Causation and Liability in Private Actions
For Proxy Violations

In *Mills v. Electric Auto-Lite Co.*, the Supreme Court dealt with shareholder recovery for management violations of the federal proxy rules. The Court held that, when management needs shareholder votes to effect a transaction, proof of a materially defective proxy statement is sufficient to show a causal relation between violation and transaction. The Court did not, however, consider the question of whether a causal relation sufficient to justify liability could exist between a proxy violation and shareholder injury when management controls enough votes to approve the action upon which the shareholders are voting. Even when management controls, injury can be inflicted on the corporation and its shareholders, and a causal relation can exist between the proxy violation and the injury, since the concept of causation in a legal sense is not coextensive with simple voting power. This Note will consider the ways in which deceptive proxy statements may deprive minority shareholders of legal remedies or the use of publicity and thus preclude those shareholders from cutting monetary losses or from attempting to prevent completion of the injurious transaction.

2. Proxy statements are sent out by management in connection with a variety of projected corporate actions: mergers, elections of directors, and sales of assets, for example. The purpose of a proxy statement is to apprise the shareholder that certain action is being considered and to provide sufficient information for him to register his informed approval or disapproval. Deceptive practices led to federal regulation of many proxy solicitations in 1934, and Section 14, 15 U.S.C. § 78(m) (1964), of the Securities Exchange Act, 15 U.S.C. §§ 78a-78hh (1964), now prohibits the solicitation of proxies in contravention of the rules and regulations issued by the Securities and Exchange Commission. Section 14(a) reads as follows:

   It shall be unlawful for any person, by the 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 (other than an exempted security) registered pursuant to Section 78(f) of this title.


   (a) 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 is 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.

In regard to the application of the proxy rules, see note 42 infra.
In those management control situations in which minority shareholders were injured by a materially defective statement or in which corrective actions were precluded, management should be liable.

I. Causation and the Courts

In *J.I. Case Co. v. Borak*, the initial Supreme Court decision on the existence of a private right of action for proxy violations, the Court held that both derivative and direct suits could be maintained for violations of Section 14(a) and rules thereunder, that jurisdiction could be founded on Section 27 of the 1934 Act, that retrospective relief might be granted, and that federal law should control the measure of such relief. The decision was intended to implement the goals of the Act by insuring fair corporate suffrage and protecting investors. The Court stressed that private enforcement of the proxy rules "provides a necessary supplement to Commission action" because of the volume of proxy statements handled by the Securities and Exchange Commission and its inability to examine each case with care. The decision hinted that

6. In *Borak* plaintiff, a stockholder of *J.I. Case Co.*, initially sought an injunction against the proposed merger of Case and the American Tractor Corp. The injunction was denied. After the merger was consummated, plaintiff filed an amended complaint, alleging, inter alia, that the merger was effectuated through the circulation of a false and misleading proxy statement by those proposing it. The Supreme Court held that jurisdiction to grant rescission or damages did exist, and remanded the case to the district court. "[T]rial on the merits of the remanded case began in June 1969, and is still in progress." *Elson, The Meaning of J.I. Case Co. v. Borak—Remedies Available for Violations of Proxy Rules under the Federal Securities Act*, 23 SW. L.J. 609, 610 n.2 (1969).
7. 377 U.S. at 431.
8. Id. at 430-31.
9. Id. at 433-35.
10. Id. at 434.
11. Id. at 431-33. The Court quoted from the House and Senate Reports on the 1934 Act. See H.R. REP. No. 1383, 73d Cong., 2d Sess. (1934); S. REP. No. 792, 73d Cong., 2d Sess. (1934). For discussion of the Congressional purpose, see pp. 121-23 infra.
12. 377 U.S. at 492. The *Borak* decision received substantial attention from commentators. In addition to the article by Elson, cited supra note 6, see the Comments and Notes in 64 COLUM. L. REV. 1336 (1964); 78 HARV. L. REV. 296 (1964); 50 CORNELL L.Q. 370 (1965);
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a causal relation between the solicitation materials and the effected transaction was required in order to hold a defendant liable, but declined to discuss the matter, stating that the question was one of fact to be resolved at trial. Subsequent cases proceeded to discuss liability in terms of causation, though in a conflicting fashion that created abundant confusion.

In this historical context, the Supreme Court decided Mills v. Electric Auto-Lite Co. Plaintiffs in Mills, shareholders of Electric Auto-Lite Co., sued to set aside a merger of Auto-Lite and Mergenthaler Linotype Co. and sought other appropriate relief for an alleged violation of Section 14(a) and Rule 14a-9. Plaintiffs claimed that the proxy statement concealed the fact that all the Auto-Lite directors were under the control of Mergenthaler and so were not in a position to render an impartial opinion on the desirability of the merger.

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13. 377 U.S. at 431.

14. See the survey offered in 5 L. Loss, supra note 12, at 2933-39. The inconclusiveness of these decisions was enough to prompt Professor Loss to state that it was "apparent that causation has now become the critical question in this area." Id. at 2933.


16. See note 2 supra.

17. See note 3 supra. According to the complaint, Mergenthaler owned 54% of Auto-Lite's outstanding common stock. Plaintiffs alleged that the proxy statement was misleading because it told Auto-Lite shareholders that their board of directors recommended approval of the merger without also informing them that all eleven of Auto-Lite's directors were under the "control and domination of Mergenthaler." 396 U.S. at 378. Through the proxy solicitation, Auto-Lite secured the necessary two-thirds majority, and the merger went through in 1963.

18. Citing Borak, the Mills district court, 281 F. Supp. 826 (N.D. Ill. 1967), held that summary judgment imposing liability should be granted. The district court agreed that plaintiffs had standing to sue for retrospective relief, and held that their motion for summary judgment as to liability should be granted because a causal relation did exist between the misleading proxy statement and the approval of the merger. The court appeared to reach this conclusion on the curious ground that the merger of Auto-Lite and Mergenthaler created a conglomerate "inherently dangerous to a healthy economy." Id. at 831. This reasoning seems irrelevant to the existence of a causal relation between violation and transaction. The district court first considered the more plausible "transactional function" test proposed by Laurenzano v. Einbender, 264 F. Supp. 356 (S.D.N.Y. 1966), application for leave to appeal pursuant to 28 U.S.C. § 1292(b) denied, [1966-67] Transfer Binder CCH Fed. Sec. L. Rep. ¶ 91,846 at 95,800 (2d Cir. 1966), but then refused to apply it, asserting that "Borak implies a different approach." 281 F. Supp. at 830. See also Record, Appendix to Respondents' Brief, vol. III, at 909-11, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970). The Laurenzano case is further discussed at pp. 112-14, 116 and note 49 infra.

The Court of Appeals, 403 F.2d 429 (7th Cir. 1968), reversed. It maintained that there was still "an issue for trial" with regard to causation because defendants had "presented evidentiary material tending to show that the merger has merit and the terms were in fact fair and equitable to the minority shareholders." Id. at 435-36. The court asserted that if a transaction had been fair, then it was not "caused" by the proxy violation. The court apparently assumed that shareholders would vote to approve a fair transaction even if there were no deception; it reasoned, therefore, that in such a case a proxy violation could not be said to be a "cause" of the shareholders voting the way they did. This conclusion, however, does not necessarily follow. For the fairness of a transaction and the existence of a causal relationship between a proxy violation and the completion of the transaction are essentially separate questions. Otherwise, an anomalous situation would result: a proxy
The Supreme Court held that in these circumstances the proper test of causation, and hence of liability, was "materiality." A "material" misstatement or omission in a proxy statement was characterized as one which "might have been considered important by a reasonable shareholder who was in the process of deciding how to vote." The Court stated:

There is no need to supplement this requirement [of materiality], as did the Court of Appeals, with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. While retaining a good deal of language about "causation" and "causal requirement," the Court eliminated the need for proof of any causal relationship and in effect substituted a presumption of causation in favor of a plaintiff when both a material misstatement or omission and the need for non-management votes had been established. This pre-

