12-1-1970

Securities Regulation -- Shareholder Derivative Suits Under Rule 14a-9

E. L. Kittrell Smith

Follow this and additional works at: http://scholarship.law.unc.edu/nclr

Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.unc.edu/nclr/vol49/iss1/23

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
Securities Regulation—Shareholder Derivative Suits Under Rule 14a-9

The judicial system continues to protect a corporate shareholder through implementation of the rapidly expanding anti-fraud provisions of the Securities Exchange Act of 1934.\textsuperscript{1} In \textit{Mills v. Electric Auto-Lite Co.}\textsuperscript{2} plaintiff-shareholders brought a derivative suit and a class action in a federal district court seeking to set aside the merger of defendant Auto-Lite with another corporation.\textsuperscript{3} As shareholders of Auto-Lite, plaintiffs alleged that management obtained proxies through materially false and misleading statements in violation of rule 14a-9.\textsuperscript{4} In the proxy solicitations, management recommended a vote for the merger without indicating that Auto-Lite's directors were actually under the control of the corporation with which they contemplated merging.\textsuperscript{5}

The district court, having found the defect in the solicitation to be material, granted plaintiffs' motion for summary judgment. On appeal, the Court of Appeals for the Seventh Circuit reversed as to the causal relationship holding that if Auto-Lite could show by a "preponderance of probabilities" that the merger was fair and would have received

\textsuperscript{1} Securities Exchange Act of 1934 §§ 10(b) & 14(a), 15 U.S.C. §§ 78j(b) & 78n(a) (1964).
\textsuperscript{2} 396 U.S. 375 (1970).
\textsuperscript{3} 396 U.S. at 377-78. The complaint, filed the day before the shareholder's meeting, sought an injunction against the voting of proxies obtained by allegedly misleading solicitations. However, a temporary restraining order was not sought and the voting took place as scheduled. After the merger, the complaint was amended to seek retrospective relief.
\textsuperscript{4} 17 C.F.R. § 240.14a-9(a) (1970), provides in part:
   No solicitation subject to this regulation shall be made by means of any proxy statement ... containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact ... necessary in order to make the statements therein not false or misleading ....
   This rule was promulgated under Securities Exchange Act of 1934 §14(a), 15 U.S.C. § 78n(a) (1964), which provides in part:
   It shall be unlawful for any person ... to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security ... 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.
\textsuperscript{5} In the 108 page solicitation Auto-Lite's management recommended a vote for the merger in bold type on page two of the pamphlet. A limited textual treatment of the relationship between the merging corporations was set forth on the same page with less emphasis. Statistical information relevant to this relationship was displayed on pages 21-23 of the same pamphlet. The position of these statements in the solicitation seemed critical to the circuit court in ruling that the misrepresentations had been material. \textit{Mills v. Electric Auto-Lite Co.}, 403 F.2d 429, 433 (7th Cir. 1968).
sufficient votes in any event, no reason would exist for setting aside the merger. The Supreme Court granted certiorari to determine the causal relationship that had to be shown between the solicitation and the subsequent merger in order to establish a shareholder's cause of action.

The Supreme Court followed a two stage analysis. A defect or omission in a proxy solicitation must first be found to be material; i.e. "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." Once materiality is established, the necessary causal relationship exists if "the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." In this posture the case was remanded to consider the question of relief.

The Court's adoption of a reasonable man test in determining the materiality of a defect or omission was predictable. The materiality test formulated under section 10(b) of the Securities Act was easily adapted to the situation of proxy solicitations. Despite the fact that disputes may arise as to what is "material," the reasonable man standard perhaps gives the uninformed shareholder the maximum amount of protection possible. While the lack of a precise definition of materiality may perplex management, it is not unfair to require complete disclosure of factually sound information in order to protect shareholder voting rights. The shareholder must necessarily accept as true the information management forwards to him. It is far better that he have too much information at his disposal than too little.

The main advantage offered by the materiality test set forth in Mills

---

8 396 U.S. at 384.
9 Id. at 385.
10 Too much information, however, can be as harmful as too little. Where a lengthy solicitation is involved, perhaps a short summary containing basic information on the merging companies should be required. A similar proposal would require that a shortened solicitation form be mailed to the shareholder separately from cumbersome financial statements. Sowards, The Wheat Report and Reform of Federal Securities Regulation, 23 VAND. L. REV. 495, 530-32 (1970).
is that courts can mold the test to varying factual situations in order to achieve the most equitable result. Thus it is anticipated that the materiality of a defect will be easily established. The pertinent inquiry, however, is what causal connection must be shown between the material defect and the resulting injury.\textsuperscript{11} As the Court in \textit{Mills} indicated, once materiality of a defect or omission is established plaintiff-shareholders' burden of proving a causal connection between the solicitation and the merger is considerably lightened.

