Civil Liability Under the Federal Proxy Rules

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Although tender offers continue to be the most popular method of acquiring control of a corporation, recent times have seen the increasing use of proxy contests. When a corporate tender offer is followed by a merger or asset acquisition, the proxy rules are also likely to be of considerable importance.1 Whatever might be said with regard to the adequacy of the disclosure rules under the Williams Act (and much has been said2) Professor Loss’s observation, made as early as 1951, that “[t]he proxy

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2. For a partial bibliography of the literature, see R. Jennings & H. Marsh, Jr., Cases and Materials on Securities Regulation 630-31, 678 (5th ed. 1982). As the date indicates, the bibliography is now four years old and an updated version would no doubt be at least twice as extensive.
rules are very likely the most effective disclosure device in the SEC scheme" continues to be a valid appraisal. 3 Indeed, the centrality of the proxy and annual reporting provisions of the Securities Exchange Act of 1934 has now been recognized both by the American Law Institute's ill-fated Proposed Federal Securities Code, and the Securities and Exchange Commission's adoption of its "Integrated Disclosure System," greatly simplifying the disclosure required by the Securities Act of 1933 for corporations which are already filing periodic reports pursuant to the Securities Exchange Act of 1934. 4

The law relating to proxy disclosure is of an older vintage than that which deals with tender offers, but there are still some issues on which courts continue to differ with respect to proxy regulation. This article will examine four of these, namely whether, and to what extent, reliance, causation, materiality and scienter are required for actions under the proxy rules.

I. RELIANCE

Although courts have continued to require "reliance" in the rule 10b-5 area, except for cases of "pure nondisclosure" 5 existing precedent is con-

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3. L. Loss, SECURITIES REGULATION 555 (1st ed. 1951). The observation was repeated, in nearly identical form, ten years later. 2 L. Loss, SECURITIES REGULATION 1027 (2d ed. 1961) and, eight years later, the author observed, "The most apparent shortcomings have now been remedied by the 1964 amendments which not only extended § 14 to many over-the-counter companies but also solved the non-solicitation problem by adding § 14(c)." 5 L. Loss, SECURITIES REGULATION 2984 (2d ed. Supp. 1969).


5. See Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972). The case has generally been interpreted as merely creating a rebuttable presumption of reliance in cases of "pure" nondisclosure (i.e., cases where there is no misrepresentation or half truth), thus permitting a defendant to establish that even if the fact in question had been disclosed the investor would not have acted differently, i.e., would have purchased or sold in any event. See, e.g., Zobrist v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983); Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982); Gower v. Cohn, 643 F.2d 1146 (5th Cir. 1981); Beissinger v. Rockwell Computer Corp., 529 F. Supp. 770 (E.D. Pa. 1981); Dura-Bilt Corp. v. Chase Manhattan Corp., 89 F.R.D. 87 (S.D.N.Y. 1981); Panzirer v. Wolf, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,363 (S.D.N.Y. 1980); State Teachers Retirement Bd. v. Fluor Corp., 500 F. Supp. 278 (S.D.N.Y. 1980), rev'd and remanded in part on other grounds, 654 F.2d 843 (2d Cir. 1981); Dower v. Masser Indus., Inc., 488 F. Supp. 1328 (E.D. Pa. 1980), aff'd, 648 F.2d 183 (3d Cir. 1981); Seiffer v. Topsy's Int'l, Inc., 487 F. Supp. 653 (D. Kan. 1980). Cf. Cavalier Carpets, Inc. v. Caylor, FED. SEC. L. REP. (CCH) ¶ 91,844 (11th Cir. 1984) (plaintiff not entitled to separate jury instructions in action involving both misrepresentations and failure to disclose, and must therefore show reliance in order to establish liability). In other words, despite the presumption, the defendant may establish lack of
fused when it comes to determining the need for "reliance" in connection

causation, *i.e.*, that the plaintiff traded because of something beyond the defendant's control. *See*, Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2d Cir. 1981) (plaintiff's transaction motivated by broker's advice); Keirnan v. Homeland, Inc., 611 F.2d 785 (9th Cir. 1980) (purchaser invested for tax reasons and not due to seller's alleged misrepresentations); Eriksson v. Galvin, 484 F. Supp. 1108 (S.D.N.Y. 1980) (purchaser invested to obtain exclusive agency agreement and not because of alleged misrepresentations); *cf.* Walsh v. Butcher & Sherrerd, 452 F. Supp. 80 (E.D. Pa. 1978) (dictum, court denying motion for summary judgment, because facts were in dispute).


The reliance requirement has been further modified in jurisdictions following the so-called "fraud on the market" theory by permitting a plaintiff to allege merely that he purchased at the prevailing market price and relied on the assumption that this price reflected all the publicly available information and also all information which the defendant had a duty to disclose. *See*, *e.g.*, Levinson v. Basic, Inc., FED. SEC. L. REP. (CCH) ¶ 92,529 (6th Cir. 1986); Lipton v. Document, Inc., 734 F.2d 740 (11th Cir. 1984), *cert. denied*, 105 S. Ct. 814 (1985); Panzirer v. Wolf, 452 F. Supp. 80 (E.D. Pa. 1978) (dictum, court not formally adopting theory but indicating that it was receiving judicial support and should not be dismissed summarily). The theory has received a limited acceptance by the Fifth Circuit Court of Appeals, which has permitted a plaintiff to show that but for the defendant's fraud, the securities he purchased would never have been brought to the market (*i.e.*, would never have been issued) and that therefore he would not have acquired them. *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983) (noted in Note, *Shores v. Sklar*: *The Fifth Circuit's New Version of the Fraud on the Market Theory*, 47 A.L.B. L. REV. 597 (1983); Case Note, *Securities Regulation—Reliance Under Rule 10b-5*, 1982 ARIZ. ST. L.J. 209 (1982); *Gibb v. Delta Drilling Co.*, 104 F.R.D. 59 (N.D. Tex. 1984). *See also T.J. Raney & Sons, Inc. v. Fort Cobb*, Oklahoma, Irrigation Fuel Auth., 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984) (when Oklahoma law prohibited issuance of bonds, purchasers were entitled to assume from availability of bonds on market that they were lawfully issued).

"Fraud on the market" merely raises a presumption of reliance, which may be rebutted by a defendant's showing that an investor relied on matters wholly extraneous to the market or would have traded even if he had known of the facts in question. *See* HSL, Inc. *v. Daniels*, [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,557 (N.D. Ill. 1983); *Oklahoma Publ. Co. v. Standard Metals Corp.*, 541 F. Supp. 1109 (W.D. Okla. 1982). And even if the plaintiff purchased at an artificially high price because of the effect of the defendant's misrepresentations on the market, he
with proxy solicitation. More specifically, need it be shown, for standing to sue purposes, that the plaintiff "relied" on an allegedly misleading proxy solicitation in the sense that he either granted or withheld a proxy because of the misleading solicitation? Although there appears to be an emerging trend of authority in the direction of not requiring "reliance," at least for standing to sue purposes, the courts are by no means unanimous on the point.

For example, in Gaines v. Haughton, the Ninth Circuit Court of Ap-
peals held that reliance was required when the plaintiff sought the removal of various directors for failure to disclose Lockheed Aircraft Corporation's fourteen-year practice of bribing various foreign governments and officials. Since the plaintiff had not alleged that he had actually granted a proxy based upon the allegedly misleading proxy solicitation, the district court had dismissed his claim and this was affirmed by the Circuit Court of Appeals. At least four other district courts have followed the Gaines holding in this respect.

To shed some light on the proper resolution of the point, it seems advisable to explore the now familiar body of precedent which forms the underpinnings of the cause of action under rule 14a-9.

In *J.I. Case Co. v. Borak,* a plaintiff was held to have a private cause of action for damages based on a false or misleading proxy solicitation in connection with a corporate merger. Although the broad basis of the Court's holding, namely that, since among the chief purposes of the Securities Exchange Act of 1934 is "the protection of investors," this "certainly implies the availability of judicial relief where necessary to achieve that result," may appear somewhat sanguine, at least in the light of the far more restrictive approach to implied remedies which is the current fashion, the holding itself retains its basic integrity. Indeed, although...

11. *Id.* at 432. Professor Loss has observed that "the Court reached the right result not for the wrong reason but for no reason at all." 5 L. Loss, *supra* note 9, at 2882.
the Borak Court's observation that "[p]rivate enforcement of the proxy rules provides a necessary supplement to Commission action," i.e. the concept sometimes referred to as that of the "private attorney general," has not been unquestioned in other contexts, it seems to have retained its essential validity in the proxy area.

One particularly illuminating observation from Borak sheds additional light on the need for reliance:

The injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done the corporation, rather than from the damage inflicted directly upon the stockholder. The damage suffered results not from the deceit practiced on him alone but rather from the deceit practiced on the stockholders as a group.

Six years later, in Mills v. Electric Auto-Lite Co. the plaintiffs knew of the alleged improprieties in the proxy materials and were questioning a merger as in Borak. The Mills court of appeals considered the essential fairness of the transaction in resolving the question of whether shareholders were likely to have been misled by defective proxy solicitation materials. The Supreme Court held that alleged fairness was irrelevant to the issue of standing to sue, observing that:

[w]here the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. . . .

There is no need to supplement this requirement, 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 the essential link in the accomplishment of the

14. See Alyeska Pipeline Service Co. v. Wilderness Soc'y, 421 U.S. 240 (1975). See also Friendly, Should We Be Turning Back The Law Flood?, 31 HArv. L. Sch. Bull. 34, 38-39 (1979) (stating that "to my mind one of the most damaging phrases ever contributed to American law was 'private attorney general.' It assumes the answer rather than furnishing a reason for it and provides an odor of sanctity for lawyers who, quite properly, are not thinking of the public at all. After all these years, if Congress wants to create a private cause of action in enacting regulatory legislation, it knows how to say so.")
15. See infra text accompanying note 37.
16. Borak, 377 U.S. at 432.
A synthesis of the reasoning of Borak and Mills then leads to the following tentative conclusion with respect to any supposed requirement of "reliance" in determining standing to sue:

Since the fundamental purpose of the proxy rules is to promote adequate disclosure in connection with proxy solicitation, he who seeks to enforce an implied cause of action under the rules need not establish that he personally was deceived by an alleged violation if he can demonstrate that other shareholders were misled. Thus if a defect is material in nature so that a reasonable shareholder would have considered it important in deciding how to vote, there is standing to raise the issue even without further proof that the defect had a decisive effect on this particular plaintiff's decision to grant or withhold a proxy. This approach is not only consistent with the Exchange Act's purpose to insure shareholder suffrage, but also is a necessary supplement to the Commission's role in carrying out that policy.

Although the Court has restricted the availability of implied causes of action in other contexts and has further circumscribed the cause of action under rule 10b-5, it has left the rule 14a-9 area unimpaired.

Aside from the Gaines v. Haughton line of cases, most later courts have interpreted the Mills decision either as foreclosing inquiry into reliance.

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18. Id. at 384-85. The court indicated that although fairness is irrelevant to the question of standing to sue, it may be taken into account in determining the appropriate remedy. Id. at 386. See also Shapiro v. Midwest Rubber Reclaiming Co., 626 F.2d 63 (8th Cir. 1980), cert. denied, 449 U.S. 1079 (1981).


20. See supra note 12.

21. See, e.g., Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (requiring that a plaintiff establish deceit or nondisclosure; thus if the facts are disclosed, there is no rule 10b-5 remedy merely because the transaction is allegedly "unfair"); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (requiring that a plaintiff establish "scienter" (i.e., something more than ordinary negligence) in a private damage action); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (requiring that a plaintiff be either a purchaser or seller of securities or be suing derivatively on behalf of a corporation which purchased or sold securities).

22. Indeed, in one case circumscribing a bidder's remedy under section 14(e) of the Securities Exchange Act of 1934 (the so-called "Williams Act" which relates to certain tender offers and market acquisitions of shares), the court went to considerable pains to distinguish the proxy regulation area, governed by section 14(a) of the Exchange Act, from other areas, such as section 14(e). Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 41 (1977). See also Schreiber v. Burlington Northern R.R., 105 S. Ct. 2458 (1985) (requiring a plaintiff to establish manipulation, deceit or nondisclosure in an action brought to enforce section 14(e)).

