1970

Corporations--Fradulent Proxy Statements--Securities Exchange Act of 1934, § 14(a)

Steve Hixson
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj

Part of the Securities Law Commons

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation
Available at: https://uknowledge.uky.edu/klj/vol59/iss1/17

This Comment is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledge@lsv.uky.edu.
cerning the status of LSD. The minority, however, relied more upon the technicalities of the administration of courts of law which restrict them from being courts of justice. It appears that the minority opinion was more concerned with the harmful effects of LSD and the need for very strict laws in regard to it. If these two manners of judicial opinion reflect the basic rationale for deciding a case of law, the question which must be answered is: should technical legal precedent be strained to further one policy over another policy backed only by general, and not direct, precedent? The answer is that precedent and policy must not be examined separately; but interwoven as the dominant and essential element of a principle of law.

Richard D. Pompelio

CORPORATIONS—FRAUDULENT PROXY STATEMENTS—SECURITIES EXCHANGE ACT OF 1934, § 14(a). A management proxy statement soliciting minority votes for a proposed corporate merger was materially defective since it failed to disclose that the directors recommending the merger were controlled by the other party to it. Rescission of the merger was sought by plaintiffs who alleged violation of section 14(a), the proxy fraud provision of the Securities Exchange Act of 1934. A federal district court held that a case of fraud had been established by showing (1) that the proxy defect was material, and (2) that the proxy votes were necessary for approval of the merger. However, the Court of Appeals for the Seventh Circuit reversed and held that if the

1 The materiality of the defect was found by the trial court as a matter of law on motion for summary judgment and affirmed by the Seventh Circuit Court of Appeals. 403 F.2d 429, 435 (7th Cir. 1968).
2 Electric Auto-Lite Company, of which plaintiffs were minority shareholders, had been under voting control of Mergenthaler Linotype Company, the other party to the merger, and all 11 of Auto-Lite's directors were nominees of Mergenthaler. The proxy statement told the minority shareholders simply that the directors recommended the merger without disclosing their relationship to Mergenthaler.
   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 i of this title.
terms of the merger were fair, plaintiffs would have no case since the merger would have been approved regardless of the defective proxy statement, i.e. no causation would exist. The Supreme Court granted certiorari. Held: Reversed. Where the proxy solicitation is an essential link in the accomplishment of the corporate transaction, a showing that the proxy defect is material establishes sufficient causal relationship between the violation and the injury without regard to the fairness of the transaction. Mills v. Electric Auto-Lite Company, --- U.S. ---, 90 S. Ct. 616 (1970).

Much life has been pumped into section 14(a) of the Securities Exchange Act of 1934 by judicial decision in recent years. Unlike other sections of the Act, section 14(a) made no provision for its enforcement by private action and the existence of such a right was in controversy. In 1964 the Supreme Court addressed itself to that issue in J. I. Case Company v. Borak, where plaintiff alleged violation of SEC Rule 14a-9, promulgated under section 14(a) of the Act to prohibit the use of materially false or misleading proxy statements. Citing strong congressional policies of curbing proxy abuse and insuring fair corporate suffrage, the Court recognized a private shareholder's right of action, either direct or derivative, for violations of section 14(a). Although unquestionably a milestone decision, the Borak opinion evaded any discussion of the causal relationship which must be shown to sustain a private proxy fraud action under the Act.

A plaintiff in a common law action for fraud and deceit normally is required to prove, inter alia, that the defendant's actions were both