The express language in \textit{Mills} indicates that a causal relationship between the misleading solicitations and the alleged injury is established by showing first a material defect or omission and second that the solicitation, not the defect itself, was an \textit{essential link} in the transaction.\textsuperscript{12} This test of causation certainly eliminates subjectivity and to that extent favors the plaintiff-shareholder.\textsuperscript{13} It is at least clear that reliance on the defect by each shareholder who authorized his vote by proxy will no longer be required to establish a cause of action.\textsuperscript{14} But other parts of the decision are not so clearly resolved. The Court fails to follow its own admonition that they deal "in an area where glib generalizations and unthinking abstractions are major occupational hazards."\textsuperscript{15} Instead, the Court left room for interpretation in two distinct areas.


\textsuperscript{12} 396 U.S. at 385. In addition, the test may impliedly resolve the troublesome question of \textit{partial invalidity}. Where a misrepresentation has been made in one aspect of a solicitation, and that aspect can be isolated from the other truthful parts, it has been held that the solicitation would only be invalid as to the misrepresented part. SEC v. Transamerica Corp., 67 F. Supp. 326, 329 (D. Del. 1946), \textit{aff'd}, 163 F.2d 511 (3d Cir. 1947), \textit{cert. denied}, 332 U.S. 847 (1948). By addressing the entire solicitation, the \textit{Mills} test would seem to preclude isolation of the misrepresented part. \textit{See generally} \textit{Loss} 972-73.

\textsuperscript{13} 396 U.S. at 385.

\textsuperscript{14} \textit{Id.} at 384-85. See also Berman v. Thomson, 312 F. Supp. 1031, 1033 (N.D. Ill. 1970). The Court in \textit{Mills} perhaps anticipated the expansion of the reliance concept seen in rule 10b-5 into actions brought under rule 14a-9. See W. \textit{PAINTER}, \textit{FEDERAL REGULATION OF INSIDER TRADING} 103-18 (1968) [hereinafter cited as \textit{PAINTER}].

Of initial concern is the meaning of the term essential link. Although several definitions are possible, the Court apparently viewed the term as meaning that a solicitation of proxies was necessary in order to approve the merger. For example, in Mills management controlled fifty-four percent of the voting stock but needed two-thirds of all outstanding shares to approve the merger.

Defining essential link in terms of what is necessary to accomplish a particular transaction tends to be rather restrictive in light of the policy of protecting minority shareholders. Of particular concern is the unusually rare situation in which management controls a sufficient number of votes to execute the merger without the necessity of securing proxies. For example, if management controls seventy-three percent of the voting stock when only a two-thirds vote is required to execute the merger, votes cast by proxy could not possibly alter the certainty of merger, and, according to a strict interpretation of Mills, the solicitation would not be an essential link. In this situation management, through the solicitation, is not seeking unnecessary proxies; rather, it has chosen the proxy solicitation as the mode of communication whereby shareholders may become "informationally competent to deliberate corporate matters." Management may be prompted to include material misrepresentations in a proxy solicitation if it fears that truthful disclosure and informed debate might preclude efficient execution of the merger. If a proxy solicitation can be viewed as a communicative device, then perhaps the essential link requirement can be satisfied by showing that fully informed shareholders conceivably could have altered the voting outcome through informed debate at the shareholder's meeting. By defining essential link in these terms, protection is extended to the maximum number of shareholders.

Of lesser concern is the Court's synonymous use of the terms "merger" and "injury." It is arguable that confusion could result from a misreading

---

16 For example, the Court might have been considering what is legally required by the proxy rules. Rule 14(c) provides that solicitations or substantially equivalent information will be provided the shareholder prior to any stockholder meeting. 15 U.S.C. § 78n(c) (1964), amending, Securities Exchange Act of 1934, ch. 404, § 14, 48 Stat. 895 (1934).

17 In a footnote the Court explicitly stated that it addressed only the situation where votes cast by authority of proxies were necessary to control the outcome of the merger. 396 U.S. at 395 n.7. Yet it cited with apparent approval Laurenzano v. Einbender, 264 F. Supp. 356 (E.D.N.Y. 1966), where the shareholder's cause of action was established even though proxies were not necessary to accomplish the merger.


20 Id.
of the opinion is the area of relief to be afforded a plaintiff-shareholder. The relief sought in *Mills* was the unwinding of the merger, and the "merger" and the "injury" were one in the same. The injury, however, may be quite separate and distinct from the merger. The most obvious example is that the market price of the corporate share might suffer as a result of a merger. In addition to the unwinding of the merger, plaintiff-shareholder should certainly be entitled to damages for any financial loss suffered, but he should be required to show that the merger did in fact cause the injury. Financial loss, however, is not an essential ingredient of a shareholder's cause of action, for requiring such an injury would preclude effective enforcement of the proxy solicitation rules.

One problem which can be anticipated in the near future is the expansion of *Mills* into the area of rule 10b-5. Rule 14a-9 and rule 10b-5 overlap to the extent that a merger usually results in the issuance of stock certificates under the name of the newly formed corporation, and the shareholder, because of this new issue, is classified as a "purchaser" of securities. Coverage under one of the rules does not preclude coverage under the other, and in fact most cases involving 14a-9 violations assert causes of action under both anti-fraud provisions. Both rules were designed to prevent the "insider" from profiting at the expense of the uninformed shareholder. Hence, the judicial guidelines encountered

---

21 Twice in his opinion Justice Harlan poses the problem before the Court as being the relationship between the misleading solicitation and the merger, but the holding is expressed in terms of the relationship between the solicitation and the shareholder's injury. 396 U.S. at 377, 385.

