman of the Securities and Exchange Commission (May 1, 1989).

103. In addition, the continued imposition on issuers of duties to correct and update is supported by the apparent willingness of courts to impose on some third parties a duty to correct or update certain statements they make relating to an issuer. For example, independent auditors have a duty to correct their certification of an issuer's financial statements if the certification was misleading at the time of issuance. See *supra* notes 86-94 and accompanying text. Other courts have concluded that a person conducting a tender offer for an issuer's securities may have a duty to correct or update his statements concerning the tender offer. See, e.g., *Butler Aviation International, Inc. v. Comprehensive Designers, Inc.*, 425 F.2d 842, 843 (2d Cir. 1970); *In re Gulf Oil/Cities Serv. Tender Offer Litig.*, 725 F. Supp. 712, 727 (S.D.N.Y. 1989); *Kamerman v. Steinberg*, 123 F.R.D. 66, 70-72 (S.D.N.Y. 1988); *Fry v. Trump*, 681 F. Supp. 252, 256, 258-59 (D.N.J. 1988); see also *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1243-46 (3d Cir. 1989) (tender offeror did not violate rule 10b-5 because he provided updated information in a timely manner).

Other third parties also may have a duty to correct or update certain statements about an issuer. See, e.g., *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1317 (5th Cir. 1977) (financial institution), *cert. denied*, 435 U.S. 952 (1978); *Financial Institut. Fund v. McDonnell Douglas Corp.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,004, at 90,699-700 (D. Colo. 1971) (investment banker); see also *Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1066-71 (7th Cir. 1975) (underwriter had a duty to conduct a reasonable inquiry of the issuer's

true even though relatively few courts have purported to impose liability for the breach of either duty,¹⁰⁴ and few of the cases have attempted to provide a detailed explanation of the bases of those duties.¹⁰⁵

As frequently is the case with "policy considerations," arguments can be constructed to support or attack the wisdom of imposing duties to correct or update. In their support, the imposition of these duties on issuers will help ensure that the securities markets promptly receive material information that is necessary to prevent statements by issuers that are or have become misleading from distorting the price of the issuers' securities.¹⁰⁶ On the other hand, the potential liability resulting from breaches of a duty to correct or update may cause issuers to forego making many voluntary statements, thus depriving the securities market of a source of corporate information.¹⁰⁷ Also, some courts have suggested that disclosure of facts that are in a state of flux may be more misleading than silence.¹⁰⁸ Under this

financial statements), *vacated*, 425 U.S. 929 (1976), *subsequent proceedings in* 554 F.2d 790 (7th Cir. 1977), 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).

Courts have been more reluctant to impose corrective or updating duties on other third parties. *See, e.g.*, *Murphy v. McDonnell & Co.*, 553 F.2d 292, 295 (2d Cir. 1977) (stock exchanges); *National Union Fire Ins. Co. v. Deloach*, 708 F. Supp. 1371, 1378-85 (S.D.N.Y. 1989) (financial guarantee surety to individual limited partners); *National Union Fire Ins. Co. v. Eaton*, 701 F. Supp. 1031, 1034-39 (S.D.N.Y. 1988) (same). This frequently has been the case when the third party is a lawyer. *See, e.g.*, *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1124 (5th Cir. 1988); *Moore v. Fenex, Inc.*, 809 F.2d 297, 306 (6th Cir. 1987), *cert. denied*, 483 U.S. 1008 (1988); *Bender v. Rocky Mountain Drilling Assoc.*, 648 F. Supp. 330, 335 (D.D.C. 1986); *Bush v. Rewald*, 619 F. Supp. 585, 590-95 (D. Haw. 1985). *But see* *Morgan v. Prudential Group*, 527 F. Supp. 957, 960-61 (S.D.N.Y. 1981), *aff'd*, 729 F.2d 1443 (2d Cir. 1983); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 712-13 (D.D.C. 1978). Further, in the case of a lawyer, the imposition of a continuing duty to correct or update might impinge on the attorney-client relationship. *See, e.g.*, *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir. 1986).

104. *See supra* notes 59-61.

105. *See id.*

106. *Cf. In re Carnation Co.*, Exchange Act Release No. 22,214, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,595 (July 8, 1985).

The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be overemphasized. To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.

Id.

107. *See, e.g.*, *Uncertainty Over Merger Disclosure is Costly, Grundfest Tells ABA Group*, 18 Sec. Reg. & L. Rep. (BNA) No. 15, at 521 (April 11, 1986); *SEC Authority, Enforcement Issues Head Topics at San Diego Conference*, 18 Sec. Reg. & L. Rep. (BNA) No. 5, at 154 (Jan. 31, 1986).

108. *See, e.g.*, *Reiss v. Pan Am. World Airways*, 711 F.2d 11, 14 (2d Cir. 1983); *Staffin v. Greenberg*, 672 F.2d 1196, 1206 (3d Cir. 1982); *Susquehanna Corp. v. Pan Am. Sulphur Co.*, 423 F.2d 1075, 1084-85 (5th Cir. 1970); *cf. Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988)

line of reasoning, the requirement that an issuer involved in a tender offer, an ongoing business negotiation, or any other "fluid" situation continuously correct or update disclosures it has made might confuse shareholders more than it enlightens them. Further, forced, premature disclosure might interfere with, or possibly destroy, the successful completion of promising business opportunities.¹⁰⁹ Accordingly, policy considerations do not appreciably advance the argument that rule 10b-5 imposes a duty to correct and a duty to update, nor do they appreciably detract from the argument.

