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ENFORCEMENT OF PROXY REGULATIONS IN PARENT-SUBSIDIARY MERGERS

The Securities Exchange Act of 1934 and its implementing regulations control the issuance of proxy statements. This legislation is intended to prohibit use of deceptive or inadequate disclosure in proxy statements to obtain shareholder authorization of corporate transactions. Moreover, the scope of this prohibition and, consequently, the enforcement powers of the courts have been held to be broad rather than restrictive. This stance is deemed necessary to ensure the investor's right to an informed appraisal of corporate action.

Although the proxy regulations apply with few exceptions to every solicitation of a proxy, protection of investors' appraisal rights is of particular importance in the case of parent-subsidiary mergers. While negotiation

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3 Id. For the purposes of the proxy regulations, "proxy" includes a consent or authorization. Id., § 240.14a-1(d). The regulations define "solicitation" as any request for a proxy, request for action on a proxy, or other communication calculated to result in the same. Id. § 240.14a-1(f). In substance, the proxy regulations require a schedule of information to be furnished to security holders. Id. §§ 240.14a-3, .14a-101, in a clear presentation. Id. § 240.14a-5. In addition, the regulations prohibit statements 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.
5 Id. at 432-34. The securities legislation was enacted for remedial rather than technical purposes and thus should be construed "flexibly to effectuate its remedial purposes." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); see, e.g., Pierre J. LeLandais & Co. v. MDS-Atron, Inc., 543 F.2d 421, 423-24 (2d Cir. 1976), cert. denied, 97 S. Ct. 786 (1977); Myzel v. Fields, 386 F.2d 718, 748-49 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). Thus, in 1964, the Supreme Court held that a private action was appropriate in the case of a proxy violation, J. I. Case Co. v. Borak, 377 U.S. 426, 432-33 (1964), and in 1970 held that the defrauded shareholder need not prove reliance on a material defect of a proxy statement to establish his cause of action. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970).
7 Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 HARV. L. REV. 297, 301 (1974) [hereinafter cited as Brudney & Chirelstein]. Although Brudney and Chirelstein recognize the importance of adequate disclosure in mergers between parent and subsidiary corporations, those authors have little confidence in the ability of the disclosure requirements alone to protect the rights of minority shareholders adequately. Id. at 301-03. They would prefer a substantive rather than procedural standard of conduct in parent-subsidiary mergers to protect minority shareholder interests. Id. at 313-25.
of merger terms in non parent-subsidiary mergers is adversary in nature, a parent corporation often controls its subsidiary's management. Such control necessarily precludes adversary negotiation, and may result in merger terms that operate to the detriment of the subsidiary's minority shareholders. Consequently, adequate disclosure is necessary so that shareholders may analyze the transaction with the additional caution that parent-subsidiary mergers warrant. Since the proxy information often will be issued by the subsidiary's management, the parent corporation may cause a deceptive proxy statement to be issued, thereby depriving the minority shareholders of their right to informed appraisal of the transaction. The significance of parent-subsidiary mergers, therefore, is that

See Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 n.6 (1970); text accompanying notes 55-64 infra.

Brudney & Chirelstein, supra note 7, at 297-98. When a parent corporation acquires the majority or a substantial amount of another corporation's stock, that parent corporation often will establish a parent-subsidiary relationship. By election of common or dummy directors to the board of directors of the subsidiary corporation, the parent may exercise some degree of control over the subsidiary and its operation and, thus, exercise greater control of the investment. Id. at 297. Occasionally, the parent will acquire ownership or control of another corporation's stock only as a transitory step to merger. In such cases, the acquiring corporation will obtain either through tender offers or on the market, only the amount of stock that is necessary to ensure shareholder ratification of the merger. There often is neither the time nor necessity to create a parent-subsidiary relationship through the election process. Thus, merger negotiations in these "two-step" mergers are at arms length and do not pose the identical problem as arises in true parent-subsidiary mergers. Id. at 346. Two-step mergers, however, raise questions concerning the acquisition of the controlling shares, but such questions lie outside the scope of the proxy regulations. Id. at 330-46.

See Id. at 298; Mills v. Electric Auto-Lite Co., 403 F.2d 429, 434 (7th Cir. 1968), rev'd on other grounds, 396 U.S. 375 (1970).

Brudney & Chirelstein, supra note 7, at 298. The parent-subsidiary relationship illustrates a classic self dealing problem. Id. The parent must balance the often competing interests of its own shareholders against the fiduciary duty owed the public shareholders of the subsidiary. Since parent corporations often perceive a primary loyalty to their own shareholders, the interests of such shareholders may be furthered to the exclusion or detriment of minority shareholder interests. Id.

Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 n.6 (1970). One of the most serious proxy defects is an omission to disclose to shareholders the close relationship between corporations. Id. The result of such deception is that the shareholders may rely on the recommendations of their management as objective. Id. If this relationship were known, the shareholders might subject the transaction to higher scrutiny. Id. Regardless of whether that transaction would or would not be approved under this scrutiny, failure to disclose the relationship defeats "the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions." Id. at 385, and is, as a matter of law, a material violation of the proxy regulations. Mills v. Electric Auto-Lite Co., 403 F.2d 429, 435 (7th Cir. 1968). See also Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1330-31 (7th Cir. 1969).

Brudney & Chirelstein, supra note 7, at 300. The investor's right to informed appraisal of corporate transactions, as distinguished from statutory appraisal remedies, is derived from congressional policy of ensuring the investor an informed choice whenever proxy statements are involved. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970). This right should not in any way be limited by the number or scope of choices available to the investor. See, id. at 384 n.6. Such choices will depend on the circumstances of each transaction, state statutes
such transactions may vest in the parent corporation an incentive to circumvent informed minority shareholder appraisal, coupled with the capacity to attain that end.\textsuperscript{14} Thus, the very nature of the parent-subsidary relationship renders such mergers suspect and enforcement of the proxy regulations critical.\textsuperscript{15}