23. See supra notes 7-9.
ance, or, at least, establishing a strong presumption of reliance. The justifying policy reasons for this trend have already been alluded to, namely the interest each shareholder has in not having other shareholders misled to his prejudice (as in the merger cases) and the functional role of shareholders’ suits in the proxy area as a necessary supplement to Commission action.

As to the first of these two policy justifications, the Sixth Circuit Court of Appeals held twenty-four years ago:

[T]he right sought to be protected by federal law is the right to full and fair disclosure in corporate elections. Therefore, it is not important whether or not the complaining stockholders were deceived—they could suffer equally damaging injury to their corporate interests merely because other shareholders were deceived in violation of federal law. Accordingly, they should be entitled to protect themselves against such violations to the same extent as if they, themselves, were the direct victims of the unlawful deception.

The real damage which results from unlawful proxy solicitation “results not from the deceit practiced [on a shareholder] alone but rather from the deceit practiced on the stockholders as a group.” Although, as has already been pointed out, reliance is still at times required in

24. See Selk v. St. Paul Ammonia Products, Inc., 597 F.2d 635, 639 (8th Cir. 1979) (“After Mills, we are not satisfied that a separate showing of reliance on a material misrepresentation in proxy solicitation materials can be required.”); Browning Debenture Holders Comm. v. DASA Corp., 524 F.2d 811, 815 (2d Cir. 1975) (in Mills the Supreme Court held “that the broad prophylactic purpose of § 14(a) would be frustrated if plaintiffs were required to prove such specific reliance.”); Hershfang v. Knotter, 562 F. Supp. 393, 397 (E.D. Va. 1983), aff’d, 725 F.2d 675 (4th Cir. 1984); Jones v. National Distillers & Chem. Corp., 484 F. Supp. 679, 684 (S.D.N.Y. 1979) (the Supreme Court in Mills “established a presumption of reasonable reliance in order to avoid an overly difficult burden of proof,” citing Chris-Craft Indus. Inc. v. Piper Aircraft Corp., 480 F.2d 341, 374 (2d Cir.), cert. denied, 414 U.S. 910 (1973)). This reading of Mills is consistent with the approach taken by the Court with respect to the reliance requirement in rule 10b-5 cases in Affiliated Ute Citizens of Utah v. United States, where the Court held that, at least in cases involving nondisclosure, “positive proof of reliance is not a prerequisite to recovery.” 406 U.S. 128, 153 (1972). In the same manner, the Court in Mills looked to whether a “reasonable shareholder” would consider a defect in the proxy solicitation material important. Mills, 396 U.S. at 384. See supra text accompanying note 17. Hence the focus is not on the plaintiff’s behavior or whether he actually relied on the constructive behavior of other shareholders. The Court viewed this test as being “objective” insofar as it was designed to “avoid the impracticalities of determining how many votes were affected,” and to “resolve[s] doubts in favor of those the statute is designed to protect” in order to effectuate the broad remedial purposes of section 14(a). 396 U.S. at 385. Requiring reliance by the plaintiff would appear to run counter to the these purposes.

25. See supra text accompanying notes 14-16.


27. See Borak, 377 U.S. 426 (1964).

28. See supra note 5.
suits under rule 10b-5, there is respectable authority for dispensing with
the element of individual plaintiff reliance if a nonrelying plaintiff can
demonstrate that misrepresentations or failures to disclose were made to
others when a reasonable shareholder would have considered the omitted
or misrepresented fact important enough in determining whether to vote
or part with his shares.29

As the Second Circuit Court of Appeals stated in the rule 10b-5 area in
Vine v. Beneficial Finance Company,30 a nondeceived shareholder:

... would never be in the position of a forced seller were it not for the
fraud. In essence, because of the distinctive nature of the short form
merger procedure, appellee by deceiving A can cause B to become a seller.
When this is all part of a single fraudulent scheme and that scheme is a
classic example of deception of an entire class of Class A public stockhold-
ers, as alleged here, we think the policies of section 10(b) and Rule 10b-5
justify holding that fraud on A is "in connection with" the forced sale by B
... What must be shown is that there was deception which misled Class A
stockholders and that this was in fact the cause of plaintiff's claimed
injury.31

The same analysis is applicable in the section 14(a) area.32 When de-
ceptive proxies lead other shareholders to elect directors who harm the
plaintiff through mismanagement or self-dealing, the District of Colum-
bria Circuit Court of Appeals recently held that it is irrelevant whether
the plaintiff personally relied or did not rely on the proxy materials.33 If

29. See supra cases cited in note 6.
31. Id. at 635.
(S.D.N.Y. 1977). In holding that reliance is not required for actions under SEC Rule 14a-9, the
court stated that "where the charged deception adversely affects the market for a particular stock,
plaintiff's personal reliance on the misstatements and/or omissions may be irrelevant to establish
causation with his injury." Id. at 92,747. Accord Hershfang v. Knotter, 562 F. Supp. 393, 398 (E.D.
33. Cowin v. Bresler, 741 F.2d 410 (D.C. Cir. 1984). The injury that the plaintiff suffered:
... was not caused by his individual reliance on deceptive proxy solicitations. Rather, his
claim is that other shareholders elected appellees as directors because they were misled by
the proxy materials. The installation of appellees as directors and their subsequent actions
has [sic] injured appellant. This injury is totally divorced from any reliance, or lack of
reliance, on Cowin's part and falls precisely into the scope of injury Congress sought to
protect. Borak, 377 U.S. at 432, 84 S. Ct. at 1559. Requiring reliance in these circum-
stances would serve no legitimate policy and we decline to do so.”
dictum, assuming, in apparent ignorance of the Cowin case, and with virtually no discussion, that
reliance is required).
reliance is required for standing purposes, a nonrelying shareholder who is injured is left without a remedy and must rely on "the other shareholders [who were] beguiled [and who] belatedly become enlightened." 34

Although the concept of a private "enforcement proceeding" has lost some vitality in recent years, it continues to have some validity in the proxy area. 35 A shareholder has a legitimate interest in precluding others from being misled to his disadvantage. Thus enforcement of section 14(a) depends in large part upon the initiative of private investors, especially those with knowledge and sophistication, to police the quality of management solicitations so as to protect investors generally. Indeed, it is for this reason that the Mills court held that successful plaintiffs would be entitled to an interim award of attorneys' fees. A requirement of individual reliance seems curiously out of step with this broad prophylactic interpretation of the nature and function of the proxy rules. In two more recent and relatively restrictive holdings in the rule 10b-5 and Williams Act areas, the Supreme Court in Blue Chip Stamp v. Manor Drug Stores 36 and Piper v. Chris-Craft Industries, Inc. 37 explicitly reaffirmed the language in the earlier Borak decision "concerning the necessity for supplemental remedies without which congressional protection of shareholders would be defeated." 38

Similarly in Alyeska Pipeline Service Company v. Wilderness Society, 39 in which the Court rejected the "private attorney general" concept as a general proposition without explicit congressional authorization, the Court specifically cited Mills as an exception. Mills was an example of the historic power of a court of equity:

... to permit the trustee of a fund or property, or a party preserving or recovering a fund for the benefit of others in addition to himself, to recover his costs, including his attorneys' fees, from the fund or property itself or directly from the other parties enjoying the benefit. That rule has been consistently followed. ... 40

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35. See supra text accompanying note 16.


38. Id. See also the more recent holding in Bateman Eichler, Hill, Richards, Inc. v. Berner, 105 S. Ct. 2622, 2628 (1985) (referring in turn to the Borak and Blue Chip decisions).


40. Alyeska, 421 U.S. at 257-58.
Finally, the argument that the private attorney general concept survives in the section 14(a) area is reinforced by the Ninth Circuit Court of Appeals decision in *Reiser v. Del Monte Properties Co.* In *Reiser*, the plaintiffs objected to proxy statements issued in support of a proposed merger between Del Monte and a subsidiary company. After the plaintiffs filed a section 14(a) suit, the directors of Del Monte postponed the shareholders’ meeting, withdrew the original proxy statement, and issued a new proxy statement. Plaintiffs then requested attorneys’ fees, but the district court denied the request on the grounds that an award of fees under *Mills* was only proper if the section 14(a) action was brought as a class action or a derivative suit, and that an award of fees in this case was precluded by *Alyeska*.\(^{42}\) The Ninth Circuit Court of Appeals reversed, and held that an award of fees to a successful section 14(a) plaintiff was proper even if the suit was not a class action or a derivative suit. The court noted that in *Alyeska*, the Supreme Court specifically approved of the “common benefit” exception to the rule generally followed by American courts, requiring a plaintiff to pay his own attorney’s fees, that was applied in *Mills*.\(^{43}\) Even though the plaintiff in *Mills* sued in a representative and derivative capacity, the Ninth Circuit Court of Appeals did not think this fact to be significant:

The [*Mills*] Court focused on the beneficial effect of the suit and the equitable reasons for shifting the expenses of litigation to the shareholders. The crucial factor in *Mills* was that the suit had resulted in correction of a “deceit practiced on the stockholders as a group,” thereby rendering an important service to the shareholders. [citation omitted]... “[B]y vindicating his own right, the successful litigant dispels the ‘chill’ cast upon the rights of others.”...  

The form of suit is not a deciding factor; rather, the question to be determined is whether a plaintiff, in bringing a suit either individually or representatively, has conferred a benefit on others. To suggest that an individual suit which corrects a violation of the proxy statutes is less beneficial than a class action accomplishing the same result would be to disregard the effect of the suit.\(^{44}\)

*Reiser* stands for the proposition that section 14(a) plaintiffs suing in a

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41  605 F.2d 1135 (9th Cir. 1979). This is the same court which later required reliance in *Gaines v. Haughton*, 645 F.2d 761, 773-74 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982). For discussion of *Gaines*, see supra text accompanying note 7.
42. *Reiser*, 605 F.2d at 1136-37.
43. *Id.* at 1139.
44. *Id.* at 1139-40 (citations omitted).
private capacity continue to serve the "policing" function set out for them in *Borak* and *Mills*. Whether this function is characterized as a "private attorney general" or not is irrelevant. Therefore reliance should not be required for standing purposes, for to do so would defeat the purposes of section 14(a) by denying standing to those who are in the best position to enforce the proxy rules.

II. CAUSATION

As might be expected, courts have had to address the problem of causation in the proxy regulation area. Once *Borak* established that there was implied civil liability under rule 14a-9, a corollary was that a plaintiff could sue only if he could establish a causal link between the alleged harm and the statutory violation. Situations where such a casual connection was ill-defined or lacking altogether were left for appropriate Commission enforcement proceedings. 45

Although it is theoretically possible to define causation in strict logical terms of "but for," courts have required a more definite linkage by requiring proximate causation. 46 In the context of proxy regulation, it is arguable that a shareholder should be able to recover for all harmful acts engaged in by a board of directors which was unlawfully elected due to a misleading proxy solicitation in connection with an annual shareholders' meeting. However, to do so would federalize entire areas of misconduct which normally would be dealt with at the state level and would burden federal courts with a disproportionate share of the workload. 47 Thus, courts have generally required a plaintiff to establish that the transaction forming the basis of the suit and allegedly causing immediate harm to him was itself subject to shareholder approval and that the allegedly misleading proxy solicitation occurred in connection with that transaction and not solely with a prior election to the board of directors.

45. A rule 14a-9 violation should not be without consequences merely because it is difficult to establish harm to some individual investor. Although the Commission is required to establish materiality, and possibly scienter in those few jurisdictions which may follow the minority view that scienter is required (see infra text accompanying note 189), it need not establish that any particular investor was harmed but only that the violation has a propensity to harm investors generally. See TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970).