3. *The Scope of and Limitations on an Issuer's Duty to Correct and Duty to Update its Own Statements*

It is not enough simply to state that issuers have duties to correct and update their statements; it also is necessary to consider the obligations that are, and that are not, imposed by these duties. In this regard, one significant limitation on an issuer's duty to update already has been highlighted: a duty to update attaches only to forward-looking statements. As will be discussed, this limitation analytically flows from the fact that a duty to update arises only when subsequent facts or events render a prior statement misleading. Further, three of the requirements necessary in any rule 10b-5 action—scienter, materiality, and causation—impose other limitations on when an issuer's conduct constitutes a breach of a duty to correct or update under rule 10b-5.¹¹⁰

(too low a standard of materiality "might bring an overabundance of information within its reach, and lead management 'simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making'") (quoting *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976)).

109. See, e.g., *Staffin*, 672 F.2d at 1206.

110. See *infra* notes 113-27 and accompanying text.

The "reliance" and "in connection with" requirements do not impose any additional elements of proof in an action alleging a breach of a duty to correct or duty to update. As previously discussed, such cases involve omissions, as opposed to misrepresentations. In cases involving omissions, the reliance requirement is satisfied by a showing of materiality. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972); see also *Basic*, 485 U.S. at 243; *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970).

The "in connection with" requirement is satisfied by showing reliance. See, e.g., *Liberty Nat'l Ins. Holding Co. v. Charter Co.*, 734 F.2d 545, 555 (11th Cir. 1984); *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965). But see *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 941-45 (2d Cir.) (misrepresentations by an accounting firm about a company it audited, which induced banks to loan the company money and take as collateral a pledge of stock of the company's parent, were too attenuated to be "in connection with" the banks' purchase of the parent company's stock), cert. denied, 469 U.S. 884 (1984); A. JACOBS, *supra* note 86, § 38.01[b], at 2-43 (nexus between the fraud and the purchase or sale that is required by the "in connection with" clause defines "the type of wrongdoing actionable under Rule 10b-5," and "should be distinguished from causation, reliance and the test to determine what is misleading") (quoting *City Nat'l Bank v. Vanderboom*,

(a) *Limitation on the Duty to Update: the Duty Attaches Only to Forward-Looking Statements*

The limitation discussed earlier on an issuer's duty to update—that such a duty attaches only to forward-looking statements—analytically follows from the fact that a duty to update, by definition, arises only if a statement has become materially “misleading” due to subsequent events.¹¹¹ A forward-looking statement may become misleading as a result of subsequent events because such a statement, by its terms, purports to remain valid beyond the date it was made. Financial projections, for example, may become misleading if events occurring subsequent to the time they were disseminated significantly alter the economic or other assumptions forming the basis for those projections, or otherwise render those projections inaccurate. As the *en banc* court in *Backman* stated:

We may agree that, in special circumstances, a statement, correct at the time [it was made], may have a forward intent and connotation upon which parties may be expected to rely. If this is a clear meaning, and there is a change, correction, more exactly, further disclosure, may be called for.¹¹²

Subsequent events, however, should not cause a nonforward-looking statement to become misleading, because such a statement, by its terms, relates only to current or historical matters. For example, a press release announcing an issuer's positive first quarter financial results, but making no mention of the issuer's expected financial performance in the future, would not become misleading as a result of a severe and unexpected economic downturn in the second quarter. The issuer should not, therefore, have a duty to update such a press release. The issuer might, however, have a duty to update

422 F.2d 221, 229 n.8 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970)). Some courts also have suggested the “in connection with” requirement encompasses the “causation” requirement. *See, e.g., In re Financial Corp. of Am. Shareholder Litigation*, 796 F.2d 1126, 1130 (9th Cir. 1986); *Liberty Nat'l Ins. Holding Co.*, 734 F.2d at 555; *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1315 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978).

111. *See supra* notes 88-94 and accompanying text.

112. *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st. Cir. 1990); *see also Greenfield v. Heublin, Inc.*, 742 F.2d 751, 758-59 (1984) (defendant's “no corporate development” statement may have spoken only as of the date of the statement); *Kennedy v. Chomerics, Inc.*, 669 F. Supp. 1157, 1162 (D. Mass. 1987) (statement in a proxy statement spoke only as of the date of the annual meeting, and therefore was not required to be updated later); *Merger Negotiations, Tender Offers Taken Up by Panelists at “SEC Speaks”*, 18 Sec. Reg. & L. Rep. (BNA) No. 11, at 345 (March 14, 1986) (reporting that then-Commissioner Aulana Peters said that “‘You are always able to qualify your statement in some way to say “this is the situation as of right now,”’ . . . indicating that a company could avoid triggering an updating requirement by appropriately qualifying its statements”).

any financial projections it made in the first quarter if the downturn caused those projections to become misleading.

(b) *Limitations Arising from the Scierter Requirement*

The requirement that, to violate rule 10b-5, an issuer must have acted with scienter means that an issuer should be liable for breaching a duty to correct or update only if the issuer intended, or recklessly disregarded the possibility, that the misleading statement it failed to correct or update would affect the price of its securities.¹¹³ In other words, to act with scienter while breaching a duty to correct or to update, an issuer must have intended to defraud,¹¹⁴ or have recklessly disregarded the possibility of defrauding,¹¹⁵ purchasers and sellers of its securities when it breached that duty. As previously discussed, the aspect of an issuer's failure to correct or update misleading statements that could deceive or defraud its shareholders is the possibility that the market will base the price of the issuer's securities in part on the uncorrected or unupdated statement, causing the issuer's shareholders to pay or receive an unfair price for those securities.¹¹⁶ In this regard, the fact that an issuer gained, or was in a position to gain, from an artificial increase or decrease in the price of its securities caused by its breach of a duty to correct or update supports the argument that the issuer intended to defraud purchasers or sellers of its securities through that breach.¹¹⁷ On the other hand, an issuer who had nothing to gain from an increase or decrease in the price of its securities caused by its breach of a duty to correct or

113. See, e.g., *Thomas v. Duralite Co.*, 386 F. Supp. 698, 726 (D.N.J. 1974), *aff'd in part and vacated in part*, 524 F.2d 577 (3d Cir. 1975), *aff'd*, 559 F.2d 1209 (3d Cir. 1977); *Financial Indus. Fund v. McDonnell Corp.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,004, at 90,700 (D. Colo. 1971); *SEC v. Shattuck Denn Mining Corp.*, 297 F. Supp. 470, 476 (S.D.N.Y. 1968); see also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (the term "manipulative," as used in section 10(b), "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities"); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) ("Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public . . . if such assertions are false or misleading or are so incomplete as to mislead . . ."), *cert. denied*, 394 U.S. 976 (1969).