violation would "cause" a sale of assets if the price were unfairly low, but it would not "cause" the sale if the corporation were able to secure a few more dollars and thus receive the fair value of the assets. See Appellees' Brief at 49-50, Mills v. Electric Auto-Lite Co., 403 F.2d 429 (7th Cir. 1968). The Supreme Court, 396 U.S. 375 (1970), vacated the judgment of the Court of Appeals and remanded the case for further proceedings. It rejected the "fairness of the merger" test employed by the Court of Appeals for three reasons: (a) such a test would insulate private redress proxy violations not related to the terms of the merger; (b) it would inhibit private enforcement of the proxy regulations because of the shareholder's difficulty in obtaining sufficient data to prove unfairness; and (c) it embodied the dubious behavioral assumption that shareholders will always vote for a fair merger. Id. at 382-83. (The third reason is mentioned only in the footnote at 382-83.) Writing for the majority, Justice Harlan stressed the importance of the first two reasons by stating that the "fairness of the merger" test would frustrate the Congressional policies behind the 1934 Act. Id. at 383. He echoed Borak by calling attention to the House and Senate Reports on the 1934 Act, which contain the fullest statement of the Congressional purpose of providing fair corporate suffrage and protecting the investor. Id. at 381. The policies of fair corporate suffrage and investor protection evinced by these Reports are further discussed at pp. 121-23 infra. 19. Id. at 384. For other views on the nature of materiality, see note 129 infra. 20. Id. at 384-85. 21. See, e.g., id. at 377 ("causal relationship"), 383 ("causation problem"), 385 n.7 ("causation"). The Court speaks explicitly of a "causation requirement," id. at 385 n.7, and begins its opinion by stating that "[t]he question with which we must deal is what causal relationship must be shown between a misleading proxy statement and the merger to establish a cause of action based on the violation of the Act." Id. at 377. It is also worth noting that, although the Court in general followed the Government's brief closely, it did not accept the Government's apparent view that a causal relation is dispensable. See Brief for the United States as Amicus Curiae at 9-10, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970). A recent case decided in light of Mills, Smith v. Murchison, 310 F. Supp. 1079 (S.D.N.Y. 1970), also speaks in terms of "causal connection." 310 F. Supp. at 1087.
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sumption may be stated as follows: if the proxy statement contains a “material” defect and if at least some votes must be obtained from minority shareholders for a transaction to be approved, then a “sufficient showing” has been made of a causal relation between the defective proxy statement and the effected transaction to entitle the plaintiff to some relief, even if only litigation expenses and reasonable attorneys’ fees. However, as noted, Mills explicitly left open the question of whether the existence of a causal relationship and hence of liability could be shown where management employed a materially misleading proxy statement but controlled a sufficient number of shares to approve the transaction without any votes from the minority.

Two conflicting interpretations have emerged from the lower federal court decisions treating the question of liability for proxy violations when management controls. One line of decision, represented by Barnett v. Anaconda Co., holds that no causal relationship between the

22. As to the rebuttability of the Mills presumption, see pp. 135-38 infra.
23. The factual situation in Mills was that management controlled 54% of the voting stock, yet needed 66% to effect the transaction. Whether certain language in the opinion invites a broader reading will be considered later. See p. 123 infra.
24. 396 U.S. at 385.
25. This may appear slightly different from Justice Harlan’s statement quoted earlier in the paragraph insofar as it substitutes “effected transaction” for “injury for which he seeks redress.” From other remarks in the opinion, it would seem that “effected transaction” more accurately captures the Court’s meaning. For example, it is said at one point that “[t]he conclusion that petitioners have established their case by showing that proxies necessary to approval of the merger were obtained by means of a materially misleading solicitation” implies nothing about the form of relief. Id. at 386 (emphasis added). Compare the phrase from Borak, “causal relationship of the proxy material and the merger.” 377 U.S. at 431 (emphasis added). It is sometimes important to distinguish between “effected transaction” and “injury for which plaintiff seeks redress.” See pp. 123-30 infra.
26. On June 4, 1970, the Seventh Circuit, on remand, modified the judgment of the district court so as to vacate the order appointing a special master and affirmed the judgment as modified. It specifically stated that the judgment of the district court “must be affirmed.” Mills v. Electric Auto-Lite Co., Civil Action Nos. 16613, 16614 (7th Cir., June 4, 1970), at 1. At this time, therefore, Mills is on remand to the district court for determination of the appropriate relief.
27. 396 U.S. at 385 n.7. A distinguishable but related question arises when management and a shareholder who claims it would have voted in identical fashion despite the violation jointly own a controlling block of shares. See pp. 135-38 infra.
28. The conflict is recognized by Justice Harlan in Mills. 396 U.S. at 385 n.7.
29. 238 F. Supp. 766 (S.D.N.Y. 1965). For other cases, see Adair v. Schneider, 293 F. Supp. 393 (S.D.N.Y. 1968). To the latter cases has significantly amplified the discussion contained in Barnett. In Adair v. Schneider the court, in granting defendants’ motion for summary judgment on the ground, inter alia, of want of causation, agreed that Laurenzano could be read to the contrary, but simply said that it preferred “the reasoning and the results of Barnett.” 298 F. Supp. at 396. In Laufer v. Stranahan the court denied rescission of a merger where defendants owned 85% of the stock on, among others, the ground of lack of causation. It conceded that the question involved was left open by Mills and that Laurenzano indicated one possible answer. But
proxy material and shareholder approval or consummation of the trans-
action is possible when management controls. In this case, the plaint-
iff shareholder brought suit under Section 14(a) for injury allegedly
due to misleading proxy statements sent out in connection with a sale
of assets. Defendant Anaconda Co. moved for dismissal on the
ground that it owned 73% of the stock of the company in which plaint-
iff was a shareholder and that only a two-thirds vote was needed to
approve the transaction. The court granted the motion:

Here there is no question as to causal relationship between the
proxy material and the transactions under attack. The “but for”
element—the element of causation—does not and, indeed, could
not exist. The transactions under attack did not result from the is-
suance of the allegedly misleading proxy material which, in view
of the affirmative and concededly true allegation as to Anaconda’s
73% stockholdings, could not have had anything to do with the ap-
proval and consummation of such transactions.

Under the Barnett rationale, then, such a proxy violation is not held
to be a “but for” cause of the transaction, since the transaction could
have been effected, even if there had been no violation, when manage-
ment had voted all its shares in favor of the transaction.

A second line of decision, however, exemplified by Laurenzano v.
Einbender, has taken a very different position from Barnett. Plain-
it stated that “in the absence of binding authority to the contrary, this court prefers to
adhere to the requirement of causation adopted by a number of judges in this district.” [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,617 at 98,775. The court probably
did not wholly subscribe to Barnett, as one passage indicated that plaintiffs might still re-
cover for any injury which they themselves suffered. See note 80 infra. But the opinion
still appears confused. The court seems to imply that there was no material misstatement
or omission at 98,774 and 98,775. If so, it is hard to see how plaintiffs could have had any
cause of action under the 1934 Act. Perhaps the only way of making the court’s opinion
consistent is to say that its reference to absence of material misstatement or omission applies
only in respect of the remedy of rescission. This is admittedly tortuous.

30. 15 U.S.C. § 78n(a) (1964). Plaintiff included claims under Section 17(a) of the 1933

31. The suit was instituted against Anaconda Co. and Anaconda Wire and Cable Co.,
(Wire and Cable). Plaintiff, a shareholder of Wire and Cable, alleged that defendants sent
out misleading proxy statements and that Wire and Cable was injured by a transaction in
which all its assets were conveyed to Wireco, Inc., a subsidiary of Anaconda.

32. The motion was made under Fed. R. Civ. P. 12(b)(1) and 12(b)(6).

33. 238 F. Supp. at 771. The rationale employed in Barnett has been cited with approval
judgment as to claim under Section 20(a) of the Investment Company Act of 1940 granted
on the ground that the minimum “but for” requirement of causation was unsatisfied); and
tion for dismissal granted, on the ground that there is “no cause of action under sec-
tion 14(a) where the transaction complained of could not have resulted from proxies”). See also Textron, Inc. v. American Woolen Co., 122 F. Supp. 305, 307-08 (D. Mass. 1954);

34. 264 F. Supp. 356 (E.D.N.Y.), application for leave to appeal pursuant to 28 U.S.C.
tiffs in *Laurenzano*, who were shareholders in Retail Centers of the Americas, Inc. brought suit against National Industries, Inc. and multiple individual defendants for violations of Sections 10(b) and 14(a) of the 1934 Act. They alleged that defendants employed materially false and misleading proxy statements in submitting certain transactions for shareholder approval and that the assets of Retail were unfairly depleted as a result of the transactions. They further claimed that the defective proxy materials concealed improprieties which, if known, would have "inhibited the defendant directors from approving the transactions" and that these proxy materials were responsible for the shareholders' failure to seek an injunction and for the dismissal of their suit in state court. Defendants moved to dismiss on the ground that the alleged proxy violations could not have caused the approval of the transactions, since National controlled Retail and therefore could have approved them by itself.

The court denied the motion but considered irrelevant plaintiffs' contentions regarding injunctive relief and dismissal of the earlier suit:

> The misstatements and their effects, it would appear, should be related to the corporate context in which proxy material functions as such and not to the outer range of their effect on the resort to legal remedies.

Instead, the court interpreted *Borak* to impose liability for proxy violations even in situations when management controlled enough votes to approve a transaction if the proxy material had a "transactional function." Although the court did not explain in detail its notion of a "transactional function," it suggested, by way of illustration, that defendants might have been seeking the shareholder *consensus* that resulted (95% of the shareholders voted in favor of the transactions) and might have acted differently had there been no such consensus. The court reasoned that shareholder consensus may be of consider-

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35. 264 F. Supp. at 361.
36. Plaintiffs' theory here was that a truthful proxy statement "would have begotten prompt injunction suits [and] assured the joinder of stockholders owning $50,000 of stock in the state court suit"—thus making a security bond (the lack of which was the basis for dismissal) unnecessary. *Id.*
37. *Id.*
38. *Id.* at 360.