A. Election of Directors

When materials soliciting proxies for the election of a slate of directors contain material misrepresentations or nondisclosures, courts have found the proxy solicitations to be essential causal links to the elections and, as with challenges to mergers or other transactions requiring shareholder approval, plaintiffs in such cases can seek appropriate equitable relief. This is so even when the underlying reason why the plaintiff is bringing the suit is related to other improper acts committed by the directors—acts not subject to shareholder approval. For example, in Weisberg v. Coastal States Gas Corp.,\(^\text{48}\) the Coastal States Gas Corporation (Coastal) and its directors allegedly paid over eight million dollars in bribes to foreign oil company officers. The plaintiffs argued that the defendants violated section 14(a) because they failed to disclose the bribes in proxy solicitation materials for the election and re-election of Coastal's board of directors between 1974 and 1978. The plaintiffs sought only equitable relief and asked that the elections of those years be set aside, for the appointment of a receiver and for new elections. The district court dismissed the case on the ground that the claim did not “satisfy the transaction causation requirements” set out in \textit{Mills}.\(^\text{49}\) The court followed a prior district court holding\(^\text{50}\) in which, in an analogous situation, the plaintiff was seeking to set aside an election of directors because of section 14(a) violations arising from a failure to disclose foreign bribes. Both district court decisions were reversed, however. As the Second Circuit Court of Appeals in reversing \textit{Weisberg} noted, the plaintiff was not seeking damages suffered by him or by the corporation because of the improper payments that were not subject to shareholder approval. Instead, “the challenged 'transaction' is the election of the directors, and we have no doubt that the proxy solicitation itself... was an essential link in the accomplishment of that transaction, within the meaning of \textit{Mills}.”\(^\text{51}\)

In \textit{Gaines v. Haughton},\(^\text{52}\) another leading Ninth Circuit Court of Appeals case, the plaintiff alleged that the defendant directors of Lockheed

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\item \textsuperscript{48} 609 F.2d 650 (2d Cir. 1979), \textit{cert. denied}, 445 U.S. 951 (1980).
\item \textsuperscript{49} See \textit{Weisberg v. Coastal States Gas Corp.}, 609 F.2d at 652.
\item \textsuperscript{50} \textit{In re Tenneco Sec. Litig.}, 449 F. Supp. 528 (S.D. Tex. 1978).
\item \textsuperscript{51} \textit{Weisberg}, 609 F.2d at 654 (remanding the case for the district court to determine if the failure to disclose the bribes was a material omission). \textit{See also} \textit{Galef v. Alexander}, 615 F.2d 51, 65-66 (2d Cir. 1980) (in which the defendant directors allegedly harmed the corporation by self-dealing involving employee stock options).
\item \textsuperscript{52} \textit{Gaines v. Haughton}, 645 F.2d 761 (9th Cir. 1981), \textit{cert. denied}, 454 U.S. 1145 (1982).
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Corporation violated the proxy rules by failing to disclose payments of thirty to thirty-eight million dollars to foreign governments and officials between 1961 and 1975. The plaintiff sought no damages under section 14(a), but instead sought a declaration invalidating past elections, removal of directors, and other equitable relief that included money damages under California law. As in Weisberg, the court distinguished between claims for money damages arising out of defendants' failure to disclose misconduct in proxy solicitation materials and claims for equitable relief relating to the election of directors, "alleged to have been facilitated by the nondisclosure of the underlying misconduct." In the former situation, relief would be denied because of a lack of transactional causation since the payments did not require shareholder approval. But with the equitable claims against the past elections, the Gaines court held that causation would be assumed if the nondisclosure of the bribes was material.

The precise scope of the relief to be granted once a section 14(a) violation is found in cases such as Weisberg or Gaines is somewhat unclear. Most of the opinions arise from motions for summary judgment on substantive issues and do not fully explore the final shape of the appropriate remedy; in many instances, other defects in the plaintiffs' case do not allow the case to proceed to the remedy stage. For example, in Gaines, even though the court found causation, it went on to hold that the nondisclosure of the bribes was not material. In Weisberg, on remand, the plaintiffs engaged in discovery and failed to find any evidence to support allegations of kickbacks or scienter, subsequently settling with Coastal and its directors. It is worth noting that the plaintiff's attorneys received over $200,000 in fees as part of the settlement, a possible motivation for bringing the suit in the first place.

Despite some uncertainties, if the suit occurs prior to the directors' election, plaintiffs can obtain an injunction against voting proxies obtained through misleading solicitations. If the suit occurs after the election, a plaintiff can have the challenged election set aside, a receiver appointed, and a new election held. These are the remedies suggested,

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53. Id. at 775-76.
54. The Court distinguished between bribes connected with kickbacks—presumptively material—and "mere" bribes not connected to kickbacks—presumptively immaterial. Id. at 776-77.
55. Id. at 779.
although not actually ordered, in *Weisberg* and *Gaines*.\(^5\)8 Once the court has jurisdiction and can order the rescission of past elections, it may also be able to exercise pendent jurisdiction over any state claims the plaintiff may have for damages arising from the underlying corporate wrongs the defendants may have committed.\(^5\)9

**B. Damage Actions and Transaction Causation**

Suppose directors A, B, and C make illegal bribes and receive kickbacks in 1978, and fail to disclose the bribes and kickbacks in proxy materials for their reelection in 1980. If a shareholder can sue to set aside the 1980 elections under section 14(a), can the shareholder also recover the bribes and kickbacks? Similarly, if the same directors in 1981 make further bribes and receive more kickbacks, or if they engage in some other wrongful activities, such as improperly borrowing money from the corporation, if plaintiffs succeed in having the 1980 election set aside may they also recover the post-election damages on the theory that full disclosure in 1980 would have prevented the directors from being reelected and thus would have prevented the post-1980 losses?

Courts have generally denied recovery in both of these situations in part because they view section 14(a)'s protection as extending only to those transactions directly subject to shareholder approval. As the Supreme Court noted in *Mills*, section 14(a)'s purpose is to insure that a shareholder would be informed about the transaction for which "authority to cast his vote is sought."\(^6\)0 Shareholders only vote on fundamental corporate changes, such as mergers or the election of directors, and not on ancillary transactions, such as the bribes, kickbacks, excessive sala-

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\(^5\)9. *See infra* text accompanying note 96.

ries, or improper loans. Therefore, such other transactions do not fall within the protection of section 14(a) and they are more properly reme-died by actions under state law. This requirement has been called “trans-action causation” although strictly speaking courts are not referring to “causation” in any physical sense but using the term as a short-hand description to limit section 14(a) liability, delimiting a point where, as with proximate cause in tort law, courts will deny recovery.

As for the undisclosed transactions that occur prior to the election, the bribes and kickbacks in 1978 in the foregoing example, the unwillingness of courts to award damages is not solely due to a desire to limit the reach of section 14(a). Rather, in this instance, there is no causation in fact between the lack of disclosure in the 1980 proxy materials and the prior questionable transactions. The proxy solicitation occurred after the bribes and the kickbacks, after the damage had been done. Thus, it cannot be said to be a cause of the earlier misconduct, even under the looser “but-for” test.

Although the misleading proxies were a “cause,” in a technical “but-for” sense, of the post-proxy misconduct, courts have denied recovery for later misconduct because of a decision to cut off legal liability and to limit section 14(a) actions only to instances when shareholder approval was sought for the challenged transaction. This is the case both when the later misconduct is totally unrelated to the proxy defect (i.e., the proxy materials fail to disclose past bribes and the directors then pay themselves excessive salaries) and when the later misconduct grows out of the proxy error (i.e., the proxy materials fail to disclose past bribes and the reelected directors continue to make bribes after the election).

Thus most courts have held that if corporate directors bribe foreign officials, their failure to disclose these payments in the proxy materials for their reelection will not support a damage action under section 14(a).


62. See Kamerman v. Pakco Cos. [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,318, at 93,066 (S.D.N.Y. 1978) (the determination of no section 14(a) liability for damages caused after an improper election “is not varied should plaintiff’s theory be that he is entitled to recover funds misspent prior to the fraudulently induced election. That is, to the extent that the 1973 proxy was materially deficient in its failure to reveal de facto director Colasurdo’s 1972 depredations, the complaint would nonetheless fail to state a claim . . . Section 14 cannot be interpreted so expansively as to provide for recovery for activities which were not the subjects of the proxy solicitation”). See also Lewis v. Valley, 476 F. Supp. 62 (S.D.N.Y. 1979) (no transaction causation when defendants allegedly failed to disclose foreign payments in connection with seeking authorization of executive compensation).
to recover the money lost or any fines imposed because of the illegal conduct. For example, the Eighth Circuit Court of Appeals has held that:

Any injury to . . . shareholders from the corporation's illegal foreign payments stems directly from the corporate waste and mismanagement involved in authorizing those payments and not from allegedly misleading proxy solicitations . . . Plaintiff's § 14(a) claim is at best marginally related to the federal policies underlying that section. 63

Similarly, a plaintiff cannot recover damages under section 14(a) because directors fail to disclose their corporate mismanagement in the proxy materials soliciting votes for their election. If, for example, the directors have a secret policy of not considering or discussing mergers and acquisition proposals, and fail to disclose this in the proxy materials soliciting reelection, a shareholder who is later harmed because of a buyout of the shares of an insurgent shareholder group, after a fierce takeover battle, cannot recover damages under section 14(a). 64

A failure to disclose past breaches of fiduciary duty and self-dealing in proxy materials will not support damage actions under section 14(a) based on a continuation of such practices after the election. 65 Similarly,

63. Abbey v. Control Data Corp., 603 F.2d 724, 732 (8th Cir. 1979), cert. denied, 444 U.S. 1017 (1980). Accord Gaines v. Haughton, 645 F.2d 761, 775-76 (9th Cir. 1981), cert. denied, 454 U.S. 1145 (1982) ("the directors' failure to disclose the questionable foreign payments (or other alleged misconduct) is not the legal cause of the pecuniary loss to the corporation, if any"); Limmer v. General Tel. & Elec. Corp., [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,111, at 92,002 (S.D.N.Y. 1977) ("[t]his is not to ignore plaintiffs' argument that defendants could not have continued to engineer the illegal diversions of GT&E funds alleged herein had they not been reelected to their directorships pursuant to the accused proxy statements . . . . This Court concludes, rather, that the connection between the exercise of corporate suffrage and the acts of waste from which plaintiffs seek relief is too tenuous to support 'federal intervention in a cause of action otherwise squarely posited in violations of state law'"). See also Rosengarten v. International Tel. & Tel., 466 F. Supp. 817, 827 (S.D.N.Y. 1979); Levy v. Johnson [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,899 (S.D.N.Y. 1977).


65. See Sanders v. Thrall Car Mfg., 582 F. Supp. 945, 956-57 (S.D.N.Y. 1983), aff'd, 730 F.2d 910 (3d Cir. 1984) (plaintiff's damage caused by later tender offer transaction, not by defendant's earlier failure to disclose true intentions to harm corporation when soliciting votes for board of directors); United Canso Oil & Gas Ltd. v. Catawba Corp., 566 F. Supp. 232, 237-38 (D. Conn. 1983) (plaintiff in a derivative suit cannot recover damages caused by 26 years of improper relationships with another company and breach of fiduciary duty by directors: "It is quickly apparent that none of these transactions were in themselves the subject of shareholder approval, rather the only shareholder involvement was in the election of the directors who carried out the transactions. Plaintiffs have not been able to cite one case in which transaction causation was found between defects in proxy statements made in connection with the election of corporate directors and transactions conducted by the board subsequent to their election."); Brayton v. Ostrau, 561 F. Supp. 156, 163-64 (S.D.N.Y. 1983) (plaintiff's shares decreased in value after management was forced to purchase...
when proxy statements failed to reveal a defendant's de facto control over a corporation, his influencing docile directors to loot the corporation's treasury through false billings for illusory services, improper loans, and other improprieties, section 14(a) would not support a damage action, either for damages caused before or after the elections.66

As the court stated in Bloom v. Bradford:

The web of causation is infinite, and in one sense everything is connected to everything else. But to impose liability for an act or omission what damages it "caused" in a legal sense must be determined on pragmatic grounds, considering both the foreseeable consequences of the dereliction and its fair relationship to the eventual loss. . . .67

In all of these cases there is concern that any charge of corporate wrongdoing or mismanagement can become actionable under section 14(a) simply because the directors failed to disclose it, or even their intention to commit wrongful acts, in the proxy solicitation materials for their election or reelection.68 In addition, there is judicial concern about defendant insurgent shareholder group's shares after a close proxy fight for control of the board of directors; harm to plaintiff was not "transactionally caused" by defendant insurgent group's failure to state true intentions in proxy solicitation materials).