Clearly, the remedy for a proxy violation must effectuate the legislative requirement of adequate disclosure.\textsuperscript{16} Prospective relief often is available

and the corporate charters involved. Thus, in the case of parent-subsidary mergers, if shareholder ratification is required by statute or charter, the minority shareholders are entitled to the protection of the proxy regulations. This protection is not necessarily extinguished when the parent corporation's subsidiary holdings alone are sufficient to effect ratification. \textit{id.} at 385 n.7; see e.g., \textit{ILL. ANN. STAT.} ch. 32, § 157.64 (1954) (Smith-Hurd). When, however, the parent holds a large majority of the stock of its subsidiary, generally over 90%, unless the particular corporate charter requires otherwise, a short form merger statute may enable the parent to avoid ratification, proxy statements and, thereby, the proxy regulations. \textit{See, e.g., \textit{ILL. ANN. STAT.} ch. 32, § 157.66a (Supp. 1977) (Smith-Hurd).} Investor options and consequently the need for adequate disclosure are not limited to the possibility of ratifying or rejecting a corporate action. The shareholder may have the opportunity to sell his shares on the market, \textit{Brudney, A NOTE ON GOING PRIVATE, 61 VA. L. REV. 1019, 1039 n.69 (1975) [hereinafter cited as Brudney]}, or seek the statutory appraisal remedy. \textit{See, e.g., \textit{DEL. CODE ANN. titl. 8, § 262 (a-f) (1974).} Statutory appraisal remedies provide the dissenting shareholder an independent appraisal of the value of his stock. \textit{Brudney \& Chirelstein, supra note 7, at 304-06.} The corporation then will be required to purchase such stock at the appraised value. \textit{Id.} If a number of shareholders elect the statutory appraisal remedy, the forced acquisition may weaken severely the corporation's liquidity. Thus, the mere threat of such action may inspire settlement between the corporation and its shareholders. \textit{Id. Appraisal, however, is not an actual remedy, as there is no requirement of an injury. Rather, appraisal is a corporate peace-keeping measure designed to balance the possibilities of minority harassment against parent overreaching. \textit{Vorenberg, Exclusiveness of the Dissenting Stockholder's Appraisal Right, 77 HARV. L. REV. 1189, 1216-17 (1964).} Thus, in the case of a parent-subsidary merger, appraisal does not provide the dissenting minority shareholder with any portion of the gain which results from that transaction. \textit{Brudney \& Chirelstein, supra note 7, at 305. Moreover, the appraisal statutes often will further limit the scope of recovery available to the dissenting minority shareholder. \textit{See, e.g., \textit{DEL. CODE ANN. titl. 8, § 262(k) (1974).} Yet when the minority shareholders have no options with regard to the proposed corporate action, the requirement for complete and accurate disclosure may prevent blatant mistreatment of such shareholders by exposing corporate activity to public scrutiny. \textit{Brudney \& Chirelstein, supra note 7, at 301.}}
to preserve the investor's right to informed appraisal of the particular corporate action. When the defects in a proxy statement are discovered before consummation of the transaction for which proxies were sought, the courts may enjoin use of the defective statement as well as any proxies already obtained. Since an injunction may require correction of the statement defects as a prerequisite to further solicitation, this prospective enforcement of the proxy regulations safeguards the investor appraisal right.  

When the proxy statement defects are discovered after the transaction has been effected, however, retrospective action is necessary to remedy the loss of the investor appraisal right. One form of retrospective relief is rescission of the transaction that was the subject of the defective statement. Rescission returns the parties to the transaction to their original positions. Again, rescission forewarns the issuer that adequate disclosure is required for resolicitation. Rescission often is inappropriate, however, due to conditions both of logistics and equity. In such cases, there is no method of returning the risk of uncertainty as to the amount of damages should fall on the wrongdoer. Gould v. American-Hawaiian S.S. Co., 555 F.2d 761, 782-84 (3d Cir. 1976). When the fiduciary expressly states a price is fair, courts may impose a higher duty to disclose, thereby lessening the degree of proof necessary to establish a proxy violation. Tanzer v. Haynie, 405 F. Supp. 650, 654 (S.D.N.Y. 1976). Furthermore, even the attorney-client privilege may be set aside to allow discovery of information pertaining to the fairness of the transaction. Valente v. PepsiCo, Inc., 68 F.R.D. 366-70 (D. Del. 1975). While the outcome of such flexibility may appear draconian when the inadequacy in a proxy statement is more a failure of articulation than an attempt to deceive, Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1304 (2d Cir. 1973), motive is unimportant under the proxy regulations, Myzel v. Fields, 386 F.2d 718, 748 (8th Cir. 1977). Moreover, since a proxy statement misrepresentation or omission which does not have a sufficient propensity to induce uninformed investor appraisal is not a material violation of the proxy regulations and as such is not actionable, material violations and the resultant injuries should be corrected regardless of why the violations occurred. See Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970).
parties to the status quo ante and providing the investor an informed reassessment of the corporate action. Thus, the retrospective remedy for loss of the investor's appraisal right and, consequently, enforcement of the disclosure requirements often will be limited to monetary relief. Since the courts usually cannot predict what assessment the investor would have made had there been no deception, or, for example, what merger terms the shareholder would accept under the true state of facts, the investor appraisal right cannot be valued monetarily. The relief awarded the defrauded investor, then, must be premised on other considerations.

In any action for monetary relief from a proxy violation, the courts necessarily must shift their analyses from the conceptual injury, loss of the investor appraisal right, to the more tangible effects or manifestations of that injury. Clearly, the primary effect of the violation is that the transaction occurred. While rescission of the entire transaction may not be appropriate, the courts can correct certain manifestations of that transaction to remedy injury to the defrauded investor or to effectuate the disclosure requirements of the proxy regulations. For example, the courts could

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24 Mills v. Electric Auto-Lite Co., 396 U.S. 375, 387 (1970). Moreover, since in the case of a parent-subsidiary merger, the parties to that transaction are the two corporations, id. at 388, the injury, and thus the right to rescind the transaction, vests in the corporation and not the shareholders. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). The defrauded shareholder might have the right to rescind his own proxies under § 29(b). Mills v. Electric Auto-Lite Co., 396 U.S. 375, 388 n.11 (1970). The right to bring a derivative action in the name of the defrauded corporation, however, is limited in that rescission will be granted only if it is in the best interest of the shareholders as a whole, presumably including the parent corporation as shareholder. Id. at 388. Rescission in parent-subsidiary mergers, then, is outside the scope of § 29(b), and will be granted only "if a court of equity concludes, from all the circumstances, that it would be equitable to do so." Id. Thus, there is no requirement that a court "unscramble a corporate transaction merely because a violation occurred." Mills v. Electric Auto-Lite Co., 403 F.2d 429, 436 (7th Cir. 1968). In Basch v. Talley Indus., Inc., 53 F.R.D. 9 (S.D.N.Y. 1971), decided under Delaware law, the court further reduced this right by ruling that once two corporations have merged, the injured corporation and derivative, the corporation's premerger shareholders could no longer sue to rescind the merger as a unity of interest arose after the merger. Id. at 11-12. But see Miller v. Steinbach, 268 F. Supp. 255 (S.D.N.Y. 1967) (decided under Pennsylvania law). In Basch, the court did allow the shareholders of the defrauded corporation to maintain a class action for rescission, but refused to grant that remedy since the merger involved thousands of shareholders, millions of outstanding shares, and innumerable transactions involving sales of that stock to good faith purchasers during the year between merger and suit. 53 F.R.D. at 12.