§ 1292(b) denied, [1966-67 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,846 at 95,900 (2d Cir. 1966). In denying a petition for rehearing of application of leave to appeal, the Court of Appeals said: "By this denial we do not intend to approve or disapprove the legal merits of the decision below or the decision in *Barnett v. Anaconda Company* . . . " [1966-67 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,846 at 95,900 (2d Cir. 1967).
able importance and that a proxy statement calculated to secure such consensus may play a role in the approval of subsequent corporate transactions or be of value to management in other ways.\textsuperscript{39}

II. Imposing Liability When Management Controls

Even when it has control, management may, for legal or practical reasons, solicit proxies.\textsuperscript{40} A solicitation requirement may be imposed by stock exchange rule\textsuperscript{41} or by federal statute.\textsuperscript{42} Furthermore, many corporations, acting under state corporation laws, may set up additional solicitation requirements in their certificates of incorporation or by-laws.\textsuperscript{43} Once management does solicit proxies, further rules apply.\textsuperscript{44} Moreover, as a strategic matter, management may wish to solicit proxies to give shareholders a sense of participation and thereby fore-stall litigation over projected corporate action. It may also wish to prevent the exercise of appraisal rights (which might drain the corporation's liquid assets) by securing shareholder approval\textsuperscript{45} in order to retain sufficient cash to make the merger desirable to the other corporation.

In situations where management possesses control there are, of course, substantial reasons for allowing it freedom to act without fear of shareholder suits. A management group that owns a controlling interest in a corporation will not be likely to act contrary to the interests of that corporation. Its own interests will be tied closely to those of the corporation, and it will usually stand to lose financially


\textsuperscript{43} See, e.g., the broad means granted jointly by 8 Del. Code Ann. §§ 102(b)(1) and (4), 109(b), 212, 215(b) and (c), 216, 241(a), 242(a) (1953, Cum. Supp. Pamph. 1968). See generally O'Neal, Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses, 10 VAND. L. REV. 1 (1956).

\textsuperscript{44} For stock exchange rules, see NEW YORK STOCK EXCHANGE CONSTITUTION AND RULES, Rules 450 to 460, at 3805-3815 (January 2, 1968); AMERICAN STOCK EXCHANGE COMPANY GUIDE, Rules 166, 574-585, at §§ 720-732 (April 15, 1968). Under federal law, see 17 C.F.R. §§ 240.14a-1—240.14f-1 (1970). As to whether Mills would countenance relief if management is able to circumvent the solicitation process, see Folk, Corporation Law Developments—1969, 56 Va. L. Rev. 755, 821-22 (1970).

\textsuperscript{45} See pp. 116-20 infra.
if the stock of the corporation suffers a decline in value. Furthermore, shareholder derivative suits may injure the corporation, since even frivolous suits are expensive to defend and the cost of defending them must ultimately be borne by the corporation. Finally, freedom from frivolous suits will enable management to act quickly in the corporation's interests when business opportunities arise. Nevertheless, there may be situations in which management's actions in the proxy solicitation process harm unduly the interests of minority shareholders.

A. Types of Injury

When management controls, a corporation may sustain a variety of injuries from a defective proxy statement. Most importantly, such a statement may be employed to conceal waste of corporate assets or to mask self-dealing by the directors. Although in many cases there will be no procedural bar to bringing a derivative suit in a state court when such injuries occur, plaintiffs may well prefer a federal forum because of the advantages of federal jurisdiction, and they may secure federal jurisdiction for this derivative suit under the federal proxy rules.

Similarly, individual shareholders may suffer significant injury. The most obvious harm occurs when the terms of the transaction (e.g., the provisions relating to the exchange ratio in a merger contract) decrease the value of the shareholder's holdings. Using generally accepted ac-

46. Many benefits of federal jurisdiction (e.g., liberalized discovery and class action rules) are commonly recognized. A recent article states:

Federal courts have become more willing to take jurisdiction in suits against corporations. In the past, many such cases would have gone into state courts, where, lawyers say, the plaintiff doesn't stand as good a chance. For example, Federal courts have more liberal "discovery" rules that permit the plaintiff to extract information from the defendant corporation. Also helping to generate suits is "Rule 23" of the Federal Rules of Civil Procedure, issued in 1966 by the Supreme Court, the Rule permits class actions by certain plaintiffs, including those bringing suits under the securities law. In a class action, one person can sue on behalf of a whole group in the same category.


47. More complicated types of shareholder injury are possible when the shareholder is itself a corporation. Suppose that Corporation A has acquired 25% of Corporation B's stock and has made a tender offer to B's minority shareholders in order to gain some measure of influence on the operation of Corporation B. To destroy the tender offer, the directors of Corporation B, who own a controlling number of shares, hurriedly negotiate a merger with A's principal competitor, Corporation C, in which they employ proxy statements depicting the desirability of the merger in a materially misleading fashion. Since Corporation A may be subject to suit for an antitrust violation if it does not immediately sell a large block of its stock in the new merged corporation, it may have to divest itself of these shares so precipitously as to suffer a great capital loss and/or to be subjected to suit under Section 16(b) of the 1934 Act for an illegal coupling of a purchase and sale within six months. Corporation A has thus been directly injured via its status as a Corporation B shareholder by the misleading proxy statement which induced the merger between B and C. (A pattern of injury rather close to this hypothetical was alleged in
counting principles, plaintiff would attempt to show that the contract
did not afford him an adequate number of shares of stock in the sur-
viving or new corporation for the shares he surrendered in the now
merged corporation. This sort of injury is often inflicted by a manage-
ment which deceives minority shareholders, causing them to lose their
statutory appraisal rights (thereby depriving them of the chance to re-
ceive payment in cash from the corporation for the fair value of their
stock) and thus locking them into the surviving or new corporation.48

B. Preclusion of Remedies and Causation

The holding in Laurenzano that management control should not
preclude liability is sound, even though the court failed to define ade-
quately its concepts of “consensus” and “transactional function,” and
incorrectly dismissed the idea that preclusion of legal remedies is im-
portant.49 Control of sufficient votes to approve a transaction may not
indicate definitively that the transaction would have been consum-
mated had there been no deception. For management may use a ma-
terially deceptive proxy statement in at least two ways to ensure the
satisfactory completion of whatever action is before the shareholders
and to thwart counterthrusts by a dissident minority.


48. For further discussion of appraisal rights, see pp. 117-18 infra.

49. It has already been noted that the court considered irrelevant the fact that a mis-
representation in a proxy statement might deceive shareholders and thus prevent them
from resorting to their legal remedies. 264 F. Supp. at 361; see p. 113 supra. “Consensus”
in Laurenzano can therefore not be defined in terms of precluding resort to legal remedies,
since if a particular state of affairs (e.g., deterrence of litigation) has no relevance, it is
hard to see how any consensus tending to produce that state of affairs is relevant either.
Nor does the court make any reference to the use of publicity by dissident shareholders.
The value of “consensus,” in the meaning that word must bear in Laurenzano, would
thus seem limited to whatever general harmony it might produce in the business life of
the corporation. But if that is what is meant, then it is difficult to explain exactly what
this general corporate harmony is. This difficulty appears to be acknowledged by the
Laurenzano court when it refers to the proxies obtained as “seemingly pointless appro-
vals.” 264 F. Supp. at 361. The court does, indeed, suggest that such “have their uses”
and that a “record of disclosure itself may serve a range of useful purposes” (td.), but it
offers no examples. If “uses” and “purposes” refer to the discouragement of shareholder
suits, or to the obtention of evidence of shareholder approval should there be a suit, it is
clear that the proxy solicitation would have an extremely important role. See, e.g., Honig-
the vote of the Class B stockholder. It states: ‘[T]he Court cannot ignore the persuasive
fact that the holders of 92.3 per cent of all outstanding Class B stock concluded that the
plan was fair to them and likewise so to the corporation.’” 309 F.2d at 671, quoting from
208 F. Supp. at 762. But any such interpretation is precluded by the fact that the notion of
“consensus” in Laurenzano excludes reference to the impact of a violation on the ability
of shareholders to resort to their legal remedies. Since the court’s notion of “transactional
function” is founded on its debilitated concept of “consensus,” it is clear that “trans-
actional function” as explained in Laurenzano is an altogether too tenuous basis for man-
gagement liability.

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First, the deception may have precluded publicity which a minority could have used to block the transaction. By hypothesis, the misleading statement or omission was "material," and the minority was thus kept in the dark about something important enough to affect the vote of a reasonable man. The shareholders might have been able to prevent completion of the transaction by waging a public campaign to dramatize the transaction's undesirable character. For example, a group of dissident shareholders might have taken a series of advertisements in major newspapers across the country to apprise fellow minority shareholders of what was taking place. These advertisements might have influenced the shareholders of the other corporation, the customers of both corporations involved in the merger, and the general public. A group of minority shareholders might also have used a series of press conferences and radio-television broadcasts to mobilize public opinion against management. Although the combined vote of all the minority shareholders would not be enough to stop the transaction, the unfavorable publicity ensuing from the revelation of the facts management had concealed might have deterred management from concluding the transaction for fear of damage to its reputation, credit standing, or business image.

