COMMENT

Shareholders and Informed Voting: How Much Information Do They Need?

This article will examine attempts by the federal courts to establish standards for materiality, causation and culpability under the federal proxy-solicitation provisions, §14(a) of the 1934 Securities and Exchange Act[1] and Rule 14a-9.[2] This analysis is made difficult by the failure of the courts to clearly delineate the elements of the 14a-9 cause of action. An examination of the major cases in the area will be helpful in unravelling the various strands of analysis followed by the courts.

Section 14(a) of the Securities and Exchange Act and Rule 14a-9, which implements §14(a), are a part of a general statutory scheme which arose in response to unfettered securities speculation during the 1920's.[3] The purpose of the 1934 Act was to replace the prevailing doctrine of caveat emptor with a philosophy of full disclosure and thereby establish a highly ethical standard of conduct in the securities industry.[4] Section 14(a) was aimed directly at achieving fair corporate suffrage in the area of proxy solicitation by precluding the use of proxy statements that are false or misleading with respect to any material fact.[5]

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1. Section 14(a) of the Securities and Exchange Act of 1934 reads in part; "It shall be unlawful for any person, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security . . . registered pursuant to section 78L of this title." 15 U.S.C.A. §78n(a) (1971).

2. Rule 14a-9, promulgated pursuant to §14(a) of the Securities and Exchange Act of 1934, reads in part: "No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it was made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading." 17 C.F.R. §240.14a-9 (1975).

3. M.. PARISH, SECURITIES REGULATION AND THE NEW DEAL (1970).

4. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). *See* Comments of Franklin Delano Roosevelt, 77 CONG. REC. 937 (1933).

5. J. I. Case Co. v. Borak, 337 U.S. 426, 431 (1964).

I. MATERIALITY AND CAUSATION

Mills v. Electric Auto-Lite Co.[6] was a suit by shareholders asserting that a merger was effected through the use of a proxy solicitation that was materially false or misleading. The Supreme Court had recognized an implied cause of action for a 14a-9 violation in *J. I. Case Co. v. Borak.*[7] In *Mills* the Court considered one element of that cause of action: what causal relationship is required between a proxy statement and the subsequent merger to establish a private cause of action based on a violation of Rule 14a-9. The Seventh Circuit had based the test for causation on common-law fraud and held that the injured party must have relied on the misrepresentation.[8] The Seventh Circuit had added that since it was impractical to check the actual reliance of thousands of shareholders, it must instead scrutinize the fairness of the merger terms. The Supreme Court reversed. It said that if a court based its decision on the merits of the merger, proxy violations that do not lead to a "bad" merger would no longer be redressable and the goal of an informed vote for shareholders would be ignored.[9]

Justice Harlan, writing for the majority, declared that a materially misleading solicitation is itself a violation of the law. Harlan added that if the omitted or misleading facts are material, causation is proved by demonstrating an essential link between the solicitation and the merger.[10] But the real problem is the degree of materiality required before this relaxed causation test may be used. Addressing the materiality question, the Court concluded:

> Where the misstatement or omission in a proxy statement has been shown to be "material" . . . that determination itself indubitably embodies a conclusion that the defect was of such a character that it *might* have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a *significant propensity* to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by 14(a).[11]

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6. 396 U.S. 375 (1970).

7. 377 U.S. 426 (1964).

8. Mills v. Electric Auto-Lite Co., 403 F.2d 429 (7th Cir. 1968).

9. 396 U.S. at 381-382. The unredressable violations would include those relating to matters other than the terms of the merger.

10. *Id.* at 383-384. *See* Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975). Under the facts of *Mills*, an essential link was established when the shareholder's proxy was necessary for approval of the merger. 396 U.S. at 383-384.

11. *Id.* at 384 (emphasis supplied).

The *Mills* opinion became the basis for two different formulations of the "materiality" standard by the lower federal courts. One formulation drew from the "might" language in the opinion and applied a "might" standard to the materiality test.[12] The other formulation relied on either the "significant propensity" language or a combination of "might" and "significant propensity" to support an application of the traditional tort test of materiality whether a reasonable man *would* attach importance to the fact misrepresented or omitted in determining his course of action.[13]

In *Gerstle v. Gamble-Skogmo, Inc.*,[14] the complaining shareholder claimed that the corporation's proxy solicitaion was materially misleading. Citing *Mills*, the Second Circuit applied a "would" materiality standard. Judge Friendly, writing for the majority, interpreted the "might" language in *Mills* as a characterization of the minimum and added that the threshold created by the "might" standard was too low. Recognizing that the "difference between 'might' and 'would' may seem gossamer," Friendly stated that "the former is too suggestive of mere possibility, however unlikely. When account is taken of the heavy damages that might be imposed, a standard tending towards probability rather than mere possibility is more appropriate."[15] Thus in sweeping terms the Second Circuit pierced the ambiguous language in *Mills* and established a clear and unequivocal materiality standard.