114. See, e.g., *Aaron v. SEC*, 446 U.S. 680, 691 (1980); *Ernst & Ernst*, 425 U.S. at 193-94 n.12.

115. See, e.g., *Van Dyke v. Coburn Enter.*, 873 F.2d 1094, 1100 (8th Cir. 1989); *Hackbart v. Holmes*, 675 F.2d 1114, 1117 (10th Cir. 1982); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-25 (6th Cir. 1979). The Supreme Court has reserved the issue as to whether recklessness satisfies the scienter requirement. *Aaron*, 446 U.S. at 686 n.5; *Ernst & Ernst*, 425 U.S. at 193 n.12.

116. See *supra* note 72 and accompanying text.

117. See, e.g., *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir. 1986); *Pittsburgh Terminal Corp. v. Baltimore & O. Ry.*, 680 F.2d 933, 942 (3d Cir.), *cert. denied*, 459 U.S. 1056 (1982).

update is less likely to have had the requisite intent to support a rule 10b-5 violation.¹¹⁸

(c) *Limitations Arising from the Materiality Requirement*

In the context of an issuer's duty to correct or update, the materiality requirement has a double-barreled application. First, it applies to the corrected or updated information, and indicates that an issuer will be liable for failing to disclose such corrected or updated information only if that information was "material." This means that there must have been a substantial likelihood that a reasonable shareholder would have considered the corrected or updated information important in deciding whether to purchase or sell the issuer's securities.¹¹⁹ In other words, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available.'"¹²⁰

Second, the materiality requirement applies to the misleading statement itself. Thus, an issuer has a duty to correct or update a misleading statement only as long as that statement still is material, that is, only so long as the misleading statement continues, in substantial likelihood, to be important to a reasonable shareholder in deciding whether to purchase or sell the issuer's securities, or to be viewed by the reasonable investor as having significantly

118. See, e.g., *Reiss v. Pan Am. World Airways*, 711 F.2d 11, 14 (2d Cir. 1983). Courts have differed in the importance they attach to whether a defendant in a rule 10b-5 action benefitted from its allegedly fraudulent conduct. Compare *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 858-62 (2d Cir. 1968) (corporation may be liable under rule 10b-5 for its misleading statements, regardless of whether the corporation or its insiders profit from the misleading statements), *cert. denied*, 394 U.S. 976 (1969) and *Fischer v. Kletz*, 266 F. Supp. 180, 190-93 (S.D.N.Y. 1967) (defendant need not gain from his fraud to be liable under rule 10b-5) with *Financial Indus. Fund v. McDonnell Douglas Corp.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,004, at 90,700-01 (D. Colo. Jan. 28, 1971) (issuer and its underwriter violated rule 10b-5 by failing to update overly optimistic financial information about the issuer where there was an incentive not to disclose negative information about the issuer to assist in a potential debt offering) and *SEC v. Shattuck Denn Mining Corp.*, 297 F. Supp. 470, 476 (S.D.N.Y. 1968) (refusing to impose liability on a corporation for failing to update a statement that had become misleading because there was no showing that the corporation derived any benefit from the nondisclosure). Cf. *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (fraudulent aspect of insider trading is the unfairness of allowing a corporate insider to take advantage of "information intended to be available for a corporate purpose and not for the personal benefit of anyone") (quoting *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)); *id.* at 654 ("[A]n insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information and thus makes 'secret profits.'") (quoting *In re Cady, Roberts & Co.*, 40 S.E.C., 907, 916 n.31 (1961)).

119. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1978).

120. *Basic*, 485 U.S. at 231-32 (quoting *TSC Indus.*, 426 U.S. at 449).

altered the total mix of available information.¹²¹ Stated somewhat more colorfully, an issuer has a duty to correct or update a misleading statement only while that statement still is "alive."¹²²

In addition, the materiality requirement suggests that issuers may satisfy a duty to correct or update in a variety of ways. An issuer's duty to correct or update requires it to disclose sufficient information so that an earlier voluntary statement no longer is materially misleading. Of course, an issuer will satisfy these duties by actually disclosing the information that rendered an earlier statement materially misleading.¹²³ In some circumstances, however, an issuer also may satisfy a duty to correct or update by disclosing only that the prior statement is materially misleading, without disclosing the corrected or updated information itself.