Second, the defective proxy statement kept from the minority shareholders the fact that the transaction was objectionable or harmful to the best interest of the corporation or its shareholders; this deception may have prevented them from resorting to one or both of the following legal remedies in an attempt to block the transaction.

(a) In a merger context, appraisal rights might have been exercised. Under many state statutes a shareholder of either of the merged corporations has a right to appraisal of his stock and payment for it in cash if he does not wish to own stock in the new or surviving corporation. The exercise of such rights would enable any particular share-

50. It should be observed that the use of publicity may be regarded as a "solicitation" under Rule 14a-1, 17 C.F.R. 240.14a-1 (1970). See Union Pacific R.R. Co. v. Chicago & N.W. Ry. Co., 226 F. Supp. 400 (N.D. Ill. 1964) (distribution of brokerage firm report held to be a solicitation). But cf. Brown v. Chicago, Rock Island & Pacific R.R. Co., 328 F.2d 122 (7th Cir. 1964) (newspaper advertisement held not to be a solicitation where its purpose is to inform and motivate the public and not to obtain proxies). If means of gaining publicity are held to be solicitations, there may, quite apart from any materially misleading statements or omissions, be a violation of Rule 14a-9 on the part of the minority shareholders. This Rule provides in part:

(a) No solicitation subject to . . . [this regulation] shall be made unless each person solicited is concurrently furnished or has previously been furnished with a written proxy statement containing the information specified in Schedule 14A.

holder to salvage the worth of his personal holdings. Furthermore, exercise of appraisal rights by a large number of minority shareholders might so drain cash assets from the corporation as to make the projected merger no longer feasible or, at least, desirable; indeed, many merger plans expressly provide for termination if a certain percentage of shareholders exercise or take steps to exercise appraisal rights. However, such rights may often be lost if the shareholder fails to vote against the merger, or fails to file a written objection to the transaction before the shareholders' meeting (even though he votes against the merger). The Illinois appraisal statute, for example, would appear to be unavailable to any shareholder who voted for the merger. If appraisal rights have been lost, a shareholder will usually be prevented by state law from contesting the fairness of a corporate agreement by suing management for damages.

(b) Injunctions or declaratory judgments might have been sought. A minority shareholder might have had two separate grounds for this relief. (i) If plaintiff had been aware of the proxy violation before the shareholders' meeting, he might have been able to block the transaction by obtaining an injunction against the holding of that meeting or the voting of any proxies, under either federal or state law, because the proxies were secured by a materially defective proxy statement.

51. See, e.g., Article IX(c)(4) of the plan of merger between Cerro Corp. and Bethlehem Steel Corp., Proxy Statement of Cerro Corp., December 27, 1967, at 4 (4% limitation); Article IX(c)(4) of the plan of merger between MCA Inc. and Westinghouse Electric Corp., Proxy Statement of MCA Inc., September 20, 1968, at 6 (10% limitation).


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He might also have sought a declaratory judgment that the approval of a given proposal involved a materially defective proxy statement and that it would be illegal for management to complete the transaction.\textsuperscript{67}

(ii) The violation might have prevented the shareholder from obtaining injunctive relief based on a violation of state law that had been concealed. If a proxy statement discloses waste of corporate assets, or self-dealing on the part of the directors, or a conflict of interest, or any other violation of state law, a court applying state law\textsuperscript{68} would be entitled to grant an injunction provided that the additional conditions demanded by equity (such as irreparable injury) are satisfied.\textsuperscript{69} In \textit{Seagrace Corp. v. Mount},\textsuperscript{69} the Court of Appeals affirmed the grant of an injunction against a proposed purchase of stock on the ground that a conflict of interest under state law was revealed by the proxy statement.\textsuperscript{61} Hence, if the deceptive proxy covered a substantial violation of state law, the shareholder might have been deprived of a chance to have the voting enjoined; in such a situation, management control


The proxy statement would not merely mask wrongdoing unrelated to the proxy rules but also conceal the materially defective character of the proxy statement itself, and thus preclude connective action under these rules.

58. There are certain problems concerning jurisdiction and the conflict of laws in this area, but these may be ignored for present purposes. \textit{See} L. Loss \& E. Cowett, \textit{Blue Sky Law} 181-244 (1958); \textit{Loss, The SEC Proxy Rules and State Law}, 73 \textit{Harv. L. Rev.} 1249 (1960).


60. 212 F.2d 389 (6th Cir. 1954).

61. The case was a stockholders' derivative suit brought to enjoin the Seagrace Corp. and its officers from carrying out a proposed purchase of all the common stock and 95% of the preferred stock of the Fyr-Fyter Company. In exchange for this stock Seagrace was to authorize and issue to Herbert A. Post, Inc. (a concern owned by one man—Wetzel—and the predominant stockholder in Fyr-Fyter) enough shares of Seagrace to give Post (Wetzel) control. In an ancillary agreement, Wetzel was to buy out the controlling Seagrace shareholders (the "Wilkes group") at a price per share that was one-third in excess of its current market price. Proxies were solicited and the transaction was approved by a majority of the Seagrace stockholders, counting the Wilkes group shares. The district court granted an injunction against carrying out the plan on the ground that the transaction was unfair and the proxy statement materially misleading. The Sixth Circuit, however, concluded that the transaction was safe within the business judgment rule and that the proxy statement adequately disclosed the plan. Nevertheless, it affirmed the granting of the injunction on the ground that a breach of the duty of loyalty to the corporation under state law was revealed:

Although good faith . . . and disclosure of the material facts eliminate the question of actual fraud, equity will still act to enforce the fiduciary obligation under circumstances amounting to constructive fraud. Constructive fraud refers to acts which may have been done in good faith, with no purpose to harm the corporation, but which are done by one who has placed himself in a position of conflict between a fiduciary obligation and his own private interests. 212 F.2d at 397. For discussion of the case, see W. Cary, \textit{supra} note 50, at 650-52.
would be irrelevant to a minority shareholder's chances of securing an injunction.\footnote{62}

If the minority shareholder is claiming that the proxy deception covered up a violation of state law sufficient in itself to support a state court injunction, the shareholder might also argue that the deception "caused" his injury by preventing him from persuading other minority shareholders to join him as plaintiffs. Some states have statutes providing that, absent the joinder of shareholders owning a certain amount of stock, the shareholders bringing the derivative suit must post a security bond against the litigation expenses of the corporation should the derivative suit fail.\footnote{63} Plaintiffs in \textit{Laurenzano}, for example, argued that they had been injured by management's deceptive proxy statement because their state court derivative suit had been dismissed for lack of a security bond.\footnote{64} Plaintiffs might therefore claim that if the proxy statement had fully disclosed the facts, they would have had no difficulty in obtaining the joinder of sufficient stock interest to make a security bond unnecessary.

By preventing adverse publicity and by precluding recourse to available legal remedies, a deceptive proxy statement might, therefore, have played a crucial role in the completion of the proposed corporate venture. In some situations, it may thus be appropriate to speak of the proxy violation as the "but for" cause of the transaction,\footnote{65} even where management possesses the requisite voting power.\footnote{66}

\footnote{62. It may also be noted that, even where there is no statement or omission which is materially misleading under either federal or state law, plaintiff might still obtain an injunction under state law on other grounds. See, e.g., Steinberg v. American Bantam Car Co., 76 F. Supp. 426, 441 (W.D. Pa. 1948), \textit{appeal dismissed as moot}, 173 F.2d 179 (3d Cir. 1949) (evidence that fraud or violence would be used at meeting); Ohrbach v. Kerkby, 3 App. Div. 2d 269, 161 N.Y.S.2d 371 (1957) (same); Bryan v. Western Pac. R.R. Co., 28 Del. Ch. 13, 35 A.2d 909 (1944) (inadequate notice of meeting); Nationwide Corp. v. Northwestern National Life Ins. Co., 251 Minn. 255, 87 N.W.2d 671 (1958) (insufficient time for use of shareholder list by insurgents); Campbell v. Loew's, Inc., 36 Del. Ch. 505, 134 A.2d 852 (1957) (proxies solicited in violation of ruling that directors sought to be ousted should have sufficient time to present their case).


\footnote{64. \textit{See note 36 supra.}

\footnote{65. Traditionally, \textit{X} is said to be a cause in fact of an event only if the event would not have occurred but for \textit{X}. This is the so-called "but for" test of causation. W. Prosser, \textit{Law of Torts} 241 (3d ed. 1964). "Proximate cause" or "legal cause," on the other hand, is "essentially a problem of law." \textit{Id.} at 282. Only if a defendant's conduct is the proximate cause of an injury may he be held liable. Normally, the proximate cause must also be a "but for" cause, but not all causes in fact are considered legal causes. The indispensable conditions of a given injury may be myriad, but the law will usually consider only one or perhaps several of these to be the legal or "proximate" cause or causes. (It is doubtful that any definite rule can be developed for determining proximate cause, as complicated issues of legal policy and theory are involved. For a survey of proposed formulae, see Prosser at 284-88.)

