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## NEGLIGENCE VS. SCIENTER: THE PROPER STANDARD OF LIABILITY FOR VIOLATIONS OF THE ANTIFRAUD PROVISIONS REGULATING TENDER OFFERS AND PROXY SOLICITATIONS UNDER THE SECURITIES EXCHANGE ACT OF 1934

Tender offers<sup>1</sup> and proxy solicitations<sup>2</sup> traditionally have been the most popular methods for acquiring corporate control.<sup>3</sup> Although both the tender offer and the proxy battle are alternative means for achieving an identical

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1. See Korval, *Defining Tender Offers: Resolving a Decade of Dilemma*, 13 SEC. L. REV. 549, 549 (1981). A tender offer is an invitation to shareholders of a target corporation to sell all or part of their shares at a substantial premium over the current market price. *Id.* The SEC and Congress, however, have declined to define the term "tender offer" for purposes of the Williams Act. See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 596 (5th Cir.) (neither SEC nor Congress defines "tender offer"), *cert. denied*, 419 U.S. 873 (1974); Note, *Preliminary Injunctive Relief and Tender Offers: An Analysis Under The Williams Act*, 49 GEO. WASH. L. REV. 563, 563 n.2 (1981) (no congressional or SEC definition of "tender offer") [hereinafter cited as *Injunctive Relief*]; *infra* note 11 (discussing Williams Act). Nonetheless, the SEC has issued a proposed rule that would define the term "tender offer" under the Williams Act. SEC Securities Exchange Act Release No. 34-16385, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,374, at 82,600 (Nov. 29, 1979). The SEC proposal consists of two alternative definitions of a tender offer. *Id.* at 82,603. The first SEC definition is that a tender offer is an offer to purchase or solicitation to sell a single class of securities during any 45 day period, directed at more than 10 shareholders with an intent to acquire more than 5% of the class of securities. *Id.* Under the second SEC proposed tender offer definition, one or more offers to purchase or solicitations to sell securities of a single class would constitute a tender offer if the transaction meets three conditions. *Id.* at 82,604. First, the tender offeror must disseminate widely the offers to purchase and solicitations to sell. *Id.* at 82,604-05. Second, the tender offeror's price for the desired securities must represent a premium of the greater of 5% over the current market price or \$2 above the current market price. *Id.* at 82,605. Finally, the price offered by the tender offeror may not be negotiated. *Id.* The primary purpose of a tender offer is to obtain control of a large corporation and replace the target corporation's incumbent management with a more efficient acquiring management. See Note, *An Implied Right of Action Under the Williams Act: Tradition vs. Economic Reality*, 77 Nw. U. L. REV. 316, 323 (1982) (effect of tender offer is to obtain more efficient management) [hereinafter cited as *Implied Right*].

2. See 17 C.F.R. § 240.14a-1(f)(1) (1983). A proxy solicitation is a request for a proxy, or a request to execute or not to execute a proxy, or the furnishing of a proxy or other communication calculated to result in the procurement, withholding or revocation of a proxy. *Id.* § 240.14a-1(f)(1)(i)-(iii). A proxy is the agency relationship that occurs when a shareholder allows a proxy holder to represent and vote for the shareholder at a corporate shareholder meeting. See Note, *Proxy Solicitation: The Need For Expanded Disclosure Requirements*, 70 MARQ. L. REV. 1100, 1101 (1977) (explaining agency relationship resulting from procurement of proxy).

3. See E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 64-65 (1973) (popularity of tender offers increased during 1960's); PRACTISING LAW INSTITUTE, ACQUISITIONS AND MERGERS 1982: RECENT DEVELOPMENTS AND TECHNIQUES 671-72 (1982) (proxy battle popular in 1940's and 1950's while tender offer popular in 1960's and 1970's); Austin, *Tender Offer Movement Off in 1982*, NAT'L L.J., Jan. 16, 1984, at 40 (use of tender offers increased from 2 in 1956 to 116 in 1981); Lewin, *A Sudden New Wave of Corporate Proxy Vote Battles*, L.A. Daily J., July 8, 1982, at 7, col. 1 (popularity of proxy battles in 1940's and 1950's replaced by tender offer in 1960's).

result,<sup>4</sup> different antifraud provisions of the federal securities laws regulate tender offers and proxy statements.<sup>5</sup> Section 14(a)<sup>6</sup> of the Securities Exchange Act of 1934 ('34 Act)<sup>7</sup> makes it unlawful to solicit proxies in contravention of the rules prescribed by the Securities and Exchange Commission (SEC).<sup>8</sup> The SEC, pursuant to section 14(a), enacted rule 14a-9<sup>9</sup> prohibiting the use of proxy solicitations containing false or misleading statements of fact, or omissions of fact that are material to a shareholder's voting decision.<sup>10</sup> In contrast to rule 14a-9, section 14(e)<sup>11</sup> of the Williams Act<sup>12</sup> proscribes not only

4. See *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 430 (6th Cir.) (both tender offers and proxy solicitations used to obtain corporate control), *cert. denied*, 449 U.S. 1067 (1980); *Implied Right*, *supra* note 1, at 323 (tender offers and proxies achieve same result).

5. Compare 15 U.S.C. § 78n(e) (1982) (prohibiting use of false material statements, material omissions, and fraudulent, deceptive or manipulative acts or practices in connection with tender offer) with 17 C.F.R. § 240.14a-9 (1983) (prohibiting use of proxy solicitation containing false or misleading statements of material fact, or omissions of material fact).

6. 15 U.S.C. § 78n(a) (1982).

7. *Id.* §§ 78a-78kk ('34 Act). In the '34 Act, Congress created the Securities and Exchange Commission (SEC) to oversee and enforce federal securities rules and regulations. See *id.* § 78d(a) (congressional creation of SEC).

8. See *id.* § 78n(a) (antifraud provision for proxy statements). The SEC is composed of five commissioners appointed by the President. *Id.* § 78d(a). The SEC may appoint officers, attorneys, examiners, and other experts to provide assistance in enforcing the securities laws. *Id.* § 78d(b).

9. 17 C.F.R. § 240.14a-9 (1983). SEC rule 14a-9 prohibits the solicitation of a proxy by means of a proxy statement that is "false or misleading with respect to any material fact, or which omits to state any material fact." *Id.*

10. *Id.*

11. 15 U.S.C. § 78n(e) (1982). Section 14(e) of the Williams Act makes it unlawful for any person to use an "untrue statement of a material fact or omit to state any material fact" or to "engage in any fraudulent, deceptive, or manipulative acts or practices" in connection with a tender offer. *Id.* Section 14(e) is a general antifraud provision that extends to any communication made in connection with a tender offer. See *id.* The language of § 14(e) is similar to the language of SEC rule 10b-5. Compare *id.* § 78n(e) (prohibiting use of false material statements, material omissions, and fraudulent, deceptive or manipulative acts or practices in connection with tender offer) with 17 C.F.R. § 240.10b-5 (1983) (prohibiting use of false material statements, material omissions, and fraudulent devices, schemes, activities or practices in connection with purchase or sale of securities). The SEC promulgated rule 10b-5 under the rulemaking authority granted in § 10(b) of the Securities Act of 1934 ('34 Act). See *infra* notes 17-19 and accompanying text (discussing rule 10b-5).

12. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982) (Williams Act). The popularity of the tender offer increased in the mid-1960's because of a favorable business climate and the fact that, unlike proxy statements, Congress had not yet given the SEC power to regulate tender offers. See Note, *Cash Tender Offers: A Proposed Definition*, 31 U. FLA. L. REV. 694, 697-99 (1979) (discussing reasons for popularity of tender offers in mid-1960's) [hereinafter cited as *Proposed Definition*]; see also E. ARANOW & H. EINHORN, *supra* note 3, at 65-66 (listing numerous factors leading to increase in popularity of tender offers). Because abuses accompanied the popularity of unregulated tender offers, Congress amended the '34 Act by enacting the Williams Act to regulate the tender offer takeover method. See Korval, *supra* note 1, at 549-51 & n.4 (abuses accompanied popularity of tender offers). The disclosure requirements of the Williams Act protect investors from corporate raiders who would compel shareholders to tender securities without allowing the shareholder time to make a knowledgeable investment decision. See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 597 (5th Cir.) (shareholder may tender shares hastily without consideration of risks

the use of false material statements and material omissions, but also fraudulent, deceptive, or manipulative acts or practices in connection with a tender offer.<sup>13</sup> Neither rule 14a-9 nor section 14(e), however, prescribes the proper standard of liability to apply in assessing violations of either provision.<sup>14</sup> Consequently, federal courts have struggled with determining the proper standard of liability for federal proxy statement and tender offer antifraud violations.<sup>15</sup>

Federal courts construing section 14(e) consistently have applied a scienter standard of liability for tender offer antifraud violations similar to the scienter standard courts have applied to SEC rule 10b-5 violations.<sup>16</sup> Rule 10b-5, promulgated by the SEC pursuant to section 10(b) of the '34 Act, prohibits the use of false material statements, material omissions, and fraudulent, deceptive or manipulative acts or practices in connection with the purchase or sale of securities.<sup>17</sup> Although neither section 10(b) nor rule 10b-5 prescribe the standard of liability courts are to apply, the Supreme Court has held that scienter

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in absence of adequate disclosure), *cert. denied*, 419 U.S. 873 (1974). A corporate raider would seize control of a target company by purchasing the target company's stock and then sell the target's assets without informing the target corporation of the stock acquisitions. See 113 CONG. REC. 857-58 (statement by Mr. Kuchel) (disclosure requirements would prevent corporate raiders from secretly obtaining control of target corporation). The primary purpose of the Williams Act is to supply targeted shareholders with adequate information concerning the identity and intentions of a tender offeror so that shareholders of a target corporation could make an informed decision on whether to sell the stock of the target corporation. See *Injunctive Relief*, *supra* note 1, at 564. The drafters of the Williams Act avoided any anti-takeover sentiment because the drafters realized that tender offers serve a useful purpose by providing a check on inefficient management. See S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967) (tender offers serve useful purpose as check on inefficient incumbent management).

13. 15 U.S.C. § 78n(e) (1982).

14. See *id.* (§ 14(e) does not state standard of liability for tender offer antifraud violations); 17 C.F.R. § 240.14a-9 (1983) (rule 14a-9 does not state standard of liability for proxy statement antifraud violations).