Consider, for example, an issuer that publicly and voluntarily has expressed interest in entering into an agreement with a retailing concern to sell certain items it manufactures to the retailer for not less than \$40 per item. Assume the issuer later determines that it might be willing to consider a lower price, say \$38 per item. If this development gives rise to a duty to update its "\$40-per-item" statement, the issuer clearly can satisfy that duty by publicly disclosing that it will now accept \$38 per item. But the issuer also might satisfy its duty to update by publicly disclosing that it may consider a lower price per item, without disclosing its new minimum price. (The issuer may have decided, for example, that not disclosing its minimum price would assist it in obtaining the highest possible price for the items.) As long as this updated statement informs purchasers and sellers of the issuer's securities that they no longer should consider the issuer's initial "\$40-per-item" statement important in deciding whether to purchase or sell the issuer's securities, and as long as the issuer does not have an independent duty

121. If the materiality requirement applied only to the corrected or updated information, but not to the misleading statement itself, issuers would have, in effect, a duty to disclose material corrected or updated information solely because that information was material. That would, of course, conflict with the Supreme Court's repeated admonishment that the possession of material information, by itself, does not give rise to an affirmative disclosure duty. See *supra* note 24 and accompanying text; cf. *Basic*, 485 U.S. at 238 ("[T]o prevail on a rule 10b-5 claim, a plaintiff must show that the statements were *misleading* as to a *material* fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant.") (emphasis in original).

122. *Ross v. A.H. Robins Co., Inc.*, 465 F. Supp. 904, 908 (S.D.N.Y.) (citing A. JACOBS, *THE IMPACT OF RULE 10B-5* § 88.04[b], at 4-14 (rev. 1978)), *rev'd*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); see also *Greenfield v. Heublein*, 742 F.2d 750, 760-61 n.2 (3d Cir. 1984) (Higginbotham, J., dissenting) (rule 10b-5 prohibits misrepresentations and omissions made "in a manner reasonably calculated to influence the investing public"), *cert. denied*, 469 U.S. 1215 (1985); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (same), *cert. denied*, 394 U.S. 976 (1969).

123. See, e.g., *Basic*, 485 U.S. at 230-32.

to disclose its new \$38 price (such as in a SEC disclosure form), the initial statement should no longer be materially misleading, and the issuer should have satisfied its duty to update.

(d) Limitations Arising from the Causation Requirement

An issuer will be liable for breaching a duty to correct or update information only if that breach proximately and foreseeably caused an economic loss to purchasers or sellers of its securities.¹²⁴ This suggests that a plaintiff alleging a breach of such a duty must demonstrate that, as a foreseeable result of the issuer's failure to update or correct a misleading statement, he purchased the issuer's securities for more, or sold them for less, than he would have had the issuer corrected or updated its statement.

The causation requirement also suggests several things about how an issuer should correct or update a misleading statement. To prevent a misleading statement from proximately and foreseeably causing shareholders an economic loss even after a corrected or updated disclosure has been made, the issuer should correct or update its disclosures in a way reasonably calculated to reach purchasers and sellers of their securities. Therefore, if possible, an issuer should disseminate the corrected or updated disclosure in the same manner in which it disseminated the initial, and now misleading, disclosure. The issuer also should consider issuing a press release, notifying any stock exchange on which its securities are listed, notifying financial publications and newswire services, and notifying interested financial organizations such as Moody's Investors Services and Standard & Poor's Corporation.¹²⁵ Further, to prevent a shareholder from purchasing or selling its securities at a time when the issuer knows of undisclosed material corrected or updated information, and thus to prevent the issuer from potentially becoming subject to rule 10b-5 liability, an issuer should promptly dis-

124. See, e.g., *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 20-21 (2d Cir. 1986), *cert. denied*, 429 U.S. 1066 (1987); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 708 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); see also *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988) ("The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss.").

125. See, e.g., *Prudent Real Estate Trust v. Johncamp Realty, Inc.*, 599 F.2d 1140, 1148 (2d Cir. 1979); *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Powell v. American Bank & Trust Co.*, 640 F. Supp. 1568, 1579 (N.D. Ind. 1986); COMPANY MANUAL, *supra* note 97, § 202.06; AMEX GUIDE, *supra* note 97, § 402(b); Bromberg, *Disclosure Programs for Publicly Held Companies—A Practical Guide*, 1970 DUKE L.J. 1139, 1161 (1970); see also *Texas Gulf Sulphur Co.*, 401 F.2d at 862 (rule 10b-5 is violated by a misrepresentation made "in a manner reasonably calculated to influence the investing public," which suggests that any correction should similarly influence the investing public).

seminate any required corrected or updated disclosures.¹²⁶ Whether an issuer promptly has made a correcting or updating disclosure depends on the facts of each case.¹²⁷

C. Special Considerations Concerning an Issuer's Duty to Update Disclosures in Documents that SEC Rules Require it to Prepare

1. Background

In the absence of a statute or a Commission rule or regulation to the contrary, section 10(b) and rule 10b-5 should impose on issuers the same duties to correct and update disclosures they make in documents that SEC rules require them to prepare ("mandatory disclosures") as issuers would have with respect to statements they make voluntarily, such as in press releases ("voluntary statements"). Nothing in the language of section 10(b), rule 10b-5, or the legislative history of the Exchange Act or section 10(b) suggests that the scope of the general antifraud provisions apply differently to voluntary statements than they do to mandatory disclosures. On the contrary, section 10(b) and rule 10b-5 expressly prohibit "any" deceptive acts or practices.¹²⁸ Similarly, case law,¹²⁹ Commission interpretations,¹³⁰ and policy considerations¹³¹ provide little basis for distinguishing between voluntary

126. See, e.g., *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1245-46 (3d Cir. 1989); *SEC Comment on Timely Disclosure of Material Corporate Developments*, Securities Act Release No. 5092, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,915, at 80,036 (Oct. 15, 1970); see also *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 103 (10th Cir.) (defendant's liability under rule 10b-5 ended when an investor reasonably should have become informed of a corrective press release), *cert. denied*, 404 U.S. 1004 (1971); *Good v. Zenith Elecs.*, 751 F. Supp. 1320, 1322 (N.D. Ill. 1990) (an issuer may have been required to update a financial forecast made in a press release as soon as the updated information "solidified," and may not have been entitled to wait until its next quarterly report to update the forecast); *D & N Fin. Corp. v. RCM Partners, Ltd.*, 735 F. Supp. 1242, 1252 (D. Del. 1990) (letter correcting statements made in a proxy statement was timely).