\footnote{66. As to the standard of proof in this situation, see pp. 125-27 \textit{infra}. For occasions...}
Hence, it is clear that the court’s view of causation in Barnett is entirely too crude to be accurate in many factual situations.\(^6\) In Swanson v. American Consumer Industries,\(^8\) a recent case under Section 10(b) and Rule 10b-5, the Seventh Circuit pointed out that application of the Barnett rationale “would . . . sanction all manner of fraud and overreaching in the fortuitous circumstance that a controlling shareholder exists”\(^6\) because injury could still be inflicted upon minority shareholders:

Unlike Barnett, in the present case the minority shareholders were entitled to appraisal rights under Illinois law. It may well be that the misstatements and omissions contained in the proxy statements caused some Peoria shareholders to approve the sale, thus losing their statutory remedies. Other minority shareholders who failed to vote for or against the plan may nevertheless have been lulled into sleeping on their dissenters’ rights.\(^7\)

C. Implementation of Policies Behind the 1934 Act

If, even with management control, a proxy violation may be the cause in fact of injury to the corporation or its shareholders, then it is necessary to consider the policies behind federal regulation of proxy statements to determine whether it should sometimes also be considered the proximate cause of that injury and hence serve as a basis for management liability. The 1933 and 1934 Acts were the result of the stock market crash of 1929, the investigations of the securities market when management may have reason to solicit proxies even though it controls, see p. 114 supra.

\(^6\) “It is probable that the reason the defendant directors in Barnett tried to deceive the minority, whose votes they did not need, was to keep them from contesting their acts, which the court assumed to be illegal under state law. Since the plan could not have been successful but for this ancillary deception of the minority shareholders, that deception can be considered one of the causes in fact of the corporate injury.” Comment, Shareholders’ Derivative Suit to Enforce a Corporate Right of Action Against Directors under SEC Rule 10b-5, 114 U. PA. L. REV. 578, 582 (1966). It should be observed that the Government’s brief in the Mills case, which was in general followed closely by the Court, appears to favor Laurenzano over Barnett. Brief for the United States as Amicus Curiae at 14 nn.13 & 14, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

\(^8\) 415 F.2d 1326 (7th Cir. 1969). Plaintiff, a shareholder of Peoria Service Co. (Peoria), objected to a plan whereby Peoria’s assets were to be transferred to American Consumer Industries (ACI) for ACI stock. He alleged that Peoria’s proxy statements were materially misleading, that the reorganization plan was unfair to Peoria, and that some Peoria shareholders approved the plan because of the misleading proxy statements, thereby losing their statutory appraisal rights. (32 ILL. ANN. STAT. § 157.73 (Smith-Hurd, 1970 Pocket Part) was in question here. See the district court’s opinion in the Swanson case, 288 F. Supp. 60, 64 (S.D. Ill. 1968).) Although ACI owned 90% of the U.S. Cold Storage Corp., which in turn owned 87% of Peoria, the court rejected ACI’s putative defense of lack of causation between violation and transaction because injury might still have resulted from the violation.

\(^7\) Id. at 1331.

\(^7\) Id. (emphasis added). Laurenzano was cited.
which followed, and the general failure of state regulation in this area.\textsuperscript{71} The proponents of the new federal Acts sought to prevent fraudulent and misleading transactions and to give the investor greater understanding of his investments by shedding on corporate affairs the "white light of publicity."\textsuperscript{72} Against this background, it is clear that the purveying of materially misleading statements is inconsistent with the two major policies which stand behind the regulation of proxies by the 1934 Act.\textsuperscript{73} First, the policy of fair corporate suffrage stresses the value of clear and sufficient explanation to the shareholder of all projected action for which proxies may be sought.\textsuperscript{74} Informed and intelligent voting is thus an important goal, particularly where the preservation of appraisal rights is at stake. Since a minority shareholder may take a variety of actions, both to preserve his own interests and to protect those of the corporation, this ideal of accurate, complete information is as important when management controls as when it does not. Second, the policy of protecting the investor and insuring him redress when his rights have been violated is applicable in all situations where materially misleading statements or omissions have been employed to deprive the shareholder of his legal remedies and of other opportunities for action (such as use of publicity).\textsuperscript{75} Since even in the case of


\textsuperscript{72} 78 Cong. Rec. 7925 (1934). See also Hanna & Turlington, supra note 71, at 276; Tracy & MacChesney, supra note 71, at 1047-49, 1055; Comment, Civil Liability for Misstatements in Documents Filed under Securities Act and Securities Exchange Act, 24 YALE L.J. 456, 457 (1935).

\textsuperscript{73} These policies are stressed in both Borah and Mills. See p. 108 and note 18 supra.

\textsuperscript{74} The Senate Report on the 1934 Act noted that "[t]oo often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934). The Report urges that "he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings." Id. Similarly, the House Report contended that "[f]air corporate suffrage is an important right that should attach to every security bought on a public exchange." H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934). For cases stressing the importance of full disclosure, see, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); Kahan v. Rosenstiel, [1969-70 Transfer Binder] CCH Fed. Sec. L. REP. 92,589 at 98,685, 98,687 (3d Cir. 1970).

\textsuperscript{75} In this connection the House Report spoke of the use of proxies obtained without full disclosure "to take from the stockholders for their [insiders'] own selfish advantages valuable property rights." H.R. REP. No. 1383, 73d Cong., 2d Sess. 14 (1934). And in discussing liability for misleading statements imposed by § 18 of the Act, 15 U.S.C. § 78r (1964), the Senate Report remarked on the inadequacy of criminal penalties under state laws as the "sole sanction" for preventing "the exploitation of the investor." S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934). It went on to argue that "if an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party." Id. See also the section entitled "Minority Views" in the House Report. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 31 (1934). Since Borah and Mills it has become clear that civil liability is to attach to proxy violations as well, and that the
management control the shareholder may be precluded from exercising his rights and availing himself of the full range of his opportunities to influence corporate decision-making, this policy likewise serves to justify liability.

D. Consistency with Mills

The foregoing argument for management liability is, moreover, consonant with the Mills case, the latest Supreme Court decision interpreting the proxy regulations. In Mills, of course, some votes were needed from minority shareholders to effect the transaction. But the principle expressed by the Court that a causal relationship has been shown if the proxy solicitation was an "essential link" in the accomplishment of the transaction may be interpreted more broadly. If proxies are solicited to discourage shareholder suits and use of publicity and to obtain evidence of shareholder approval, that solicitation should be regarded as an "essential link" in the accomplishment of the transaction. This is particularly so where a requirement exists that proxies be sought. It would, therefore, appear that the argument for management liability presented above finds support in the language of the Mills opinion.

III. Patterns of Causal Connection

A. Definitions and Standard of Proof

If liability is to be imposed in situations when management controls the votes necessary to complete a transaction, the concept of "causation" in this context must be greatly clarified. Some courts imply that the proxy violation must cause the transaction; others suggest that it must cause the injury to the corporation or shareholder; and still others mingle "transaction" and "injury" with seeming indifference. While it is generally settled that there must be some causal connection between violation and injury for a defendant to be held liable, it is not


76. 396 U.S. at 385. The passage is quoted in full at p. 110 supra.

77. See p. 114 supra.

78. "Thus, as the Supreme Court obliquely indicated in Mills, the causation requirement, and more specifically the 'essential link' test, could probably be met in this situation [of management control] if proxies are solicited through misleading statements or omissions," Folk, supra note 44, at 820-21 (footnote omitted).

79. See the cases discussed in note 80 infra.
settled whether a causal relation must also exist between violation and transaction. This confusion frequently makes it difficult to harmonize past decisions under Section 14.80

Terms must be clearly defined if the different patterns of causation which may be involved in private actions are to be understood. “Violation” will here mean management’s use of a proxy statement which is materially defective under the current Mills standard. A “transaction” will be defined as any corporate action for which proxies are sought (e.g., a merger). “Injury” will mean any pecuniary harm suffered by the corporation (e.g., waste of its assets) or by shareholders (e.g., decrease in value of stock holdings because of an inadequate merger exchange ratio).

If “cause” is taken in the general sense of “cause in fact,” i.e., A is the “cause” of B if B would not have occurred but for A,81 it is clear that a proxy violation can function as a “cause” in two ways. On the

80. There are a number of passages in both Borak and Mills which suggest that a causal relation between violation and transaction is essential. “But the causal relationship of the proxy material and the merger are questions of fact to be resolved at trial, not here.” J.I. Case Co. v. Borak, 377 U.S. 426, 451 (1964) (emphasis added). “The question with which we deal is what causal relationship must be shown between such a statement [i.e., a “materially false or misleading” proxy statement] and the merger to establish a cause of action based on the violation of the Act.” Mills v. Electric Auto-Lite Co., 396 U.S. 375, 377 (1970) (emphasis added). Similarly: “Our conclusion that petitioners have established their case by showing that proxies necessary to the approval of the merger were obtained by means of a materially misleading solicitation implies nothing about the form of relief to which they are entitled.” Id. at 386 (emphasis added). But cf. the passage in which the Court states “Where there has been a finding of materiality, a shareholder has made a sufficient showing of a causal relationship between the violation and the injury for which he seeks redress if....” Id. at 385 (emphasis added).


