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Iii. Proxy Solicitation

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III. PROXY SOLICITATION

To ensure dissemination of accurate information to shareholders, section 14(a) of the Securities Exchange Act of 1934¹ authorizes the SEC to prescribe rules for the regulation of proxy disclosures. Pursuant to that power, the commission has promulgated rule 14a-9,² which prohibits proxy statements that contain misleading statements or omissions of material facts.³ The purpose of this rule is to provide shareholders with facts essential to an informed corporate suffrage.⁴

The courts have developed two standards to determine whether a particular omission is material, and thus violative of Rule 14a-9.⁵ The standard adopted by the Second, Third and Fifth Circuits, defines as material any fact omitted from the proxy statement that *would* be considered significant by a shareholder preparing to vote.⁶ The Seventh Circuit, however, has construed material omissions to include the omission of facts that *might* have influenced a reasonable shareholder.⁷

¹ 15 U.S.C. § 78n(a) (1970).

² 17 C.F.R. § 240.14a-9(a) (1976).

³ Rule 14a-9(a) reads:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

⁴ TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976); Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381 (1970); J. I. Case Co. v. Borak, 377 U.S. 426, 431 (1964); H.R. REP. NO. 1838, 73d Cong., 2d Sess. 13-14 (1934); Note, *False and Misleading Proxy Statements*, 3 GA. L. REV. 162 (1968) [hereinafter cited as *False and Misleading Statements*].

⁵ To establish a violation of Rule 14a-9, the plaintiff must show that the proxy statement omitted or misstated a fact, that the fact was material, and that the omission or misrepresentation was the cause of the injury alleged. See generally *False and Misleading Statements*, *supra* note 4. The materiality element determines what facts the shareholder should be informed of before he casts his vote. See 11A Business Organizations—Securities Regulation, E. GADSBY, FEDERAL SECURITIES EXCHANGE ACT § 7.04[2][a] at 7-50 (1976).

⁶ Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 770-71 (3d Cir. 1976); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603-04 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1301-02 (2d Cir. 1973).

⁷ Northway, Inc. v. TSC Indus., Inc., 512 F.2d 324, 329-31 (7th Cir. 1975), *rev'd*,

Recently, the Supreme Court resolved this conflict among the circuits in favor of the more stringent test applied by the Second, Third and Fifth Circuits. In *TSC Industries, Inc. v. Northway, Inc.*,⁸ the Court held that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."⁹ In *TSC, Northway*, a shareholder of TSC, sued the company under Rule 14a-9, alleging that TSC had omitted certain material facts from a proxy statement. TSC had issued the statement jointly with National Industries, a prospective merger partner.¹⁰ The proxy statement recommended shareholder approval of a plan by which TSC would sell its assets to National and liquidate.¹¹ Northway charged that the proxy statement failed to state material facts relating to National's prior control of TSC and the unfavorability of the transaction to TSC shareholders.¹²

Northway alleged that the proxy material understated National's control of TSC because it did not reveal that two TSC officers also held executive positions at National,¹³ and that TSC had informed the SEC that National could be considered the "parent" of TSC.¹⁴

426 U.S. 438 (1976); see generally Kirland, *Misleading Proxy Statements—The Seventh Circuit Strengthens the Minority Stockholder's Rule 14a-9 Action: Northway v. TSC Industries*, 512 F.2d 324 (7th Cir. 1975), 31 BUS. LAW. 1449 (1976); Note, *The Materiality Test—Mills Revisited*, 14 DUQ. L. REV. 723 (1976); Note, *Securities Law—Proxy Regulation—A Fact is Material Under SEC Rule 14a-9 Only if There is a Substantial Likelihood that a Reasonable Investor Would Consider it Important*, 22 VILL. L. REV. 205 (1977).

⁸ 426 U.S. 438 (1976).

⁹ *Id.* at 449.

¹⁰ National Industries previously had purchased 34% of TSC's outstanding stock in a private transaction with TSC's founder, Charles E. Schmidt, and his family. Schmidt and his son thereupon resigned from TSC's board. *Id.* at 440.

¹¹ Under the plan, TSC's assets were to be sold to National, and TSC securities were to be exchanged for National Series B Preferred Stock and Warrants. Each National warrant could be exchanged for one share of National common stock at a fixed price until October 1978. *Id.* at 441.

¹² Northway also charged members of the Schmidt family with failure to protect the interests of other shareholders under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), and with aiding and abetting National and TSC to carry out the allegedly fraudulent scheme. 512 F.2d at 338-39. The court of appeals upheld the district court's grant of summary judgment to the Schmidt defendants on both charges. *Id.* at 339-42. Northway did not challenge this aspect of the case in the Supreme Court.

¹³ The proxy statement failed to state that the chairman of TSC's board was the president and chief executive officer of National, and that the chairman of TSC's executive committee was also National's executive vice president. 426 U.S. at 451-53.