The Seventh Circuit, when confronted with the task of defining materiality in *Northway v. TSC Industries*,[16] relied on *Mills* and *Affiliated Ute Citizens v. United States*,[17] a Rule 10b-5 case,[18] as authority for establishing a "might" test. The court reasoned that a "would" test of materiality, requiring a finding of probability, would necessarily entail problems of proof that the Supreme Court, by eliminating the need for independent proof of causation, had sought to avoid in *Mills*. The "might" test would require only a finding of possibility. The court concluded that the lower threshold embodied in the "might" test was more consistent with the congressional aim of fair corporate suffrage.[19]

The Supreme Court granted certiorari in *Northway*[20] in an effort to re-

12. Northway v. TSC Industries, 512 F.2d 324 (7th Cir. 1975); Dasho v. Susquehana Corp., 461 F.2d 11 (7th Cir. 1972); Colonial Realty v. Baldwin Montrose Chem., 312 F. Supp. 1296 (E.D. Penn. 1970).

13. Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973); General Time v. Talley Industries, 403 F.2d 159 (2d Cir. 1968); Walpert v. Bart, 280 F. Supp. 1006 (D.C. Md. 1967).

14. 478 F.2d 1281, 1291 (2d Cir. 1973).

15. *Id.* at 1302.

16. Northway v. TSC Industries, 512 F.2d 324 (7th Cir. 1975).

17. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

18. Rule 14a-9 and Rule 10b-5 are siblings but not twins. Rule 10b-5 is aimed primarily at acts or omissions that are similar to common-law fraud or self-dealing; Rule 14a-9 is designed primarily to ensure informed voting.

19. 512 F.2d at 330-332.

20. TSC Industries v. Northway, 423 U.S. 820 (1975).

solve the conflicting standards of materiality. The court adopted the "would" test.[21] First, agreeing with Judge Friendly's opinion in *Gerstle*, the Court said that the low threshold created by the "might" test could lead to corporate liability for trivial defects. Second, since the "might" test is too suggestive of possibility no matter how slight, corporate directors would drown the public in a deluge of incomprehensible material to avoid the specter of liability. A "would" test, which requires probability, would limit the reams of material that corporate management might feel compelled to include and would be more congruent with the goals of transactional fairness and adequate disclosure embodied in Rule 14a-9. Finally, the Court focused on the "significant propensity" phrase from *Mills* and concluded that it foreclosed the use of a "might" standard.[22] When faced with the dilemma of providing either protection for corporations on the one hand, or a more open forum for aggrieved shareholders on the other, the Supreme Court apparently opted for corporate protection.

II. CULPABILITY

As the situation stands now, the Supreme Court has chosen a "would" materiality standard and has held that the causation requirement is satisfied if there is an *essential link* between the proxy solicitation and the subsequent merger. Aside from materiality and causation, culpability is the remaining essential element of a 14a-9 cause of action. The degree of culpability required could range from a high standard—intent—to an extremely low standard—strict liability. The question in the securities context, therefore, is how much fault the courts will require before corporate liability will be imposed.

In *Gerstle*,[23] the Second Circuit, having adopted a "would" standard of materiality, held that the minimum standard of culpability under Rule 14a-9 should be negligence.[24] Judge Friendly, writing for the court, reached this conclusion by comparing Rule 14a-9 to Rule 10b-5 and drawing from the common law of torts.[25] Some degree of scienter is required under Rule 10b-5, he said, because 10b-5 was designed to punish "manipulative" or "deceptive" practices.[26] Rule 14a-9, however, was designed to impose a broad standard of culpability to assure that directors will be held to a high duty of care in the preparation of proxy statements. Friendly added that since negligence is the standard for liability under the common-law tort of

21. TSC Industries v. Northway, ___ U.S. ___, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1976).

22. 96 S. Ct. at 2132-2133, 48 L. Ed. 2d at 765-766.

23. 478 F.2d 1281 (2d Cir. 1973). See text accompanying notes 15 and 16, *supra*.

24. *Id.* at 1300. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

25. *See* W. PROSSER, LAW OF TORTS §107 (4th ed. 1971); RESTATEMENT (SECOND OF TORTS §552 (Tent. Draft No. 12, 1966).

26. 478 F.2d at 1299. See SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968); Ernst & Ernst v. Hochfelder, ___ U.S. ___, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976).

misrepresentation, it is unlikely that 14a-9 contemplates a higher standard. Friendly did say, though, that "this does not mean that scienter should never be required under a 14a-9 action."[27]

The Delaware district court in *Gould v. American Steamship Co.*[28] considered intent, negligence and strict liability as possible 14a-9 culpability standards. The court dismissed the strict liability alternative, because it would impose too great a burden on the corporation by making corporate directors no less than guarantors and would undermine the deterrence factor of the 1934 Securities Act. The court also rejected the argument that the 10b-5 scienter requirement should be injected into Rule 14a-9. Referring to the remedial purposes of the statute as evidenced by the broad sweep of its language, the court declared that a scienter requirement would thwart these purposes by relieving directors of their fiduciary duty to examine proxy statements. Holding that negligence is the proper standard of culpability, the court said:

> Given the importance of corporate suffrage, the necessity for adequately informed shareholders, and the limited scope of this section, the additional burden of imposing a standard of reasonable care or due diligence as opposed to actual knowledge or gross negligence is easily defendable. This is especially true for the corporate directors . . ., since they hold a position of fiduciary trust to the very persons to whom the proxy materials were issued . . . .[29]

Negligence, therefore, seems to be the established 14a-9 culpability standard.[30] However, the securities laws are subject to decisive modification, as *Ernst & Ernst v. Hochfelder*[31] shows. In that recent 10b-5 case, the Supreme Court held that there must be allegations of scienter before a corporation can be held liable in a shareholder's derivative suit. The Second Circuit took a similar step when it propounded a scienter requirement for actions under §14(a) of the Securities and Exchange Act[32] in *Chris-Craft Industries v. Piper Aircraft.*[33] Although the Supreme Court in *TSC Industries v. Northway* did not have occasion to decide what showing of culpability is required under §14(a), it did cite *Ernst & Ernst* and *Gerstle* for future guidance.[34]

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27. 478 F.2d at 1300.

28. 351 F. Supp. 853 (D. Del. 1972).

29. *Id.* at 864-865.

30. *See* Richland v. Crandall, 262 F. Supp. 538 (S.D. N.Y. 1967); Note, *The Proper Standard of Fault for Imposing Personal Liability on Corporate Directors for False or Misleading Statements in Proxy Solicitations under Section 14(a) of the Securities Exchange Act of 1934 and SEC rule 14a-9,* 34 OHIO ST. L. J. 670 (1973).

31. ___ U.S. ___, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976). *See* Note, *Scienter Required for Civil Liability Under SEC Rule 10b-5,* 28 MER. L. REV. 401 (1976).

32. 15 U.S.C.A. §78n(e) (1971).

33. 480 F.2d 341 (2d Cir. 1973).

34. 96 S. Ct. at 2131 n.7, 48 L. Ed. 2d at 763 n.7.

III. CONCLUSION

The congressional purpose behind Rule 14a-9 was to ensure fair corporate suffrage by burdening the corporation with the duty to disclose to the shareholder all information required for casting an informed, intelligent vote. The courts consequently have been faced with the problem of balancing the need for informed shareholder voting with the need for a measure of corporate freedom.

The Supreme Court placed a heavy burden of proof on the shareholder-plaintiff in *TSC Industries* when it concluded that the "would" test was the proper 14a-9 materiality standard. The Court failed to recognize that materiality is only one spoke in the wheel of a 14a-9 cause of action. Other limitations are placed on a shareholder's ability to recover. The shareholder must (1) show culpability on the part of the corporation and (2) establish an essential link between the solicitation and the subsequent merger. Under the culpability requirement, even if a shareholder proves that an omission or misstatement is material and establishes an essential link between the solicitation and the merger, he still must show that the corporation's act was at least negligent. Under the causation requirement, a shareholder may be denied recovery for a material misstatement or omission in a proxy solicitation if his vote does not meet the "essential link" criteria established in *Mills.*[35] The Supreme Court, by refusing to look at the 14a-9 cause of action as a unit and instead concentrating on the individual aspects of the cause of action, indicates its reticence to allow an open forum for wronged shareholders. *TSC Industries,* because it firmly entrenches the stringent "would" standard of materiality, takes on more significance when viewed in light of the possibility that a stiffer 14a-9 culpability standard may be in the offing.

Perhaps a departure is required. The underlying (and probably false) assumption of §14(a) is that the average shareholder reads and understands all the corporate information available to him. It is more likely, though, that if the shareholder even bothers to return a proxy solicitation, he bases his vote on some personal incantation, such as fluctuations in the price of goats, or on the bottom line of the corporate books.[36] Added to this is the fact that the character of the securities market has undergone drastic changes over the past few decades. No longer is the small investor a major force in the securities market. Institutional investors, such as banks, holding companies, conglomerates and mutual funds, dominate the market.[37] Perhaps a departure is in order; perhaps disclosure rules should be oriented toward the business specialist, who is more sophisticated and

35. Comment, *Causation and Liability in Private Actions for Proxy Violations,* 80 YALE L.J. 107 (1970-71).

36. *See* Kripke, *The Myth of the Informed Layman,* 28 BUS. LAW. 631 (1973).

37. W. CARY, CASES AND MATERIALS ON CORPORATIONS 234-237 (unabridged 4th ed. 1969).

38. *See* Kripke, *supra* note 36.

better equipped to appreciate and react to corporate information. Such disclosure would ameliorate the present information dilemma—whether to provide a mass of information which no shareholder will understand or provide simplistic information which supplies a less than adequate basis for incisive business decisions. If more sophisticated information were provided, some would undoubtedly trickle down to the average shareholder. Perhaps then we would be closer to the goal of informed corporate suffrage.

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