127. E.g., *Phillips Petroleum Sec. Litig.*, 881 F.2d at 1246.

128. 15 U.S.C. § 78j(b) (1988); 17 C.F.R. § 240.10b-5 (1990).

129. Courts frequently have imposed, or have been willing to impose, liability under rule 10b-5 for materially misleading mandatory disclosures. See, e.g., *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 75-77 (D.C. Cir.), *cert. denied*, 449 U.S. 1012 (1980); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 551-56 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *SEC v. Benson*, 657 F. Supp. 1122, 1131-32 (S.D.N.Y. 1987); see also Securities Act Rule 408, 17 C.F.R. § 230.408 (1990) (requiring a registration statement to include, in addition to the information expressly required, any other information necessary to make the required information not misleading); Exchange Act Rule 12b-20, 17 C.F.R. § 240.12b-20 (1990) (same with respect to information expressly required to be included in a statement or report); cf. *Issen v. GSC Enter.*, 538 F. Supp. 745, 751-52 (N.D. Ill. 1982) (issuer must provide all material information in an annual report).

130. See *supra* notes 96-102 and accompanying text.

131. See *supra* notes 106-09 and accompanying text.

statements and mandatory disclosures in the context of a duty to correct or update. Indeed, the *Ross* decision, which was discussed in the introductory portion of this Article,¹³² and which generally is viewed as one of the leading cases on the duty to correct, involved an issuer's failure to correct mandatory disclosures. Likewise, the *Backman* decisions, which also were discussed in the introductory portion of this Article,¹³³ involved an issuer's duty to update mandatory disclosures. Nonetheless, it may be helpful to consider the extent of an issuer's duty to update disclosures it makes in certain types of documents it is required to prepare under SEC rules.

2. *The Extent of an Issuer's Duty to Update Disclosures in Certain Documents*

(a) *Periodic Reporting Documents*

For the most part, an issuer should not have a duty to update many of the mandatory disclosures it makes in periodic reporting documents such as Annual Reports on Form 10-K¹³⁴ and Quarterly Reports on Form 10-Q.¹³⁵ These documents generally require issuers to make disclosures concerning previous fiscal periods and, with certain exceptions, do not call for forward-looking disclosures.¹³⁶

In this vein, the Commission does not expressly require an issuer to update information contained in its periodic reports until the issuer is required to file its next quarterly or annual report, unless one of the six events requiring an issuer to file a Current Report on Form 8-K¹³⁷ occurs. These six events are: a change in control of the issuer, the acquisition or disposition of assets by the issuer or its majority owned subsidiaries, the entry of the issuer into bankruptcy or receivership, a change in the issuer's certifying accountant, the resignation of one or more of the issuer's directors, and a change in the issuer's fiscal year.¹³⁸ Conversely, Form 8-K does not expressly require, although it does permit, an issuer to update other events that may affect prior disclosures in periodic documents: Form 8-K provides that "[t]he [issuer] may, at its option, report . . . any events, with respect to which infor-

132. See *supra* notes 6-9 and accompanying text.

133. See *supra* notes 11-14 and accompanying text.

134. 17 C.F.R. § 249.310 (1990).

135. *Id.* § 249.308a.

136. See generally SEC. AND EXCH. COMM'N, Form 10-K (1990) (previous fiscal year report); SEC. AND EXCH. COMM'N, Form 10-Q (1987) (previous fiscal quarter report); see also Form 10-K, General Instruction C(2) ("Except where information is required to be given for the fiscal year or as of a specified date, it shall be given as of the latest practicable date.").

137. 17 C.F.R. § 249.308.

138. SEC. AND EXCH. COMM'N, Form 8-K, Items 1-4, 6, 8 (1990).

mation is not otherwise called for by this form, that the registrant deems of importance to security holders."¹³⁹

Certain mandatory disclosures in periodic documents, however, may be forward-looking. Therefore, under appropriate circumstances, these disclosures may be the subject of a duty to update. Most notably, the "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") sections of Form 10-K¹⁴⁰ and Form 10-Q¹⁴¹ require an issuer to: identify known trends, demands, commitments, events or uncertainties affecting an issuer's liquidity and discuss proposed actions to remedy any identified deficiencies;¹⁴² describe material commitments for capital expenditures and anticipated sources of funding for those commitments;¹⁴³ describe known material trends in the issuer's capital resources and indicate expected material changes in the mix and relative cost of those resources;¹⁴⁴ and describe known trends or uncertainties that the issuer reasonably expects will have a material favorable or unfavorable impact on net sales, revenues, or income, and disclose any known events that will cause a material change in the relationship between costs and revenues.¹⁴⁵ In addition, the Commission's instructions for preparing the MD&A section state that "[t]he discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."¹⁴⁶

139. *Id.*, Form 8-K, Item 5. In addition, unlike other information in a Form 8-K, which must be reported within a specified time period, there is no mandatory time for filing a Form 8-K reporting information pursuant to Item 5. Registrants simply are encouraged to file such forms "promptly." *Id.*, Form 8-K, General Instruction 5.2; *see also* Securities Act Release No. 6383, 47 Fed. Reg. 11,387 (1982) ("Since reports pursuant to Item 5 are voluntary, the Commission believes it is inconsistent to establish a specific time by which such reports must be filed.").