---

4 403 F.2d 429, 435 (7th Cir. 1968).
5 See § 9(e), 15 U.S.C. § 78i(e) (1964) and § 18(a), 15 U.S.C. § 78r(a) (1964), both of which clearly grant private rights of action for violations of those sections.
7 17 C.F.R. 240.14a-9(a) (1966):
   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.
9 J. I. Case Co. v. Borak, 377 U.S. at 432. Intertwined with the statement of policy and congressional intent was the Court's pragmatic recognition of the fact that the number of proxy statements examined by the SEC (more than 2000 per year) necessitates a supplement to Commission action. The recognition of a private right of action constitutes such a supplement. Id.
10 Id.
relied upon and responsible for the plaintiff's harm. It is important to note the distinction between the elements of reliance and causation because the two are sometimes mistakenly lumped together and referred to as "causation" or "causal relationship." To illustrate, the defendant's fraud may harm the plaintiff without any reliance by the latter; or the plaintiff may rely on the fraud but he harmed by some other force. The confusion may stem from the "supporting role" which reliance plays to causation: once it is shown that the fraud prompted plaintiff's action (reliance), one may infer that the fraud actually caused the harm suffered (causation). As illustrated above, however, this is only an inference. Reliance can even be irrelevant to the issue of causation, such as when the fraud harms one who has taken no volitional action of his own.

Litigation has centered around the need for and the methods of proving both reliance and causation as they relate to private fraud actions under the Act and causation has been the more important of these issues. The related but independent element of reliance is not further treated herein except as used in its supporting role of inferring causation.

The first securities fraud case to grapple with the causation issue which the Borak case had left unresolved was Barnett v. Anaconda Company, wherein a minority shareholder complained that approval for corporate dissolution was fraudulently obtained in violation of section 14(a). The case was dismissed for failure to show that the fraud caused the dissolution because the defendant owned enough stock (seventy-three percent) to dissolve the corporation without using the fraudulently obtained votes. Recognizing that this view of causation scarcely protected the minority shareholder, some courts began to find causation where the Barnett court would not.

11 3 Loss, Securities Regulation 1431 (2d ed. 1961). Additionally he would have to allege and prove (1) a false representation (2) of a material fact (3) made with knowledge (sciente) of the falsity for the purpose of inducing the plaintiff to rely on it. Id.
12 See Comment, 46 N.C. L. Rev. 599, 626 (1968), citing List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), in which the court enunciated the "supporting role" theory, explaining that proof of reliance is required because it infers that the conduct of the defendant caused plaintiff's injury.
14 For an excellent and more cogent explanation of the relationship between the elements of reliance and causation and the securities fraud case law involving each, see Comment, 46 N.C. L. Rev. 599 (1968).
16 "The transactions under attack did not result from the issuance of the allegedly misleading proxy material which, in view of . . . Anaconda's 73% stock holdings, could not have had anything to do with the approval or disapproval and consummation of such transactions." 238 F. Supp. 766, 771 (S.D.N.Y. 1965).
17 E.g., Weber v. Bartle, 272 F. Supp. 201 (S.D.N.Y. 1967); Globus, Inc. (Continued on next page)
zano v. Einbender\textsuperscript{18} directly contradicted Barnett on similar facts in a much more realistic approach to the causation issue. When the defendant moved dismissal of the proxy fraud action on the ground that it possessed enough majority votes to have approved the contested action without using the fraudulently procured votes, the court refused to rule as a matter of law that causation was absent, saying:

The [shareholders'] meeting does not become nugatory and dispensible because one stockholder owns enough shares to carry any resolution and can be expected to vote in favor of his own resolutions. The vote is not legally pre-determined simply because it seems practically predictable. . . . The misleading proxy material deprives the meeting, and the majority stockholder, of the expressions of view and the votes that would have ensued upon truthful disclosure. . . .\textsuperscript{19}

It is against this background of conflicting decisions that the Court in the instant case addressed itself to the issue it had declined six years ago to resolve. Two facts in the case strongly suggested that the plaintiff deserved a trial on the merits. First, there was a material omission in the proxy statement clearly in violation of Rule 14a-9;\textsuperscript{20} secondly, the minority proxy votes were "necessary and indispensable to the approval of the merger."\textsuperscript{21} On the other hand, the defendants argued that if the terms of the merger were fair, the defrauded shareholders should not be heard to complain because it could be justifiably concluded that a sufficient number of voters would have approved the merger had there been no fraud. The Court's choice to deny the fairness of the merger as a defense can be functionally evaluated by analyzing both the stated rationale and the underlying policies.