¹⁴ The possibility of this relationship was revealed in the information required by Schedule 13D, 17 C.F.R. § 240.13d-101 (1976), Form 8K, 3 FED. SEC. L. REP. (CCH) ¶ 31,103, and Form 10K, 3 FED. SEC. L. REP. (CCH) ¶ 31,103. In general, these disclo-

Northway also charged that omission of certain comments concerning the premium over market price each TSC shareholder would receive under the merger plan¹⁵ and the possibility of market manipulation by National and a mutual fund¹⁶ unreasonably exaggerated the favorability of the transaction.

The district court, applying the standard that defined materiality as that which would be considered significant by a shareholder, held that genuine questions of fact existed, and denied Northway's motion for summary judgment.¹⁷ The Seventh Circuit, however, announced that the district court had applied the wrong standard in defining materiality and reversed.¹⁸ The court of appeals held that the proper

sure requirements compel the parties to reveal to the SEC information concerning the control and goals of parties contemplating corporate acquisitions or mergers.

¹⁵ The proxy statement included the contents of a letter from the company's investment banker describing as "substantial" the premium over market price that TSC shareholders would receive under the plan. 426 U.S. at 454-55. The Seventh Circuit noted that an examination of current market prices found elsewhere in the proxy statement would, in effect, define the term "substantial" in dollar amounts. 512 F.2d at 334. Based on those prices, an exchange for National Series AB Preferred Stock and warrants would have returned a premium of \$3.23 per share to holders of TSC Series 1 Preferred Stock and of \$2.94 per share to holders of TSC common stock.

The proxy statement did not include a second letter stating that the prediction of a substantial premium was not based upon current market prices, but upon a lower price level anticipated after National released an additional 2.6 million warrants. 426 U.S. at 457 n.17. The premium based upon this figure consequently would be lower than the figures a shareholder might compute based upon current market prices. Based upon the lower predicted figure for National warrants, a holder of TSC Series 1 Preferred Stock would receive a premium of \$2.10 per share, and a holder of TSC common stock would receive a premium of \$1.62 per share. *Id.* at 459 n.18.

¹⁶ Northway maintained that the proxy statement should have revealed extensive purchases of National common stock by National and the Madison Fund. These purchases accounted for 8.5% of all recorded sales of National common stock in the previous two years. *Id.* at 460-61. Northway contended that a shareholder could infer from the purchases that a scheme existed to manipulate the price of the stock. Since such manipulation, if true, could artificially inflate the price of the stock, Northway urged that the purchases should have been revealed.

¹⁷ 361 F. Supp. 108, 112 (N.D. Ill. 1973).

¹⁸ 512 F.2d 324, 330 (7th Cir. 1975). The court of appeals did hold that a genuine issue of fact existed on one Rule 14a-9 claim, even under the liberal test of materiality. *Id.* at 336-38. Northway alleged that the proxy statement misled shareholders by stating that TSC's directors had approved the liquidation plan. Northway claimed that this assertion was misleading because only four of the ten directors actually had approved the proposal. The five National members of TSC's board had either abstained or had not attended the meeting, while one TSC member had abstained as well. Although this fact was not disclosed in the proxy statement, the court of appeals found that reasonable minds could differ over the materiality of the information. *Id.* at 338. Unlike information related to market price or corporate control, the circumstan-

test of materiality required only that the omitted fact be one that *might* affect the vote of a reasonable shareholder.¹⁹

The court derived this standard from language of the Supreme Court in *Mills v. Electric Autolite Co.*,²⁰ another case involving Rule 14a-9. The *Mills* opinion, however, dealt with causation rather than materiality. The Supreme Court held that causation would be presumed where the defect in the proxy statement was found to be material.²¹ In stating this rule, the *Mills* opinion uses the word "might" to describe materiality.²² The Seventh Circuit relied on that language to support its holding in *TSC*. Moreover, the court of appeals concluded that the lower threshold of materiality, implied by use of the word "might", would result in more extensive disclosure and, thus, would further the congressional goal of shareholder protection.²³ The Supreme Court reversed, stating that a showing of a substantial likelihood that the omission would have influenced the vote of a reasonable shareholder was the proper standard for defining materiality under Rule 14a-9.²⁴ The Court concluded that *Mills* was not dispositive because the issue there was causation and not materiality.²⁵

ces of board approval did not bear on the substance of the liquidation plan or suggest self dealing. *Id.* Therefore, the court could not find that as a matter of law a reasonable shareholder's vote might be affected by the information. *Id.*

¹⁹ *Id.* at 330-32.

²⁰ 396 U.S. 375, 384 (1970). The relevant portion of the *Mills* opinion states:

Where the misstatement or omission in a proxy statement has been shown to be "material," . . . that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9. . . .