66. Kamerman v. Pakco Cos. [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,318 at 93,065-66 ("Although such depredations might well have been avoided had the proxy statements accurately reflected Colasurdo's true relationship to Pakco, his malfeasance has not, within the meaning of Section 14, been 'caused' by the fraudulent elections of a docile board of directors"). See also Rosenbaum v. Klein, 547 F. Supp. 586, 588-90 (E.D. Pa. 1982) (breach of trust and self-dealing by trustees of real estate investment trust not caused by failure to inform shareholders of these activities in election proxies); Issen v. GSC Enterprises Inc., 522 F. Supp. 390, 396 (N.D. Ill. 1981) (harm to plaintiff caused by defendants' failure to disclose improper corporate loans to themselves not related to deficient earlier proxies for defendants' election which did not disclose true financial situation of company); Zilker v. Klein, 510 F. Supp. 1070, 1074 (N.D. Ill. 1981) (failure to reveal, in proxy statements for three elections, directors' self-dealing and other improprieties with subsidiary not cause of later expenses incurred because of directors' relationships with underworld figures: "Section 14 actions cannot be grounded on allegations that directors, elected by proxies thus tainted, thereafter during their term of office carried out transactions harmful to their corporations."); Bloom v. Bradford, 480 F. Supp. 139, 147-48 (E.D.N.Y. 1979) (claim under Section 20(a) of Investment Company Act, 15 U.S.C. § 80a-20; failure to disclose in proxy materials soliciting approval for investment advisory contract for open-end investment company an investment advisor's family's controlling interest in a particular corporation held not to be causally related to subsequent negligence in investing of funds in that corporation); Halle & Stieglitz v. Empress Int'l, Ltd., 442 F. Supp. 217 (D. Del. 1977) (nominees for directors failed to disclose alleged plan to make tender offer for corporate shares; court held that there was no federal cause of action although there might be relief at the state level).


68. See, e.g., United Canso Oil & Gas Ltd. v. Catawba Corp., 566 F. Supp. 232, 238 (D. Conn. 1983) ("Under this theory all directors accused of continuing state law improprieties would be subject to a federal cause of action under § 14(a) for failure to disclose the improprieties in proxy state-
“bootstrapping” or attempts to “dress-up” state claims into section 14(a) violations merely by alleging a failure to disclose in proxy materials the state law violations the plaintiff wishes to attack. Courts have objected to this trend on a number of grounds.

Federalizing all corporate misdeeds through section 14(a) is intellectually cumbersome. Instead of challenging waste or breach of fiduciary duty head-on, plaintiffs must shape their claims to fit the proxy rules. In addition, as one court stated, requiring management to accuse itself of antisocial or illegal conduct, or even illicit intent, in each proxy solicitation for each election “is simply contrary to human nature.”

Although it is arguable that permitting section 14(a) suits in these situations would serve as a deterrent to questionable conduct and would also promote more conscientious preparation of proxy materials, there is a more powerful countervailing policy—to avoid the federalization of state corporate law without express congressional approval, especially when diversity between state laws has traditionally been the case. If there is a need for development of more uniform federal standards of fiduciary duty, possibly ones not subject to the troublesome state law “business judgment” rule, then this should be done by Congress and not by judicial extension of section 14(a) to cover a corporate “universe” of wrongdoing which traditionally has been remedied under state law.

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69. See, e.g., Maldonado v. Flynn, 597 F.2d 789, 796 (2d Cir. 1979).


71. See generally Burks v. Lasker, 441 U.S. 471 (1979); Galef v. Alexander, 615 F.2d 51, 62-64 (2d Cir. 1980) (“In short, we conclude that to the extent that a complaint states claims against directors under § 14(a) upon which relief may be granted, federal policy prevents the summary dismissal of those claims pursuant to the business judgment of those defendant directors”).


73. See Santa Fe Indus., Inc. v. Green, 430 U.S. at 462, 480 (1977).
C. Mootness Defense

One potential problem for plaintiffs in these cases, even if they can prove all elements of a section 14(a) action, is the problem of mootness. For instance, assume a slate of directors—A, B, and C—is elected in 1980 for three-year terms. In the proxy materials soliciting votes for their election, they fail to disclose that they received illegal kickbacks from overseas bribes during their prior terms. The plaintiff, on discovering the kickbacks, files a section 14(a) action in 1982, seeking to rescind the 1980 election on the ground that the failure to disclose the receipt of illegal kickbacks was a material omission. While the case is being litigated, the directors come up for reelection in 1983. Directors A and B choose not to run and retire. New nominees are proposed to take their place. Director C runs for reelection, discloses the pending lawsuit in the proxy solicitation materials, and is reelected by a 99 percent vote. When plaintiff’s suit is finally decided, the defendant directors move to dismiss the case because of mootness, claiming either that full disclosure has since been made and the director was reelected or that the other defendants no longer serve on the board of directors, their terms having expired, and arguing that rescinding the 1980 election would be meaningless gesture.

Of course, if the directors’ terms are not yet up and new elections can be held, or if the defendants are serving new terms but no disclosure has been made, mootness is not an issue. But, when this is not so, as in the foregoing example, the courts have not provided much guidance. On the one hand, Gaines and Weisberg seem to suggest that equitable relief may be granted against past elections, even when the terms of office have already expired. On the other hand, a number of courts have held or suggested in dicta that cases are moot if directors elected in the contested elections are no longer on the board of directors or if they have since been reelected.

74 See Maldonado, 597 F.2d 789, 797 n.10 (2d Cir. 1979).
75 The Court in Weisberg stated, however, that it “need not consider whether any of the claims against individual directors are now moot.” 609 F.2d at 655 n.5.
76 See Browning Debenture Holders Comm. v. DASA Corp., 524 F.2d 811 (2d Cir. 1975). In Browning, plaintiff sought a declaration that an election in 1972 was void. The court held that not only was it impossible to hold the 1972 election over again, but also officers elected in 1972 had served their terms of office and had been reelected in 1973 and 1974. A declaration of illegality in this context, the court held, “would not change anyone’s behavior and would be an empty exercise resulting, at most, in a judicial declaration of no practical import.” Id. at 814, 816. See also Galef v. Alexander, 615 F.2d 51, 66 n.23 (2d Cir. 1980) (“[w]e note also that there may be a problem of
One may question the propriety of the cases finding mootness. Surely, a mere declaration of past wrongdoing serves some valid purpose and is no less superfluous than the requirement that even majority shareholders should abide by the proxy rules. A declaration of past wrongdoing may also have an effect on future elections or battles for corporate control. The prospect of plaintiffs collecting attorneys' fees may alone be a sufficient deterrent to future misconduct, even if past elections can no longer be reheld. Dismissing cases on mootness grounds would seem to reward corporate defendants for delaying litigation, since they need only delay until the terms of the incumbent directors are up to have the case dismissed. This is especially so when the defendants have superior access to legal counsel and are able to mount an effective campaign of delay with relative ease. Finally, refusing a dismissal for mootness in favor of a declaration against past wrongdoing seems more in line with the underlying purpose and remedial function of section 14(a) in its effort to insure fair corporate suffrage and accurate preparation of proxy materials. 77

D. Suits Against Majority Shareholders

Even if the challenged transaction is itself subject to shareholder approval, the defendants may argue that the plaintiff ought not to recover because they had such control over the corporation that the disputed transaction would have been approved even if the proxy materials had not been deceptive or misleading. In other words, a minority shareholder's votes are arguably irrelevant and are not needed for a majority shareholder to engage in fundamental corporate changes, such as merging with another corporation or dissolving a subsidiary. Thus, the proxy solicitation is not a causal link in the process leading to the plaintiff's harm.

The Supreme Court has never dealt with the issue of causation and majority control because in both Borak and Mills, the plaintiffs alleged that the defendants required the votes of minority shareholders to gain approval for the disputed mergers and that the mergers were approved

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only by small margins. In a footnote to Mills, the Supreme Court stated that it need not decide at that time “whether causation could be shown where the management controls a sufficient number of shares to approve the transactions without any votes from the minority.”\textsuperscript{78} The Court referred to two conflicting lines of cases in the district courts on this issue with no hint as to how it would decide such a case. Later the Second Circuit Court of Appeals would argue that because the Supreme Court cited to one line of cases as “see” and to the other line as “but see,” the Court approved of the first line of authority.\textsuperscript{79}

The major case taking a strict view of causation in this type of situation is Barnett v. Anaconda Co.\textsuperscript{80} In Barnett, the corporate defendants allegedly used a misleading proxy statement to gain approval for the dissolution of a subsidiary. The court refused to find a section 14(a) violation, however, because the defendant owned 73 percent of the shares of the subsidiary and only a two-thirds vote was required to authorize the dissolution. Thus, the deception in the proxy materials had no causal connection to the actual harm that the minority suffered when the subsidiary was dissolved. The strict view of causation found in Barnett was followed by a number of other courts in the late 1960s and early 1970s.\textsuperscript{81} In most of these opinions, discussions of policy were kept to a minimum. Stress was often placed on the fact that the corporate action would have occurred despite the deceptive proxy statements because of the votes controlled by the defendants. Arguably this strict approach to causation forestalls pointless litigation since an order to repeat the vote with full disclosure would merely end in the same result; damages would be pointless unless they were considered punitive since the plaintiffs would have been in the same situation financially even if full disclosure had been

\textsuperscript{78} Mills, 396 U.S. at 385 n.7.


\textsuperscript{80} 238 F. Supp. 766 (S.D.N.Y. 1965).

made.\textsuperscript{82}

Eventually, most courts abandoned the \textit{Barnett} line of reasoning and adopted a looser standard of causation.\textsuperscript{83} The leading case rejecting \textit{Barnett} at the time of the \textit{Mills} decision was \textit{Laurenzano v. Einbender},\textsuperscript{84} upholding a section 14(a) action even though the defendant’s majority control made the votes of the minority shareholders on a series of financial transactions superfluous. The \textit{Laurenzano} court reasoned that proxy solicitations by majority shareholders are not “purposeless and legally inert.” Rather, “[s]uch seemingly pointless approbations have their


\textsuperscript{84} 264 F. Supp. 356 (E.D.N.Y. 1966).
Contrary to Barnett's strict view of causation, even if the minority shareholders cannot defeat an oppressive majority with their votes, requiring truthful proxy solicitations still has value because the "potential victim may have recourse to measures other than the casting of proxies." For example, a minority shareholder could bring a suit for injunctive relief prior to the completion of the transaction if full disclosure is required. Full disclosure may also permit minority shareholders to seek the full benefit of appraisal rights. Furthermore, the requirement of full disclosure and the threat of lawsuits has a prophylactic effect. As the Second Circuit Court of Appeals noted in Schlick v. Penn-Dixie Cement Corp.: We cannot assume that even a rapacious controlling management would necessarily want to hang its dirty linen out on the line and thereby expose itself to suit or Securities Commission or other action—in terms of reputation and future take-overs.

The Schlick court also noted that full disclosure in proxy materials...
serves to inform the market "so as to permit well-based decisions about buying, selling and holding the securities involved in the transaction." 90

This broader view of causation finds support in the spirit and intent of section 14(a), the purpose of which is to compel full and fair disclosure and to promote fair corporate suffrage. 91 Congress was particularly concerned about protecting minority shareholders from the schemes of management. 92 Pursuant to this broad remedial purpose, the Mills Court identified the relevant causal test to be one of materiality when the proxy solicitation "was an essential link in the accomplishment of the transaction." 93 If a corporation is required by law to solicit proxies to approve certain transactions, the proxy solicitation is an essential link and meets the causal test set out in Mills 94 even if management has "the naked strength to consummate a fraudulent transaction." 95 The proxy solicitation is essential because it is required by law before managers can engage in fundamental corporate changes. Corporate managers with majority control should not be allowed to engage in misleading proxy solicitations, regardless of their voting strength.