25 Id. at 388 n.5. Since investors may not always premise their investment decisions on the adequacy of the acquisition price of a merger, accurate reconstruction of the investor's decision is impossible. Id. An exception arises when the proxy misstatement occurs in the merger terms. In those cases, the remedy afforded the defrauded minority shareholders is an accounting to ensure that such shareholders received the amount represented by the merger terms. Id. at 388.

26 Id. at 388-89.

27 Id.

28 See note 23 supra; note 82 infra.

award the injured investor the measure of his actual damages,\(^3\) or the sum of profits that accrue to the issuer of the defective proxy statement.\(^3\)

Clearly, monetary remedy for a proxy violation should act to safeguard the investor appraisal right, as do the remedies of injunction and rescission.\(^2\) When faced with a claim for monetary relief, the court must make

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\(^3\) Id. at 389. In Mills, the Supreme Court suggested that damages may be awarded to defrauded minority shareholders to compensate for the reduced earnings potential of their holdings or to remedy the unfairness of the merger terms. Id. The Court, however, did caution that "damages should be recoverable only to the extent that they can be shown." Id. In Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir.), cert. denied, 408 U.S. 922 (1972), the Seventh Circuit interpreted this statement to mean that damages may be awarded on a showing that the shareholders would have been better off without the merger, or that such shareholders could have received a better exchange rate. Id. at 31. These possibilities, however, were "not intended to exclude others." Mills v. Electric Auto-Lite Co., 396 U.S. 375, 389 (1970); see note 16 supra.  

\(^2\) Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972). Section 28 of the Securities Exchange Act, provides that the rights and remedies available under the act are in addition to any other rights and remedies, except that there may be no award for damages in excess of the actual damages suffered. 15 U.S.C. § 78bb(a) (1970). In 1975, however, the Supreme Court held that damages allowable under § 28 are to be measured by the greater of the difference between the fair value of what the injured party received for his property and the fair value of what should have been received absent the fraud, or the wrongdoer's profits. 406 U.S. at 155. The first alternative, plaintiff's actual damages, is the traditional remedy available to the defrauded buyer of property. See Myzel v. Fields, 386 F.2d 718, 748 (8th Cir. 1977), cert. denied, 399 U.S. 951 (1969). The disgorging of defendant's profit rationale, known as the "Janigan theory," was recognized in the context of the proxy regulations in Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1304 (2d Cir. 1973). While in the "buyer" cases, damages should not include "the expected fruits of an unrealized speculation," Sigafus v. Porter, 179 U.S. 116, 125 (1900); see Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971); Estate Counseling Serv. Inc. v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962); Kohler v. Kohler Co., 208 F. Supp. 609, 625-26 (E.D. Wis. 1962), aff'd, 319 F.2d 634 (7th Cir. 1963), the profits of a defendant who fraudulently induced another to sell his property "are subject to another factor, viz; that they accrued to the fraudulent party." Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965) cert. denied, 382 U.S. 979 (1965). Thus, equity demands that the defrauded party be awarded such profits rather than let the wrongdoer keep them and thereby affirm him actions. See Falk v. Hoffman, 233 N.Y. 105, 135 N.E. 243 (1922); People v. Schmidt, 216 N.Y. 324, 341, 110 N.E. 454, 460 (1915); Rice v. Price, 340 Mass. 502, 164 N.E.2d 891, 894-96 (1960); 15 U.S.C. § 78aa (1970); 3 L. Loss, SECURITIES REGULATIONS 1793-94 (2d ed. 1961); 4 A. Scott, THE LAW OF TRUSTS §§ 507, 508, 508.1 (3d ed. 1967); RESTATEMENT OF RESTITUTION § 151, 202, Comments b,c (1937); RESTATEMENT (SECOND) OF TORTS § 549 (1977). The Janigan theory is limited in that the wrongdoer must have acquired the property by fraud, his profits must have been a proximate consequence of that fraud, and those profits must not be more directly attributable to the wrongdoer's talents than to the value of the fraudulently acquired property. For example, if an artist were to acquire paint and canvas fraudulently, the seller of that property could not claim the resulting masterpiece. Janigan v. Taylor, 344 F.2d 781, 786-87 (1st Cir. 1965). In addition, there may be a requirement that the profits were realized. Id. at 786. But see Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1305 (2d Cir. 1973) (defendant required to account for unrealized increase in stock value).  

\(^3\) J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964). In Borak the Supreme Court held that the courts have a duty "to be alert to provide such remedies as are necessary to make effective the congressional purpose." Id. Moreover, the court held that the creation of a federally protected right carries with that creation the power to enforce the right and the power to enforce further implies the power to grant any necessary remedy. Id. at 433-35. One problem
several elections upon which the existence and amount of an award will depend. First, the court must decide which effects or manifestations of the transaction are to be examined. Second, these manifestations and their degree must be ascertained. For example, if a court decides to premise any award to the defrauded investor on the difference between the premerger and postmerger values of the investor's corporation, the court must value the corporation before and after the merger to ascertain the occurrence and amount of any change in value. There are many approaches which may be taken in these elections. The courts, however, must act flexibly in order to ensure that monetary remedies for proxy violations effectuate the disclosure requirements of the securities legislation.

In no case is the need for remedial flexibility more apparent than in the case of parent-subsidiary mergers. Since the determination of corporate value, particularly for the purposes of a merger, is more a subjective analysis of intangibles than an objective fact, remedial flexibility should extend to this valuation process. The complexity of corporate valuation for mergers is illustrated best by merger negotiations between unaffiliated corporations.

In its simplest form, a merger is a transaction through which one corporation is absorbed into another. When two previously unaffiliated corpo-

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the courts face when granting remedy of a proxy violation is that such remedies more often will emphasize the fairness of the transaction than the proxy violation. Yet fairness should not be a complete defense to a proxy violation. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381-83 (1970). While unfairness of the transaction may be an important factor on which to base a damages award, id. at 386, fairness is excluded as a complete defense to a material proxy violation for several reasons. First, "outrageous misrepresentations in a proxy solicitation" not relating to the terms of the transaction, would not give rise to a cause of action under § 14(a). Id. at 382. Consequently, permitting fairness as a defense "would subvert the congressional purpose of ensuring full and fair disclosure to shareholders." Id. Second, the risk that shareholders would not be able to rebut the corporation's evidence of fairness would discourage shareholder suits, and thus, hinder a necessary supplement to SEC enforcement of the proxy regulations. Id. Third, since fairness does not give rise to a cause of action under the proxy regulations, a showing of fairness should not act as a defense to an established violation. See Scott v. Multi-Amp Corp., 386 F. Supp. 44, 65 (D.N.J. 1974). Moreover, in Santa Fe Indus., Inc. v. Green, 97 S. Ct. 1292 (1977), the Supreme Court held that the unfairness of a merger as evidenced by the inadequacy of the price afforded minority shareholders or the profits accrued to the wrongdoer does not give rise to an independent cause of action under federal law. Id. at 1303-04. Such conditions are actionable in federal court only when they occur ancillary to the violation of a federally protected right. Id.