High on the list of reasons supporting the present holding is the previously mentioned congressional policy of promoting fair corporate suffrage\textsuperscript{22} and discouraging maneuvers designed to bypass minority


\textsuperscript{19} Id. at 362. The court cautioned, however, that the mere existence of fraudulent proxy material did not establish causation and that the material must serve some transactional function: "It may be supposed that J.I. Case Co. v. Borak requires that the accused proxy material . . . have a transactional function and not merely be randomly present in the context of the transaction with respect to which a remedy is sought." Id. at 360.

\textsuperscript{20} See note 1 supra.

\textsuperscript{21} -- U.S. at --, 90 S. Ct. at 619.

\textsuperscript{22} See note 8 supra, and accompanying text.
stockholders. Additionally, a parade of horrors is foreseeable if judicial appraisal of the merger's fairness were required in every case of this kind.\(^{23}\) There is also the fear that with fairness as a defense, fewer proxy fraud challenges would be prosecuted by small stockholders, adding weight to the SEC's already heavy burden.\(^{24}\) The objective test of materiality,\(^{25}\) which must be met in order to state a cause of action, is strongly preferred to a subjective inquiry into the number of votes actually affected by the fraud; and the materiality requirement itself functions to screen complaints of defects so insignificant as not to affect the voting process.\(^{26}\)

Initially the decision appears to be a milestone in the trend toward corporate democracy. Now the defrauded minority shareholder can establish a cause of action under section 14(a) merely by showing that proxies were obtained through use of a materially misleading solicitation. Proof that the defect actually affected the voting is not necessary, the Court holds, since proof of materiality "indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote."\(^{27}\) Having thus established his case, the plaintiff cannot be defeated by a showing that the transaction was a fair one, for the presumption that the shareholders of every corporation are willing to accept any fair transaction put before them is not justified.\(^{28}\) Furthermore, the Court holds that once he has established liability in this more simplified fashion,\(^{29}\) the plaintiff qualifies for an interim award of litigation expenses and reasonable attorneys' fees, notwithstanding the lack of statutory authorization and

\(^{23}\) Mr. Justice Harlan may be hinting at this fear in one short sentence of the opinion: [If liability could be foreclosed by a showing that the merger was fair], "[a] judicial appraisal of the merger's merits could be substituted for the actual and informed vote of the stockholders." — U.S. at —, 90 S. Ct. at 620.

\(^{24}\) Id., citing J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964), in which the Court observed that private enforcement of the proxy rules is a necessary supplement to Commission action.

\(^{25}\) A defect in a proxy solicitation is material, said the Court, if it is "of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote." — U.S. at —, 90 S. Ct. at 621. Cf. List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

\(^{26}\) — U.S. at —, 90 S. Ct. at 621.

\(^{27}\) Id.

\(^{28}\) "But, in view of the many other factors that might lead shareholders to prefer their current position to that of owners of a larger, combined enterprise, it is pure conjecture to assume that the fairness of the proposal will always be determinative of their vote." — U.S. at —, 90 S. Ct. at 620 n.5.

\(^{29}\) In this case, liability was established by a partial summary judgment which was certified for appeal by the district court under 28 U.S.C. § 1292(b) (1958). Certiorari was granted as to the Court of Appeals decision, 394 U.S. 971 (1969), and the issues of damages and relief remained to be considered by the trial court after rendition of the instant decision.
the possible lack of a monetary recovery creating a fund from which to pay the award.  

However, the decision's apparent breadth may be deceiving and the plaintiff may have won the battle only to lose the war. While fairness is now irrelevant to the causation issue, it is still a factor to be considered in determining damages and the appropriate remedy. The disgruntled shareholder bent on having the corporate transaction undone will find the court suddenly unsympathetic if he cannot prove damages justifying that drastic a remedy, and that is likely the case if transaction is fair. Money damages or an accounting may be his only remedy and the fraudulently procured transaction would remain intact. The most significant limitation, however, lies in the application of the new causation requirement set forth by the Court. Materiality is tantamount to proof of causation only where the proxy solicitation is an “essential link” in the accomplishment of the corporate transaction; where management controls enough votes to approve the transaction without any minority votes, the instant holding is expressly inapplicable.  

