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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Time Limitation on Recovery for Securities Claims for False Statements

Ritchey v. Horner, 244 F.3d 635 (2001), a case before the United States Court of Appeals for the Eighth Circuit, involved buyers of the outstanding stock of a family-owned lumber company bringing a securities fraud action against the sellers for allegedly making false statements relating to the company's tax liability. The facts in the case reflect that plaintiffs met with the defendants on September 22, 1997, to finalize their purchase of the defendants' family-owned lumber company. At the meeting, the parties executed a written agreement in which the defendants warranted that the company had filed all tax returns required by law, that the returns had been timely filed, and that the company had no outstanding tax liabilities. Following execution of the agreement, the purchase of the company was restructured with plaintiffs acquiring all of the outstanding stock of the company. Subsequently, the plaintiffs requested copies of the 1995 and the 1996 tax returns from the company on numerous occasions. Plaintiffs never verified whether the tax returns had in fact been filed. On June 12, 1998, plaintiffs received a letter from the accountant for the company explaining that the tax returns had not been completed or filed because the company had failed to pay the accounting firm for its past services. After attempts to resolve the tax liability with the defendants failed, plaintiffs brought suit on April 19, 1999, asserting that the defendants engaged in securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") and Rule 10b-5 promulgated thereunder, based on the representations of the defendants that the company's tax returns had been filed and the company owed no outstanding taxes. Section 13 of the 1934 Act provides that an action must be brought within one year after discovery of the alleged misrepresentation or "after such discovery should have been made by the exercise of reasonable diligence." The reasonable diligence standard is an objective one, commonly referred to as the doctrine of "inquiry notice," because the one year limitations may be triggered even though the victim is unaware of the misleading statements if, in exercising reasonable diligence, he should have discovered their misleading nature. The Court noted that the "inquiry notice exists when there are 'storm warnings' that would have alerted a reasonable person of the possibility of misleading information, relayed either by an act or by omission." In its analysis, the Court noted the three determinations that must be made in ascertaining whether the inquiry notice standard has been satisfied:

- The facts of which the victim was aware;
- Whether a reasonable person with knowledge of those facts would have investigated the situation further; and

- Upon investigation, whether the reasonable person would have acquired actual knowledge of defendant's misrepresentations.

The Court also noted that the facts relied upon to support the "inquiry notice" must rise to a level of more than mere suspicion and must instead be "sufficiently confirmed or substantiated" to a point in which the victims are incited to investigate. The lower district court had granted summary judgment on the federal claim in favor of the defendants concluding that it was not brought within the one year period as required by the 1934 Act. On appeal, the issue in this case was whether the defendants had shown there was no genuine dispute of fact that plaintiffs were on "inquiry notice" that the returns had not been filed sometime before April 19, 1998, i.e. one year prior to the filing of the lawsuit. The Court reversed the decision by the lower district court holding that the alleged failure by plaintiffs to file suit within the period prescribed by Section 13 of the 1934 Act being a affirmative defense, the defendants had the burden of establishing it.

Elimination of Pooling-of-Interests Accounting

The Financial Accounting Standards Board ("FASB") has released tentative decisions relating to the elimination of the pooling-of-interests method of accounting and the treatment and testing for goodwill. In pooling-of-interests, the assets of the two merging companies are combined and the financial results reported as if the two companies had previously been one company, and the value of the assets of each company are not repriced. The FASB has tentatively established June 30, 2001, as the effective date for elimination of the pooling-of-interests method of accounting. Transactions initiated after June 30, 2001, must use the purchase method of accounting for business combinations. Under the purchase accounting method, the price paid above the acquired Company's net worth is accounted for as goodwill which must be amortized or subtracted from the combined companies' reported earnings over a period of time. Following June 30, 2001, companies will be required to subject goodwill (the difference between the purchase price of an acquired company and the net value of its assets) to an impairment test. If the test determines that goodwill has fallen in value, it would then have to be amortized. Since the impairment test will not take effect for most companies until January 1, 2002, companies will generally have to continue to amortize goodwill regardless of its relative value during the intervening period between June 30 and December 31. The FASB Statement, *Business Combinations and Intangible Assets,* would be effective for fiscal years beginning after December 15, 2001. Early adoption would be permitted for companies with a fiscal year beginning after March 15, 2001 provided that the first quarter financial statements have not been previously issued. In all cases, the Statement must be adopted as of the beginning of a fiscal year. Companies would be required to perform the first step of the impairment test (comparison of the fair value of a reporting unit to its carrying amount) on all reporting units within six months of adoption. If the fair value of a reporting unit is less than its carrying amount, an impairment loss would be recognized and treated as a change in accounting principle. That change in accounting principle must be recognized by year-end. An impairment loss recognized as a result of an impairment test occurring after the first six months of adoption would be reported as a part of operating income. Goodwill and intangible assets acquired in a transaction completed after June 30, 2001, but before the Statement is initially applied would be accounted for in accordance with the amortization and nonamortization provisions of the Statement. The tentative decisions of the FASB are available on its web site at *http://accounting@rutgers.edu/raw/fasb.*

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