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See text accompanying notes 84-120 infra.


See notes 30-31 supra; see text accompanying notes 43-54, 84-149 infra.

See note 16 supra.

See text accompanying notes 6-15 supra.


Fillman, Cash and Property as Consideration in a Merger or Consolidation, 62 Nw. U.L. Rev. 837 (1968) [hereinafter cited as Fillman].
rations merge, the initial step in the merger process is negotiation of the merger terms by the managements of the respective corporations. These terms then are submitted to the shareholders of the corporations in proxy statements which also will contain other information pertinent to the transaction. The shareholders then return proxies through which they give authorization for their votes to be cast on their behalf.

The negotiation process through which the merger terms are established necessarily involves valuation of the respective corporations. Resolution of these valuation questions determines the acquisition price of the merger. The market price of each corporation's stock is the initial consideration in this valuation process. If a corporation's stock is traded actively on the market, the price of the corporation's shares may be seen as the appraisal of that corporation's present value by the stock market. In addition to market price, the parties to a merger also will consider such factors as dividend ratios, earnings to price ratios, future earnings estimates, book values and asset values in arriving at the merger terms.

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40 Brudney & Chirelstein, supra note 7, at 298.

41 Id. at 300; see note 3 supra. The general disclosure requirements of the proxy regulations are supplemented by specific requirements in certain cases. Thus, in the cases of mergers or consolidations as well as certain acquisitions and sales, the solicitation issuer is required to furnish an explanation of the proposed action, the reasons therefor, and its effects upon existing shareholders. In addition, when the merger or consolidation is other than between parent and its totally owned subsidiary, the issuer must include a description of the business of the merger parties, the location and description of that party's assets, a description of the economic status of that party, and a description of that corporation's capital structure, the corporation's recent earnings and its dividends history. 17 C.F.R. § 240.14(a)-101 (1977). Furthermore, when the merger or consolidation occurs in such fashion as results in a change of directors of the acquiring firm, the issuer may be required to provide further information pertaining to the election of such directors. Id. § 240.14(a)-101 n.A (1977).

42 Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381 (1970); see note 13 supra. Under Illinois law, a merger or consolidation requires the affirmative vote of 2/3 of the outstanding shares entitled to vote. If one or more classes of stock are entitled to vote as a class, the merger requires the affirmative vote of 2/3 of both the class and the shares as a whole. ILL. ANN. STAT. ch. 32, § 157.64 (1954) (Smith-Hurd).

43 HELFERT, supra note 38, at 106.

44 The complexity of the valuation process is conditioned on the nature of the particular merger or consolidation. In a merger when one corporation pays cash for the merger partner's outstanding shares, there is generally only a valuation of the acquired corporation. When the acquired corporation's shareholders receive stock or debt of the acquirer, however, those considerations also must be valued. When two corporations join in a newly created third corporation, the transaction is further complicated. In consolidations, not only must the two pre-consolidation corporations be valued, but also the value of the stocks or debt issued by the consolidated entity must be ascertained. See text accompanying notes 83-120 infra. In addition, the valuation process may be complicated by an expectation of synergy. See text accompanying notes 49-54 infra.

45 CHOKA, supra note 34, at 67.


47 CHOKA, supra note 34, at 51-65, 67; accord, Batkin & Macauley, Valuation for Mergers.
These factors may disclose a discrepancy between the stock market appraisal of value and a corporation's actual present value.\(^4\)

Factors other than market price also may serve to establish the "merger value" of a corporation.\(^5\) The merger value is the special value of that particular corporation to the proposed merged operation.\(^6\) The decision of two nonaffiliated corporations to merge their operations often is premised on the expectation of a higher return on capital for the resulting combined enterprise and, consequently, a higher value for that enterprise than the aggregate value of the individual premerger corporations.\(^7\) This increment in value, called "synergism," may be attributable to reduced competition, economies of scale, shifting of assets, or a shift in stock market activity.\(^8\) Because synergism is a function of the merger, and as a general rule results from factors that may not be present in independent operation,\(^9\) the premerger market price of a corporation's stock will not reflect this expectation. Therefore, merger value for the purpose of mergers between nonaffiliated corporations must include the expectation of the amount and rela-

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\(^{4}\) Choka, supra note 34, at 67-68; May, Value Approaches to Investment Decisions, in Readings in Investment 239 (1985) [hereinafter cited as May]. The value of a business in the context of its present operation is the "going concern value." This valuation should be based primarily on the present and prospective earnings that the corporation could derive from the use of its assets. Central States Elec. Corp. v. Austrian, 183 F.2d 879, 884 (4th Cir. 1950); Choka, supra note 34, at 51. Market price, however, does not always reflect this intrinsic value. 2 J. Bonbright, The Valuation of Property 824 (1937) [hereinafter cited as Bonbright]; Brudney, supra note 12, at 1038 n.69. Moreover, the market value of a stock is not necessarily related to the asset value of the corporation. United States v. Burrell, 505 F.2d 904, 910 (5th Cir. 1974). Since the nature of mergers precludes valuation with mathematical precision, Ahlenius v. Bunn & Humphreys, Inc., 358 Ill. 155, 192 N.E. 824, 829 (1934); market price should not be considered the sole indicator of corporate value. Bastian v. Bourne, Inc., 256 A.2d 680, 683 (Del. Ch. 1969).


\(^{6}\) Brudney & Chirelstein, supra note 7, at 308. Whereas the "going concern value" measures the value of the corporation based on the predictable future earnings of that business in the context of its present operation, see note 48 supra, "merger value" incorporates the future earnings derivable from the utilization of the business assets in the radically different context of the merged entity. See A. Dewing, Financial Policy of Corporations 306-07 (1953) [hereinafter cited as Dewing]. Since the context in which the assets will be used varies from one transaction to the next, the expected earnings and thus the merger value of a corporation will vary for each proposed merger. See Stella v. Graham-Paige Motors Corp., 255 F.2d 476, 478 (2d Cir. 1958).

\(^{7}\) R. Brealey, Security Prices in a Competitive Market 49 (1971) [hereinafter cited as Brealey]; Brudney & Chirelstein, supra note 7, at 308.