E. Pendent Jurisdiction Over State Claims

Although the section 14(a) cases have not discussed the possibility in much detail, one might assume that if a plaintiff alleges a section 14(a) violation and seeks equitable relief against past elections, then the court would also have pendent jurisdiction to hear the state damage claims.

The system of federalism normally precludes federal courts from hearing cases based on state law, unless the requirements of diversity jurisdiction are met. However, if a federal court has a case or controversy properly before it that contains both federal and state claims, it may exercise pendent jurisdiction over the state claims and decide the case as a

90. Id.
94. See Smillie v. Park Chem. Co., 466 F. Supp. 572, 577-78 (E.D. Mich. 1979) ("[I]f the regulations required that these omissions be included in every proxy statement, then they are material as a matter of law. If the proxy votes were necessary to carry the resolutions being considered and to elect directors, then causation is established. Although they may have held sufficient shares to approve all matters under consideration, defendants do not deny that management found the proxy solicitations to be essential. It would appear to us that causation is established as a matter of law").
whole. In order to determine if a federal court has the power to decide state claims, the court must decide that:

. . . [t]he state and federal claims . . . derive from a common nucleus of operative fact. But if, considered without regard to their federal or state character, a plaintiff's claims are such that he would ordinarily be expected to try them all in one judicial proceeding, then, assuming substantiality of the federal issues there is power in federal courts to hear the whole. 96

But even if a federal court has the power to decide state claims, it may exercise its discretion and not assume pendent jurisdiction for a number of reasons. The key factors include considerations of judicial economy, convenience and fairness to the litigants, and whether the state law is clear and settled on the matter:

Certainly, if the federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well. Similarly, if it appears that the state issues substantially predominate, whether in terms of proof, of the scope of the issues raised, or of the comprehensiveness of the remedy sought, the state claims may be dismissed without prejudice and left for resolution to state tribunals. 97

In the section 14(a) context, if a plaintiff can obtain equitable rescission of past elections, it would appear that in most cases a federal court has the power to hear pendent state claims as well. For example, a failure to disclose past self-dealing would appear to be derived from a "common nucleus of operative fact" with the continuation of self-dealing after the elections. Similarly, if a court could set aside an election for failure of the defendant directors to disclose past bribes and kickbacks, it would have the power to hear state law claims relating to waste of corpórate assets in the post-election period since the subject of both the state and federal claims is the wrongful conduct of the directors over a period of time.

The question of discretion to exercise pendent jurisdiction over the state claims is more difficult. If it appears that the section 14(a) claim for rescission of elections and the holding of new elections is substantial and not frivolous, a federal court may wish to consider the state claims. This certainly makes sense in terms of judicial economy and fairness to the litigants even when the court ultimately dismisses the federal claims before the final resolution of the case. 98

97. Id. at 726, 727.
98. See Klaus v. Hi-Shear Corp., 528 F.2d 225, 231 (9th Cir. 1975) ("The court therefore also had pendent jurisdiction over the state claims. The federal issues presented were substantial and not frivolous; the district court will retain power to adjudicate the state claims even if it should ulti-
However, if a court believes that an equitable claim against elections is being invoked solely to get the state claims into federal court, it may use its discretion to dismiss the state claims. Dismissal of state claims is also appropriate if the state laws regarding the underlying corporate wrong are unclear or unsettled, or if proof of the state claim will occupy much of the case. It seems likely that in most cases plaintiffs will be more interested in obtaining damages than in seeking to rescind a past election. More often than not, the underlying corporate transaction that a plaintiff wishes to attack—i.e., the bribes, self-dealing, etc.—will involve more complex proof than the material nondisclosures or misstatements in the proxy solicitation materials. Therefore, in many cases, a court may wish to dismiss the state claims.

III. Materiality

A. The Fundamental Standard

The Supreme Court announced the basic test of materiality in TSC Industries, Inc. v. Northway, Inc. In this case, National Industries (“National”) acquired 34 percent of TSC Industries (“TSC’s”) voting shares. National placed five of its nominees on TSC’s board. Thereafter, the TSC board approved a proposal to liquidate and sell all its assets to National, with the TSC shareholders receiving shares of National in exchange for their TSC shares. TSC and National issued a joint proxy statement recommending shareholder approval of the proposal, and the proposal was thereafter adopted.

Northway, Inc. (“Northway”) was a shareholder in TSC. Northway brought suit against National and TSC under rule 14a-9 alleging that the joint proxy statement omitted material facts. More specifically, Northway argued that the proxy statement did not adequately disclose National’s control over TSC by its failure to mention that the current chairman of the TSC board was also the president of National. In addi-

100. 426 U.S. 438 (1976).
101. Id. at 440-41.
tion, Northway claimed that the proxy statement did not state that, in reports filed with the SEC, TSC and National had stated that National was the parent of TSC. Northway also argued that the defendants should have disclosed unfavorable statements made by an investment banking firm that had earlier approved of the transaction, as well as the fact that in the two years prior to the merger, National had been buying up its own shares, thereby manipulating the market price.\textsuperscript{102}

The district court denied Northway’s motion for summary judgment. On appeal, the Seventh Circuit Court of Appeals reversed the lower court’s decision.\textsuperscript{103} The focus of the court’s reversal was its definition of materiality. An omitted fact is material, the court held, if it “might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.”\textsuperscript{104} The court characterized this as a fairly lenient standard that satisfied the broad prophylactic purposes of section 14(a) and furthered a policy of full disclosure.\textsuperscript{105} It stated that any stricter test would require the plaintiff to introduce evidence at trial showing that “the challenged omission had an actual impact on his case,” and that such proof of an actual impact would be inconsistent with the Supreme Court’s holdings in \textit{Mills} and \textit{Affiliated Ute} that independent proof of causation or actual reliance is unnecessary.\textsuperscript{106} Given this view of materiality, the court held that the omissions were material as a matter of law.

In doing so, the court rejected a more stringent test adopted by the Second Circuit Court of Appeals in \textit{Gerstle v. Gamble-Skogmo, Inc.}\textsuperscript{107} The \textit{Gerstle} court, following the Restatement of Torts,\textsuperscript{108} held that the

\begin{footnotesize}
\begin{enumerate}
\item[102.] Id. at 451-64.
\item[103.] Northway, Inc. v. TSC Indus. Inc., 512 F.2d 324 (7th Cir. 1975), rev’d, 426 U.S. 438 (1976).
\item[104.] Id. at 330.
\item[105.] Id. at 330-31 n.12.
Where the misstatement or omission in a proxy statement has been shown to be “material,” . . . that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.
Similarly, in \textit{Affiliated Ute Citizen v. United States}, 406 U.S. 128, 154 (1972), the Court stated:
[P]ositive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.
\item[107.] 478 F.2d 1281, 1301-02 (2d Cir. 1973). The \textit{Gerstle} test has also been followed by the Fifth Circuit Court of Appeals. \textit{See} Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603-04 (5th Cir.), \textit{cert. denied}, 419 U.S. 873 (1974).
\item[108.] \textit{RESTATEMENT OF TORTS} § 538(2)(a) (1938).
\end{enumerate}
\end{footnotesize}
The basic test of materiality is whether "a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question" or whether there was a "substantial likelihood" that the misstatement or omission may have led a shareholder to grant a proxy different than he would have otherwise done. The Gerstle court stated that it did not believe that the Supreme Court's statements in Mills or Affiliated Ute were "in fact intended to establish a definition of materiality." While Judge Friendly (the author of the Gerstle opinion) recognized that "the difference between 'might' and 'would' may seem gossamer, the former is too suggestive of mere possibility, however unlikely. When account is taken of the heavy damages that may be imposed, a standard tending toward probability rather than toward mere possibility is more appropriate."  

On appeal of TSC Industries, the Supreme Court followed Judge Friendly's view of materiality and rejected that of the Seventh Circuit Court of Appeals, observing that its statements in Mills and Affiliated Ute were not meant to be precise statements of the law, and that it never meant "to foreclose further inquiry into the meaning of materiality under Rule 14a-9."  

The Supreme Court defined materiality as follows:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . [This standard] does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have significantly altered the "total mix" of information made available.  

The Court thought this test to be a reasonable balance between the broad remedial purposes of section 14(a) and the dangers of requiring too much disclosure, expressing its concern that the Seventh Circuit Court of

109. Gerstle, 478 F.2d at 1302 (emphasis in original).
110. Id. at 1301.
111. Id. at 1302.
113. Id. at 449. To the extent that the Supreme Court's standard precludes a showing that an omitted fact would have caused a shareholder to switch a vote had it been included, it differs from the Second Circuit Court of Appeals' standard. See supra text accompanying notes 109-110.
Appeals’ less stringent test would lead to corporate liability “for insig-
ificant omissions or misstatements.” Also, “management’s fear of exposing
itself to substantial liability may cause it simply to bury the shareholders
in an avalanche of trivial information.” The Court went on to hold
that the issue of materiality involved “delicate assessments of the infer-
ences a ‘reasonable shareholder’ would draw from a given set of facts,”
and that such a determination was particularly suited for the trier of
fact. Only in cases where established omissions are “so obviously im-
portant to an investor, that reasonable minds cannot differ” can the issue
of materiality be resolved as a matter of law by summary judgment.

The Supreme Court’s definition of materiality in TSC has since been
repeated, almost mechanically, in numerous cases arising under section
14(a), section 14(e) and rule 10b-5. Application of the section 14(a)
standard to other areas is appropriate because “Section 10(b) and Rule
10b-5 and Section 14(a) and (e) and Rule 14a-9 are obviously aimed at
the same general evils in the field of corporate ownership, management
and finance, are in pari materia and should be similarly construed.”

Although the TSC definition of materiality is the accepted one, there
have been a few attempts at slight modifications. For example, in Pav-
lidis v. New England Patriots Football Club, Inc., the plaintiffs argued
that the TSC standard should be relaxed (from a plaintiff’s view) in cases
involving insiders or uncontested mergers “where the management of the
target company is identical with the management of the offeror.” This
less stringent standard of materiality (“less” in the sense that more infor-

114. Id. at 448.
115. Id. at 450.
117. See, e.g., Flynn v. Bass Bros. Enters., Inc., 744 F.2d 978, 985 (3d Cir. 1984) (§ 14(e)—“We
see no reason not to utilize the [TSC] formulation for evaluating materiality in the context of a
tender offer.”); Staffin v. Greenberg, 672 F.2d 1196, 1205 (3d Cir. 1982) (§ 14(e)); Panter v. Marshall
Catalyst Recovery of Pennsylvania Inc., 616 F.2d 641, 647 (3d Cir. 1980) (rule 10b-5); James v.
Gerber Products Co., 587 F.2d 324, 327 (6th Cir. 1978) (rule 10b-5); Augenstein v. McCormick &
Co., 581 F. Supp. 452, 459 (D. Md. 1984) (rule 10b-5); Resource Exploration v. Yankee Oil & Gas,
1983) (rule 14a-9).
119. 737 F.2d 1227 (1st Cir. 1984).
120. Id. at 1231.
ests differ from those of the shareholders, and management may have access to information which is not available to the shareholders, so as to insure that the public has market risks identical with those of insiders.121 Although the Pavlidis court rejected a lower standard of materiality in such cases as being inconsistent with TSC,122 it recognized that what would not be material in the context of an adversarial transaction may be material in a one-sided transaction. In other words, “although the same standard of materiality would apply to both kinds of transactions, the standard might identify different facts as material in each transaction.”123 Thus, when management’s interest conflict with those of the shareholders, a court may be more skeptical of management’s disclosure than normal:

[A]lthough § 14(a) requires any party soliciting proxies, regardless of his status or interest in the transaction, to disclose all material information, a self-dealing insider may have a “heavier burden of disclosure” in the sense that he will find it more difficult to convince the court that he has met the requirements of § 14(a).124

Alternatively, some courts have tightened the TSC standard, making it more difficult for plaintiffs to prevail on the materiality issue. For example, in Radol v. Thomas,125 a rule 10b-5 and section 14(e) case, the district court held that, in addition to the standard of materiality set out in TSC Industries, there was “an additional requirement” before a plaintiff could show omitted information was material. “That requirement is that the facts or conclusions contained in information claimed to be ‘material’ can be determined with ‘substantial certainty.’”126 The purpose of the “substantial certainty” requirement is to avoid forcing management to disclose information which may appear quite significant but which “if disclosed, would risk misleading the shareholder because the bases for these conclusions are speculative and unreliable.”127 Although this “sub-

122. Pavlidis v. New England Patriots Football Club Inc., 737 F.2d 1227, 1231 (1st Cir. 1984) (“The fact that a proxy statement is drafted by insiders acting in their own interest does not change the standard of materiality. A fact does not become more material to the shareholder’s decision because it is withheld by an insider, or because the insider might profit by withholding it”).
123. Id.
124. Id.
126. Id. at 1308 (citing cases).
127. Id. at 1307.
substantial certainty” requirement is characterized by the court as an “additional requirement,” it might be better characterized as merely a modification of the basic TSC standard. Whatever uncertainty might exist about various pieces of information, the standard of materiality itself might be the same in all contexts. Thus it might be analytically better to consider certain types of information as not being “material” as a matter of law if they cannot be determined with “substantial certainty.” In other words, a reasonable shareholder, when deciding how to vote, would not take into account information based on mere speculation or unsubstantiated hunches.