²¹ 396 U.S. 375 (1969), *rev'g* 403 F.2d 429 (7th Cir. 1968). In *Mills*, the Seventh Circuit held that the defendants could defeat the element of causation by showing that despite a materially misleading proxy statement, the challenged merger "would have received a sufficient vote even if the proxy statement had not been misleading. . . ." 403 F.2d at 436. The Supreme Court noted that a determination of the actual number of votes affected by proxy statement defects would prove difficult and, consequently, would frustrate the purposes of the disclosure provisions. 396 U.S. at 385. Therefore, the Court announced that where a defect has been shown to be material, the requirement of causation will be satisfied by proof that "the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." *Id.*

²² See note 20 *supra*.

²³ 512 F.2d at 330-31. See *J. I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964).

²⁴ 426 U.S. at 449.

²⁵ *Id.* at 446-47. The *TSC* Court did note that the higher standard was more

The TSC Court also rejected the circuit court's reasoning that the lower standard was necessary to effectuate the congressional goal of an informed corporate suffrage.²⁶ To the contrary, the Court considered the lower standard likely to lead to unwarranted disclosure of trivial information.²⁷ This standard would result in proxy statements so bulky that many shareholders would be unable to discern the truly significant facts.²⁸ Thus, the lower standard actually would frustrate rather than further the legislative purpose.

Adoption of the higher standard, on the other hand, would not impose an unreasonable measure of liability upon the party responsible for the proxy solicitation. The greater latitude afforded by this standard would allow the issuing party to prepare a more easily understood proxy statement without fear of liability for an insignificant omission.²⁹ Thus, the Court concluded that defining materiality in terms of a substantial likelihood that shareholders would consider the fact important would better serve the statutory policy of accurate disclosure.

Applying the higher standard of materiality, the Supreme Court found that reasonable minds could disagree on the materiality of all four omissions complained of by Northway, and reversed the grant of summary judgment. Although the proxy material did not state clearly that two TSC officers also held executive positions at National, the Court held that reasonable minds could find that other facts revealed in the proxy statement rendered the omission immaterial.³⁰ Likewise, statements to the SEC that National might be consid-

consistent with that part of *Mills* which had described materiality as an impediment to actions for omissions of trivial facts. *Id.* at 447, citing 396 U.S. at 384. See note 20 *supra*.

²⁶ 426 U.S. at 448-49.

²⁷ *Id.*; see Brief for SEC as Amicus Curiae, at 15.

²⁸ See SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (THE WHEAT REPORT) 376-77 (1969). The Wheat Report found that proxy statements connected with merger proposals frequently extended 60-100 pages in length, and were too bulky to be assimilated by the average shareholder. The Report recommended that merger proxy statements should be organized into a concise, six or seven page summary of certain basic facts, followed by a more detailed appendix. *Id.* at 380-81.

²⁹ 426 U.S. at 446-40. The Court quoted Judge Friendly in *Gerstle v. Gamble-Skogmo, Inc.* 478 F.2d 1281, 1302 (2d Cir. 1973), to the effect that the "'might' formulation is 'too suggestive of mere possibility, however unlikely.'" 426 U.S. at 449.

³⁰ Although the proxy statement did not reveal that the chairmen of TSC's board and executive committee held executive positions at National, the information was disclosed in another context. A list of National's nominees to TSC's board included the names and occupations of the two officers in question, thus creating a question on

ered a parent of TSC could be considered immaterial in view of factual questions concerning the degree of actual control that National exercised.³¹ Sufficient questions of fact also existed as to whether the opinion of TSC's investment banker would be considered material by a reasonable shareholder. The adviser had informed TSC that the premium offered by National would be worth less than previously predicted. Likewise, questions of fact existed as to whether the premium was nevertheless "substantial," and thus consistent with an earlier forecast.³² Finally, the Court found that in the absence of clear evidence of collusion, reasonable minds could differ as to the materiality of facts concerning possible manipulative stock purchases by National and a mutual fund.³³ Therefore, the court remanded the case for trial upon the merits of these omissions.³⁴

the materiality of the omission. Moreover, the statement revealed that National owned 34% of TSC's outstanding stock, that no other shareholder held more than 10%, and that five of the ten TSC directors were National nominees. *Id.* at 452-53.

³¹ *Id.* at 453. Northway had alleged that the proxy statement violated Rule 14a-3, 17 C.F.R. § 240.14a-3 (1976). Item 5(e) of Schedule 14A states that if the party soliciting the proxy has knowledge of a change in control of the corporation within the past year, the proxy statement must indicate appropriately the change in control. 17 C.F.R. § 240.14a-101, item 5(e) (1976). Northway charged that the proxy statement failed to reveal this fact adequately. 512 F.2d at 329. The Seventh Circuit found that a genuine question of fact existed as to whether a change in control actually had occurred, and upheld the trial court's denial of summary judgment. *Id.* Although the Rule 14a-3 claim was not before the Supreme Court, the Court deemed this finding by the court of appeals dispositive of the related charges under § 14(e). 426 U.S. at 452-53.