140. SEC. AND EXCH. COMM'N, Form 10-K, Item 7.

141. SEC. AND EXCH. COMM'N, Form 10-Q, Item 2.

142. Regulation S-K, Item 303(a)(1), 17 C.F.R. § 229.303(a)(1) (1990).

143. *Id.*, Item 303(a)(2)(i), 17 C.F.R. § 229.303(a)(2)(i).

144. *Id.*, Item 303(a)(2)(ii), 17 C.F.R. § 229.303(a)(2)(ii).

145. *Id.*, Item 303(a)(3)(ii), 17 C.F.R. § 229.303(a)(3)(ii).

146. *Id.*, Item 303, Instruction 3 to paragraph 303(a), 17 C.F.R. § 229.303(a).

These various requirements call for the disclosure of forward-looking information despite the Commission's statement that issuers preparing an MD&A "are encouraged, but not required, to supply forward-looking information." *Id.*, Instruction 7 to Paragraph 303(a); *see also id.*, Instruction 6 to paragraph 303(b). The Commission expressly noted in a recent interpretive release concerning MD&A that "[s]everal specific provisions in Item 303 require disclosure of forward-looking information." Release No. 33-6835, 43 SEC Dkt. 1330, 1333 (May 18, 1989); *see also* E. FLEISCHMAN, ADDRESS TO THE ELEVENTH ANNUAL SOUTHERN SECURITIES INSTITUTE, THE INTERSECTION OF BUSINESS NEEDS AND DISCLOSURE REQUIREMENTS: MD&A, at 8-9, 17 (March 1, 1991) (edited and annotated) (noting that MD&A

The potential need to update such statements was highlighted in the *Backman* cases. Those cases involved, in part, an issuer's alleged failure to update a statement in a quarterly report to reflect that actual sales of a product were below the initially optimistic sales expectations. Under the particular facts of the case, however, the court eventually found that no duty to update arose because the statement in the quarterly report never became misleading.¹⁴⁷

(b) *Transactional Documents*

As compared to periodic reporting documents, "transactional documents" frequently call for forward-looking information that, under appropriate circumstances, may be subject to a duty to update.¹⁴⁸ In this context, the term "transactional documents" refers to documents such as prospectuses, through which issuers offer and sell their securities to the public; proxy statements, through which issuers seek to obtain shareholders' authorizations, or "proxies," to vote in a particular way on behalf of those shareholders at a shareholder meeting; and tender offer documents.

Transactional documents generally contain a number of forward-looking disclosures because their principal function is to advise shareholders (or potential shareholders) of pertinent facts about a transaction or event that will occur in the future. It also follows, however, that an issuer's duty to update forward-looking statements in such a document usually should continue only until the relevant transaction or event is consummated.¹⁴⁹ At that

disclosure is forward-looking and thus arguably subject to a duty to update under the *en banc* decision in *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990), but questioning whether such a duty must be satisfied immediately).

147. *Backman*, 910 F.2d at 16-17.

148. See, e.g., Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,938 (June 25, 1979).

With respect to forward-looking statements of material facts made in relation to specific transactions or events (such as proxy solicitations, tender offers, and purchases and sales of securities), there is an obligation to correct such statements prior to consummation of the transaction where they become false or misleading by reason of subsequent events which render material assumptions underlying such statements invalid.

Id. at 81,943.

149. See, e.g., *A.J. White & Co. v. SEC*, 556 F.2d 619, 623 (1st Cir. 1977); *SEC v. Manor Nursing*, 458 F.2d 1082, 1095-96 (2nd Cir. 1972); Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,943 (June 25, 1979); see also Exchange Act Rule 13e-3(d)(3), 17 C.F.R. § 240.13e-3(d)(3) (1990) (requiring an issuer or its affiliate to file a final amendment to its Schedule 13E-3 no later than ten days (or in some cases, ten business days) after the termination of the 13e-3 transaction); Exchange Act Rule 13e-4(c)(3), 17 C.F.R. 240.13e-4(c)(3) (requiring an issuer or its affiliate to file a final amendment to its schedule 13E-4 no later than ten business days after the termination of the 13e-4 transaction); Exchange Act Rule 14a-1(f), 17 C.F.R. § 240.14a-1(f) (1990);

point, the statements no longer will be forward-looking because they will then relate to a transaction or event that already has occurred, and thus no longer will be material, or "alive."¹⁵⁰

In addition to an issuer's duty under rule 10b-5 to update forward-looking statements in a transactional document, other SEC rules and regulations often expressly require an issuer to update all materially misleading disclosures in transactional documents prior to the consummation of the relevant transaction or event. For example, SEC rules require an issuer to update documents it prepares in connection with a "going private" transaction,¹⁵¹ a self-tender offer,¹⁵² a proxy solicitation,¹⁵³ and a tender offer by a third party.¹⁵⁴ In addition, Commission rules implicitly, although not expressly, require an issuer selling securities to the public to update the information contained in its prospectus during the course of the offering.¹⁵⁵

Exchange Act Rule 14a-2, 17 C.F.R. § 240.14a-2 (defining the term "solicitation" and requiring an issuer to comply with the proxy rules, and thus the rules requiring an issuer to update its proxy statement and information statement, only during a "solicitation of a proxy"); *cf.* RESTATEMENT (SECOND) OF TORTS § 551(2)(c) (1977) (stating that a "party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated . . . subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so").

150. *See supra* notes 119-22 and accompanying text.

151. *E.g.*, Exchange Act Rules 13e-3(d)(2), (e)(2), 17 C.F.R. §§ 240.13e-3(d)(2), (e)(2).

152. *E.g.*, Exchange Act Rules 13e-4(c)(2), (d)(2), 17 C.F.R. §§ 240.13e-4(c)(2), (d)(2).

153. *E.g.*, Exchange Act Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a); *see also* Exchange Act Rule 14c-6(a), 17 C.F.R. § 240.14c-6(a) (1990) (requiring issuers to update information statements).