15. Compare *Fradkin v. Ernst*, 571 F. Supp. 829, 843 (N.D. Ohio 1983) (negligence standard of liability is appropriate standard for misstatements in proxy) with *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir.) (scienter standard of liability is appropriate standard for misstatements connected with tender offer), *cert. denied*, 414 U.S. 910 (1973).

16. See, e.g., *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.) (scienter is element of § 14(e) violation), *cert. denied*, 419 U.S. 873 (1974); *Gulf & W. Indus., Inc. v. Great A & P Tea Co.*, 476 F.2d 687, 696 (2d Cir. 1973) (elements of relief in § 14(e) same as rule 10b-5); *SEC v. Texas Int'l Co.*, 498 F. Supp. 1231, 1252 (N.D. Ill. 1980) (similarity in language between § 14(e) and § 10(b) justifies applying rule 10b-5's scienter standard to § 14(e) actions); *Indiana Nat'l Bank v. Mobil Oil Corp.*, 457 F. Supp. 1028, 1032 (S.D. Ind. 1977) (scienter requirement applicable to § 14(e) actions), *aff'd*, 578 F.2d 180 (1978); *A & K R.R. Materials, Inc. v. Green Bay & W. R.R.*, 437 F. Supp. 636, 642 (E.D. Wis. 1977) (knowledge of falsity or reckless disregard for truth sufficient standards of liability under § 14(e)); *Applied Digital Data Sys. v. Milgo Elec. Corp.*, 425 F. Supp. 1145, 1156-57 (S.D.N.Y. 1977) (must act with scienter to violate § 14(e)); *Billet v. Storage Technology Corp.*, 72 F.R.D. 583, 585 (S.D.N.Y. 1976) (§ 14(e) language implies prohibition on fraudulent conduct); see *supra* note 11 (explaining rule 10b-5); *infra* text accompanying notes 17-19 (explaining rule 10b-5). In a confusing analysis, one court has held that scienter need not be shown by the SEC under § 14(e). See *SEC v. Wills*, 472 F. Supp. 1250, 1268 (D.D.C. 1978) (SEC need not show scienter in § 14(e) action).

17. 17 C.F.R. § 240.10b-5 (1983) (prohibiting use of manipulative or deceptive activity associated with purchase or sale of security). Section 10(b) of the '34 Act prohibits the use of

is the proper standard of liability for an implied private cause of action under rule 10b-5.<sup>18</sup> The Supreme Court has defined scienter as a mental state that encompasses an actual intent to manipulate, defraud, or deceive.<sup>19</sup> The Supreme Court adopted a scienter standard under rule 10b-5 primarily because the language of rule 10b-5 prohibits manipulative and deceptive activity.<sup>20</sup> Although section 14(e) applies to tender offers and rule 10b-5 applies to the purchase or sale of securities, courts have applied the scienter standard of liability developed under rule 10b-5 to section 14(e) tender offer cases primarily because of the similarity in language between rule 10b-5 and section 14(e).<sup>21</sup> For example, in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,<sup>22</sup> the Second Circuit held that scienter is the appropriate standard of liability in a section 14(e) action.<sup>23</sup> In *Piper*, Chris-Craft had announced a cash tender offer for shares of Piper common stock.<sup>24</sup> Piper decided to oppose Chris-Craft's bid to gain control of Piper by forwarding a letter to Piper stockholders stating that the tender offer would not be in the best interests of Piper's shareholders.<sup>25</sup>

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manipulative or deceptive devices, in connection with the purchase or sale of securities, that violate rules which the SEC enacts. 15 U.S.C. § 78j (1982).

18. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (scienter is proper standard of liability for rule 10b-5 violation); *infra* notes 88-99 and accompanying text (discussion of *Hochfelder*); see also *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 77 (D.C. Cir.) (rule 10b-5 private action requires that plaintiff prove defendant acted with scienter), *cert. denied sub nom. Kalmanovitz v SEC*, 449 U.S. 1012 (1980); *SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978) (SEC must prove defendant acted with scienter in rule 10b-5 injunctive action); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.) (*Hochfelder* decision eliminated negligence as basis for liability under rule 10b-5), *cert. denied*, 439 U.S. 970 (1978).

19. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976) (definition of scienter includes intent to defraud or deceive); *infra* notes 88-99 and accompanying text (discussion of *Hochfelder*). The Supreme Court in *Hochfelder* would not extend the standard of liability under rule 10b-5 actions to mere negligence. See 425 U.S. at 215.

20. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (rule 10b-5 language requires imposition of scienter standard).

21. See *SEC v. Texas Int'l Co.*, 498 F. Supp. 1231, 1252 (N.D. Ill. 1980) (similarity in language between § 14(e) and § 10(b) justifies applying rule 10b-5's scienter standard to § 14(e) actions).

22. 480 F.2d 341 (2d Cir. 1973), *rev'd on other grounds*, 430 U.S. 1 (1977) (Supreme Court reversed because tender offeror found to have no cause of action for damages under § 14(e)).

23. *Id.* at 364. The Second Circuit in *Piper* consolidated three separate appeals which involved the same set of facts from the United States District Court for the Southern District of New York. *Id.* at 349. See generally, *Bangor Punta Corp. v. Chris-Craft Indus., Inc.*, 337 F. Supp. 1147 (S.D.N.Y. 1971); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 337 F. Supp. 1128 (S.D.N.Y. 1971); *SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154 (S.D.N.Y. 1971), *reversed*, 480 F.2d 341 (1973).

24. 480 F.2d at 351. In *Piper*, Chris-Craft made eight separate purchases of Piper stock before announcing the cash tender offer. *Id.* at 350. These eight purchases brought Chris-Craft's stock holding in Piper to approximately 13% of all outstanding shares. *Id.* The tender offer by Chris-Craft could have involved up to 300,000 shares at a price of \$65 per share. *Id.* at 351. In a press release, Chris-Craft stated that the tender offer was to be used to gain control of Piper. *Id.*

25. *Id.* In an attempt to increase the number of shares of Piper stock in the marketplace, Piper agreed to sell 300,000 authorized but unissued shares to Grumman Aircraft Engineering Corp. for \$65 per share. *Id.* The transaction between Piper and Grumman failed when the New

Moreover, Piper family members agreed to an exchange offer with Bangor Punta Corporation that included specified Bangor Punta stock, warrants, and debentures traded for the entire Piper family holdings of Piper stock.<sup>26</sup> Both Piper and Bangor Punta issued press releases describing the transaction.<sup>27</sup> Chris-Craft then filed suit for damages in the United States District Court for the Southern District of New York alleging that the Piper letter to shareholders and the press releases filed by Piper and Bangor Punta violated rule 10b-5 and section 14(e) since the letter and press releases contained material misstatements.<sup>28</sup> The district court denied Chris-Craft an award of damages and dismissed Chris-Craft's complaint.<sup>29</sup>

On appeal, the Second Circuit held that both Piper and Bangor Punta violated section 14(e) of the Williams Act.<sup>30</sup> The *Piper* court noted that although section 14(e) applies to tender offers while rule 10b-5 applies to the purchase or sale of securities, section 14(e) and rule 10b-5 prohibit identical activities.<sup>31</sup> Because of structural similarities between section 14(e) of the Williams Act and SEC rule 10b-5, the Second Circuit chose to apply the principles developed under rule 10b-5 in determining whether Piper and Bangor Punta violated section 14(e).<sup>32</sup> Specifically, the Second Circuit stated that a violation of section 14(e) occurs when a defendant includes a material misstatement or omission within a tender offer that is sufficiently culpable to justify a holding for

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York Stock Exchange (NYSE) refused to list the shares. *Id.* at 352. In addition to Piper's agreement with Grumman, Piper agreed to exchange 320,000 authorized but unissued shares of Piper stock for all of the outstanding shares of United States Concrete Pipe Company of Florida, and to exchange 149,199 authorized but unissued shares of Piper stock for substantially all of the outstanding shares of Southply, Inc. stock. *Id.* The NYSE refused to list the shares because Piper did not obtain approval of Piper shareholders. *Id.* Nonetheless, Piper issued stock certificates and the NYSE suspended trading in Piper stock until Piper cancelled the agreements. *Id.*

26. *Id.* at 353. In *Piper*, the exchange agreement between Bangor Punta and Piper included a promise by Bangor Punta to use its best effort to acquire more than 50% of the outstanding shares of Piper stock. *Id.*

27. *Id.* The press releases in *Piper*, issued by Bangor Punta and Piper, included an offer by Bangor Punta to Piper shareholders to sell a package of Bangor Punta securities that would be valued at not less than \$80 per share of Piper stock. *Id.* The SEC subsequently brought suit against Bangor Punta under § 5(c) of the Securities Act of 1933 ('33 Act). See 15 U.S.C. § 77e(c) (1982) (prohibiting offer to sell securities before filing registration statement). Section 5 prohibits an offer to sell securities before the registrant files a registration statement. *Id.*

28. 480 F.2d at 355.

29. *Id.* at 355-56. The district court in *Piper* held that although the press release violated the securities laws, Chris-Craft failed to prove scienter and causation which are necessary for a § 14(e) cause of action. *Id.* at 355.

30. *Id.* at 362.

31. *Id.*; see 15 U.S.C. § 78n(e) (1982) (prohibiting manipulative or deceptive activity in connection with tender offer); 17 C.F.R. § 240.10b-5 (1983) (prohibiting manipulative or deceptive activity in purchase or sale of securities).