\(^{8}\) Brealey, supra note 51, at 49.

\(^{9}\) Whitman, supra note 49, at 46. In the case of parent-subsidiary mergers, many economies of scale which result in synergism may be realized in the parent-subsidiary relationship. To the degree that such economies may not exist absent total unity, there is the possibility of synergism in parent-subsidiary mergers. Brudney & Chirelstein, supra note 7, at 308; see Lintner, Expectations, Mergers and Equilibrium in Purely Competitive Securities Market, 61 Am. Econ. Rev. 101 (1971).
tive contribution to the synergism created by the particular merger.°

Resolution of these conflicting indicators of value is analogous to a "horse trade." Each party attempts to establish the highest value for his corporation inferrable from the evidence while attempting to undervalue the other corporation. Relative bargaining strength is the final arbitrator in this process. Many factors, however, can offset the usually stronger financial position of the acquiring firm. First, the board of directors of the acquired corporation, in effect, may veto any outrageous offer. Second, the offer must be attractive enough to draw shareholder support sufficient for ratification. Finally, the initial merger offer either may initiate competing bids from other corporations, or cause the management of the acquired firm to solicits offers. The effect of these factors is to increase the merger price of acquisition. In most instances, therefore, the acquiring corporation is compelled to pay a substantial premium over the market price of the acquired corporation's stock.

In the parent-subsidiary context, however, many of the forces that play a role in the negotiation of merger terms are not present. A parent-subsidiary relationship is created when one corporation acquires a majority interest in another corporation. This relationship often includes control of the subsidiary's directors. Thus, when a parent and subsidiary corporation merge, the parent corporation may sit on both sides of the bargaining

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5 See Brudney & Chirelstein, supra note 7, at 309-313.
6 CHOKA, supra note 34, at 72.
7 Id. at 67-68.
8 BONBRIGHT, supra note 48, at 817.
9 Id.
10 See Brudney & Chirelstein, supra note 7, at 301-02. But see id. at 302 n.12. The virtually total control that corporate management maintains over the proxy machinery skews shareholder appraisal in favor of managerial recommendations. Id. at 300. Since management has unlimited access to the corporate proxy machinery, they may couch their solicitations and recommendations in such terms that shareholder approval or rejection practically is assured. Id. at 301-04. Moreover, since there is no strong requirement for disclosure of offers to the shareholders, corporate management may, in effect, discard options which it does not favor. Id. at 301-02.
11 Id. at 300; see note 42 supra.
12 Id. The offer of one firm to acquire another corporation often illustrates a perceived undervaluation of the target corporation. Since the potential synergism resulting from a merger with the target corporation will vary from one proposed transaction to the next, third corporations often will weigh the potential of a merger with the target firm. See note 50 supra. The resulting competition may lead to a greater acquisition price. See Stella v. Graham-Paige Motors Corp., 259 F.2d 476, 478 (2d Cir. 1958).
14 CHOKA, supra note 34, at 68.
16 Brundey & Chirelstein, supra note 7, at 297.
17 See note 9 supra.
The resulting merger terms may be the product of the parent's unilateral action rather than of arms length negotiation between two self-interested parties. The bargaining position of the minority shareholders of the subsidiary as represented by the subsidiary's management is weakened not only by the loss of a managerial veto at the negotiation stage, but also by the loss of the managerial option to consider or solicit competing offers. If the subsidiary's directors are in fact controlled by the parent, the negotiation of merger terms necessarily must be considered a product of unilateral action and, as such, illustrates a classic self-dealing problem. Although the parent corporation owes a fiduciary duty of fairness to the minority shareholders of its subsidiary, in practice fairness has been held to require only that the merger terms award the subsidiary's minority shareholders the value of their holdings in their premerger corporation, exclusive of any expectation or realization of postmerger gain.

Since the minority shareholders of a subsidiary may not rely on the unbiased judgment of their management, nor on the courts to reconstruct the equivalent of an arms length transaction, these shareholders must rely on their own analysis of the merger terms to protect their interest. The Securities Exchange Act and implementing regulations protect this investor appraisal right by requiring that merger proxy statements disclose all information necessary for an adequate understanding of the transaction, and present this information in an easily understandable manner. When a parent corporation merges with a subsidiary through manipulation of the subsidiary's proxy machinery, the courts must provide a right of recovery to the defrauded minority shareholders. An effective right of recovery is necessary not only to correct the injury to the minority shareholders, but also to enforce the disclosure requirements of the proxy regulations.

The merger of Mergenthaler Linotype Company (Mergenthaler) and its subsidiary, the Electric Auto-Lite Company (Auto-Lite), illustrates the
difficulties inherent in providing an effective right of recovery to the de-
frauded minority shareholders of a subsidiary following a merger and the
concomitant difficulties in enforcing the disclosure requirements of the
proxy regulations. In 1962 Mergenthaler proposed a merger in which a new
corporation, Eltra, would be formed by the exchange of outstanding Auto-
Lite and Mergenthaler shares for Eltra preferred and common stock.77
Auto-Lite management issued a proxy statement recommending that the
terms be ratified. Charging that the proxy statement failed to disclose
adequately the control that Mergenthaler exercised over Auto-Lite's direc-
tors,78 several Auto-Lite minority shareholders challenged the resulting
merger in a derivative action.79

In Mills v. Electric Auto-Lite Co.,80 the courts found that the minority
shareholders had suffered legal injury as a result of the defective merger
proxy statement that violated section 14(a) of the Securities Exchange Act
of 1934.81 Because the passage of time and the intervention of third party
interests precluded rescission of the merger, the minority shareholders
were limited to an action for monetary relief.82

An award of monetary relief requires valuation of the corporations as a
prerequisite to discerning the ancillary effects of the fraud.83 In establishing