154. *E.g.*, Exchange Act Rules 14d-3(b), -4(c), -6(d), -9(b), 14e-2(b), 17 C.F.R. §§ 240.14d-3(b), -4(c), -6(d), -9(b), .14e-2(b) (1990); *see also In re Revlon, Inc.*, 48 S.E.C. 496, 503-05 (1986) (rule 14d-9(b) requires the subject company to update promptly material information in its Schedule 14D-9).

155. *See* Securities Act Rule 424(b)(3), 17 C.F.R. § 230.424(b)(3) (1990). Courts also have recognized the duty of an issuer to update its prospectus during the pendency of an offering. *See, e.g.*, *A.J. White & Co. v. SEC*, 556 F.2d 619, 623 (1st Cir.), *cert. denied*, 434 U.S. 969 (1977); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1095-96 (2d Cir. 1972).

Other SEC rules and regulations also impose updating requirements on issuers. *See, e.g.*, Regulation S-K, Item 512(a)(1)(ii)-(iii), 17 C.F.R. § 229.512(a)(1)(ii)-(iii) (1990); Securities Act Rule 144A(d)(4)(i), 17 C.F.R. § 230.144A(d)(4)(i) (1990); Securities Act Rule 503(d), 17 C.F.R. § 230.503(d) (1990).

Further, SEC rules and regulations require various third parties to make and update disclosures about issuers. For example, officers, directors and significant shareholders must disclose and update their transactions in an issuer's securities. *See* Exchange Act Sections 13(d), (g), 15 U.S.C. §§ 78m(d), (g) (1990) (requiring reporting by 5% shareholders); Exchange Act Rule 13d-1, 17 C.F.R. § 240.13d-1 (1990) (same); Schedules 13D and 13G, 17 C.F.R. §§ 240.13d-101 to -102 (1990) (same); Exchange Act Section 16(a), 15 U.S.C. § 78p(a) (1988) (requiring reporting by officers, directors and 10% shareholders); Forms 3, 4, and 5, 17 C.F.R. §§ 249.103 to .105 (1990) (same). The securities laws and SEC rules and regulations also require a third party conducting a tender offer for an issuer's securities to update certain disclosures it is required to make. *See, e.g.* Exchange Act Sections 13(d)(2), (g)(2), 15 U.S.C.

(c) *Safe Harbor for Projections*

Finally, the Commission has expressly provided a "safe harbor" sanctioning the voluntary inclusion, in certain periodic reports and transactional documents, of specified projections and other forward-looking information.¹⁵⁶ The Commission, however, has expressly reminded issuers of their duty to correct and to update this information.¹⁵⁷

III. AN ISSUER'S DUTY UNDER RULE 10B-5 TO CORRECT AND TO UPDATE STATEMENTS MADE BY A THIRD PARTY

Courts almost uniformly have concluded that an issuer does not have a duty to correct misleading statements or omissions made about it by a third party.¹⁵⁸ For example, an issuer generally has not been required to correct third-party statements circulated about it in the press,¹⁵⁹ by a financial analyst,¹⁶⁰ or by other members of the financial community.¹⁶¹ Although

§§ 78m(d)(2) (g)(2) (1988); Exchange Act Rules 13d-2(a), -2(b), 17 C.F.R. §§ 240.13d-2(a), -2(b); Exchange Act Rules 14d-3(b), -6(d), 17 C.F.R. §§ 240.14d-3(b), -6(d).

156. Securities Act Rule 175, 17 C.F.R. § 230.175 (1990); Exchange Act Rule 3b-6, 17 C.F.R. § 240.3b-6 (1990).

157. Regulation S-K, Item 10(b)(3)(iii), 17 C.F.R. § 229.10(b)(3)(iii) (1990); Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,943 (June 25, 1979).

158. See, e.g., *Osofsky v. J. Ray McDermott & Co.*, 725 F.2d 1057, 1059 (2d Cir. 1984); *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, 850-51 (2d Cir. 1981); *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980); *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969); *Etshokin v. Texasgulf, Inc.*, 612 F. Supp. 1212, 1216 (N.D. Ill. 1984); *Zuckerman v. Harnischfeger Corp.*, 591 F. Supp. 112, 118-20 (S.D.N.Y. 1984); *Weintraub v. Texasgulf, Inc.*, 564 F. Supp. 1466, 1470 (S.D.N.Y. 1983); *Zucker v. Sable*, 426 F. Supp. 658, 662-63 (S.D.N.Y. 1976); *Hutto v. Texas Income Properties Corp.*, 416 F. Supp. 478, 482 (S.D. Tex. 1976); *Milberg v. Western Pac. R.R.*, 51 F.R.D. 280, 282 (S.D.N.Y. 1970). But see Report of Investigation in the Matter of Sharon Steel Corporation as it Relates to Prompt Corporate Disclosure, Exchange Act Release No. 18,271, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,049, at 84,615 (Nov. 19, 1981) [hereinafter "*Sharon Steel Report*"] (the Commission, in a report pursuant to Exchange Act section 21(a), indicated that an issuer had a disclosure duty when rumors surfaced that it held a large block of stock in the target of a potential takeover, when trading in the issuer's stock increased).

Also, stock exchanges often require immediate disclosure if rumors concerning material information develop. See COMPANY MANUAL, *supra* note 97, §§ 202.01, .03, .05; AMEX GUIDE, *supra* note 97, §§ 401(c), 402(c); see also *Elkind*, 635 F.2d at 162-63 n.8 (stock exchange may impose a disclosure duty); *Intercontinental Indus., Inc. v. American Stock Exch.*, 452 F.2d 935, 940 (5th Cir. 1971) (same), *cert. denied*, 409 U.S. 842 (1972).