32. 480 F.2d at 362. The *Piper* court stated that the principle of materiality and the proper standard of liability should be applied in assessing both rule 10b-5 and section 14(e) violations. *Id.* The Second Circuit stated that materiality focuses on the weight of the misstated or omitted information in a reasonable investor's decision to buy or sell. *Id.*

the plaintiff.<sup>33</sup> The *Piper* court held that a defendant is sufficiently culpable of a section 14(e) violation if the defendant either knowingly misstated or omitted material facts in connection with a tender offer, or failed to ascertain the correct facts when the facts were available or could have reasonably been discovered.<sup>34</sup> The Second Circuit, however, implied that negligent conduct would not permit recovery under section 14(e) because negligent conduct is not sufficient to allow recovery under rule 10b-5.<sup>35</sup>

Similar to section 14(e)'s purpose of ensuring informed shareholder voting during tender offers, Congress intended section 14(a) to promote the free flow of accurate, reliable information in proxy statements.<sup>36</sup> Congress intended the information requirements of section 14(a) to guarantee that shareholders had sufficient information to make informed voting decisions concerning proxy solicitations.<sup>37</sup> To ensure compliance with the congressional purpose of section 14(a), the SEC enacted rule 14a-9 which imposes a duty on solicitors of proxies to disclose any information that reasonably would tend to influence the voting decision of a shareholder.<sup>38</sup> Congress and the SEC sought to prevent proxy solicitation abuses by focusing public attention on the proxy statement.<sup>39</sup>

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33. *Id.* The Second Circuit in *Piper* held that the materiality concept concerns whether a reasonable investor would have considered the misstatement or omission important in deciding whether to buy or sell a security. *Id.* at 362-63; *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (to establish materiality plaintiff must prove that reasonable investor would have viewed omitted fact as significantly affecting investment decision); *Holmes v. Bateson*, 583 F.2d 542, 559 (1st Cir. 1978) (omitted fact material if substantial likelihood exists that reasonable shareholder would have considered fact important to investment decision); *Harkavy v. Apparel Indus., Inc.*, 571 F.2d 737, 741 (2d Cir. 1978) (omitted fact material if reasonable investor would have considered fact significant); *Richland v. Crandall*, 262 F. Supp. 538, 553 (S.D.N.Y. 1967) (test for materiality includes determination of whether misstated or omitted fact could have led reasonable investor not to vote for proposal).

34. 480 F.2d at 364. The *Piper* court noted in its discussion of the concept of culpability that the purpose of a scienter standard of liability is to properly limit liability to those defendants whose conduct is deserving of punishment. *Id.* at 363.

35. *Id.* at 364.

36. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964). The Supreme Court in *Borak* discussed the broad remedial purposes served by § 14(a). *Id.* at 431. The Court stated that § 14(a) prevents management from utilizing a misleading proxy statement to obtain authorization for corporate action. *Id.* The *Borak* Court noted that § 14(a) arose out of the congressional belief that every owner of an equity security should be guaranteed fair corporate suffrage. *Id.* Additionally, the Court stated that Congress was concerned with the fact that shareholders too often cast their proxies with little understanding of the actual issue in question. *Id.*

37. *See* *Richland v. Crandall*, 262 F. Supp. 538, 553 (S.D.N.Y. 1967) (test for materiality under rule 14a-9 includes determination of whether misstated or omitted fact could have influenced reasonable shareholder's voting decision).

38. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964) (Congress designed § 14(a) to ensure informed shareholder voting); *Proxy Regulation: Ensuring Accurate Disclosure Through a Negligence Standard*, 50 *FORDHAM L. REV.* 1423, 1426 (1982) (Congress enacted § 14(a) to promote informed shareholder voting) [hereinafter cited as *Proxy Regulation*].

39. *See* *Proxy Regulation*, *supra* note 38, at 1426 (Congress designed § 14(a) to shed light of publicity on proxy transactions). Congress did not design § 14(a) to serve as a prohibition against the use of proxies. *Id.*

In promoting the congressional purpose of informed shareholder voting under section 14(a), the lack of an explicit standard of liability has forced courts to create a standard for rule 14a-9 violations.<sup>40</sup> Federal courts are in general agreement that negligence is the proper standard of liability under rule 14a-9.<sup>41</sup> For example, in *Gerstle v. Gamble-Skogmo, Inc.*,<sup>42</sup> the Second Circuit decided that negligence is sufficient to warrant recovery in a rule 14a-9 action.<sup>43</sup> *Gerstle* involved a class action by stockholders of an outdoor advertising company that had merged into defendant Gamble-Skogmo.<sup>44</sup> The plaintiff class claimed that Gamble-Skogmo procured the merger through the use of a false and misleading proxy statement.<sup>45</sup> In assessing the standard of liability for violations of SEC rule 14a-9, the Second Circuit contrasted the language of section 14(a) with the language of section 10(b) of the '34 Act.<sup>46</sup> The *Gerstle* court noted that while section 10(b) refers to manipulative or deceptive activity, section 14(a) is devoid of any language indicating a prohibition on fraud or deception.<sup>47</sup> The Second Circuit further stated that courts have applied a scienter standard under rule 10b-5 because any other standard would exceed the SEC's authority under section 10(b) to regulate only manipulative or deceptive devices in connection with the purchase or sale of securities.<sup>48</sup> The *Gerstle* court explained that the rulemaking authority granted the SEC under section 14(a) is broad, contains no words of limitation, and extends to all regulation necessary to protect securities investors.<sup>49</sup> The Second Circuit stated that Congress in-

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40. See 17 C.F.R. § 240.14a-9 (1983) (rule 14a-9 does not state standard of liability for proxy statement antifraud violations).

41. See, e.g., *Gruss v. Curtis Publishing Co.*, 534 F.2d 1396, 1403 (2d Cir.) (negligence is standard of liability under rule 14a-9), cert. denied, 429 U.S. 887 (1976); *Halpern v. Armstrong*, 491 F. Supp. 365, 379 (S.D.N.Y. 1980) (no need to show intent to defraud in § 14(a) action); *Bertoglio v. Texas Int'l. Co.*, 488 F. Supp. 630, 651 (D. Del. 1980) (lower courts agree negligence is standard in 14a-9 action); *Del Noce v. Delyar Corp.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,670, at 90,284 (S.D.N.Y. July 30, 1976) (negligence sufficient basis for rule 14a-9 liability); *Berman v. Thomson*, 403 F. Supp. 695, 699 (N.D. Ill. 1975) (negligent conduct imposes liability under § 14(a)); *Richland v. Crandall*, 262 F. Supp. 538, 553 n.12 (S.D.N.Y. 1967) (plaintiff need not prove scienter under § 14(a)). The Supreme Court has never determined what the proper standard of liability is in a § 14(a) action. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 n.7 (1976) (declining to address standard of culpability necessary to establish § 14(a) liability).

42. 478 F.2d 1281 (2d Cir. 1973).

43. *Id.* at 1299, 1301.

44. *Id.* at 1283.

45. *Id.* at 1291. The plaintiffs in *Gerstle* alleged that the proxy statement violated § 14(e) because the proxy statement inadequately disclosed the market value of the advertising company's remaining advertising plants. *Id.*

46. *Id.* at 1299; see 15 U.S.C. § 78j(b) (1982) (prohibiting use of manipulative or deceptive devices in connection with the purchase or sale of securities).

47. 478 F.2d at 1299; see 15 U.S.C. § 78j(b) (1982) (prohibiting use of manipulative or deceptive devices in purchase or sale of securities); *id.* § 78n(a) (prohibiting proxy solicitations in violation of rules SEC promulgates); *supra* notes 6-10, 36-38 and accompanying text (discussion of § 14(a)); *supra* note 11 (discussion of § 10(b)).

48. 478 F.2d at 1299.

49. *Id.*



tended the broad language of section 14(a) to protect the outside investor, or shareholder, who possesses a sought-after proxy, and that courts may impose liability under rule 14a-9 without an allegation of scienter.<sup>50</sup> The *Gerstle* court added in dicta that the court's application of a negligence standard of liability to Gamble-Skogmo's violation of rule 14a-9 does not mean that federal courts should never require a scienter standard in a rule 14a-9 action.<sup>51</sup> For example, the court suggested that the presence or absence of privity between the issuer of a proxy statement and shareholders might affect the applicable standard of liability.<sup>52</sup> The Second Circuit stated that the facts and circumstances in *Gerstle* required the application of a negligence standard of liability.<sup>53</sup>

Although the *Gerstle* court applied a negligence standard of liability to a rule 14a-9 violation by a corporate insider, the Third Circuit has held that negligence is also the appropriate standard for a proxy statement antifraud violation by an outside, non-management director.<sup>54</sup> In *Gould v. American-Hawaiian Steamship Co.*,<sup>55</sup> a class of shareholders of McLean Industries brought suit alleging that the defendants procured a merger of McLean Industries into the R.J. Reynolds Tobacco Company with a misleading proxy statement.<sup>56</sup> One of the defendants claimed that he should be subject to a scienter standard of liability because of his status as an outside, non-management director.<sup>57</sup> The Third Circuit, however, rejected the defendant's argument and held that even outside directors must be subject to a negligence standard of liability.<sup>58</sup> The *Gould* court, like the Second Circuit in *Gerstle*, noted that the actual language of section 14(a) and rule 14a-9 does not suggest the imposition of a scienter requirement.<sup>59</sup> Moreover, the Third Circuit noted that persuasive precedent existed favoring the application of a negligence standard of liability to proxy solicitations under rule 14a-9.<sup>60</sup>

The *Gould* court also analogized rule 14a-9 with section 11 of the Securities

50. *Id.* at 1299, 1301. The *Gerstle* Court stated that the imposition of a broad negligence standard of liability would strengthen the high duty of care already owed by a corporation to minority shareholders in soliciting proxies. *Id.* at 1300.

51. *Id.*

52. *Id.*

53. *Id.*

54. See *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 777 (3d Cir. 1976) (negligence is proper standard of liability to apply to outside director in rule 14a-9 action).

55. 535 F.2d 761 (3d Cir. 1976).

56. *Id.* 767-68. The plaintiffs in *Gould* alleged that the proxy solicitation violated rule 14a-9 because the solicitation falsely stated that certain parties had approved the merger and failed to disclose that certain parties possessed veto power over the entire transaction. *Id.* at 769-70.

57. *Id.* at 777.

58. *Id.* at 777-78.

59. *Id.* at 777; see *supra* notes 42-53 and accompanying text (discussion of *Gerstle*).

60. 535 F.2d at 777; see *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1300-01 (2d Cir. 1973) (negligence standard of liability proper under rule 14a-9); *Berman v. Thomson*, 403 F. Supp. 695, 699 (N.D. Ill. 1975) (negligent conduct imposes liability under § 14(a)); *Norte & Co. v. Huffines*, 304 F. Supp. 1096, 1109-10 (S.D.N.Y. 1968) (scienter not essential to § 14(a) claim), *cert. denied*, 397 U.S. 989 (1970); *Richland v. Crandall*, 262 F. Supp. 538, 553 (S.D.N.Y. 1967) (plaintiff need not prove scienter under § 14(a)).