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77 Although the Mergenthaler/Auto-Lite transaction is described better as a consolida-
tion than a merger, the principal effects are identical. While a merger results in the absorp-
tion of one corporation into another, a consolidation involves two corporations merging there
identities in a newly created third corporation. Fillman, supra note 39, at 837.
78 See note 12 supra.
79 See note 16 supra.
(7th Cir. 1968), rev'd and remanded, 396 U.S. 375 (1970), No. 63c 113 (N.D. Ill. 1976), rev'd
81 See note 3 supra.
82 396 U.S. at 388. The initial action which arose from the Mergenthaler/Auto-Lite
merger in 1963 in the District Court for the Northern District of Illinois was based on the
failure to disclose clearly the relationship between Mergenthaler and Auto-Lite in the merger
proxy statement. The District Court found that the proxy statement violated §14(a) of the
Securities Exchange Act, 15 U.S.C. §78n(a) (1970), and that the plaintiffs had established
the requisite causal link between that violation and the resulting merger. 281 F. Supp. 826,
829 (N.D. Ill. 1967). The court of appeals reversed the district court's decision on the causa-
tion issue. 403 F.2d 429, 436 (7th Cir. 1968). The Supreme Court reversed the Seventh Circuit,
holding that the statutory requirement that the omission or deception be material in order to
establish a violation precluded the necessity of further proof of causation. 396 U.S. 375,
385 (1970). On remand the district court awarded the defendants partial summary judgment
on the rescission issue. The court held that rescission was an impractical remedy nine years
after the merger transpired. In that time, thousands of persons had traded millions of those
shares involved in the original transaction. The court concluded that it would be inequitable
to require innocent purchasers to return those shares, and almost impossible to trace the
original owners. Moreover, any damages suffered as a result of the proxy violation could be
The district court considered several alternative theories on which the minority shareholders
could base a claim for monetary relief. See 552 F.2d at 1241. The court awarded the minority
shareholders damages in the sum of $1,235,918.35 and $740,000 interest. See id.; note 93 infra.
83 See text accompanying notes 27-31 supra.
these values, the Seventh Circuit held that where the market price of corporate stock accurately reflects value, an analysis of other factors indicative of value is not necessary. The court noted that market price represents the informed appraisal of independent investors of the value of an enterprise and that use of other factors to establish a different value would be economically unsound. Additional factors should be considered only when manipulative activities render the market price unreliable. Since in Mills the minority shareholders were unable to establish manipulation, market price alone served as the basis for all valuations necessary to the court's analysis.

When parents and subsidiaries merge as they did in Mills, however, market price should not be granted so great a presumption of accuracy. Courts should consider other indications of corporate value at least as rebuttal evidence to the presumption that the market price of a corporation's stock accurately measures that corporation's value. The burden of proving market manipulation is often difficult to meet. Moreover, the parent need not manipulate market price to reap the benefit of a divergence between market price and actual present value. The parent simply may instigate the merger at such time as to take advantage of coincidental fluctuations of market price. Since the parent corporation has this control, there should arise the suspicion that market price may not assay present value accurately.

A more fundamental problem with market price valuation is that the
market value of a corporation's stock may not assess accurately that corporation's value for the purposes of a merger. The market, correctly or incorrectly, appraises the value of a corporation in the context of its present operation. The peculiarities of a merger, however, may give rise to operational conditions for the merged entity that create synergism. Since there is no expectation that these synergistic effects may arise in independent operation, the market price of a corporation's stock will not include the expected synergism. Thus, market price will not reflect the possibility of a corporation's higher merger value.

With valuation premised solely on market price, however, the Seventh Circuit in Mills considered which effects of the proxy violation were to be corrected. The court first considered whether a reduction had occurred in the earnings potential in the holdings of the minority shareholders as a result of the merger. This reduction was to be determined through examination of the relative postmerger performances of Auto-Lite and Mergenthaler. If the ratio of Auto-Lite to Mergenthaler earnings per share was excessively high when compared to the relative values of the two stocks under the merger terms, an inference could be drawn that those merger terms undervalued the future earnings potential of the Auto-Lite subsidiary. Such undervaluation would indicate that the acquisition price of Auto-Lite under the merger terms was insufficient.

The postmerger ratio of earnings per share was found to be 4.85/1 over the ten year period following the merger. On the other hand, the ratio of values established by the merger terms, the "effective exchange ratio," was 2.31/1. The court held, however, that a comparison of these figures was

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\[ \text{Earnings per share of Auto-Lite: } 10.57 \text{ (Auto-Lite divisions of Eltra)} \]

\[ \text{Earnings per share of Mergenthaler: } 2.18 \]
valid to determine a reduction in earnings potential only if the Auto-Lite and Mergenthaler operations remained independent after the merger. Since there was considerable evidence that postmerger commingling of assets and economies of scale arose as a result of the merger, the postmerger earnings statistics were held to be unreliable.

While the reduction in earnings potential effect was based on postmerger earnings, the second effect the Mills court considered was based solely on data present at the time of the merger. The court chose to examine whether the price paid the minority shareholders at the time of the merger was unfair. The court sought to discern this effect through a comparison of the premerger and merger term relative values of one share of Auto-Lite to one share of Mergenthaler. Again, if the premerger price ratio was excessively high as compared with the exchange ratio under the merger terms, the price paid the minority shareholders under those terms would be held insufficient.

Based on the average market price of Auto-Lite and Mergenthaler stocks during the six month period preceding the merger, the price ratio or relative premerger value was established as 2.1/1. Since the effective exchange ratio or relative value under the merger terms was established as 2.31/1, based on the average market price of Eltra preferred and Eltra common stock during the one month period following the merger, the price received by the Auto-Lite minority shareholders was more than ade-

\[
\text{Effective Exchange Ratio (E.E.R.)} = \frac{\text{Exchange value of Auto-Lite}}{\text{Exchange value of Mergenthaler}}
\]

\[
E.E.R. = \frac{1.88 \times 31.06}{1 \times 25.25} = \frac{58.39}{25.25} = 2.31/1
\]

\[\text{See note 105 supra.}\]

\[\text{Exchange value of Auto-Lite} \times \text{Market price of Auto-Lite}
\]

\[\text{Exchange value of Mergenthaler} \times \text{Market price of Mergenthaler}
\]

\[\text{Price ratio} = \frac{\$52.25}{\$24.875}
\]

\[\text{Price ratio} = \frac{\text{Market price of Auto-Lite}}{\text{Market price of Mergenthaler}}
\]

\[\text{Market price of Auto-Lite} \times \text{Market price of Auto-Lite}
\]

\[\text{Market price of Mergenthaler} \times \text{Market price of Mergenthaler}
\]

\[\text{See note 105 supra.}\]
The court held, however, that the price ratio-exchange ratio formulation would not indicate fairness adequately unless any synergistic gain created by the merger was considered. Thus, the price received by the minority shareholders would be held inadequate unless such shareholders received not only the value of their premerger holdings, but also a share of the synergistic gain in proportion to their relative contribution to the merger.

The amount of this synergistic gain was held to be the difference between the premerger and postmerger aggregate values of Auto-Lite and Mergenthaler stock based on the market prices of those stocks averaged over the six month period prior to the merger, and Eltra preferred and common stock averaged over the one month period following the merger. The "fair exchange ratio" was held to be 2.16 to 1. Since the merger

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111 552 F.2d at 1249. The "simplest" method of determining the fairness of a merger is a comparison of the price and exchange ratios. Id. at 1248.
Exchange ratio > price ratio = fairness
2.31 >2.1 Id.

