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Corporations - Securities Regulation - Material Misstatements of Omissions of Fact Under the Securities Act of 1933

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CORPORATIONS — SECURITIES REGULATION — MATERIAL MISSTATEMENTS OR OMISSIONS OF FACT UNDER THE SECURITIES ACT OF 1933—Plaintiff sued for rescission of his purchase of stock in a corporation under section 12 (2) of

the Securities Act of 1933[1] (hereafter referred to as the act) alleging a material misleading statement of fact in the prospectus. The alleged misstatement was that defendant was an "underwriter (as defined pursuant to the Securities Act of 1933 as amended)." No further explanation of defendant's status and consequent obligation was made in the prospectus. Defendant had agreed in fact to be only a "best efforts" underwriter. The trial court found that the statement was misleading and material. On appeal, *held,* affirmed. Defendant's statement conveyed the impression that he had made a "firm commitment" to dispose of the entire issue. *Dale v. Rosenfeld,* (2d Cir. 1956) 229 F. (2d) 855.

One of the basic purposes of the various federal acts regulating securities and security transactions is to require the disclosure of all information necessary for an investor to deal intelligently in the market.[2] These statutes prescribe liability or deny registration where there are material misstatements or omissions of fact which tend to mislead.[3] What constitutes a material misstatement or omission under section 12 (2) of the act has been explored in only two previous cases. One case suggested that a statement that the securities in question did not have to be registered was material when the buyer was a dealer in securities.[4] The other said it was material that a buyer was led to believe that the market was going to be manipulated to the mutual advantage of the buyer and seller.[5] No distinction is found in the principal case, however, between the interpretation given these terms in section 12 (2) and the meaning ascribed to them in connection with stop-order proceedings under section 8 (d), and the court in fact relies on one of these latter cases.[6] In that case the registration statement issued by the respondent represented that the underwriter had agreed to "take down" the issue. This statement was ambiguous and in fact the underwriter had only agreed to use his best efforts to sell the stock. The Securities and Exchange Commission pointed out that the early investor stands to lose his entire investment unless substantially all of the expected consideration of a new corporation's issue of stock is received. It is only by having sufficient funds with which to operate that any firm can make a profit. If there is a firm commitment by the underwriter to take the unsold shares, the investor takes only the risk that the

1 48 Stat. 84 (1933), 15 U.S.C. (1952) §77*l* (2).

2 LOSS, SECURITIES REGULATION 76 et seq. (1951).

3 "The term 'material' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered." 17 C.F.R. §240.12b-2 (j) (1949). The various statutes seem to have the same tests as to what constitutes a "misstatement" of a "material" fact. See LOSS, SECURITIES REGULATION 1018 (1951).

4 Moore v. Gorman, (S.D. N.Y. 1948) 75 F. Supp. 453.

5 Rosenberg v. Hano, (3d Cir. 1941) 121 F. (2d) 818.

6 Livingston Mining Co., 2 S.E.C. 141 (1937). Cf. Thomas Bond, Inc., 5 S.E.C. 60 (1939).

firm will not be able to make money, given adequate financing. He does not incur the additional risk of an unsuccessful stock issue. In a similar case the Securities and Exchange Commission decided it was misleading to say that there was a firm commitment if the underwriter did not have sufficient capital with which to purchase the issue.[7] Other cases under this section indicate that the names of all of the underwriters must be set out so that the investor does not lose his right to sue by lack of information as to the possible defendant.[8] Likewise, the names of the promoters are material.[9] If a corporation has been experiencing labor difficulties, the name of the company's labor relations man may be a material fact.[10] The same is true if the accountants who certified the financial statements were not in fact independent.[11] Statements must not only be true but must not leave a false impression.[12] Even though a statement need not have been made, if made it must meet the standards of required information.[13] If a coined term is used, it must be defined.[14] The history of a firm, especially of a new firm, is sufficiently important to an investor that it must be full and accurate.[15] In many small, closely held corporations the same lack of system which gives rise to inaccurate histories gives rise to inaccurate financial information. If the financial statements have been prepared from records which in themselves are inadequate, this fact must be disclosed.[16] This would seem to be so even though the accountant is reasonably sure that his statements do in fact reflect past operations and the present standing of the corporation. It stands to reason that the financial data must not only be technically correct, but must be presented in such a way as not to be misleading. Inventory adjustments which result in a substantial change in net profit must be reflected,[17] and they must be set forth in such a way as not to lead one to think that the profits of the corporation are increasing.[18] A statement that film studios could be rented for $100 per day with no obligation to pay for days on which the corporation was not shooting was misleading when there was a commitment to use the studio for at least 100 days a year.[19] Actual or potential litigation which will affect the position of the company must be set out in full.

7 Potrero Sugar Co., 5 S.E.C. 982 (1939).
8 Sweet's Steel Co., 4 S.E.C. 589 (1939); Livingston Mining Co., note 6 supra.
9 Oklahoma-Texas Trust v. S.E.C., (10th Cir. 1939) 100 F. (2d) 888; Comstock-Dexter Mines, Inc., 10 S.E.C. 358 (1941).
10 Central Specialty Co., 10 S.E.C. 1094 (1942).
11 Red Bank Oil Co., 21 S.E.C. 695 (1946).
12 S.E.C. v. Macon, (D.C. Col. 1939) 28 F. Supp. 127.
13 Shawnee Chiles Syndicate, 10 S.E.C. 109 (1941).
14 Ibid.
15 Livingston Mining Co., note 6 supra.
16 Livingston Mining Co., note 6 supra; Automatic Telephone Dialer, Inc., 10 S.E.C. 698 (1941).
17 Globe Aircraft Corp., 26 S.E.C. 43 (1947).
18 Kaiser-Frazer Corp. v. Otis & Co., (2d Cir. 1952) 195 F.(2d) 838, cert. den. 344 U.S. 856 (1952).
19 Shonts v. Hirliman, (D.C. Cal. 1939) 28 F. Supp. 478.

This includes litigation against a regulatory commission to enjoin enforcement of its decision in favor of the registrant,[20] possible liability for misstatements or omissions under the act itself,[21] as well as any possible litigation which may affect rights in the firm's assets.[22] It would seem that the Securities and Exchange Commission and the courts are in substantial agreement as to the meaning of material misstatements or omissions, for the principal case employs in an action under section 12 (2) the meanings of these terms developed by the commission in connection with stop-order proceedings under section 8 (d). Both the courts and the commission feel that those who deal in securities should conform to the strictest possible standards in informing the public of all matters which an investor might find useful in entering the investment market.

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20 Oklahoma-Texas Trust v. S.E.C., note 9 supra.

21 United States Molybdenum Corp., 10 S.E.C. 796 (1941); Petersen Engine Co., 2 S.E.C. 893 (1937).

22 Livingston Mining Co., note 6 supra.