In some cases the question of “substantial certainty” may become particularly relevant. Such cases involve management’s subjective motivations for a certain proposal; various types of “soft” information, such as projections of profits or asset valuations; alternative possible transactions; and management’s opinion as to a proposal’s fairness or unfairness. In these situations, there is a tension between requiring the disclosure of all sorts of information which a shareholder would consider significant and restricting disclosure to definite facts rather than subjective opinions or speculations.

B. Subjective Motivation

The question of whether subjective motivation need be disclosed often arises in two contexts, in both of which the interests of management diverge from those of the shareholders. The first of these involves “going private” situations where shareholders are asked to approve a transaction in which a new privately held corporation purchases all the shares or assets of the old corporation. Usually, the “going private” transaction is in the interests of management, which stays on to run the new corporation and may receive extra compensation for doing so. Minority shareholders opposed to the transaction argue that management should disclose in the proxy statement its true reasons for supporting the proposed transaction, which may be personal financial gain. The second area involving subjective motivation is when management proposes anti-takeover amendments to the by-laws or the articles of incorporation. Shareholders have argued that management should disclose that its personal motivation for supporting these propositions is its wish to protect itself against replacement by a new management.

128. See Pavlidis, 737 F.2d 1227 and supra text accompanying note 122.
In both these situations—going private transactions and anti-takeover proposals—most courts have held that subjective motivation need not be disclosed, agreeing with the district court in *Stedman v. Storer* which stated: “The unclean heart of a director is not actionable, whether or not it is ‘disclosed,’ unless the impurities are translated into actionable deeds or omissions both objective and external.”129 If the underlying facts are fairly stated, subjective motivations need not be disclosed.130

This is not to say that management never has the duty to disclose subjective motivations; if such a duty exists, it exists under state law—not under federal securities law. As the Eighth Circuit Court of Appeals pointed out in *Golub v. PPD Corp.*,131 the same considerations that led the Supreme Court in *Santa Fe Industries, Inc. v. Green*132 to hold that rule 10b-5 did not protect shareholders from breach of the fiduciary duty by majority shareholders are applicable in the section 14(a) area. Anti-takeover proposals or going private transactions which harm shareholders and work to the advantage of majority shareholders or management, may create causes of action under state law, but “it was not the purpose

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129. 308 F. Supp. 881, 887 (S.D.N.Y. 1969). *See also* Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co., 475 F. Supp. 328 (S.D.N.Y. 1979), *vacated as moot*, 638 F.2d 7 (2d Cir. 1980) (management need not be required to accuse itself of anti-social tendencies, such as to thwart a union).


131. 576 F.2d at 764.

of the federal security laws to provide a federal cause of action for stockholders who have been damaged by mere corporate mismanagement or breach of fiduciary duty."\(^{133}\)

On the other hand, it is arguable that a requirement that subjective motivation be disclosed may enable shareholders to seek injunctive or other relief under state law. An example of this view is found in \textit{SEC v. Parklane Hosiery},\(^{134}\) in which the Commission sought to enjoin a “going private” transaction because the proxy statement failed to inform shareholders that the purpose of the transaction was to allow the president and principal shareholder to discharge his personal debts from the company’s treasury. Although the defendant argued that the purpose of the transaction was not material and relied on \textit{Santa Fe Industries}, the Second Circuit Court of Appeals held the purpose to be a material fact, stating that if the purpose of the transaction had been announced, the shareholder might have been able to enjoin it under state law since it involved a merger which lacked a valid corporate purpose.\(^{135}\) Thus, when the nondisclosed purpose could have supported a suit by minority shareholders based on state law, the subjective motivation becomes material. The same argument would apply in the context of an anti-takeover proposal; if the proposal has an illicit purpose, disclosure may be required under the proxy rules.\(^{136}\)

The Second Circuit Court of Appeals and the District Court for the Southern District of New York subsequently tried to restrict \textit{Parklane Hosiery} by stressing the fact that the defendant, apart from failing to disclose the subjective motivation for the “going private” transaction, had not disclosed his substantial personal debts.\(^{137}\) However, a fair read-

\(^{133}\) Golub v. PPD Corp., 576 F.2d at 764. \textit{See also} Lewis v. Oppenheimer Co., 481 F. Supp. at 1204.

\(^{134}\) 558 F.2d 1083 (2d Cir. 1977). \textit{See also} Parklane Hosiery Co., Inc. v. Shore, 439 U.S. 322 (1979) (corporate defendant collaterally estopped from relitigating proxy violation issue in private cause of action after SEC action).

\(^{135}\) \textit{Parklane Hosiery}, 558 F.2d at 1088. For discussion of similar point with respect to the question of causation, see \textit{supra} text accompanying note 87.

\(^{136}\) \textit{See} Texas Partners v. Conrock Co., 685 F.2d 1116, 1120 (9th Cir. 1982), \textit{cert. denied}, 460 U.S. 1029 (1983) (triable issue as to whether failure of proxy materials to disclose true motives behind anti-takeover proposal was material to shareholders).

\(^{137}\) Rodman v. Grant Found., 608 F.2d 64, 71 n.5 (2d Cir. 1979) ("\textit{SEC v. Parklane Hosiery Co. . . .} relied upon by appellant, is not to the contrary. There, the 'overriding purpose' for a going-private scheme was to enable the president and principal shareholder of the company to discharge his personal debts from the company treasury, and there was 'not so much as a hint' of these debts in the proxy statement."); Lewis v. Oppenheimer Co., 481 F. Supp. at 1206.
ing of *Parklane Hosiery* reveals that the court did not emphasize the non-disclosure of the personal debts; rather the broad language of the opinion stresses the requirement that, in general, subjective motivation in going private transactions be disclosed if it is relevant to a shareholder's seeking appropriate relief under state law.\(^{138}\)

While most cases do not require disclosure of subjective motivation, the reasoning behind *Parklane Hosiery* is more convincing. Certainly, if a reasonable shareholder would consider a director's subjective motivation to be important when deciding how to vote, and can use that information to enjoin a particular transaction in a state court, then that information is material and should be included in a proxy statement. Although there may be some problems in determining management's precise subjective motivation behind a particular transaction, such a task appears to be no more difficult in the proxy area than it is in other areas of the law in which subjective motivation is important. When the subjective motivation is too ephemeral or too vague and not easily determinable, then the “substantial certainty” test of *Radol v. Thomas*\(^{139}\) would preclude a finding of materiality.

### C. Soft Information

Apart from the subjective motivation for proposing a particular transaction, management may have made predictions as to the profitability of transactions it presents for shareholder approval. Appraisals of assets

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\(^{138}\). *See Parklane Hosiery*, 558 F.2d at 1088. The court distinguished *Santa Fe Indus.* by arguing that in that case the short-form merger could be accomplished without the consent of the minority shareholders and that it was admitted by the plaintiffs that there had been full and fair disclosure. Contrary to the situation under the Delaware short-form merger statute, had the shareholders of Parklane been aware of Somekh's reasons for the going-private transaction, they, or others, might well have been able to enjoin the merger under New York law... This case involved a failure to disclose when the non-disclosed information could have been used by the minority shareholders to attempt to enjoin the merger. *The purpose for the merger was, therefore, relevant.* (Id. emphasis added).

One might attempt to distinguish *Parklane Hosiery* on the ground that it involved a Commission enforcement action and therefore a lower standard of materiality should apply. However, there seems to be little support for such a position in the Supreme Court’s formulation of the materiality standard in *TSC Industries*. Whether or not the Commission is involved, the standard of materiality should be the same—what a reasonable shareholder would consider important. Furthermore, in *Parklane Hosiery*, the Court held that the corporate defendant was collaterally estopped from relitigating factual issues regarding materiality, once a Commission action had decided these issues. Thus, the standard of materiality must be the same in both a private and a Commission action. *But see id.* at 325 n.2 (observing that in private action a plaintiff has the additional burden of proving that he was injured and suffered damages).

\(^{139}\). *See supra* text accompanying notes 125-27.
owned by the company may have been prepared for management's internal use. In both instances such information is clearly material within the parameters of the standard already discussed. Nonetheless, both the Securities and Exchange Commission and the courts have until recently not required its disclosure and, in fact, have had a policy prohibiting disclosure.

The Commission had a long-standing policy against the inclusion of soft information in proxy materials. Prior to 1976, the examples of misleading statements following rule 14a-9 included "[p]redictions as to specific future market values, earnings or dividends."\footnote{140} Even though asset valuations or appraisals were not specifically mentioned, "[i]t has long been an article of faith among lawyers specializing in the securities field that appraisals of assets could not be included in a proxy statement."\footnote{141} Commission policy was considered to be the same toward asset appraisals as toward predictions of future earnings.\footnote{142} The policy stemmed from a distrust of the reliability of projections and appraisals, fears that investors and shareholders would place more weight on the soft information than was warranted, and the impracticability of the Commission's limited staff confirming the accuracy of soft information on a case-by-case basis. In addition, there was a fear of imposing enormous liabilities on corporations either for not disclosing what the defendants thought was reliable information or for disclosing information that ultimately was found to be unreliable.\footnote{143} Thus, even if under the normal standard soft information would be material, the entire category was, for policy reasons, excluded from proxy statements.

During the more recent past, however, the Commission began to change its policy. The former policy led to situations in which crucial information about particular transactions was reserved for insiders and withheld from the investing public.\footnote{144} The older policy thus seemed out
CIVIL LIABILITY UNDER PROXY RULES

of date, particularly so in view of the increasing use of proxy contests and tender offers.¹⁴⁵

In 1973, the Commission announced its intention to issue new comprehensive rules regarding soft information. The basic policy would not require forecasts, but if forecasts were made, they should be treated like any other material event, such as a declaration of dividends, a merger or major management changes, and thus filed with the Commission and made publicly available.¹⁴⁶

The Commission’s announcement accompanied the controversy arising from its brief in a private section 14(a) action, *Gerstle v. Gamble-Skogmo, Inc.*¹⁴⁷ In *Gerstle*, the plaintiffs argued that the defendants violated section 14(a) by failing to include, in proxies seeking approval of a merger, the defendant’s appraisals of the market value of the company’s assets. Even though the Commission staff had in 1963 specifically excluded asset appraisals from the proxy materials for this very transaction, the Commission, in its brief *amicus*, in effect reversed the staff position and argued that in certain circumstances disclosure of asset appraisals is necessary to make the proxy statement not misleading.¹⁴⁸ Even though the Second Circuit Court of Appeals refused to penalize the defendant in *Gerstle* for the Commission’s quite informal change of position, the Commission’s change of policy appeared to be a landmark.