22 Plaintiff-shareholders also sought attorneys' fees. See Note, Securities Regulation—Allowance of Attorneys' Fees in 14(a) Derivative Suits, 49 N.C.L. Rev. 204 (1970).


24 17 C.F.R. § 240.10b-5 (1970), provides in part:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality

(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......

25 In SEC v. National Sec. Inc., 393 U.S. 453, 467 (1969), a re-issuing of stock certificates following a merger was held to be a "purchase or sale" sufficient to satisfy the requirement of rule 10b-5. See also Dasho v. Susquehanna Corp., 380 F.2d 262, 266 (7th Cir.), cert. denied, 389 U.S. 977 (1967).


28 PAINTER 264.
under either rule can be readily applied to a particular situation to give utmost effect to congressional policy. The most obvious example is the reasonable man standard for determining materiality promulgated under rule 10b-5, but now utilized in cases brought under the proxy solicitation rules.

The application of a single standard to an action brought under both rules would lend uniformity to the enforcement of the Securities Act. However, certain judicial standards may be designed peculiarly for one rule or the other. At present, an action brought under rule 10b-5 requires the plaintiff to establish some causal relationship between the misrepresentation and the purchase or sale of securities. Whether expressed in terms of reliance, privity, or causation this causal requirement is designed, in part, to identify the proper party plaintiff. It establishes some "rational means of deciding who, among those trading through the vastly impersonal medium of an exchange or over-the-counter market, should recover and who should not." Thus the causation requirement actually serves to limit defendant's liability to a defined group of individuals. On the other hand, the proper party to bring an action under rule 14a-9 is readily defined; he is the shareholder of the corporation to whom the misleading solicitation was sent. Relaxation of the causation requirement in this instance does not increase the scope of defendant's liability, but merely makes enforcement of the proxy rules easier by decreasing the shareholder's burden of proof. Because of the peculiar function served by the causation requirement under rule 10b-5—limiting the scope of defendant's liability through identification of the proper party plaintiff—it is anticipated that the abandonment of the causation requirement set forth in Mills will not be extended into the area of rule 10b-5.

Even though causality is required under rule 10b-5, strong protection is afforded the corporate shareholder. The reasonable man test of materiality leaves vast room for judicial construction in the individual case.

See notes 8 & 9 supra.

The most recent example of the adaptability of judicial standards between these two anti-fraud provisions is found in Berman v. Thomson, 312 F. Supp. 1031 (N.D. Ill. 1970), wherein the court applied the rationale of SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-56 (2d Cir. 1968), a 10b-5 case, to an action brought under rule 14a-9 and concluded that good faith on the part of management was no defense.

One commentator indicates that causation but not reliance is essential to plaintiff's cause of action. Painter 109.

Id. at 103-18.

Id. at 112.

The shareholder need not show a financial injury to maintain his cause of action, for such a requirement would frustrate the enforcement of the proxy solicitation rules.\textsuperscript{35} Moreover, the two anti-fraud provisions of the Securities Act usually lend support to one another as the shareholder is increasingly given more protection. An unfortunate consequence of the judiciary's continued support of minority shareholders is evidenced by the power that they possess to control the outcome of corporate activities. Indeed, the day looms near when a corporation may stand at the mercy of one insignificant, discontented shareholder.\textsuperscript{86} The corporate merger has become at best a tenuous relationship. As a matter of public policy, perhaps some degree of protection should be given a corporate merger already consummated.\textsuperscript{87} Indeed, the judiciary should possibly reconsider their interpretation of the Securities Act.

E. L. Kittrell Smith

**Torts—Mental Distress Damages for Racial Discrimination**

In *Massachusetts Commission Against Discrimination v. Fransaroli\textsuperscript{1}* the Commission Against Discrimination\textsuperscript{2} found that Mandred Henry, a Negro, had been denied an apartment by the defendants solely because of his race. The commission ordered cessation of defendants' discriminatory rental practices\textsuperscript{3} and awarded Henry compensation for his increased ex-

\textsuperscript{35} Id. at 1033.

\textsuperscript{86} Perhaps the individual minority shareholder is not so powerful. In Rekant v. Dresser, 425 F.2d 869, 876 n.7 (5th Cir. 1970), the court noted that although the individual shareholder has a powerful weapon in section 10(b), he occupies a fiduciary relationship with other shareholders as a consequence of his bringing suit. This same fiduciary capacity is presumably shared by the plaintiff-shareholder in a suit under section 14(a).

\textsuperscript{1} See generally *Mass. Ann. Laws* ch. 152B, §§ 1-10 (1957), which outlines the powers and duties of the anti-discrimination commission.