In Barnett ..., Judge Bryan held that there was no cause of action under section 14(a) where the transaction complained of could not have resulted from proxies. Id. at 762 (emphasis added). But it can be argued that Barnett is far from clear on this issue, since the court states at one point:

In the case at bar the necessary causal connection between the alleged violation of section 14(a) and the alleged injury to the minority shareholders is wholly lacking. 288 F. Supp. at 773 (emphasis added).

On the other hand, language can be found in most of the cases to suggest that only the relation between violation and injury is important, at least where dissolution of the transaction is not sought. For example, in Laufer v. Stranahan, [1969-70 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,617 at 98,773 (S.D.N.Y. 1970), the court was prepared to follow Barnett to a point, and denied rescission where defendants owned 85% of the stock on, inter alia, the ground of lack of causation. However, the court refused to say that a causal connection between violation and transaction is in all circumstances necessary to state a cause of action under Section 14(a):

What has been said is not intended to permit a dismissal of the action, but only so much of it as seeks rescission of the merger. The plaintiffs will be permitted to show what impairment of stockholding interest, if any, resulted from the merger, as distinct from the alleged corporate misstatement. If they have been injured by the merger in this sense they should be able to pursue their claims for damages or other appropriate relief.

Id. at 98,775. See also note 29 supra.

81. See note 65 supra.
one hand, a violation may cause *injury*, though there will often be an intermediate step. Thus, a materially misleading proxy statement may in the first instance be causally responsible for a shareholder's loss of appraisal rights by inducing him to vote for a merger; this loss of appraisal rights may, in turn, be causally responsible for the decreased value of a shareholder's stock, since, but for that loss, he would have been able to receive the fair cash value of his holdings by exercising those rights. On the other hand, a violation may be said to cause the *transaction*. The defective proxy statement may preclude resort to publicity and legal remedies; that preclusion may in turn be considered the "cause" of the transaction, since, if the proxy statement had not prevented the use of publicity or legal remedies, the employment of these "corrective" devices might have deterred management from completing the transaction.

A finding of "causation" necessarily entails application of a standard of proof to determine whether there is a causal link between violation and injury and/or between violation and transaction. The applicable standard should be one of preponderance of the evidence, *i.e.*, it must appear more likely than not that the necessary causal relation existed.

When plaintiffs are attempting to establish a causal link between the proxy violation and the injury they have suffered, the fact of a material misstatement or omission under *Mills* means that, had plaintiff known of the true state of affairs, he *might have* voted differently. In this case, such a vote (against, rather than for, a proposed merger) would have enabled plaintiff to preserve his appraisal rights and avoid financial injury. Where the plaintiff is claiming injury from loss of appraisal rights, the existence of a material violation will usually imply that it is "more likely than not" that a causal relation existed between violation and this injury.\(^\text{82}\)

For example, assume that a merger was negotiated between Corporation A and Corporation B, whereby A shareholders would receive one share of the stock of B (the surviving corporation) for each share of A stock. However, A's directors sent out a misleading proxy statement, which they used to conceal the fact that on generally accepted accounting principles the fair exchange ratio was two shares of B stock for each share of A stock. The A shareholders voted in favor of the merger, thereby losing their appraisal rights, and later found out that their holdings had been diminished in value by one-half. A Section 14(a)

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\(^{82}\) For preservation of appraisal rights would allow plaintiff to exercise them once he learned of the injury.
suit brought by A shareholders under the theory of this Note should nearly always be successful; for it would be most unusual for the trier of the fact to find that it was not more likely than not that they would have exercised their appraisal rights and thus avoided injury had they known of the unfair exchange ratio. Indeed, the only practical difference between application of the standard of preponderance of the evidence and the imposition of per se liability in this case after a finding of materiality is that the former allows, while the latter does not, the unlikely introduction by management of an admission or a declaration against interest made by a plaintiff A shareholder to the effect that he would not have exercised his appraisal rights.

In other cases, plaintiffs seeking rescission of a transaction will be attempting to establish a causal link between the violation and the transaction. To prevail they must make it appear more likely than not both that they would have taken action of a certain type or types and that management would have been deterred from consummating the transaction by virtue of that action.

An example may serve to make this notion of causation clearer. Suppose that a proxy statement materially misrepresented the fairness of a merger exchange ratio between Corporations A and B, but that the ratio was inadequate by only $.50 per share of A stock. The A directors controlled 95% of the A stock; the remaining 5%, amounting to 50,000 shares, was distributed equally among fifty shareholders. Various other factors in the corporate context, such as the fact that B’s assets were extremely valuable (owing to a short-term dislocation between supply and demand in favor of sellers) and could be used by A, indicated that the merger was very important to both corporations. The fifty A shareholders now demand rescission, alleging that they would have exercised appraisal rights and used publicity to block the transaction. In this case, the trier of the fact would find that no causal connection existed between violation and transaction. In the first place, a mere fifty shareholders, with only $500 apiece to lose, are unlikely to resort to publicity on a scale that would influence management. Secondly, even if all fifty were to have exercised their appraisal rights, it is doubtful that the net effect would have been sufficient to dissuade management from pursuing the important merger. Plaintiffs would therefore not be able to meet the test of preponderance of the evidence.

83. For further discussion, see pp. 128-29 infra.
84. A and B stock were both listed securities. Hence, the federal proxy regulations were applicable. See note 42 supra.
Nevertheless, as the relevant variables are altered in favor of the shareholders, it is clear that the existence of a causal link between violation and transaction becomes more likely. Thus if the above example were modified by positing an exchange ratio inadequate by a margin of $3.00 per share of A stock, or by increasing the number of shares of A stock in the hands of minority shareholders, or by diminishing the importance of the merger to management, or by some combination of these changes, plaintiffs would stand a much better chance of proving that it was more likely than not that a causal link between violation and transaction existed.

In general, therefore, to show a causal relation between violation and injury plaintiff must make it appear more likely than not that, had there been no misleading proxy statement, he would have been able to take steps sufficient to protect himself or the corporation from injury. To prove that such a relation exists between violation and transaction, he must show by a preponderance of the evidence that, but for the violation and the preclusion of publicity and/or legal remedies, the transaction would not have been consummated. In this context, the dual impact of appraisal rights should be noted. Insofar as appraisal rights are exercised by any particular shareholder, they serve to protect him from injury; insofar as they are exercised en masse, they may dissuade management from consummating the transaction.

In accordance with this definition of terms and analysis of standard of proof, four possible causal patterns can be distinguished.

B. **The Four Patterns**

1. *Violation causes both transaction and injury.* If a violation causes both transaction and injury, plaintiff should be entitled to both damages for the harm suffered and (possibly) rescission of the transaction.\(^{85}\) Suppose, for example, in regard to a proposed merger between Corporations A and B, A’s directors misrepresented in a proxy statement the fairness of the exchange ratio: A shareholders were in fact shortchanged $20 per share of A stock. There were 10,000 A shareholders with a total of 1,000,000 shares of stock, and the merger would not have been feasible if cash assets had been depleted. In these circumstances, the trier of the fact must certainly find that the violation both caused the injury (decrease in value of individual stock holdings), because A shareholders would probably have exercised appraisal rights,

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85. As to punitive damages, see pp. 130-34 *infra.*
and caused the transaction (merger), because wholesale exercise of appraisal rights would have drained the corporation's liquid assets and made the merger financially undesirable. In accordance with the argument presented for liability above, once the violation is shown to "cause" both the injury and the transaction, management should be held liable for the injury sustained by the plaintiff, and rescission is a possible form of relief.86

2. Violation causes injury but not transaction. If plaintiff proves that the violation caused the injury but fails to prove that it caused the transaction, he should be entitled to damages but not rescission.87 The most obvious example of this causal pattern is when plaintiff suffers a limited loss in the value of his stock holdings, but neither the loss itself nor the amount of stock not under management control is very significant. Such an example was given earlier,88 viz., the case where a ma-

86. It should be noted that, even if there is a causal relation between violation and transaction, it does not follow that rescission must be granted. Before granting rescission and/or damages, the court should consider at least the following factors. (1) Time elapsed. In some cases the passage of several years after the consummation of the transaction, particularly in the case of mergers, will itself make rescission inappropriate or impossible, since the acquired company may have lost its employees, good will, and very identity. Elson, supra note 6, at 619-20. (2) Nature of the transaction and parties. A merger, for instance, is obviously more difficult to undo than most transactions. Again, it is easier to return conveyed assets to an extant corporation than to a corporation that has been dissolved subsequent to the transaction but before relief could be decreed.

87. As to punitive damages, see pp. 130-34 infra.

88. See p. 126 supra.
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terially defective proxy statement was sent out in connection with a merger, but the exchange ratio was inadequate by only $.50 per share and a mere 50,000 shares (5%) were not under management control. It was seen that the trier of fact must in those circumstances find that there was no causal connection between violation and transaction. But there was such a connection between violation and injury, since plaintiffs would more probably than not have preserved their appraisal rights by voting against the merger.