Although the securities community expected the Commission to issue a comprehensive soft information policy after 1973, such a policy was never issued. Instead, the Commission has made a series of gradual changes. For example, in 1976, the Commission deleted the reference to future earnings as a type of misleading statement under rule 14a-9,¹⁴⁹ and stated that it wished neither to encourage nor discourage the making of earnings projections but that it would permit corporations to release projections that were made in good faith and that had a reasonable ba-

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¹⁴⁵. Flynn v. Bass Bros. Enterprises, Inc., 744 F.2d 978, 987 (3d Cir. 1984) (“The present spate of proxy contests and tender offers was not anticipated when the SEC initially formulated its policy of nondisclosure of soft information.”).

¹⁴⁶. See supra note 144.

¹⁴⁷. See supra note 141.


In 1979, the Commission adopted a “safe harbor” rule for “for-
warding-looking” statements containing projections of earnings and
losses, dividends, capital structure, or future management objectives. 151 If
such projections are disclosed in good faith and with a reasonable ba-
sis, then they will not be considered fraudulent, subjecting manage-
ment to liability solely because the projected results do not materialize. In
1980, the Commission authorized disclosure of appraisals in proxy state-
ments when the principal issue in a proxy contest is the liquidation of all
or part of the assets of an issuer. 152 Such asset valuations, however, must
have a reasonable basis and be made in good faith, and the information
must be presented in a way so as to not distort the original context.

Given these changes in Commission policy, there are still some uncer-
tainties as to corporate liability for failing to disclose soft information in
particular situations. Much of the problem in recent decisions has been
that the disputed proxy statements were issued when the Commission’s
policy was hostile to soft information disclosure even though the case
was finally resolved when the Commission’s policy had changed. In such
situations, most courts have been reluctant to impose liability on defend-
ants for not disclosing information 153 and have followed the reasoning of
the Commission’s former policy that soft information need not be dis-
closed because it is unreliable and potentially misleading. 154

SEC. L. REP. (CCH) ¶ 80,461 (Apr. 23, 1976).
152. Interpretative Release Relating to Proxy Rules, Sec. Exch. Act Rel. No. 34-16833 (May 23,
153. See South Coast Services Corp. v. Santa Ana Valley, 669 F.2d 1265, 1271 n.3 (9th Cir.
1982) (later SEC releases “are not binding on our decision, as the proxy materials in this case pre-
date their formulation”); Gerstle, 478 F.2d at 1294 (“But we would be loath to impose a huge liabil-
ity on Skogmo on the basis of what we regard as a substantial modification, if not reversal of the
SEC’s position on disclosure of appraisals in proxy statements, by way of its amicus brief in this
case.”); Lewis v. Oppenheimer Co., 481 F. Supp. 1199, 1208 n.6 (S.D.N.Y. 1979) (deletion of future
earnings from note to rule 14a-9 and safe harbor rules held to have no effect since proxy statements
which failed to disclose prediction of future earnings predated Commission changes). But see Flynn
v. Bass Brothers Enterprises, Inc., 744 F.2d 978, 988 (3d Cir. 1984) (court, without altering the
outcome of the litigation before it, stated prospectively that “[i]n order to give full effect to the
evolution of the law of disclosure, and to avoid in the future, at least in the Third Circuit, the
problem caused by the time lag . . . today we set forth the law for disclosure of soft information as it
is to be applied from this date on”).
154. See Pavlidis v. New England Patriot’s Football Club, Inc., 737 F.2d at 1227, 1233 (1st Cir.
1984) (“The federal securities laws do not require corporate managers to include speculations about
future profitability in proxy statements.”); South Coast Services Corp., 669 F.2d at 1270-72 (no rule
14a-9 violation for failure to disclose board of directors’ estimates of fair market value of assets in
A few courts have departed from the norm and have considered the change in Commission policy as imposing a duty to disclose soft information under certain circumstances, recognizing the materiality of soft information under the TSC standard. However, no court has ruled that soft information must always be disclosed and the approach has been on a case-by-case basis.

A good example of this approach is *Flynn v. Bass Brothers Enterprises, Inc.*[^1] a section 14(e) case based on section 14(a) reasoning and precedent. In *Flynn*, former minority shareholders of a target company argued that the tender offeror and the management of the target company violated section 14(e) by failing to disclose internal asset valuations of the target. After surveying the changing Commission policy, the court established the proper standard for determining the materiality of soft information in the future, presumably under both section 14(e) and section 14(a):

Henceforth, the law is not that asset appraisals are, as a matter of law, immaterial. Rather, in appropriate cases, such information must be disclosed. Courts should ascertain the duty to disclose asset valuations and other soft information on a case by case basis, by weighing the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released with a proper cautionary note.

The factors a court must consider in making such a determination are: the facts upon which the information is based; the qualifications of those who prepared or compiled it; the purpose for which the information was originally intended; its relevance to the stockholders' impending decision; the degree of subjectivity or bias reflected in its preparation; the degree to which the information is unique; and the availability to the investor of other

more reliable sources of information.156

In Flynn, however, the court did not believe that the disputed information met the requirements of the test since it lacked reliability, the preparer was not sufficiently expert, and there was insufficient basis in fact for the asset valuations.157

The test announced in Flynn follows the TSC materiality standard. Presumably, reasonable shareholders would not desire access to information that did not meet the Flynn test, i.e., information that was too subjective, that was prepared by an unqualified person, that was taken out of context and that was not generally reliable, and such information should not be considered material. Presumably, there will be many instances in which soft information will be reliable and when insiders rely on such soft information, such reliance should be prima facie evidence as to its materiality. Although the Flynn test is difficult to apply in that it requires balancing of various factors, a policy favoring disclosure in particular instances seems more consistent with the underlying spirit of the securities laws in its emphasis on the ability of the investor to make his or her own evaluation, than is a policy which underestimates the ability of investors to fend for themselves, even if they have access to full information.158

156. Id. at 988. See also Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 819 (D. Del. 1974) ("To conclude . . . that no asset valuations need be disclosed under any circumstances is to paint with too broad a brush. In the cases cited, the valuations of assets involved the exercise of a substantial amount of subjective judgment in the selection of data and in the weighing of the information selected as relevant. In each case the court noted the subjective judgmental element of the appraisal process. Where the assets involved admit of a reasonably objective evaluation, however, a different result has obtained."); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), modified, 235 F.2d 369 (3d Cir. 1956) (when corporate purchasers of minority shareholders' shares failed to disclose plan to liquidate the corporation and that the market value of assets had risen substantially above book value, and the market value could be ascertained with reasonable certainty, the defendants had the duty to disclose market value).

157. Flynn, 744 F.2d at 988-90.

158. See South Coast Services Corp. v. Santa Ana Valley, 669 F.2d 1265, 1275-76 (9th Cir. 1982) (one dissent):

The policy reflecting a solicitous regard for shareholders who might place indiscriminate trust in estimates of questionable reliability, had its genesis in the Commission's early effort . . . to protect investors from certain companies' practices of luring the unsuspecting with overstatement of assets in registration statements. . . . The Commission's mandate 'to stem the speculative tide whenever necessary,' . . . called for measures and policies designed to correct certain abuses thought to have initiated the stock market collapse of 1929 and the ensuing economic depression, but ill suited to fulfillment of other aspects of the Act's remedial purposes. Attainment of one of those goals, to promote fair corporate suffrage, is inhibited by a policy that counsels withholding material information from shareholders voting on a merger proposal.
D. Alternative Possible Transactions

Another troublesome problem which illustrates the tension between “hard facts” and “soft information” is whether management must disclose possible transactions which are alternatives to the one proposed. For example, suppose that the shareholders of Corporation X are voting on a management-sponsored proposal to sell all of X’s assets to Corporation Y or to merge with Corporation Y. Must X’s management disclose in its proxy statement that it has received offers from other potential purchasers?

Under most circumstances, “management is not required to discuss the panoply of possible alternatives to the course of action it is proposing.” ¹⁵⁹ For example, if management proposes liquidation, it need not present alternate methods to the shareholders, each with different tax consequences, and leave the final choice up to them. ¹⁶⁰ While its failure to make the best choice among different alternatives may be grounds for an action under state law, such a failure is no violation of federal law.

However, in merger or liquidation cases, the courts are united in holding that management does have a duty under section 14(a) to disclose alternative firm offers from other potential purchasers. ¹⁶¹ This is especially so when the alternative offers are more favorable to the shareholders than the one proposed by management. The duty is confined to firm offers and does not extend to alternative offers which are tentative or speculative. A single telephone call by a potential purchaser suggesting a possible purchase, without follow-up, is not firm enough to require dis-


¹⁶⁰ 467 F. Supp. at 553 (“The failure to disclose that KIC might garner a ‘control premium’ or accomplish the liquidation in tax-free fashion was immaterial as a matter of law.”). See also Koppel v. Wien, 575 F. Supp. 960, 968-69 (S.D.N.Y. 1983), aff’d, 743 F.2d 129 (2d Cir. 1984) (defendant need not have disclosed that a more financially advantageous brokerage deal could have been obtained to sell joint venture’s assets).

¹⁶¹ See South Coast Services Corp. v. Santa Ana Valley, 669 F.2d 1265, 1273 (9th Cir. 1982) (“Firm offers from other potential purchasers, if they are more favorable than the offer being endorsed by management, must be disclosed in proxy materials soliciting shareholder approval of a proposed sale of corporate assets.”); Gerstle, 478 F.2d at 1294-95 (“The matter of disclosing ‘firm offers’, however, may well stand differently. Such offers, emanating from outside sources, do not have the potential of overstatement of prospects at the instance of management that has so alarmed the SEC about appraisals. Perhaps more important, there has not been a general understanding within the legal and accounting professions that reference to such offers in a proxy statement would not be permitted, as has existed with respect to appraisals.”); United States Smelting, Ref., & Mining Co. v. Clevite Corp., [1969-70 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,691, at 99,051-54 (N.D. Ohio 1968) (failure to inform shareholders of second merger offer at higher price).
closure.  Similarly, if the directors have reasonable grounds to believe that an offer has been withdrawn, if the offer had such unreasonable conditions attached to it that it was unrealistic, or if it was a mere step in negotiations, then it need not be disclosed.

On the other hand, one might argue that disclosure of information about the mere interest of other companies, even if not at an advanced stage, may be of concern to shareholders in deciding how to vote. Disclosure of potential offers, even tentative ones, helps shareholders gain an awareness of the intensity of demand, the value of the corporation's assets, "and the adequacy of the offer under consideration." In some situations a single communication from another purchaser (such as one from a large multinational corporation to a much smaller one) may be significant enough to disclose to all shareholders, particularly if the second offer is one which could be pursued further if management took the opportunity to do so.

E. Characterization of Transaction as Fair or Unfair

A final area illustrating the tension between facts and opinion involves whether a transaction should be characterized as fair or unfair. The few cases addressing this issue typically state that all that need be disclosed are the facts from which a stockholder may draw his or her own conclusion.


164. South Coast Services, Corp., 669 F.2d at 1277.

However, in some situations a fairness opinion may be required. Thus under rule 13e-3, covering “going-private” transactions, management is required to include in its proxy statement a statement “whether the issuer or affiliate . . . reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders.” The issuer must also “[d]iscuss in reasonable detail the material factors upon which the belief stated . . . is based and, to the extent practicable, the weight assigned to each such factor.”

The factors include current and historical market price of the stock; the book, liquidation, and going concern values of the corporation, and the price paid in previous repurchases. In such cases, if the supporting data is materially misleading, the issuer could be liable under several theories, including a violation of section 14(a).

Aside from rule 13e-3 transactions, if a corporation includes a fairness statement in its proxy statement to increase its chances of obtaining shareholder approval, one could argue by analogy to rule 13e-3 that management should not be permitted to offer a mere conclusory statement, but should have to provide supporting information. The extent of the supporting information should depend on the particular circumstances. For example, as the First Circuit Court of Appeals suggested in the Pavlidis case, if there is a proxy contest, management’s statement of fairness may not have to be supported by as much information as when a transaction is unilaterally proposed by management. If management obtains a fairness opinion from an outside and independent source, the outsider should be independent in fact and any fees which the outsider receives should be disclosed.