Act of 1933 ('33 Act).<sup>61</sup> Section 11 explicitly applies a negligence standard of liability to claims by a person obtaining a security when the registration statement for that security contains a misstatement or omission of a material fact.<sup>62</sup> The Third Circuit found in comparing rule 14a-9 and section 11 that both provisions proscribed the use of misleading statements or omissions of material fact, and that both provisions involved specific documents from fundamental areas of securities regulation.<sup>63</sup> The *Gould* court stated that because of the parallel between section 11 and rule 14a-9, and because section 11 requires a negligence standard of liability, courts should apply a negligence standard of liability to rule 14a-9 violators.<sup>64</sup> The *Gould* court, therefore, held that outside, non-management directors are subject to the same negligence standard of liability under rule 14a-9 that the *Gerstle* court applied to an insider's violation of rule 14a-9.<sup>65</sup>

The Sixth Circuit in *Adams v. Standard Knitting Mills, Inc.*,<sup>66</sup> however, complicated the heretofore settled proxy statement standard of liability.<sup>67</sup> The *Adams* court held that an accountant should be subject to a scienter standard of liability under rule 14a-9 for misstatements contained in a proxy statement.<sup>68</sup> In *Adams*, a class of shareholders sued the defendant accounting firm for alleged violations of sections 10(b) and 14(a) of the '34 Act.<sup>69</sup> Specifically, the plaintiff class alleged that the defendant accounting firm violated SEC rule 14a-9 by omitting material information from a proxy statement used to effect a merger.<sup>70</sup> The Sixth Circuit relied heavily upon the legislative history

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61. 535 F.2d at 777. Section 11 of the Securities Act of 1933 ('33 Act) provides a cause of action for any person acquiring a security when the effective registration statement for that security contains a false statement of material fact or omitted to state a material fact. 15 U.S.C. § 77k(a) (1982). The person acquiring the security may then sue certain corporate insiders and specified outsiders responsible for drafting and executing the registration statement. *Id.* § 77k(a)(1)-(5). Section 11 requires a negligence standard of liability. *Id.* § 77k(a); see *Gould v. American-Hawaii S.S. Co.*, 535 F.2d 761, 777 (3d Cir. 1976) (§ 11 establishes negligence standard of liability); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 787 (2d Cir. 1951) (§ 11 does not require proof of fraud); *Straus v. Holiday Inns, Inc.*, 460 F. Supp. 729, 732 (S.D.N.Y. 1978) (§ 11 violation requires negligence standard of liability).

62. 15 U.S.C. § 77k(a) (1982); see *supra* note 61 (discussing § 11 of '33 Act).

63. 535 F.2d at 777; see 15 U.S.C. § 77k (1982) (providing cause of action for any person acquiring security when registration statement contains material misstatements or omissions); 17 C.F.R. § 240.14a-9 (1983) (prohibiting material misstatement or omission in proxy solicitation).

64. 535 F.2d at 777.

65. *Id.* at 778. The *Gould* court confirmed its negligence standard for determining the proper standard of liability under § 14(a) and rule 14a-9 by citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), for the proposition that the language and purpose of the provision in question are the important considerations for determining the standard of liability. 535 F.2d at 778; see *infra* notes 88-99 and accompanying text (discussion of *Hochfelder*).

66. 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980).

67. *Id.* at 431.

68. *Id.* at 425, 431.

69. *Id.* at 423-24.

70. *Id.* at 424. In *Adams*, the plaintiffs alleged that the proxy solicitation violated rule 14a-9 because the solicitation failed to state that restrictions on the payment of dividends by the acquiring corporation applied to preferred as well as common stock. *Id.* The transaction

of section 14(a) in finding that Congress intended to prohibit wrongdoing accompanied by some degree of knowledge in connection with proxy solicitations.<sup>71</sup> Since the *Adams* court discovered numerous references to knowing conduct and manipulative intent within the '34 Act's congressional documents, the court decided that scienter was the proper standard of liability in suits under rule 14a-9 for proxy statement antifraud violations.<sup>72</sup> Additionally, the Sixth Circuit equated the regulation of tender offers under section 14(e) with the regulation of proxies under section 14(a).<sup>73</sup> The *Adams* court stated that in passing the Williams Act, Congress intended that proxy statements and tender offers be regulated by the same standards.<sup>74</sup> The Sixth Circuit reasoned that because tender offers are subject to a scienter standard of liability, proxy statements should be subject to the same standard.<sup>75</sup> The *Adams* court concluded that because the accounting firm was not in privity with the shareholders and because the accounting firm did not benefit directly from the proxy vote, the accountants should not be held to the same high duty of care as a corporate insider.<sup>76</sup>

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in *Adams* concerned a merger of Standard Knitting Mills, Inc., into Chadbourn, Inc. *Id.* The stockholders of Standard Knitting Mills agreed to the merger and consented to exchange their shares in Standard Knitting Mills for a package of Chadbourn securities. *Id.* Standard Knitting Mills obtained the consent of its shareholders by a proxy statement that contained the financial statements of Chadbourn as prepared by the defendant accounting firm. *Id.*

71. *Id.* at 429-30; see *infra* note 72 and accompanying text (discussing congressional documents examined by *Adams* court in determining congressional intent behind § 14(a)).

72. 623 F.2d at 429-30. In examining the legislative history of § 14(a), the *Adams* court cited a Senate report, floor debates, and a committee report. *Id.*; S. REP. NO. 1455, 73d Cong., 2d Sess. 77 (1934), reprinted in 5 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 21 (1973) (§ 14(a) intended to prevent concealing and distorting of facts in proxy statements by corporate officials); *Hearings on H.R. 7852 Before The House Comm. on Interstate & Foreign Commerce*, 73d Cong., 2d Sess. 480 (1934), reprinted in 8 J. ELLENBERGER & E. MAHAR, *supra*, item 23 (equating fraudulent activity of directors in using misleading proxy statements with larceny); 78 CONG. REC. 7961 (1934) (statement by Mr. Dirksen) (drafters of § 14(a) concerned with unscrupulous acts); 78 CONG. REC. 7961 (1934) (statement by Mr. Wadsworth) (proxies used for purposes of manipulation); 78 CONG. REC. 7713 (1934) (statement by Mr. Wadsworth) (seeking prohibition against proxy solicitations that conceal illegal acts of corporate insiders); see also H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13-14 (1934), reprinted in 5 J. ELLENBERGER & E. MAHAR, *supra*, item 18 (exhibiting concern for deliberate misuse of proxies to benefit individuals in control of corporation); S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934), reprinted in 5 J. ELLENBERGER & E. MAHAR, *supra*, item 17 (discussing failure of corporate insiders to inform shareholders of purpose for proxy); S. REP. NO. 1455, 73d Cong., 2d Sess. 75 (1934), reprinted in 5 J. ELLENBERGER & E. MAHAR, *supra*, item 21 (Congress concerned with actual intent to deceive in proxy solicitations). The *Adams* court noted that the legislative history of § 14(a) never stated that Congress intended to protect the public from the negligence of accountants. 623 F.2d at 430.

73. 623 F.2d at 428.

74. *Id.*

75. *Id.*

76. *Id.* In addition to stating that the accounting firm was not in privity with the shareholders, the *Adams* court also reasoned that if the federal courts apply a negligence standard to accountants, accountants would potentially be subject to enormous liability for minor mistakes. *Id.* Additionally, the Sixth Circuit equated the regulation of tender offers under § 14(e) with the

Although the Sixth Circuit's application of a scienter standard of liability to rule 14a-9 violations appears to conflict with the Second Circuit's adoption of a negligence standard of liability, the United States District Court for the Northern District of Ohio harmonized the decisions of the two circuits in *Fradkin v. Ernst*.<sup>77</sup> The *Fradkin* court followed the holding of the *Gerstle* court by holding the corporate officials responsible for drafting a proxy statement to a negligence standard of liability.<sup>78</sup> In *Fradkin*, the Mohawk Rubber Company sought to implement a stock option plan for two senior executives.<sup>79</sup> To speed board approval of the stock option plan, Mohawk telephoned the directors personally and obtained unanimous consent to adopt the plan.<sup>80</sup> The proxy materials that Mohawk distributed to obtain shareholder approval of the plan, however, stated that the board had approved the compensation plan at a formal meeting.<sup>81</sup> Plaintiff Fradkin brought a shareholder derivative action under section 14(a) claiming that the proxy statement issued by Mohawk was materially misleading.<sup>82</sup> In determining that the proxy solicitation contained false and misleading statements of fact, the district court examined the standards of liability other courts had applied to rule 14a-9 violations.<sup>83</sup> The *Fradkin* court examined the *Gerstle* negligence standard and the *Adams* scienter standard and recognized that the holdings in *Gerstle* and *Adams* were harmonious.<sup>84</sup> The district court reasoned that the *Gerstle* negligence standard applies when the defendant is a corporate official who potentially could benefit from a misleading proxy statement.<sup>85</sup> The *Fradkin* court, however,

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regulation of proxies under § 14(a). *Id.* at 430. The *Adams* court stated that in passing the Williams Act, Congress intended that proxy statements and tender offers be regulated by the same standard. *Id.* The Sixth Circuit concluded that because tender offers are subject to a scienter standard of liability, proxy statements should be subject to the same standard. *Id.*

77. 571 F. Supp. 829 (N.D. Ohio 1983).

78. *Id.* at 843.

79. *Id.* at 833-36.

80. *Id.* at 836. In *Fradkin*, the president of Mohawk telephoned each individual board member to speed board approval of a stock option plan for two senior executives because Mohawk's president was concerned that Mohawk would soon become a takeover target. *Id.* Part of the proposed compensation plan involved the requirement that the executives surrender unexercised options for a cash premium in the event of a merger, acquisition or consolidation. *Id.* at 835. The directors had no prior notice of the proposed plan or the telephone calls and at no time were all of the directors on the phone simultaneously. *Id.* at 836. Mohawk had minutes prepared that outlined the telephone discussions as though the plan had been approved at a formal meeting. *Id.* at 837.

81. *Id.* at 837. The stock option plan in *Fradkin* required shareholder approval of the plan in order to exempt the plan from the short-swing profit rules contained in rule 16b-3 of the '34 Act. *Id.* at 836; see 17 C.F.R. § 240.16b-3 (1983) (shares acquired through stock option plan not subject to short-swing profit rules if majority of stockholders approve plan).

82. 571 F. Supp. at 832.

83. *Id.* at 842-43, 846. The *Fradkin* court found that because the proxy indicated that a valid meeting of Mohawk directors had approved the stock option plan, the proxy was materially false and misleading. *Id.*

84. 571 F. Supp. at 843.