112 Id.

113 Id. The circuit court adopted the Brudney & Chirelstein thesis for the sharing of postmerger gains. This thesis is analogous to "the principle which determines the allocation of investment opportunities in the administration of common trust funds." Brudney & Chirelstein, supra note 7, at 320. Their illustration is as follows:
A trustee manages an account for the benefit of X valued at $100 and an account for the benefit of Y valued at $50. By joining the accounts into a single administrative unit a savings of $10 may be effected. Fairness dictates that such savings be shared between the parties in proportion to the values of their accounts.
X + Y = $150
$10 represents a gain of 6.67% on 150.

Thus each beneficiary receives a 6.67% gain in the value of his account or X receives $6.67 and Y receives $3.33. Id. at 319-20.

117 552 F.2d at 1248. The Seventh Circuit held the amount of synergism created by the Auto-Lite-Mergenthaler merger to be the difference between premerger and postmerger values of the combined corporations. Premerger values:

Auto-Lite = Market price per share x no. minority shares
       = $52.25 x 532,500 = $27,825,737
Mergenthaler = Market price per share x no. shares
               = $24.875 x 2,698,822 = $67,133,197
Aggregate Premerger value = $94,958,934

Postmerger values:
Eltra preferred = exchange value Auto-Lite x no. minority shares
                 = $58.39 x 532,500 = $31,095,594
Eltra common = exchange value Mergenthaler x no. shares
              = $25.25 x 2,698,822 = $68,145,255
Aggregate Postmerger value = $99,240,849
Synergism = $99,240,849 — $94,958,934 = $4,281,915

118 Id. at 1249. The fair exchange ratio is that distribution which allows the minority shareholders the value of their premerger holdings and a proportionate amount of the gain resulting from the merger. Id. at 1248. Since Auto-Lite contributed $27,825,737 or 29.3% of the $94,958,934 aggregate premerger value, the fair exchange value of all Auto-Lite minority shares was:
terms provided an exchange ratio of 2.31 to 1,\(^{119}\) the price paid the minority shareholders was held to be adequate and the dictates of fairness satisfied.\(^{120}\)

The court's fairness analysis raises several questions. First, comparison of the price ratio to the exchange ratio measures relative values rather than the actual value received. Thus, in certain circumstances the minority shareholders may not receive even the equivalent value of their premerger holdings.\(^{121}\) If the merger were to result in a loss and the minority shareholders suffer a loss in a proportion equal to or less than the parent corporation, the comparison of premerger to postmerger relative values still would indicate a fair transaction.\(^{122}\)

\[
\text{Fair exchange value of all Auto-Lite minority shares} \div \text{exchange value of Mergenthaler} = 2.16/1
\]

\[
\text{Aggregate post merger value} - \text{fair exchange value of all Auto-Lite shares} = 70,160,511
\]

The fair exchange value of one share of Mergenthaler must be adjusted accordingly to 25.996.

\[
\text{Fair exchange value of one share of Mergenthaler} = \frac{25,996}{532,550}
\]

The fair exchange ratio, which includes a proportionate sharing of the merger synergisms, by definition must equal the ratio of premerger values, or in this case the "price ratio." \(^{119}\) See Brudney & Chirelstein, supra note 7, at 320. Although the court's error proved to be harmless, see text accompanying note 21 infra, the Seventh Circuit was a victim of the same "circular reasoning" as it noted in the district court's fairness analysis. See 552 F.2d at 1244 n.6.

\[^{119}\] Id. at 1242. See note 105 supra.

\[^{120}\] 552 F.2d at 1249.

\[^{121}\] See notes 105, 112, 114 supra.

\[^{122}\] Consider the following example:

\[A = 9, B = 6 \text{ Total Value} = 15\]

\[A' = 6, B' = 3 \text{ Total Value} = 9\]

\[
\text{Price ratio} = \frac{A}{B} = 1.5/1
\]

\[
\text{Exchange ratio} = \frac{A'}{B'} = 2/1 > 1.5/1
\]

Thus, the merger seems to be fair. In a simple fairness context the Brudney and Chirelstein thesis would be of no assistance. To award minority shareholders the benefits of a transaction while burdening such shareholders with none of the risks of the transaction would be inequitable. In the context of a proxy violation, however, a court might award some measure
Furthermore, the court used the same market prices to establish the amount of synergism as were used in establishing the price and exchange ratios. The exchange ratio incorporated the amount of the synergistic gain, and the comparison of the price and exchange ratios already reflected the distribution of that gain. Since synergism was measured by the same market prices used to establish the price and exchange ratios, the court’s further examination of that gain was unnecessary. An effective sharing of postmerger gains necessitates isolation of that gain based on postmerger data. Since the fairness analysis as applied by the court is intended to exclude postmerger performance data, the sharing of postmerger gain is both inappropriate and impossible.

The most serious problem with the Mills court’s fairness analysis also applies to the court’s reduction in earnings potential analysis. Both monetary relief theories may be ineffective in remedying the injury suffered by the minority shareholders. Since both approaches attempt to correct any unfairness of the merger transaction as evidenced by an inadequate acquisi-

of actual damages based on A’s out-of-pocket loss, see note 28 supra, or the difference in value between A and A’ premised on the theory that B’s fraudulent conduct deprived A of his appraisal right. See Swanson v. American Consumers Indus., Inc., 475 F.2d 516, 521 (7th Cir. 1973). Moreover, these remedies will not suffice when market price incorrectly measures the actual values of corporations. Consider the following example: A has an actual value of 30, but a market price of 20. B has an actual value and market price of 50. If A and B merge and value is premised on market price, A loses 10.

If a Brudney & Chirelstein analysis is applied, and the postmerger market perceives the initial undervaluation as synergy, A still loses.

Premerger value of A + B = 70
Postmerger value of A + B = 80

Under the sharing thesis A should receive 20 + (2/7 x 10) = 22.85. Since the initial undervaluation is incorporated in the proportion of A’s contribution to premerger value (2/7), A’s loss increases under the Brudney & Chirelstein thesis with the occurrence of actual as well as perceived synergy.

70 (premerger A + B) + 10 (initial undervaluation perceived as synergy) + 20 (actual synergy) = 100. A, then, receives 20 + (2/7 x 30) = 28.57. Were there no initial undervaluation, however, A would receive 30 + (3/5 x 20) = 37.5. Thus, when there is no actual synergy, A loses 30 - 22.85 = 7.15. With an increment of actual synergy, however, A loses 37.5 - 28.57 or 8.93. Remedies based on the adequacy of a merger acquisition price simply will not correct any deficiencies in the valuation process. See Brudney & Chirelstein, supra note 7, at 345-46.