³² See note 15 *supra*. The defendants contended that the two letters dealt with different concepts and could not be compared. Brief for Petitioner at 35-38. According to this argument, the first letter sought to appraise the fairness of the exchange plan to TSC shareholders, and was based on current market values. This letter indicated that the price of the warrants might decline, but the premium would still be fair. *Id.* at 35. The second letter, according to the defendants, was directed to value, not fairness. This letter did not discuss market prices or try to predict a future price for the warrants. Rather, the second letter attempted to estimate the present value to National for accounting purposes of the 2.6 million additional warrants. *Id.* at 37-38. Nevertheless, the Supreme Court treated the second letter as a clarification of the first. 426 U.S. at 456-60. The Court viewed the crucial question, as whether the possibility of a decline in the price of National warrants should have been revealed. *Id.* at 457-58. Resolution of this question turned upon definition of the term "substantial," which the Court decided involved factual issues. *Id.* at 459-60.

³³ See note 16 *supra*. The court of appeals acknowledged that a question existed as to possible collusion between National and Madison, yet held that the proxy statement should have revealed the possibility, so that shareholders would have an opportunity to decide the matter for themselves. 512 F.2d at 336.

³⁴ 426 U.S. at 464. Although *TSC* involved only omissions the Court clearly stated that the higher standard applied to misleading statements as well. The Court feared that the lower standard of materiality would result in managerial liability for

Although the Court rejected the lower, more liberal standard of materiality, the decision in *TSC* should not be characterized as another in a series of restrictions upon the federal judicial role in securities regulation.³⁵ The Supreme Court's definition of materiality was supported by three courts of appeals³⁶ and the SEC.³⁷ Moreover, lower courts within the Seventh Circuit had used the higher standard until the dictum in *Mills* led to adoption of the lower threshold of materiality.³⁸ Finally, the Court's ruling rests upon its conclusion that the higher standard is a more effective means to achieve the congressional goal of shareholder protection through accurate disclosure. Although the approach of the Supreme Court restricts liability, it does so in order to promote concise, more easily understood proxy statements. While the procedure may mean that fewer shareholders will

"insignificant omissions or misstatements." *Id.* at 448. *But see The Supreme Court, 1975 Term*, 90 HARV. L. REV. 56, 262 (1976).

³⁵ See, e.g., *Santa Fe Indus., Inc. v. Green*, 97 S.Ct. 1292 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232 (1976); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975); see also Pitt, *An SEC Insider's View of the Utility of Private Litigation Under the Federal Securities Laws*, 5 SEC. REG. L. J. 3 (1977); Note, *Judicial Retrenchment Under Rule 10b-5: An End to the Rule as Law?*, 1976 DUKE L. J. 789; *The Supreme Court, 1975 Term*, 90 HARV. L. REV. 56, 255 (1976).

³⁶ *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 770-71 (3d Cir. 1976); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 603-04 (5th Cir. 1974); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1301-02 (2d Cir. 1973).

³⁷ The SEC urged the Court to define materiality in terms of "whether the omitted facts have a significant propensity to affect the judgment of a reasonable shareholder in deciding how to vote." Brief for SEC as Amicus Curiae, at 13. Although this formulation differs somewhat from the one ultimately adopted, the Court noted that the SEC supported the higher standard. 426 U.S. at 449 n.10. Endorsement of a definition not using the term "would" implies that the crucial element to the Court was not "would" or "might," but rather, the words "substantial likelihood." R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES AND MATERIALS* 931 (4th ed. 1977).

³⁸ See, e.g., *Berman v. Thomson*, 45 F.R.D. 342 (N.D. Ill. 1968), *vacated*, 312 F.Supp. 1031 (N.D. Ill. 1970). In *Berman*, the plaintiff challenged a merger that had followed issuance of an allegedly misleading proxy statement. The proxy material included a balance sheet showing that the defendant corporation had investments of \$6 million in "corporations." In truth, the investment represented 22% of the defendant's total assets, and was in only one corporation. In the first opinion, issued before *Mills* was decided, the *Berman* court applied the "would" standard to deny summary judgment to the plaintiff. 45 F.R.D. at 344-45. The second opinion followed *Mills* and applied the "might" standard. Using the lower standard, the court vacated the first opinion and granted summary judgment to the plaintiff. 312 F. Supp. at 1033-35.

³⁹ Determination of what facts are material and should be included in a proxy statement will be difficult, regardless of the standard employed. Although ostensibly an objective standard, materiality ultimately rests upon subjective factual interpreta-