In such circumstances, it is necessary to ascertain the type of relief sought by the plaintiff. The absence of a causal link between violation and transaction seems irrelevant to whether plaintiff should be allowed to recover damages for the injury inflicted upon him. If defendant's illegal conduct (the violation) is the cause in fact of plaintiff's injury (e.g., the decrease in value of stock holdings because of an unfair merger exchange ratio and loss of appraisal rights), that would under standard tort principles be sufficient to hold defendant liable. However, if plaintiff sues for rescission of the transaction, the failure to prove that the transaction itself is causally linked to the violation should negative granting that form of relief since the interests of innocent third parties (e.g., post-merger purchasers of the merged corporation's stock) may be adversely affected by any dissolution of the transaction.

3. Violation causes neither transaction nor injury. If plaintiff is able to show only the bare fact of a violation and cannot prove that the violation caused either the transaction or the injury, then he should be entitled to neither damages nor rescission. As an example, suppose that management recommended a merger to the shareholders, but that the terms of the merger were fair under general accounting principles and that neither shareholders nor the corporation suffered injury. However, management materially misrepresented its relation to Corporation B (e.g., they were all the nominees of Corporation B, which owned the controlling interest in Corporation A). The publicity value of that revelation (it will be assumed) is small. Here the trier of the fact will find that the violation was not causally responsible for any injury, since there was none. Similarly, he will find no causal relation between violation and transaction because exercise of appraisal rights

90. For additional requirements in regard to rescission, see supra note 86 supra.
91. In regard to punitive damages see pp. 130-34 infra.
would have had no deterrent effect (since the terms were fair and so there was no reason for minority shareholders to exercise their appraisal rights), plaintiffs would not have been able to get an injunction (since they could not have shown irreparable injury), and the use of publicity would have been unavailing.

4. Violation causes transaction but not injury. If the violation causes the transaction but no injury, plaintiff is generally, under the theory advanced in this Note, entitled to no relief. In rare instances, punitive damages may be awarded. Suppose that Corporation A negotiated a merger with Corporation B, and that A's directors recommended approval to the shareholders. The exchange ratio proposed was entirely adequate, and there were no problems concerning waste of assets or conflict of interest. However, the A directors materially omitted from the proxy statement the fact, known to them and to the B directors but not to the general public, that Corporation B had just signed a large contract for the production of war materiel with the government of a foreign state. The war being waged by the foreign state was extremely unpopular with American citizens; had the existence of this contract been known to the minority A shareholders, they could have used publicity to force management to withdraw from the proposed transaction. It seems apparent that the trier of fact must find that the proxy violation caused no injury to A shareholders (since they have suffered none) but did cause the transaction.

This case may arise infrequently, but when it does it will pose considerable difficulties. Since neither plaintiff nor the corporation has suffered injury as a result of the violation, it is apparent that there is no basis on which to award actual damages. For the purpose of actual damages is to compensate for loss proximately resulting from the defendant's conduct, and here there is no such loss. Nevertheless, it is important to consider whether, because the violation caused the transaction, plaintiff should recover punitive damages.92

At common law, punitive or exemplary damages were sometimes awarded on theories of revenge, indignation,94 punishment or deter-

92. Punitive damages are, of course, arguably a remedy in the case of the first three causal patterns as well, and the discussion of punitive damages here should be understood to apply also to the earlier examples.
94. See, e.g., Gostkowski v. Roman Catholic Church of the Sacred Heart of Jesus and Mary, 262 N.Y. 239, 241-25, 166 N.E. 798, 800 (1930).
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rance. Such damages are generally allowable only where there has been malicious, wanton, or oppressive misconduct, and most cases hold that both the amount of such damages, and indeed whether they are to be given at all, rest in the jury's discretion.

The question here is whether they should be allowed for violations of Section 14 of the 1934 Act. Although there are no cases under Section 14 on point, the question of punitive damages has been discussed in regard to other claims under the 1934 Act and also in regard to claims under the Securities Act of 1933. Those cases are not in complete harmony. Most of the decisions in the early 1960's concluded that punitive damages were not allowable under either the 1933 Act or the 1934 Act, and this line of interpretation has since been reinforced by Green v. Wolf Corp. and Globus v. Law Research Service, Inc. The argument against punitive damages under the 1934 Act, as enunciated in Green, was that Section 28(a) of the Act clearly precluded punitive damages by limiting damages awarded in any suit per-

95. See, e.g., Funk v. Kerbaugh, 222 Pa. 18, 70 A. 953 (1908).
98. See, e.g., Bergman v. Jones, 94 N.Y. 51 (1883).
100. This question can arise when there is actual harm as well as when there is not, and the discussion in the text is intended to apply to both cases. At common law, some courts have held that there must be actual damage before punitive damages can be awarded. See, e.g., Shore v. Shore, 111 Kan. 101, 205 P. 1027 (1922). But this rule is not generally followed. See, e.g., Clark v. McClurg, 215 Cal. 279, 9 P.2d 505 (1932). See also C. COlLMICK, HANDBOOK ON THE LAW OF DAMAGES § 89 (1965).
104. 15 U.S.C. § 78bb(a) (1964) reads in part: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." Emphasis added.
mitted under the Act to "actual damages." In support of this conclusion, the court contended that punitive damages are unnecessary as a deterrent under Rule 10b-5, since liability for actual damage may be very heavy, and since the 1934 Act also contains provisions for criminal penalties. The court asserted that the burden of punitive damages would "ultimately fall on all the stockholders, including mere innocent pawns."

Nevertheless, a number of very recent cases in the district courts have rejected this reasoning and have allowed punitive damages or indicated them to be a possible form of relief. The most far reaching of these decisions was deHaas v. Empire Petroleum Co., which held that the Section 28(a) "actual damages" limitation does not preclude punitive damages, because it is applicable only to suits specifically authorized by the Act; therefore, since implied causes of action—for example, private actions under Section 10(b) or 14(a)—are not specifically authorized, Section 28(a) does not apply to them.

For two reasons, however, punitive damages must usually be rejected as a justifiable form of relief under Section 14(a). First, although the line of reasoning employed in deHaas has found some favor, it seems a departure from the language of Section 28(a). For that section does not speak of actions "specifically authorized," but rather states that "no person permitted to maintain a suit for damages under the provisions of this chapter" shall recover more than "actual damages." And it is difficult to see how a private plaintiff seeking relief under Section 14(a)
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is not a person permitted to maintain such a suit. Moreover, quite apart from statutory construction, there is the fact that the Court in Mills stated that "damages should be recoverable only to the extent that they can be shown." This statement would also seem to bar exemplary damages under Section 14.

Second, even if the courts could be persuaded that neither Section 28(a) nor Mills precludes punitive damages, policy considerations rarely favor their award. Since Mills expressly allows costs and reasonable attorneys' fees, only "punitive damages" in a strictly noncompensatory sense are in issue. Hence, the rationale that punitive damages help to defray the expenses of litigation is inapplicable. Furthermore, the retributive purpose which punitive damages allegedly serve in other areas of the law may be fulfilled largely by the criminal law.


115. 396 U.S. at 389.

116. Elson has argued, however, that if the courts will allow a rescissional measure of damages, it is inconsistent for them not to allow punitive damages, for both may bring a windfall to the plaintiff. Elson, supra note 6, at 617. The argument is a non sequitur, for there would seem to be at least two differences between rescissional and punitive damages. First, rescissional damages do bear some relation to the wrong committed in that they represent the amount the wrongdoer has profited, while punitive damages bear no such relation. Second, punitive damages are granted for some express purpose such as punishment or revenge, whereas rescissional damages are often awarded simply because the court must give the ill-gotten gains to someone and is reluctant to let the wrongdoer profit. "It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them. . . . It is simple equity that a wrongdoer should disgorge his fraudulent enrichment." Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965). Elson has also argued that decisions denying the award of punitive damages cannot be reconciled with the holdings in Borak and SEC v. National Securities, Inc., 393 U.S. 453 (1968), because the "federal courts have broad discretion in shaping the relief necessary and can specifically grant rescission—a remedy not specified in any of the provisions of the 1934 Act," Elson, supra note 6, at 617. This argument is also unconvincing. In some cases rescission may be the only way of returning matters to the status quo ante, and hence could be argued to be the analogue of actual damages and so within the limits of § 28(a) of the Act. Punitive damages are not even arguably within those limits.

117. 396 U.S. at 389-97.