85. *Id.*; see *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1381, 1299 (2d Cir. 1973) (corporate insider subject to negligence standard under rule 14a-9).

stated that the *Adams* scienter standard applies when the defendant is not in a position to benefit directly from a misleading proxy statement.<sup>86</sup> Since the defendants in *Fradkin* could have benefitted from the misstatement in the proxy solicitation, the district court applied a negligence standard in finding a violation of rule 14a-9.<sup>87</sup>

Seven years before the *Fradkin* decision, the Supreme Court in *Ernst & Ernst v. Hochfelder*<sup>88</sup> created a formula for determining the proper standard of liability under any provision of the federal securities laws.<sup>89</sup> In *Hochfelder*, the president of a small brokerage firm executed a fraudulent securities scheme resulting in the loss of investors' money.<sup>90</sup> The brokerage firm retained the defendant accounting firm to periodically audit the brokerage firm's books and records.<sup>91</sup> The plaintiff customers of the brokerage firm brought suit against the accounting firm alleging that the accounting firm's failure to utilize proper auditing procedures in auditing the brokerage firm violated section 10(b) of the '34 act and rule 10b-5 by aiding the brokerage firm's fraudulent securities scheme.<sup>92</sup> The *Hochfelder* Court employed a three part analysis to determine the proper standard of liability for cases involving violations of section 10(b) of the '34 Act and SEC rule 10b-5.<sup>93</sup> First, the Supreme Court examined the

86. 571 F. Supp. at 843; see *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 431 (6th Cir.) (outside accountant subject to scienter standard of liability under rule 14a-9), *cert. denied*, 449 U.S. 1067 (1980).

87. 571 F. Supp. at 843.

88. 425 U.S. 185 (1976).

89. See *id.* at 197-211 (examining statutory language, legislative history, and regulatory scheme of rule 10b-5).

90. *Id.* at 188-89. In *Hochfelder*, the president of a small brokerage firm persuaded customers to invest in escrow accounts that would produce a high rate of return. *Id.* at 189. No escrow accounts actually existed and the president of the firm converted the customers' investment to personal use. *Id.* The escrow accounts were not shown in the books or records of the brokerage firm. *Id.* The president of the brokerage firm later revealed his scheme in a suicide note. *Id.*

91. *Id.* at 188.

92. *Id.* at 189-90. The plaintiff customers in *Hochfelder* contended that a proper audit would have uncovered the rule instituted at the brokerage firm that only the president could open mail addressed to the president. *Id.* at 190. The plaintiffs reasoned that a discovery of the "mail rule" would have been disclosed to the SEC as an irregular practice by the accounting firm and the SEC would have had to investigate the brokerage firm. *Id.*

93. *Id.* at 197-211. The Supreme Court in *Aaron v. SEC* utilized an analysis similar to that used in *Hochfelder*. See *Aaron v. SEC*, 446 U.S. 680, 689-700 (1980); *infra* text accompanying notes 86-88 (listing three part analysis employed by *Hochfelder* court in determining standard of liability under rule 10b-5). The issue in *Aaron* was whether a plaintiff must prove scienter under § 17(a) of the '33 Act. 446 U.S. at 695-700; see 15 U.S.C. § 77q (1982) (prohibiting use of fraudulent or manipulative activity in offer or sale of security). The *Aaron* Court, however, only evaluated two of the three steps found in the *Hochfelder* analysis since the Court found the statutory language and the legislative history of § 17(a) dispositive on the issue of the standard of liability. See 446 U.S. at 700 n.19; *infra* text accompanying notes 93-98 (discussing three part analysis used by *Hochfelder* Court). The *Aaron* Court stated that § 17(a)(1) requires a scienter standard of liability because words of fraud and deceit are found in § 17(a)(1). 446 U.S. at 696-97. The Supreme Court also found that § 17(a)(2) and § 17(a)(3) do not require a showing of scienter because the statutory language of each provision is devoid of any suggestion of a scienter requirement. *Id.*; see 15 U.S.C. § 77q(a)(2) (1982) (prohibiting use of untrue statement of fact or material omission to obtain money or property in the offer or sale of securities); *id.* § 77q(a)(3) (pro-

specific statutory language of the '34 Act for evidence of the proper standard of liability.<sup>94</sup> The Court found that the use of the words "manipulative or deceptive" in section 10(b) implied that Congress intended to prohibit knowing or intentional misconduct in connection with the purchase or sale of any security.<sup>95</sup> Second, the *Hochfelder* Court scutinized the legislative history of section 10(b) for an explanation of the congressional intent in enacting the provision.<sup>96</sup> In examining the legislative history of section 10(b), the Court found that Congress intended to prohibit only manipulative activities accompanied by scienter.<sup>97</sup> Finally, the Supreme Court in *Hochfelder* compared and contrasted section 10(b) with various sections of the federal securities laws to determine the standard of liability most compatible with the general securities regulation scheme.<sup>98</sup> After considering the statutory language and legislative history of section 10(b), and section 10(b)'s role in the federal securities regulation scheme, the *Hochfelder* Court concluded that a private right of action under section 10(b) and rule 10b-5 would not succeed unless the plaintiff alleged scienter.<sup>99</sup>

A *Hochfelder* analysis of section 14(a) and rule 14a-9, combined with the *Adams* holding that accountants are subject to a scienter standard of liability under rule 14a-9, indicates that the correct standard of liability for rule 14a-9 violations is not clear.<sup>100</sup> Consistent with the first element of the *Hochfelder*

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hibiting any practice or transaction that would operate as a fraud on the purchaser in the offer or sale of securities). Additionally, the *Aaron* Court held that although the legislative history of § 17(a) was ambiguous, § 17(a)'s legislative history is consistent with the plain meaning of § 17(a). 446 U.S. at 699-700.

Although the *Hochfelder* Court held that a plaintiff must prove scienter in a rule 10b-5 action, the Court refused to address whether reckless behavior will satisfy the scienter standard of liability under § 10(b) and rule 10b-5. 425 U.S. at 193 n.12. Recklessness is traditionally defined as highly unreasonable conduct that departs from the standards of ordinary care. *See* *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.) (recklessness is a departure from standards of ordinary care), *cert. denied*, 434 U.S. 875 (1977). Lower federal courts are in general agreement that recklessness satisfies the scienter requirement in rule 10b-5 actions. *See, e.g.*, *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-24 (6th Cir. 1979) (reckless behavior satisfies scienter requirement in rule 10b-5 action); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.) (Congress intended § 10(b) to extend to reckless conduct), *cert. denied*, 439 U.S. 970 (1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir.) (recklessness satisfies scienter in rule 10b-5 case), *cert. denied*, 439 U.S. 1039 (1978); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977) (plaintiff may recover in rule 10b-5 action for reckless misrepresentations), *cert. denied*, 439 U.S. 830 (1978); *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977) (plaintiff may prove reckless disregard of falsity of information in rule 10b-5 action), *cert. denied*, 435 U.S. 952 (1978); *Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1049-50 (7th Cir.) (lower court acted correctly in applying recklessness standard in rule 10b-5 action), *cert. denied*, 434 U.S. 875 (1977).

94. 425 U.S. at 197-201.

95. *Id.* at 199-201.

96. *Id.* at 201-06.

97. *Id.* at 203, 206.

98. *Id.* at 206-11.

99. *Id.* at 212-14.

100. *See infra* notes 101-26 and accompanying text (analyzing rule 14a-9 under *Hochfelder* formula and *Adams* decision).

formula for determining the proper standard of liability under the securities laws, other Supreme Court cases have stressed that the language of a securities statute is the starting point for every statutory construction problem.<sup>101</sup> Section 14(a), however, contains no language indicative of the proper standard of liability for proxy statement antifraud violations.<sup>102</sup> Instead, the language of section 14(a) is broad, not limited by words of fraud or deceit, and extends to all proxy regulation necessary to protect the interests of investors.<sup>103</sup> The broad language of section 14(a) illustrates that Congress intended to grant the SEC almost unlimited rulemaking authority to protect investors from proxy statement abuse.<sup>104</sup> Additionally, the language of section 14(a) and rule 14a-9 indicates an intent to prohibit the potentially devastating effects of misstatements on investors instead of establishing the extent of a violator's liability.<sup>105</sup> The absence of language within rule 14a-9 specifically prohibiting fraudulent conduct, therefore, implies that a negligence standard of liability instead of the *Hochfelder* scienter standard is appropriate in proxy statement antifraud case.<sup>106</sup>

The second step in the *Hochfelder* analysis for determining the proper standard of liability in a federal securities law case is an examination of the relevant provision's legislative history.<sup>107</sup> The *Hochfelder* Court emphasized that it examined the legislative history of section 10(b) only to confirm the court's interpretation of the statutory language of section 10(b) which clearly

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101. See 425 U.S. at 200 (ascertaining standard of liability depends upon statutory language); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring) (begin with language of statute in statutory construction); *supra* text accompanying note 94 (first requirement under *Hochfelder* formula involves examination of statutory language).

102. See 15 U.S.C. § 78n(a) (1982) (statute devoid of proper standard of liability); *supra* notes 6-10 and accompanying text (discussing § 14(a) and rule 14a-9).

103. See *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299 (1973) (§ 14(a) not limited by words connoting fraud and extends to protect investors); *supra* notes 6-8 and accompanying text (discussing § 14(a)).

104. See *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299 (1973) (rulemaking authority given by Congress to SEC is broad and extends to all regulations necessary to protect investors).

105. See *Proxy Regulation*, *supra* note 38, at 1431 (§ 14(a) focuses on protecting investors rather than on establishing standard of liability). In determining the proper standard of liability under § 17(a) of the '33 Act, the Supreme Court in *Aaron v. SEC* focused on whether the language of § 17(a) was regulatory or designed to provide relief. *Aaron v. SEC*, 446 U.S. 680, 697 (1980); see 15 U.S.C. § 77q(a) (1982) (prohibiting fraudulent interstate transactions in connection with offer or sale of securities), *supra* note 93 (discussing *Aaron* and § 17(a)). The *Aaron* Court found that the wording of § 17(a)(3), specifically the positioning of the word "operate" before "fraud" and "deceit", indicated that § 17(a)(3) focused upon the effect of wrongful conduct rather than upon the culpability of violators. 446 U.S. at 696-97. The focus of § 17(a)(3) persuaded the Court to hold that a plaintiff need not prove scienter in a § 17(a)(3) action. *Id.* at 697.

106. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (words prohibiting fraudulent conduct in securities statute require imposition of scienter standard of liability); *Proxy Regulation*, *supra* note 38, at 1430 (negligence standard of liability appropriate when statute does not contain language prohibiting fraudulent conduct).

107. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-06 (1976) (second step in *Hochfelder* test is examination of legislative history).

proscribed intentional misconduct.<sup>108</sup> The legislative history of section 14(a) of the '34 Act does not refer to a specific standard of liability for proxy statement antifraud violations.<sup>109</sup> The Sixth Circuit in *Adams*, however, closely examined the legislative history of section 14(a) and concluded that because the applicable congressional documents contained numerous references to wrongdoing coupled with intent, Congress intended scienter to be the proper standard of liability.<sup>110</sup> Despite the *Adams* court's thorough examination of the legislative history of section 14(a), other courts determining the proper standard of liability in a section 14(a) action have not examined legislative history but have instead concentrated on statutory language.<sup>111</sup> A conflict, therefore, arises in identifying the proper standard of liability under section 14(a) because the scienter oriented legislative history does not confirm the finding of most courts that the statutory language of section 14(a) requires a negligence standard of liability.<sup>112</sup>

The final step in the *Hochfelder* formula for determining a standard of liability in federal securities cases focuses on the fact that the federal securities laws as a whole comprise a general regulatory scheme of interrelated components.<sup>113</sup> The *Hochfelder* Court recognized that a relevant factor in interpreting statutory language is the relative interdependence and similarity of diverse provisions of the securities laws.<sup>114</sup> A comparison of section 14(a) and

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108. See *id.* at 201. The *Hochfelder* Court determined that the language of § 10(b) clearly prohibited misconduct accompanied by some degree of scienter. *Id.* Nonetheless, the Supreme Court examined the legislative history of the '34 Act to reinforce its reading of the statutory language of § 10(b). *Id.*

109. See *Proxy Regulation*, *supra* note 38, at 1483 (legislative history of § 14(a) void of standard of liability).

110. See 623 F.2d at 429-30. Notwithstanding the *Adams* decision, some federal courts have failed to find the legislative history of federal securities laws decisive in ascertaining congressional intent. See, e.g., *Aaron v. SEC*, 446 U.S. 680, 697-700 (1980) (legislative history of § 17(a) ambiguous); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-02 (1976) (legislative history of § 10(b) lacks thorough explanation of congressional intent); *SEC v. American Realty Trust*, 586 F.2d 1001, 1006 (4th Cir. 1978) (legislative history of § 17 of '33 Act contains no indication of congressional intent); *Gould v. American-Hawaiian S.S. Co.*, 351 F. Supp. 853, 860 (D. Del. 1972) (legislative history of § 14(a) provides no assistance in divining standard of liability), *aff'd*, 535 F.2d 761 (3d Cir. 1976).

111. See *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 777-78 (3d Cir. 1976) (no discussion of legislative history of § 14(a)); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298-1301 (2d Cir. 1973) (standard of liability determined without examination of legislative history of § 14(a)); *Fradkin v. Ernst*, 571 F. Supp. 829, 842-43 (N.D. Ohio 1983) (no discussion of legislative history of § 14(a)); *supra* notes 66-76 and accompanying text (discussion of *Adams*).

112. See *supra* notes 71-72 and accompanying text (*Adams* court decision that legislative history of § 14(a) requires scienter standard of liability); *supra* notes 46-50, 59 and accompanying text (examination of statutory language of § 14(a) in *Gerstle* and *Gould* indicates negligence is proper standard of liability).

113. See 425 U.S. at 206 (third step in *Hochfelder* test is comparison with other securities provisions to determine compatibility with securities regulation scheme); see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727-30 (1975) ('33 Act and '34 Act are interrelated components of federal securities regulatory scheme).

114. 425 U.S. at 206; see *SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1969) (interdependence of securities laws crucial to interpretation of statutory language).



rule 14a-9 with similar provisions of the securities laws, therefore, should aid in determining whether a negligence or scienter standard under section 14(a) and rule 14a-9 is compatible with the general securities regulatory scheme.<sup>115</sup>

The language of SEC rule 14a-9 concerning misstatements and omissions is identical to the language contained in sections 11 and 17(a)(2) of the '33 Act.<sup>116</sup> Section 17(a)(2) prohibits the use of an untrue statement of material fact or an omission of material fact to obtain money or property in the offer or sale of any security.<sup>117</sup> Section 11 provides for civil liability for misstatements or omissions contained in an effective registration statement.<sup>118</sup> Federal courts unanimously agree that section 11 violators are subject to a negligence standard of liability.<sup>119</sup> Likewise, the Supreme Court, concentrating on the statutory language of section 17(a), has held that a negligence standard of liability applies to section 17(a)(2).<sup>120</sup>

In contrast to the statutory language of section 11 and section 17(a)(2), the actual language of section 14(a) contains no reference to material misstatements or omissions.<sup>121</sup> Rule 14a-9 contains relatively neutral language prohibiting material misstatements or omissions in proxy solicitations.<sup>122</sup> In rule 14a-9, the SEC chose to employ language similar to section 11 and section 17(a)(2) instead of implementing stronger language prohibiting intentional misconduct as found in section 10(b).<sup>123</sup> By opting for the neutral language found in rule 14a-9, the SEC apparently desired not to limit the application

115. See *Proxy Regulation*, *supra* note 38, at 1434 (comparing § 14(a) with other securities laws to determine compatibility with securities regulation scheme).

116. See 15 U.S.C. § 77a(a)(2) (1982) (prohibits obtaining money or property through offer or sale of securities by use of false material fact or omission of material fact); *id.* § 77k (prohibiting false material fact or material omission in effective registration statement); *supra* notes 9-10 and accompanying text (explanation of SEC rule 14a-9); *supra* note 61 (explanation of section 11 of '34 Act). Section 17(a) of the '33 Act outlaws fraudulent interstate securities transactions. 15 U.S.C. § 77q (1982). Specifically, § 17(a)(2) makes it unlawful for any person, in the offer or sale of securities, to obtain money or property by means of an untrue statement of material fact or a material omission. *Id.* § 77q(a)(2).

117. 15 U.S.C. § 77q(a)(2) (1982); see *supra* note 116 (discussion of § 17(a)(2)).

118. 15 U.S.C. § 77k (1982); see *supra* note 61 (discussion of § 11).

119. See *supra* note 61 (citing cases holding that negligence standard of liability applies under § 11).

120. See *Aaron v. SEC*, 446 U.S. 680, 695-97, 702 (1980). In addition to holding that a negligence standard of liability applies under § 17(a)(2), the *Aaron* court held that a negligence standard of liability also applies under § 17(a)(3) because of the statutory language of § 17(a)(3). *Id.* at 697; see 15 U.S.C. § 17(a)(3) (1982) (prohibiting any person from engaging in transaction or practice which operates as fraud or deceit upon purchaser of securities); *supra* note 93 (discussing § 17(a)(3)).

121. See 15 U.S.C. § 78n(a) (1982) (no language in § 14(a) referring to misstatements or omissions); *supra* note 61 (discussion of § 11); *supra* note 116 (discussion of § 17(a)(2)).

122. See 17 C.F.R. § 240.14a-9 (1983) (prohibiting misstatements or omissions in connection with proxy solicitations).

123. See 15 U.S.C. § 77k (1982) (prohibiting misstatements or omissions in effective registration statement); *id.* § 77q(a)(2) (prohibits obtaining money or property by use of misstatements or omissions in offer or sale of securities); 17 C.F.R. § 240.14a-9 (1983) (prohibiting misstatements or omissions in proxy solicitations).

of rule 14a-9 to situations involving only knowing misconduct.<sup>124</sup> As the Second Circuit stated in *Gerstle*, the scope of section 14(a) is broad and extends to all regulation "necessary or appropriate in the public interest or for the protection of investors."<sup>125</sup> A negligence standard of liability under rule 14a-9, therefore, is compatible with the statutory scheme of permitting a negligence standard of liability when the language of a securities provision is neutral and does not specifically prohibit intentional misconduct.<sup>126</sup>

In contrast to section 14(a), a *Hochfelder* analysis of section 14(e) indicates that courts are justified in assigning a scienter standard to tender offer anti-fraud cases.<sup>127</sup> An examination of the statutory language of section 14(e) demonstrates that, unlike section 14(a), Congress chose to limit section 14(e) by utilizing express language which strongly suggests that Congress intended section 14(e) to proscribe intentional or knowing misconduct.<sup>128</sup> The words "fraudulent," "deceptive," and "manipulative" as found in section 14(e), though not contained in rule 14a-9, have been held by the Supreme Court to imply that Congress intended to prohibit conduct accompanied by some degree of scienter.<sup>129</sup> Moreover, federal courts have held that since SEC rule 10b-5 also proscribes fraudulent conduct, the elements of a section 14(e) violation, including an allegation of scienter, are identical to those under rule 10b-5.<sup>130</sup> The statutory language of section 14(e), therefore, indicates that

124. See 17 C.F.R. § 240.14a-9 (1983) (language of rule 14a-9 does not refer to knowing misconduct).

125. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299 (2d Cir. 1973).

126. See *Aaron v. SEC*, 446 U.S. 680, 697 (1980) (language of § 17(a)(2) requires imposition of negligence standard); *supra* note 61 (citing cases holding that negligence standard of liability applies under language of § 11); 17 C.F.R. § 240.14a-9 (1983) (language of rule 14a-9 does not refer to knowing misconduct).

An additional argument for the proposition that a negligence standard of liability under rule 14a-9 follows the statutory scheme is that the plaintiff in a rule 14a-9 action is a voting shareholder while § 11 and § 17(a)(2) plaintiffs are securities investors. Compare 17 C.F.R. § 240.14a-9 (1983) (applies to shareholder receiving proxy solicitation) with 15 U.S.C. § 77k (1982) (applies to any person purchasing securities) and *id.* § 77q(a)(2) (applies to purchaser of securities); see also *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978) (implying private right of action under § 17), *cert. denied*, 442 U.S. 909 (1979). It is improbable that Congress intended to assign less protection to a voting shareholder under the securities laws than to purchasers by implying a scienter standard of liability under rule 14a-9. See *Proxy Regulation*, *supra* note 38, at 1438.

127. See *supra* note 16 (listing cases holding that scienter is proper standard of liability under section 14(e)).

128. See 15 U.S.C. § 78n(e) (1982) (§ 14(e) contains language prohibiting intentional misconduct); *supra* notes 11-13 and accompanying text (explaining content of § 14(e)).