159. See, e.g., *Electronics Specialty Co.*, 409 F.2d at 949; *Zucker*, 426 F. Supp. at 662-63; *Milberg*, 51 F.R.D. at 282; cf. *Panzirer v. Wolf*, 663 F.2d 365, 366-67 (2d Cir. 1981) (issuer could be liable for misstatements and omissions made in its annual report when a shareholder purchased securities after reading a favorable story about the issuer in the Wall Street Journal, because the misstatements and omissions affected the "integrity of the market"), *vacated*, 459 U.S. 1027 (1982).

160. See, e.g., *Elkind*, 635 F.2d at 163.

courts generally have addressed these issues in a duty to correct context, there is no reason to believe that the results would or should be any different in a duty to update context. Courts have held, however, that an issuer does have a duty to correct (and presumably a duty to update) a statement by a third party, if the issuer was "sufficiently entangled" in the preparation of the statement so that the statement can be attributed to it.¹⁶²

The principle reason why an issuer should not have a duty under rule 10b-5 to correct or update a statement by a third party is that an issuer's failure to correct or update such a statement is not "deceptive" conduct by the issuer. No doubt, rumors or other information circulated by third parties may well affect the price of an issuer's securities. The market, however, should appropriately discount the effect of those statements on the price of the issuer's securities to reflect that the source of those statements was not the issuer.¹⁶³ The issuer's failure to reveal what it knows about the third party statement, therefore, is not deceptive conduct by the issuer because it fails to mislead either the market or purchasers or sellers of the issuer's securities into treating the third party statement as though the issuer had indicated its agreement with, or "vouched" for, the accuracy of the statement. By contrast, an issuer that was so sufficiently entangled in the preparation of a statement that the statement can be attributed to it may well be viewed by the market, and by its shareholders, as having vouched for the accuracy of that statement. In such a case, the issuer is not so much required to correct or update a third party statement as it is required to correct or update a statement it has accepted as its own.

Moreover, there is little in the legislative history of section 10(b), common law fraud principles, or Commission interpretations of rule 10b-5 to support imposing a duty on issuers to update or correct third party statements.¹⁶⁴

161. See, e.g., *Fluor Corp.*, 654 F.2d at 850; *Zuckerman*, 591 F. Supp. at 118-20; *Weintraub*, 564 F. Supp. at 1470.

162. *Elkind*, 635 F.2d at 163. See *Fluor Corp.*, 654 F.2d at 850-51; *In re General Motors Class E Stock Buyout Sec. Litig.*, 694 F. Supp. 1119, 1129 (D. Del. 1988) ("A corporation may also have a duty to correct or verify rumors in the marketplace directly attributable to the company."); see also *Panzirer*, 663 F.2d at 366-67 (issuer could be liable for misleading statements it makes that result in a favorable press report that causes shareholders to purchase the issuer's securities); *Swanson v. Wabash, Inc.*, 577 F. Supp. 1308, 1321 (N.D. Ill. 1983) (target company may have a duty to correct misstatements by the tender offeror "when the target company's officers or directors act in concert with the offeror in a fraudulent scheme").

163. Cf. *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988) (the market price of publicly traded shares reflects all publicly available information).

164. In the *Sharon Steel Report*, the Commission did suggest that an issuer has a duty to correct rumors. *Sharon Steel Report*, *supra* note 158, at 84,615, 84,618-19. The Commission, however, did not bring suit to test this position, did not articulate a detailed justification in support of the position, and has not frequently reasserted this position.

The virtually unanimous judicial opposition to the imposition of such a duty, combined with the apparent acquiescence by Congress (and, to a large extent, by the Commission) to that opposition also is support for refusing to impose a duty on issuers to correct or update third-party statements.

In addition, there are significant policy arguments that support not imposing these duties on issuers. Among the arguments are that the imposition of a duty on issuers to correct or update third party statements could increase issuers' costs by requiring them to monitor constantly all statements made about them. These duties could well require issuers to make disclosures that, in their business judgment, are better left undisclosed. These duties also could allow competitors and others to compel issuers to disclose confidential information by circulating unfounded rumors about the issuers. There are, of course, policy arguments that support the imposition of these duties. Most notably, the imposition of these duties would further the goal of ensuring that the information investors receive is accurate. This benefit, however, is heavily outweighed by the significant costs and burdens the imposition of a duty to correct or update third party statements would entail.

Finally, even if issuers have such duties, there is some question as to whether breaches of them would provide the requisite causation to support a rule 10b-5 action. Specifically, for the same reasons that it is not deceptive conduct, an issuer's failure to correct or update a materially misleading third party statement may not constitute a proximate and foreseeable cause of an economic loss sustained by a shareholder who purchased or sold the issuer's securities based on the third party's statement. Such a case also might pose a difficult scienter question, because the plaintiff would be required to identify some fraudulent scheme or activity the issuer intended to further through its failure to correct or update the third party's misstatement.

IV. CONCLUSION

An issuer's shareholders should be able to rely on the accuracy of statements made by that issuer when determining whether to purchase or sell its securities. An issuer, however, should not be required to review continuously every disclosure it ever made to ensure that none of them have become in any way inaccurate. Rule 10b-5 strikes a reasonable balance between these competing concerns. It requires issuers to correct and to update their statements when the failure to do so would defraud their shareholders. The rule also recognizes that not every failure to correct or update a misleading statement is fraudulent. Accordingly, allegations involving an issuer's breach of a duty to correct or update cannot be resolved simply by reciting that issuers have such duties. The more pertinent question, which inevitably

must turn on the facts of each case, is whether that particular issuer had a duty to correct or update the particular statement identified by the plaintiff.