See notes 105, 112 supra.

See note 105 supra.

See note 118 supra. Since the exchange ratio in Mills was computed on postmerger stock prices, comparison of that exchange ratio to the premerger price ratio essentially incorporated, as self executing, the Brudney & Chirelstein fairness test. See Brudney & Chirelstein, supra note 7, at 310 n.36.

Id. at 308.

552 F.2d at 1241. Although Brudney and Chirelstein noted that their sharing formula presented no significantly greater problems in implementation than other remedies, Brudney & Chirelstein, supra note 7, at 323, others have argued that difficulty in isolating the synergistic element limited the sharing thesis to prospective application, Chirelstein, Sargeant & Lipton, supra note 72, at 280-90.

See text accompanying notes 99-120 supra.
ination price," fairness of the transaction as evidenced by an adequate price is a complete defense to the original proxy violation. Yet courts have held that fairness may not stand as a complete defense to a proxy violation. In addition, the fairness and reduction in earnings potential methods may confront the plaintiff minority shareholders with burdens of proof they are not able to meet. The resulting ineffectual remedy seems "to insulate from private redress an entire category of proxy violations. . . ."

The effects of a merger are not limited to the harm suffered by the plaintiffs. Since a remedy based on the inadequacy of the price appears to be ineffective in the Mills context, courts should look to other possibilities. Such effects may include the benefits the wrongdoer receives as a result of his illegality. This changed focus is necessary for several reasons. First, the loss of an effective appraisal right by the minority shareholders may be seen as the gain of the fraudulent party. Second, and more importantly, allowing the wrongdoer to retain the fruits of his illegality affirms the wrong and defeats the preventive purpose of the proxy regulations. Consequently, such effects of the merger should be excised.

The Mills court did discuss several cases requiring that a wrongdoer disgorge the profits proximately resulting from his fraudulent conduct. Whether such profits were foreseeable or speculative was held to be unimportant in cases in which a party had been induced through fraud to dispose of his property. Courts will award the defrauded party a windfall rather than allow the wrongdoer to retain the fruits of his illegality. The Seventh Circuit, however, rejected the contention of the minority shareholders that the measure of the wrongdoer’s profits should be the sum of assets siphoned off the Auto-Lite subsidiary.

The court’s analysis should not have ended at that point. Both the earnings potential reduction theory and the fairness theory should have been examined from the perspective of the wrongdoer. A reasonable inference could be drawn from the postmerger earnings-per-share ratio that profit from the merger had been realized. Whether this profit resulted

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1. Id.
3. 396 U.S. at 382; see Brudney & Chirelstein, supra note 7, at 309 n.34.
4. 396 U.S. at 382.
5. See note 31 supra.
6. Id.
7. See text accompanying notes 16-32 supra.
8. 552 F.2d at 1242-43.
10. See note 31 supra.
11. 552 F.2d at 1243.
from commingling should not be important. Furthermore, whether those profits were foreseeable is irrelevant when the analysis shifts from the plaintiff's damages to the defendant's profits. If the minority shareholders did not receive this profit, it must have accrued to the wrongdoer, and he should be made to disgorge this gain as the fruits of the fraudulently effected merger.

By the same reasoning, the methodology of the court's fairness analysis could have been used to determine the effect of the merger on Mergenthaler. Since the shares of the wrongdoer corporation increased in value as a result of the merger, that increment in value should be excised and awarded the minority shareholders. Moreover, since the disgorging remedy principally is intended to deprive the wrongdoer of his profits, the gain realized by the minority shareholders through the fraudulently induced merger should be irrelevant.

Although excessive application of this remedy in a case such as Mills clearly works a hardship on the shareholders of the parent corporation, reasonable application of this remedial device may be necessary to provide not only an effective remedy for loss of the investor appraisal right, but also a means to ensure further compliance with the proxy regulation disclosure requirements. A remedy based solely on the inadequacy of the price afforded the minority shareholders may be insufficient for such purposes. First, the injury that the minority has suffered is not unfair treatment under the merger terms, but rather is deprivation of the right to decide whether those terms are sufficiently fair. Second, there may be unusual difficulties in rebutting the defendant corporation's evidence and proving damages. Finally, if a corporation may violate the proxy regulations to its benefit with impunity the requirements of those proxy regulations lose all meaning.

The remedy afforded defrauded minority shareholders in cases similar

142 Marcus v. Otis, 169 F.2d 148, 150 (2d Cir. 1948).
143 Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965). While the defrauded seller may be awarded the wrongdoer's profits, when a party is induced to buy property fraudulently, he does not have that remedy and is limited to actual damages. Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962).
144 See note 104 supra.
145 Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965).
146 See text accompanying notes 109-121 supra.
147 See note 107 supra. Each Mergenthaler share gained $0.375 as a result of the fraudulently induced transaction. Id.
149 Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965).
152 See notes 12, 13 supra.
154 Id.
to *Mills* clearly is dependent on which analysis a court utilizes. Since the parent-subsidiary merger presents a potential seedbed for future proxy violations due to the nature of parent-subsidiary relationships,155 as well as a complex remedy problem due to the nature of the transaction,156 a flexible and, perhaps, punitive approach seems demanded.157 Failure of courts to exercise such an approach may indicate a further development in the enforceability and, therefore, the scope of the proxy regulations. Perhaps those regulations currently require either adequate disclosure or a fair transaction as determined by minimal standards. While this interpretation, contrary to both the express purpose of the proxy regulations and the stated policy on fairness as a federal cause of action,158 may be premature, the Supreme Court did refuse to grant certiorari on the *Mills* appeal.159 Until the Supreme Court reconsiders these issues or lower courts provide a greater rationale for what are obviously policy laden decisions, the results in the cases will continue to conflict with the stated policies of the proxy regulations.

**Richard A. Davis**

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153 *See text accompanying notes 6-15 supra.*
154 *See text accompanying notes 37-73 supra.*
155 *See notes 5, 16 supra.*
156 *See notes 13, 32 supra.*
157 *In August of 1977, the plaintiff shareholders in *Mills* filed a petition for certiorari to the Supreme Court. The petition presented several questions. First, plaintiffs questioned whether the fairness of a merger should be determined solely and conclusively by stock market prices shortly before and after the transaction, particularly in cases where the defendant controls terms and time of the transaction. Second, the shareholders questioned whether damages under § 28 of the Securities Exchange Act are measured by the defendant's profits. 46 U.S.L.W. 3229 (U.S. Aug. 31, 1977) (77-331). In late October the Court declined to review these questions. Id. at 3293 (U.S. Oct. 31, 1977).*