129. See *Aaron v. SEC*, 446 U.S. 680, 696 (1980) (words of fraud or deception contained in § 17(a)(1) illustrate congressional intent to proscribe knowing conduct); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (words of fraud or deception indicate imposition of scienter standard of liability); 15 U.S.C. § 78n(e) (1982) (§ 14(e) contains language prohibiting intentional misconduct); *Proxy Regulation*, *supra* note 38, at 1436-37 (language of § 14(e) implies scienter standard of liability); *supra* notes 11-13 and accompanying text (explaining content of § 14(e)).

130. See, e.g., *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.) (elements of § 14(e) violation identical to elements of rule 10b-5 violation), *cert. denied*, 419 U.S. 873 (1974);

scienter is the proper standard of liability for a violation of section 14(e).<sup>131</sup>

An examination of the legislative history of section 14(e) indicates that Congress included no reference to the proper standard of liability applicable to tender offer antifraud violations.<sup>132</sup> The only assistance that the legislative history of section 14(e) furnishes is in determining the purpose behind the congressional enactment of section 14(e).<sup>133</sup> According to the legislative history of the Williams Act, Congress intended section 14(e) to promote full and fair disclosure of information a shareholder requires in deciding whether to tender his shares to a tender offeror.<sup>134</sup> The Williams Act's legislative history also indicates that Congress designed section 14(e) equitably so that neither management nor the tender offeror occupies a favored position during a hostile tender offer.<sup>135</sup> The legislative history of section 14(e), however, is silent concerning the proper standard of liability for tender offer antifraud violations.<sup>136</sup>

In accord with the third step of the *Hochfelder* test, a comparison of the statutory language of section 14(e) with the language of sections 17(a)(1) and 10(b) of the '34 Act indicates that a scienter standard of liability conforms to the statutory scheme of the federal securities laws.<sup>137</sup> Section 17(a)(1) of the '33 Act prohibits the employment of any device or scheme to defraud purchasers of securities.<sup>138</sup> The Supreme Court has ruled that the intent oriented language of section 17(a)(1) requires the application of a scienter standard of liability to section 17(a)(1) violators.<sup>139</sup> In the same opinion, however, the

Indiana Nat'l Bank v. Mobil Oil Corp., 457 F. Supp. 1028, 1032 (S.D. Ind. 1977) (§ 14(e) is counterpart to rule 10b-5); Applied Digital Data Sys. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1157 (S.D.N.Y. 1977) (elements of § 14(e) violation identical to elements of rule 10b-5 violation).

131. See 425 U.S. at 214-15 (scienter is proper standard of liability for violation of rule 10b-5).

132. See S. REP. No. 550, 90th Cong., 1st Sess. 1 (1967) (Senate never refers to standard of liability for § 14(e)); H.R. REP. No. 1711, 90th Cong., 2d Sess. 1 (1968), reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2811-23 (House never refers to standard of liability for § 14(e)); 113 CONG. REC. 24662-67 (1967) (no reference to standard of liability in report on disclosure of corporate equity ownership); *supra* notes 9-10 and accompanying text (discussion of § 14(e)).

133. See *Proposed Definition*, *supra* note 12, at 700 (primary objectives of Congress in enacting § 14(e) found in legislative history).

134. See S. REP. No. 550, 90th Cong., 1st Sess. 2-4 (1967) (stressing need for disclosure of material information to shareholder caught in proxy battle to aid shareholder in deciding how to vote); H.R. REP. No. 1711, 90th Cong., 2d Sess. 4 (1968), reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2813 (§ 14(e) designed to require full disclosure).

135. See S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967) (Congress took care to avoid tipping balance to management or offeror during tender offer); H.R. REP. No. 1711, 90th Cong., 2d Sess. 4 (1968), reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2813 (Congress avoided tipping balance during tender offers to management or offeror).

136. See *supra* notes 11-13 and accompanying text (discussion of § 14(e)); *supra* note 132 and accompanying text (legislative history of § 14(e) does not prescribe proper standard of liability).

137. See 15 U.S.C. § 78n(e) (1982) (prohibiting fraudulent, deceptive or manipulative activity in connection with tender offer); *id.* § 77q(a)(1) (prohibiting employment of device or scheme to defraud in offer or sale of securities); *id.* § 78j(b) (prohibiting use of manipulative or deceptive devices in connection with purchase or sale of securities).

138. See *id.* § 77q(a)(1) (prohibiting use of device or scheme to defraud in offer or sale of securities).

139. See Aaron v. SEC, 446 U.S. 680, 696-97 (1980) (§ 17(a)(1) violators subject to scienter standard of liability).

Supreme Court held that the more neutral language of sections 17(a)(2) and 17(a)(3) necessitates a negligence standard of liability.<sup>140</sup> Rule 10b-5, promulgated by the SEC under section 10(b), prohibits manipulative or deceptive devices in connection with the purchase or sale of any security in three subsections identical to the three subsections of section 17(a).<sup>141</sup> According to the Supreme Court in *Hochfelder*, however, all three subsections of rule 10b-5 are subject to a scienter standard of liability primarily because of the language contained in section 10(b).<sup>142</sup> The implementation of a single standard of liability under rule 10b-5 is consistent with Congress' choice of a section heading for section 10 which clearly limits the scope of section 10 to manipulative and deceptive devices.<sup>143</sup> Imposing differing standards of liability under the subsections of rule 10b-5, like the differing standards required by the Supreme Court under the subsections of section 17(a), therefore, would exceed the authority that Congress granted the SEC under section 10(b) to regulate only manipulative or deceptive activity.<sup>144</sup> In keeping with the scheme instituted by the Supreme Court in *Hochfelder*, and the Supreme Court decision determining the standard of liability under section 17(a), the language of section 14(e) would seemingly require that a scienter standard of liability be applied to tender offer antifraud violations.<sup>145</sup>

A potential problem, however, could arise in conducting a statutory scheme analysis of section 14(e).<sup>146</sup> Although Congress did not separate section 14(e) into subsections, section 14(e) does consist of two distinct clauses.<sup>147</sup> The first clause of section 14(e) prohibits the use of an untrue statements of a material fact or an omission of any material fact in connection with a tender offer.<sup>148</sup> The language of the first clause of section 14(e) precisely tracks the language of section 17(a)(2) to which the Supreme Court has applied a negligence stan-

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140. *Id.*; see *supra* note 93 (discussing § 17(a)(2) and § 17(a)(3)).

141. Compare 15 U.S.C. § 77q(1) (1982) (unlawful to use device or scheme to defraud in offer or sale of securities) and *id.* § 77q(a)(3) (unlawful to participate in fraudulent or deceitful transaction in offer or sale of securities) with 17 C.F.R. § 240.10b-5(a) (1983) (unlawful to use device or scheme to defraud in purchase or sale of securities) and *id.* § 240.10b-5(b) (unlawful to use misstatement or omission in purchase or sale of securities) and *id.* § 240.10b-5(c) (unlawful to participate in fraudulent or deceitful transaction in purchase or sale of securities).

142. See 425 U.S. at 214 (language of rule 10b-5 requires imposition of scienter standard of liability).

143. See 15 U.S.C. § 78j (1982) (section heading for § 10 limits application of provision to regulation of manipulative and deceptive activity only).

144. See *Aaron v. SEC*, 446 U.S. 680, 697 (1980) (listing standards of liability for subsections of § 17(a) of '33 Act); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, 214 (1976) (SEC rulemaking authority under § 10(b) limited to regulation of manipulative or deceptive activity).

145. See *Aaron v. SEC*, 446 U.S. 680, 692 (1980) (language of § 17(a)(1) requires imposition of scienter standard of liability); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200-01 (1976) (words referring to intentional misconduct in § 10(b) require scienter standard of liability); 15 U.S.C. § 78n(e) (1982) (prohibiting fraudulent, deceptive or manipulative activity in connection with tender offer).

146. See 15 U.S.C. § 78n(e) (1982) (tender offer antifraud provision); *supra* notes 11-14 and accompanying text (discussion of § 14(e)).

147. See 15 U.S.C. § 78n(e) (1982) (Congress did not divide § 14(e) into separate clauses).

148. *Id.*

dard of liability.<sup>149</sup> The second clause of section 14(e) prohibits manipulative and deceptive acts or practices in connection with any tender offer.<sup>150</sup> As previously stated, the language of the second clause of section 14(e) parallels the language of section 17(a)(1) which the Supreme Court has held to require a negligence standard of liability.<sup>151</sup> Arguably, if the statutory scheme is followed the language of section 14(e) would permit either a negligence standard under the first clause or a scienter standard under the second clause, depending on the type of violation.<sup>152</sup> Moreover, section 14(e), unlike section 10(b), is not limited strictly to a scienter standard of liability by a section heading confining the scope of section 14(e) to manipulative and deceptive activity.<sup>153</sup> Although no courts have applied a negligence standard to section 14(e) based on the language of the first clause of the provision, a dual standard of liability under section 14(e) is plausible in light of the Supreme Court's decision to apply differing standards under the subsections of section 17(a).<sup>154</sup>

Although a dual standard of liability under section 14(e) is only a possibility, a dual standard of liability under section 14(a) is a reality.<sup>155</sup> According to the present case law, a dual standard of liability exists under section 14(a) and SEC rule 14a-9 since federal courts addressing the issue would apply a scienter standard to corporate outsiders and a negligence standard to corporate insiders.<sup>156</sup> In addition to the *Adams* decision, the *Fradkin* court supported the imposition of a scienter standard on outside accountants in dicta, and the *Gerstle* court stated that the facts of a particular case could sometimes

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149. See *Aaron v. SEC*, 446 U.S. 680, 696 (1980) (language of § 17(a)(2) requires imposition of negligence standard of liability). Compare 15 U.S.C. § 77q(a)(2) (1982) (prohibiting use of "untrue statement" or material omission to obtain money or property in connection with offer or sale of securities) with *id.* § 78n(e) (prohibiting use of "untrue statement" or material omission in connection with tender offer).

150. 15 U.S.C. § 78n(e) (1982).

151. See *Aaron v. SEC*, 446 U.S. 680, 696 (1980) (language of § 17(a)(1) requires imposition of scienter standard of liability). Compare 15 U.S.C. § 77q(a)(1) (1982) (prohibiting employment of device or scheme to defraud in offer or sale of securities) with *id.* § 78n(e) (prohibiting use of fraudulent, deceptive, or manipulative activity in connection with tender offer).

152. See L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 590 (1983) (Supreme Court's implementation of differing standards of liability under § 17(a) should apply to the two clauses of § 14(e) because of similarities in language).