IV. SCIENTER—THE STANDARD OF CARE

Most courts which have considered the appropriate standard of care required by the proxy rules have rejected the suggestion that, since actions under rule 10b-5 require a showing of scienter or something more

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167. Id.
169. See Radol, 534 F. Supp. at 1314 (characterization of financial advisor as independent did not violate rule 14a-9 even though advisor played a role in the negotiation of merger and its fee was contingent on outcome, since proxy statement contained extensive disclosures about advisor's role and the fee arrangements were adequately discussed).
than ordinary negligence, such as recklessness or behavior more heinous than that, similar principles should apply to the preparation of proxy statements. Thus the great weight of authority appears to be that, at least in actions by shareholders against an issuer, i.e., the corporation distributing a negligently prepared proxy statement, ordinary negligence should suffice. In doing so, courts have relied upon the conspicuous differences in the statutory language of sections 14(a) and 10(b), the legislative history of these provisions, similar differences in the language of rule 14a-9 and rule 10b-5, and the roles which they play in the overall legislative scheme.

Section 14(a) gives the Commission broad regulatory authority to prescribe rules governing the solicitation of proxies. Unlike section 10(b), it makes no mention of manipulation or deception and thus extends well beyond conventional fraud.

The differences between rule 14a-9 and rule 10b-5 are obvious, intentional, and pronounced. The former states that proxy materials must not contain a false or misleading statement, or omit any material fact that would make the statements false or misleading. The latter speaks pri-


172. Rule 14a-9(a) states in part that no proxy statement shall contain "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. . . ." 17 C.F.R. § 140.14a-9 (1981).
marily in terms of prohibiting fraud or deceit, although, like rule 14-9, it also prohibits so-called "half truths." The differences are apparent not only from the rules themselves but also from their differing functions. The primary purpose of the proxy rules is to insure accurate preparation of proxy materials so as to inform investors adequately and enable them to vote their shares in an intelligent manner. The primary purpose of rule 10b-5, on the other hand, is to prohibit fraud or deceit, including "half truths," in connection with the purchase or sale of securities in interstate commerce or by use of the mails or facilities of national securities exchanges. The differences in language and function justify different standards of culpability.

The legislative history of the proxy provisions indicates that Congress had become concerned that "too 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." Thus "fair corporate sufferage is an important right that should attach to every equity security bought on a public exchange" and section 14(a) of the Exchange Act was therefore intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which..."
[had] frustrated the free exercise of the voting rights of stockholders."\textsuperscript{177} It is thus not surprising that "the scope of the rulemaking authority granted under section 14(a) is broad, extending to all proxy regulation necessary or appropriate in the public interest or for the protection of investors and not limited by any words connoting fraud or deception."\textsuperscript{178} Moreover, since negligence is sufficient for tort liability under the common law when a person supplies false information to another intending to influence a transaction in which he has a pecuniary interest,\textsuperscript{179} it seems highly unlikely that Congress, in enacting section 14(a), or the Commission in promulgating rule 14a-9, intended that those provisions incorporate a lesser standard of liability. Although, to be sure, section 18(a) of the Exchange Act, which provides for express civil liability in connection with false reports or other documents filed with the Commission, enables a defendant to establish his "good faith" or lack of knowledge as a defense, it is also equally true that "most of the documents within the scope of section 18 are not distributed to stockholders for the purpose of inducing action . . . ."\textsuperscript{180} Thus proxy materials are disclosure documents of a specialized type in that they contemplate action by those for whom they are intended. In this respect they resemble prospectuses. If Congress provided for a standard of "due diligence" as regards the preparation of prospectuses, it seems unlikely that it also intended that a lesser standard, one requiring "scienter" prevail with respect to the preparation of proxy materials.\textsuperscript{181} Moreover, the primary reason for requiring "scien-

\textsuperscript{177} Id. at 14.

\textsuperscript{178} Gerstle, 478 F.2d at 1299.

\textsuperscript{179} Id. at 1300, citing RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966); Gediman v. Anheuser Busch, Inc., 299 F.2d 537, 543-46 (2d Cir. 1962); W. Prosser, TORTS § 107, at 706-09 (4th ed. 1971).

\textsuperscript{180} Gerstle, 478 F.2d at 1299 n.18.

\textsuperscript{181} See Securities Act of 1933 § 11(b)(3). The overall standard, for persons other than the issuer, is that of "reasonable investigation, reasonable ground to believe . . . [and actual belief]" in the truth and accuracy of the material in the registration statement. There is strict liability for the issuer (subject to a defense that the misrepresentation or omission was not material) and the issuer is therefore virtually the insurer of the accuracy of the registration statement. Although it has been argued that a similar standard (i.e., strict liability) should apply to an issuer preparing proxy materials, the courts have thus far rejected the suggestion, requiring that negligence be shown, as with other possible defendants, such as directors, officers and others. See Shidler v. All American Life & Fin. Corp., [Current Volume] FED. SEC. L. REP. (CCH) ¶ 92,326 at 92,169-70 (8th Cir. 1985) (pointing out that prospectuses are usually addressed to those who are making their initial investment in an issuer and who therefore cannot be expected to be as well-informed about its affairs as those for whom proxy materials are prepared, persons who are continuing investors in a corporation and who can therefore be expected to be more familiar with its activities; accordingly a stricter standard should be applied with respect to the preparation of prospectuses).
ter" in connection with rule 10b-5, namely to reconcile it with the other provisions of the securities laws which provide remedies to purchasers of securities without requiring scienter,182 does not exist with regard to section 14(a), which is restricted to proxy materials. In addition, the coverage of rule 10b-5 is broader than that of rule 14a-9 in that the former embraces situations where corporations make statements concerning their affairs without necessarily being under a legal obligation to do so. To impose too high a standard of care in such situations would discourage corporate candor, especially if there is no upper limit on the measure of damages.183

The case law following Ernst & Ernst v. Hochfelder184 confirms the foregoing analysis. Thus, in Gould v. American-Hawaiian Steamship Co.,185 one of the issues was the appropriate standard of liability applicable in an action under rule 14a-9 to an outside, i.e., nonmanagement, director. In rejecting the defendant's argued analogy between rule 14a-9 and rule 10b-5 and his suggestion that the scienter requirement of Hochfelder should control, the court stated that if an analogy were to be drawn between various rules, it would:

agree with the district court that section 14(a) and Rule 14a-9(a) may be more closely analogized to section 11 of the Securities Act of 1933 . . . which deals with civil liability for false registration statements. . . . Since section 11 of the Securities Act clearly establishes negligence as the test for determining liability, the parallel between the two sections would strongly support adoption of negligence as the standard under section 14(a).186

In addition, the court reaffirmed a point already made in Gerstle187 by observing that, "unlike sections 10(b) and 18 of the [Exchange] Act, which encompass activity in numerous and diverse areas of securities markets and corporate management, section 14(a) is specially limited to materials used in soliciting proxies."188

Only a scattering of cases following Gerstle and Gould have suggested the propriety of a scienter requirement with regard to rule 14a-9. This

183. Gerstle, 478 F.2d at 1300.
185. 535 F.2d 761 (3d Cir. 1976).
186. Id. at 777. Indeed, the analogy between § 14(a) and § 11 of the Securities Act of 1933 has led to an argument that issuers should have strict liability under § 14(a). See supra note 181.
187. 478 F.2d at 1299 n.18. See supra text accompanying note 180.
188. Gould, 535 F.2d at 778. See supra text accompanying note 180.
minority view appears to prevail primarily in the Sixth Circuit Court of Appeals which, in *Adams v. Standard Knitting Mills, Inc.*, chose to follow an earlier pre-*Hochfelder* holding which required scienter. The case actually involved liability of a controlling party under section 20(a) of the Exchange Act, obviously a different issue from whether scienter should be required for primary liability under rule 14a-9. In *Adams*, the later of the two cases, a North Carolina hosiery manufacturer, Chadbourn, Inc., merged with Standard Knitting Mills, Inc., a small publicly held textile manufacturer. In soliciting approval of the merger, Standard's proxy materials contained Chadbourn's financial statements which had been prepared by the latter's accountants.

Approximately one year after the merger, Chadbourn's sales of hosiery plummeted unexpectedly, resulting in substantial losses and wiping out Chadbourn's retained earnings with the result that it was not able to redeem or make payments on its preferred shares held by former Standard shareholders. The shareholders then brought an action for damages against the accounting firm under rule 10b-5 and 14a-9, alleging that the financial statements were false and misleading. Although the court held that scienter was required for determining the accountant's liability under either rule 10b-5 or rule 14a-9, after carefully reserving the question of the liability of the corporation itself, the court confessed that it was "influenced by the fact that the accountant here, unlike the corporate issuer, does not directly benefit from the proxy vote and is not in privity with the stockholder" and went on to observe that "[u]nlike the corporate issuer, the preparation of financial statements to be appended to proxies and other reports is the daily fare of accountants, and the accountant's potential liability for relatively minor mistakes would be enormous under a negligence standard." Thus, entirely apart from the propriety of its holding that scienter is applicable in rule 14a-9 actions, the case is clearly distinguishable from other decisions which dispense

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192. *Id.*. Cf. *Gerstle*, 478 F.2d at 1298 n.16, where the court reserved the question of the proper standard to be applied in actions against persons other than the issuer itself or in favor of persons who traded on the basis of information provided in the proxy statement.

193. 623 F.2d at 428.
with scienter in actions brought against issuers or other direct beneficiaries of a proxy solicitation. Added to this is the court's dubious discussion of the legislative history of section 14(a), which suggests a clear nonsequitur, namely that, since Congress was also aware of instances in which proxies had been solicited in a fraudulent or at least reckless manner, it arguably intended only to prohibit fraudulent or recklessly prepared proxy materials rather than to outlaw negligently prepared ones.194 Finally, the court's analogy to actions under section 14(e) is misplaced since the language of that provision more closely resembles rule 10b-5 than it does rule 14a-9.195 It is thus apparent that the Adams case is doubtful authority for the proposition that scienter should be required for actions under rule 14a-9. Indeed, a later district court in the same jurisdiction has refused to require scienter in a rule 14a-9 action brought against corporate directors, rather than accountants.196

V. CONCLUSION

A plaintiff need not establish that he personally was deceived by an allegedly misleading proxy solicitation if he can demonstrate that other shareholders were misled, resulting in authorization of a transaction which led to the plaintiff's injury. In this sense personal "reliance" should not be required to determine standing to sue.

Even though reliance is not necessary, a plaintiff must still establish causation. Thus it must be shown that the transaction forming the basis of the suit, and allegedly causing harm to the plaintiff, was itself subject to shareholder approval and that the misleading proxy solicitation occurred in seeking authorization for that transaction. When directors have been elected as a result of misleading proxy materials, breaches of fiduciary duty occurring thereafter, although arguably having a "but for" causal relationship with the prior election, may be remedied only under state law, although claims based on state law may occasionally be resolved by a federal court under the doctrine of pendent jurisdiction. It should not be a defense to a majority shareholder engaged in a mislead-

194. Id. at 429-30.
ing proxy solicitation that it would have had power to authorize the transaction in any event by voting the controlling block.

The standard for determining materiality for the purpose of the proxy rules is the same as that for rule 10b-5, namely whether there is a substantial likelihood that a reasonable shareholder would consider the fact important in deciding how to vote or that disclosure of the fact would have significantly altered the “total mix” of information made available. Generally this means that only “facts” need be disclosed. A proponent need not disclose its subjective motivation or characterize a proposed transaction as fair or unfair. Similarly, one need not disclose alternative possible transactions unless in a liquidation, merger, or other acquisition, management has received firm offers from other prospective purchasers, in which case disclosure is required. Although certain types of “soft” information, such as earnings projections and estimates of current value, are not generally required, they are nonetheless permissible and may give rise to liability if recklessly made.

In sharp contrast to actions brought under rule 10b-5, suits based on misleading proxy solicitations need not show scienter and need only establish that proxy materials were negligently prepared. A possible exception to this rule has developed with respect to actions brought against outside accountants, where scienter has sometimes been required. Whether the exception will eventually broaden to include actions brought against “outside” directors is a matter of conjecture at the present time.