118. Damages are here considered to be "compensatory" not only when they redress the actual harm suffered by the plaintiff, but also when they provide recompense for expenses incurred by the plaintiff in obtaining redress for actual harm.
penalties available under the 1934 Act.\textsuperscript{119} In any case, retribution seems apposite only where a defendant's conduct is particularly reprehensible. For example, if the president of the corporation knowingly inserted false accounting data into the proxy statement in an effort to conceal the true state of the corporation's finances and thereby to insure the election of directors who would re-elect him president (and would permit him to continue looting the corporation), punitive damages might be appropriate. By contrast, such damages would not have a defensible retributive function if the defendant was an outside director who had, by inadvertence, permitted the issuance of a deceptive proxy statement. Finally, the only substantial reason for punitive damages is the additional deterrence they would provide. In view of the fact that liability for proxy violations may be quite high anyway and that the precise deterrent effect of punitive damages is difficult to estimate, this reason does not seem very convincing. The burden of punitive damages may quite unfairly fall on innocent shareholders.\textsuperscript{120} Although there is some evidence that juries can distinguish degrees of reprehensibility among various wrongdoers,\textsuperscript{121} and even though the courts can restrain unwarranted or excessive awards,\textsuperscript{122} it is doubtful that the possibility of unfairness can be eliminated entirely. In summary, the arguments in favor of punitive damages at best support their award in only a very limited number of cases.\textsuperscript{123}

\textsuperscript{119} Section 32(a), 15 U.S.C. § 78ff(a) (1964).

\textsuperscript{120} Indemnification for punitive damages apparently is not, for example, precluded by the Delaware indemnification statute. See 8 DEL. CODE ANN. § 145 (Cum. Supp. Pamph. 1968).

\textsuperscript{121} See, e.g., Globus v. Law Research Service, Inc., 287 F. Supp. 188 (S.D.N.Y. 1968), rev'd as to award of punitive damages, 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970). The jury awarded punitive damages against Hoppenfeld, the president of Law Research Service, and Blair & Co., Granbery, Marache Inc., the underwriter, but not against Law Research itself. Compensatory damages were assessed against all defendants. The evidence tended to show that Hoppenfeld and the underwriter were aware of defects in the offering circular and failed to correct them, whereas officers and directors of Law Research apart from Hoppenfeld were not aware of them.


\textsuperscript{123} Note, Punitive Damages in Implied Private Actions for Fraud under the Securities Laws, 55 CORNELL L. REV. 646 (1970), discusses the various arguments and concludes that punitive damages may in some cases be justified. This conclusion appears to be restricted to cases involving especially undesirable behavior under the fraud provisions of the 1933 and 1934 Acts.

A plaintiff's remedies in private actions under section 17(a) [of the 1933 Act] and rule 10b-5 [issued under the 1934 Act] are potent, but there are areas where additional punitive and deterrent devices are needed. Under proper procedures, punitive damages awarded after an aggravated tort would serve a necessary function as an extraordinary remedy.

Id. at 628-29 (emphasis added; footnotes omitted).
IV. Rebuttablity of the Mills Presumption

A related but distinguishable question of liability, also left unanswered by Mills, is whether a management which does not itself own a controlling block of stock would be allowed to introduce evidence that the requisite number of shareholders would have voted to approve the transaction, despite the materially defective proxy statement. Here management owns less than a controlling interest (i.e., the Mills situation), but would be able to produce in court testimony from shareholders (whose votes coupled with management would yield the necessary total) that even had they known of the material defect they would have voted in the same fashion. The question is whether the Mills presumption (that materiality and the need of votes to approve a transaction is sufficient for a showing of causation) may be rebutted. For example, suppose that Corporation A controlled 59% of the voting stock of Corporation B, and B’s management (who had been appointed by A) used a materially defective proxy statement to obtain the necessary two-thirds vote of B shareholders to authorize a merger with A. All B shareholders entitled to vote did so, and the result was 69% in favor and 31% against the transaction. If a mutual fund holding 10% of the B stock had voted all its shares for the merger, and if B’s management could prove that the mutual fund was not in fact misled and would have voted the same way even had the proxy statement not been materially defective, would this enable B’s management to rebut the Mills presumption of causal relation between violation and transaction?

Although the Court did not confront this question in Mills, it might be argued that, since Mills states that there is a “sufficient showing of

124. This supposition avoids certain problems raised by Heit v. Davis, [1964-66 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,698 at 95,565 (S.D.N.Y. 1966). Heit held that, where a simple majority was needed to approve a transaction, defendants’ motions for dismissal and summary judgment in an action under section 14(a) must be denied, since, though defendants accounted for 51.31% of the votes cast at the shareholders’ meeting, they did not have a majority of the shares outstanding. There was, in the eyes of the court, “no mathematical demonstration of non-causality.” Id. at 95,567.

125. Such proof might, for example, proceed by way of affidavits from directors or officers of the mutual fund.

126. Since there is (1) a proxy violation and (2) the necessity for management to secure votes from other shareholders to approve the merger, application of the Mills test yields the result that a “sufficient showing” has been made.

The above question is said to be “related” to that posed at the beginning of this Note because in a sense the practical issue is in each case the same—viz., whether management is to be held liable when plaintiff’s minority votes are unneeded. On a formal plane, however, the two questions are distinguishable. “Can causation be shown if management controls?” asks whether a causal relation can be established if condition (2) of the Mills presumption is unsatisfied, that is, if no minority votes are needed. “Can causation ever be rebutted?” asks whether defendant can show a causal relation to be absent even if both conditions of the Mills presumption are met.

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causal relationship" if some votes must be obtained from minority shareholders and if there is a material misrepresentation, liability will result here. However, this interpretation depends on reading "sufficient" as "sufficient no matter what the circumstances," whereas there is authority for construing "sufficient" to mean only that there is a *prima facie* case. It would therefore be consistent to allow the introduction of countervailing evidence. Moreover, reference to other statements in the *Mills* opinion suggests that the Court had no such rigid construction in mind. For example, the Court asserted that a "material" defect is one which "might have been considered important by a reasonable shareholder who was in the process of deciding how to vote." It is clear that a plaintiff does not have to prove the actual effect on himself of the material misrepresentation, but it seems consistent to allow a defendant to prove that the misrepresentation had no effect on some minority shareholder other than plaintiff. Finally, the Court does not use "*per se*" language or specifically state that the presumption is irrebuttable. It is evident, therefore, that the *Mills* opinion itself provides no clear and final answer as to whether the presumption is rebuttable. A line of decisions under Section 10(b) and Rule 10b-5, however, provides an analogy which suggests that the presumption is rebuttable. These decisions hold that for a plaintiff to recover he must have "relie[d]" on a material misrepresentation. In the leading case, *List v. Fashion Park, Inc.*, plaintiff brought suit under Section 10(b) and Rule 10b-5 for

127. 396 U.S. at 385 (emphasis added).
128. See, e.g., Parker v. Overman, 59 U.S. (18 How.) 137, 141-42 (1855) ("sufficient" in Arkansas statute is a synonym for "*prima facie*," not "conclusive"); State v. Newton, 33 Ark. 276, 284 (1878) ("sufficient" means "*prima facie*"). See also Rebel v. Standard Sanitary Manufacturing Co., 340 Pa. 313, 318, 16 A.2d 534, 537 (1940), where "sufficient" as used in statute was said to be "a relative term depending upon the facts of each case." *Contra*, Spilman v. Gulf & S.I. R.R. Co., 178 Miss. 725, 731, 169 So. 445, 446 (1935): "In law, when anything is said to be sufficient, it means that nothing else is required."
130. 396 U.S. at 384-85.
lost profits owing to allegedly wrongful non-disclosure by an insider purchaser of his stock. In affirming the district court’s dismissal of the action, the Court of Appeals ruled that it was necessary to establish both materiality of the non-disclosure and individual reliance and that plaintiff had failed to prove either. As to the nature of reliance, the court said:

The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.

While there has been criticism of the requirement of reliance, the List “reliance” requirement is, however, merely a requirement of causation in fact; proof is only required that the violation was actually responsible for the conduct of those putatively affected. As one commentator has declared:

It does seem proper to limit the defendant’s liability to those injuries which, but for his illegal conduct, would never have been suffered. Any broader liability would be inconsistent with the policies thought to justify the imposition of civil liability in the first place.

The present state of the law under Section 10(b) and Rule 10b-5 is thus that, even if plaintiff can prove that a misstatement or omission was materially misleading, he will have no case if the defendant can prove that he would have acted no differently had there been no misstatement or omission.

If the reasoning of List is adhered to, proof that the materially misleading statement had no effect on two-thirds of the voting stock will rebut the Mills presumption of causation. In terms of the earlier hypo-
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thetic, while the misrepresentation was material, there was no “reliance” on it by either management or the mutual fund. Thus, since these two blocks of stock represent enough votes to effect the transaction, if the List rationale is followed, the violation could not be said to have “caused” the transaction solely on the strength of the Mills presumption.

Even though the causal relationship countenanced by the Mills presumption may be rebuttable, however, it does not follow that a causal relation may not be established in some other way. Even where the Mills presumption is initially rebutted, as here when management proves that the mutual fund’s votes were not influenced by the violation, a plaintiff will still be able to prove that the violation was the cause in fact of the consummated transaction where, if the true character of the transaction had been known, the consequences (e.g., wholesale exercise of appraisal rights, use of publicity, etc.) would more probably than not have deterred management from effecting the transaction. Even where no causal relation exists between violation and transaction, there may still be such a relation between the violation and injury to the minority shareholder. Hence, rebuttal of the Mills presumption does not preclude all possibility of management liability.

139. See TAN pp. 116-21, 123-25, 128-29 supra.