153. See 15 U.S.C. § 78n (1982) (section heading of § 14 does not limit scope to manipulative and deceptive activity only); *supra* note 143 and accompanying text (§ 10(b) limited by section heading which only allows regulation of manipulative and deceptive acts).

154. See L. Loss, *supra* note 152, at 590 (dual standard of liability possible under § 14(e)); *supra* note 16 (federal court decisions applying scienter standard to § 14(e) tender offer violations).

155. See *supra* note 41 (cases applying a negligence standard of liability to rule 14a-9 violations); *supra* notes 66-76 and accompanying text (discussing *Adams* decision that scienter standard applied to outside accountants under rule 14a-9); *supra* notes 147-54 and accompanying text (discussing possibility of dual standard of liability under § 14(e)).

156. See *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 431 (6th Cir.) (scienter standard required in rule 14a-9 action against outside accountants), *cert. denied*, 449 U.S. 1067 (1980); *Fradkin v. Ernst*, 571 F. Supp. 829, 843 (N.D. Ohio 1983) (negligence standard required in rule 14a-9 action against corporate insider).

justify a scienter standard of liability.<sup>157</sup> Under section 14(a) and rule 14a-9, a dual standard of liability depends on different categories of actors, specifically corporate insiders and outside accountants.<sup>158</sup> Under section 14(e), a dual standard of liability, however, would focus on the type of act a defendant commits.<sup>159</sup> A dual standard of liability under section 14(e), therefore, would be similar to the dual standard under section 17(a) where a court will apply either a scienter or negligence standard depending on whether the alleged violation involves a material misstatement or omission, or a manipulative or fraudulent act.<sup>160</sup> Arguably, the Supreme Court's application of a dual standard of liability under section 17(a) would more strongly support a dual standard under section 14(e) since the dual standard under section 14(a) is based on the type of actor while under section 14(e) the standard is based on the type of action.<sup>161</sup>

Despite the contribution of the *Adams* decision to a dual standard of liability under rule 14a-9, the rationale of the *Adams* court in deciding that outside accountants are subject to a scienter standard of liability is suspect.<sup>162</sup> The Sixth Circuit neglected to consider the language of either section 14(a) or SEC rule 14a-9 and the relationship of these provisions to other provisions of the federal securities laws.<sup>163</sup> The *Adams* court, however, examined the statutory language of section 14(e) and agreed with the *Hochfelder* court that words prohibiting knowing misconduct, as found in the legislative history of section 14(a), require the imposition of a scienter standard of liability.<sup>164</sup> Curiously, the Sixth Circuit found important the inclusion of words connoting intentional misconduct in section 14(e), but was unconcerned by the absence of language prohibiting intentional wrongdoing in section 14(a) and rule 14a-9.<sup>165</sup> Additionally, the *Adams* court relied excessively upon the congres-

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157. See *supra* notes 77-87 and accompanying text (discussion of *Fradkin*); *supra* notes 53-54 and accompanying text (*Gerstle* dicta that in some situations rule 14a-9 may support scienter standard of liability).

158. Compare *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299 (2d Cir. 1973) (corporate insider subject to negligence standard of liability in rule 14a-9 action) with *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 431 (6th Cir.) (outside accountant subject to scienter standard of liability in rule 14a-9 action), *cert. denied*, 449 U.S. 1067 (1980).

159. See *supra* note 93 (discussion of differing standards of liability under § 17(a)).

160. See *supra* note 93 (discussion of differing standards of liability applicable to violators of § 17(a)); *supra* notes 147-54 and accompanying text (discussion of possibility of dual standard of liability under § 14(e)).

161. See *supra* note 93 (discussion of differing standards of liability under § 17(a)); *supra* text accompanying notes 155-56 (dual standard of liability under § 14(a) based on kind of actor while under § 14(e) based on kind of action).

162. See 623 F.2d at 431 (outside accountants subject to scienter standard of liability); *supra* notes 66-76 and accompanying text (discussion of *Adams*).

163. See 623 F.2d at 428-31; Comment, *Misleading Proxy Statements—Outside Accountants Can Be Held Liable Under Rule 14a-9 Only Upon a Showing of Scienter*, 56 NOTRE DAME LAW. 579, 584 (1981) (*Adams* court failed to examine language of rule 14a-9 and relation of rule 14a-9 to other securities provisions) [hereinafter cited as *Misleading Proxy*].

164. See 623 F.2d at 431; *supra* notes 88-99 and accompanying text (discussion of *Hochfelder*).

165. See *Misleading Proxy*, *supra* note 163, at 584 (*Adams* court unconcerned with absence

sional history of section 14(a) in deciding that outside accountants should be subject to a scienter standard of liability.<sup>166</sup> Finally, the Sixth Circuit expressed concern for the potential over-liability of accountants under a negligence standard for minor mistakes.<sup>167</sup> A concern for the liability of accountants, however, should not take precedence over the primary goal of protecting shareholders from the effects of faulty financial statements in the context of a rule 14a-9 action.<sup>168</sup>

A thorough examination of section 14(e) under the *Hochfelder* formula for determining the proper standard of liability illustrates that federal courts are correct in assigning a scienter standard of liability to section 14(e) tender offer violations.<sup>169</sup> The actual statutory language and legislative history of section 14(e), in conjunction with the fact that a scienter standard under section 14(e) conforms to the federal securities regulatory scheme, reinforces the im-

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of language prohibiting intentional misconduct in rule 14a-9).

166. See 623 F.2d at 429-30 (numerous citations by *Adams* court to congressional history); *Misleading Proxy*, *supra* note 163, at 584-85 (*Adams* court relied heavily upon legislative history in determining standard of liability for outside accountants); Comment, *Liability of Accountants for Proxy Violations—The Appropriate Standard of Culpability*, 56 WASH. L. REV. 743, 756 (1981) (legislative history of § 14(a) cited in *Adams* not persuasive because of conflicting statutory language of § 14(a)).

167. See 623 F.2d at 428. The Sixth Circuit in *Adams* noted that tender offers and proxy solicitations are alternative means of achieving corporate control and both are subject to similar abuses. *Id.* at 430. The *Adams* court stated that in passing the Williams Act, Congress intended proxy statements and tender offers to be subject to the same standards of liability. *Id.* Because § 14(e) requires a scienter standard of liability, the Sixth Circuit reasoned that § 14(a) violators should be subject to the same standard. *Id.* The *Adams* court regulatory scheme analysis, however, is not persuasive because the court failed to examine the important consideration of whether the two provisions contain similar statutory language. See *id.* at 430-31 (*Adams* court failed to examine statutory language of § 14(a) and § 14(e)).

168. See *Misleading Proxy*, *supra* note 163, at 586 (concern for accountants cannot outweigh protection of shareholders' interests). Despite the faults contained in the reasoning of the *Adams* decision, the Sixth Circuit impliedly raised an important consideration in the context of determining the standard of liability under rule 14a-9. See 623 F.2d at 428-29. The *Adams* court noted that in addition to containing a negligence standard of liability, § 11 of the '33 Act requires proof of actual investor reliance to convict. *Id.* The Sixth Circuit also stated that rule 10b-5, which requires proof of scienter, substitutes a less burdensome standard of materiality for reliance. *Id.* at 429; see *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972) (materiality and not investor reliance must be proven in rule 10b-5 case). The Supreme Court, however, has held that the less exacting standard of materiality, and not actual reliance, applies to rule 14a-9 actions. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970). An action under rule 14a-9, therefore, only requires a showing of materiality and negligence. See *id.* at 384-85 (proof of materiality necessary in rule 14a-9 action); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299 (2d Cir. 1973) (negligence standard of liability required under rule 14a-9). Since rule 14a-9 only requires a negligence standard of liability and a showing of materiality instead of reliance, rule 14a-9 is arguably the easiest rule of the federal securities regulation scheme under which a shareholder may bring suit. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970) (proof only of materiality necessary in rule 14a-9 suit); *Gerstle v. Gamble Skogmo, Inc.*, 478 F.2d 1281, 1301 (2d Cir. 1973) (negligence standard of liability required in rule 14a-9 suit).

169. See *supra* notes 127-45 and accompanying text (applying § 14(e) to three part *Hochfelder* analysis).

position of a scienter standard of liability by the federal courts.<sup>170</sup> Although the standard of liability under section 14(e) appears settled, the language of section 17(a)(2) may allow a future court to impose a negligence standard of liability on tender offer antifraud violators thereby creating a dual standard of liability under section 14(e).<sup>171</sup> Under section 14(a), however, the statutory language of the proxy statement antifraud provision and the general securities regulatory scheme imply that negligence is the proper standard although the legislative history of section 14(a) implies that a scienter standard is the proper standard of liability.<sup>172</sup> The present applicable case law under section 14(a) and SEC rule 14a-9 illustrates that a dual standard of liability, determined by whether the defendant is a corporate insider or outsider, exists under the proxy statement antifraud provisions.<sup>173</sup> Although a dual standard of liability under section 14(a) and rule 14a-9 may create confusion and interpretive difficulties, a dual standard is not incompatible with the federal securities regulatory scheme since the Supreme Court has already approved a standard of liability under section 17(a) of the '33 Act.<sup>174</sup> A Supreme Court decision similar to *Hochfelder* would be necessary to avoid the continuance of a standard of liability under section 14(a) and rule 14a-9.<sup>175</sup>

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170. See *supra* notes 127-45 and accompanying text (examining statutory language of § 14(e) and legislative history of § 14(e), and position of § 14(e) in federal securities regulation scheme); *supra* note 16 and accompanying text (listing decisions holding that scienter is proper standard of liability under § 14(e)).

171. See *supra* notes 147-54 and accompanying text (noting possibility of dual standard of liability under § 14(e)).

172. See *supra* notes 100-26 and accompanying text (applying § 14(a) and rule 14a-9 to three part *Hochfelder* analysis).

173. See *supra* notes 42-65, 77-87 and accompanying text (discussion of *Gerstle*, *Gould*, and *Fradkin* court holdings that negligence is proper standard of liability under rule 14a-9); *supra* notes 66-76 and accompanying text (discussion of *Adams* court holding that scienter is proper standard of liability under rule 14a-9); *supra* note 158 and accompanying text (determination of proper standard of liability under rule 14a-9 depends on whether the defendant is a corporate insider or outsider).

174. See *Aaron v. SEC*, 446 U.S. 680, 697 (1980) (dual standard of liability approved by Supreme Court under § 17(a) of '33 Act).

175. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-15 (1976) (fixing scienter as proper standard of liability under rule 10b-5).