Noted in the opinion, but left unresolved as a consequence of this restriction, is the causation conflict between the Borak and Laurenzano cases, because the proxy solicitations were not essential links in the completion of those corporate transactions (i.e., the defendants each controlled enough votes to approve the respective transactions without any minority votes). Failure to recognize this restriction causes one to interpret this case as holding that proof of materiality always obviates the need to show actual causation, while this is true only when management needed the proxy votes to complete the transaction. The result is that the plaintiff cannot cite the instant holding as mandatory authority in a Borak-Laurenzano type fact situation. It can be expected, however, in view of the Court's

30 "... [t]he stress placed by Congress on the importance of fair and informed corporate suffrage leads to the conclusion that, in vindicating the statutory policy, petitioners have rendered a substantial service to the corporation and its shareholders [for which they should be reimbursed]." — U.S. at —, 90 S. Ct. at 627.
31 — U.S. at —, 90 S. Ct. at 622 n.7.
32 The Third Circuit Court of Appeals seem to have overstated the true scope of the instant holding in the recent case of Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir. 1970). Discussing causation, the court stated, "In the recent Mills case, the Supreme Court ruled that reliance on false or misleading proxy statements is not required in order to set forth a cause of action under § 14(a) of the Securities Exchange Act." Id. at 173. This blanket statement seems to sweep beyond the true scope of the instant holding.

Kahan v. Rosenstiel is a highly significant case, however, in that it extends the instant holding to fraud under section 10(b) and significantly liberalizes the circumstances under which a defrauded minority plaintiff can be awarded counsel fees and litigation expenses.
heavy emphasis on corporate suffrage, its effort to ease the small plaintiff's financial burden, and its not unfavorable reference to the Laurenzano approach to causation,\textsuperscript{33} that with the proper facts before it, the Supreme Court will eventually hold that materiality of the proxy defect establishes a cause of action in all section 14(a) fraud cases.

\textit{Steve Hixson}

\textbf{Evidence—Attorney-Client Privilege—The Identity of the Client.}—Petitioner, an attorney, was called as a witness in a criminal trial involving the alleged theft of a typewriter by Williams. Petitioner had been the intermediary in the return of the typewriter to the police. While on the witness stand, he testified that someone had phoned him and employed him to deliver the typewriter to the police. He refused, however, to reveal the name of the individual who employed him, asserting that this information was a privileged communication which he should not be compelled to disclose. He was found in contempt of court\textsuperscript{1} because of this refusal, and sought a writ of prohibition\textsuperscript{2} restraining enforcement of the contempt rule. \textit{Held}: Petition denied. The identity of a person who employed an attorney to deliver stolen property to the police is not privileged and therefore must be disclosed by the attorney. \textit{Hughes v. Meade}, 453 S.W.2d 538 (Ky. 1970).

\footnote{1}{The difference between civil and criminal contempt is well established. A commitment or fine for civil contempt is to coerce the witness. The sentence for criminal contempt is not intended to coerce, but rather as a punishment to vindicate the Court's authority. \textit{Tillotson v. Boughner}, 350 F.2d 663 (7th Cir. 1965). In the instant case, the Court of Appeals classified the contempt as civil. 453 S.W.2d at 542.}

\footnote{2}{Writs of prohibition will issue from the Court of Appeals to prohibit actions by inferior courts where, although proceeding within their jurisdiction, they are exercising or are about to exercise it erroneously and there exists no adequate remedy by appeal or otherwise, and great injustice and irreparable injury would result to the applicant if they should do so. \textit{Stafford v. Bailey}, 301 Ky. 155, 191 S.W.2d 218 (1945), \textit{Littler v. Woods}, 223 Ky. 582, 4 S.W.2d 395 (1928). Appellant attorney, since he was not a party and did not represent the defendant, had no adequate remedy by appeal and once the identity of his client is revealed the harm is irreparable. Ky. R. Civ. P. 81 Provides: Relief heretofore available by remedies of . . . prohibition . . . may be obtained by appropriate action or by appropriate motion, for injunction [or otherwise]. . . .}