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# Private Enforcement of the Federal Proxy Rules: Remedial Alternatives

## *NOTE*

# PRIVATE ENFORCEMENT OF THE FEDERAL PROXY RULES: REMEDIAL ALTERNATIVES

Consonant with the fundamental purpose of the federal securities laws to protect investors,[1] section 14(a) of the Securities Exchange Act of 1934 was designed to buttress shareholder suffrage rights by ensuring the integrity of the proxy solicitation process.[2] The language of the section[3] and its attendant legislative history[4] evidence the judgment of

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1. Securities laws were enacted primarily "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

2. "A proxy is nothing more than the agency created when a shareholder authorizes the proxy holder to cast the votes, to which the shareholder is entitled through his stock ownership, at a corporate meeting." Von Mehren & McCarroll, *The Proxy Rules: A Case Study in the Administrative Process*, 29 LAW & CONTEMP. PROB. 728, 729 (1964). In contrast to most agencies, the agent (solicitor) in the proxy situation has more information than does his principal (shareholder); it is this distortion which makes possible the abuses which section 14(a) was designed to correct. *Id. See generally* Axe, *Corporate Proxies*, 41 MICH. L. REV. 38, 225 (1942).

3. Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1970), provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to Section 12 of this title.

Although the Commission has promulgated numerous rules relating to the proxy solicitation process, discussion in this Note will be limited to SEC Rule 14a-9, 17 C.F.R. § 240.14a-9 (1973), which provides:

> 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 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. The legislative history, although less than replete, indicates congressional awareness of the need to afford protection to the shareholder in every transaction which requires his approval. *See* H.R. REP. No. 1383, 73d Cong., 2d Sess. 13-14 (1934);

its drafters that full and fair disclosure in proxy solicitations is an essential safeguard of a system of informed corporate suffrage.[5]

In *J.I. Case Co. v. Borak*,[6] the Supreme Court observed: "The purpose of § 14(a) is to *prevent* management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."[7] Prevention of abuse is crucial to the integrity of the proxy solicitation process; indeed, the primary enforcement device of the Securities Exchange Act is the injunction. Section 21(e)[8] empowers the Securities and Exchange Commission (SEC) to institute suit in the federal district courts to enjoin activities or practices "which constitute or will constitute" violations of the Act.

Although the right of an individual investor to enforce the provisions of section 14(a) through the rules promulgated pursuant thereto was not explicitly articulated in the Act, it had become apparent by 1964 that the SEC, acting alone, was unable effectively to prevent proxy abuses.[9] Accordingly, the Supreme Court in *Borak* held that the availability of derivative and representative actions by individual shareholders was implied by section 14(a) as a "necessary supplement" to SEC enforcement.[10] Furthermore, the Court, recognizing that effective en-

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S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934). The possibility for abuse in a proxy contest was specifically recognized:

> It is contemplated that the rules and regulations promulgated by the Commission will protect investors from promiscuous solicitation of their proxies, on the one hand by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials; and, on the other hand, by unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts.

S. Rep. No. 1455, 73d Cong., 2d Sess. 77 (1934).

5. *See* Cohen, *The SEC and Proxy Contests*, 20 Fed. B.J. 91, 98 (1960): "The primary underlying concept of the proxy rules—consistent with the philosophy of the statute—is that of disclosure."

6. 377 U.S. 426 (1964).

7. *Id.* at 431 (emphasis supplied).

8. 15 U.S.C. § 78u(e) (1970). Those who violate the Act are also subject to criminal sanctions. Securities Exchange Act § 32, 15 U.S.C. § 78ff (1970). Resort to criminal prosecution under section 32, however, has been infrequent. For one of the few successful criminal actions, see United States v. Pope, 189 F. Supp. 12 (S.D.N.Y 1960) (failure to file proxy statements with the Commission).

9. By 1964, over 2,000 proxy statements were being filed annually with the SEC. The *Borak* Court recognized the Commission's inability to review effectively each statement, noting: "Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value . . . ." 377 U.S. at 432.

10. *Id.* at 431-32. The precise question in *Borak* was whether section 27 of the Securities Exchange Act, 15 U.S.C. § 78aa (1970), authorizes a federal cause of action

forcement of the proxy rules would be enhanced if a wide range of remedies were available for violations, sanctioned retrospective as well as prospective relief.[11]

*Borak* firmly established a private right of action for violations of the proxy rules and the availability of wide-ranging remedies to redress such violations; however, the specific formulation of remedies was left to the district courts.[12] The three forms of relief generally articulated are injunction, rescission, and compensatory damages.[13] The paucity of damage awards and the complete absence of successful actions for rescission suggest that these two remedies are ill suited to redress the majority of section 14(a) violations. Moreover, although the SEC has achieved marked success in obtaining injunctions,[14] courts have exhibited reluctance to afford similar relief in actions brought by individual shareholders.[15]

This Note will analyze each of these remedies in terms of its efficacy in preventing or redressing section 14(a) violations. It would appear that retrospective relief in the form of compensatory damages or rescission generally is inappropriate in the context of proxy solicitation abuses and that in order to guarantee informed corporate suffrage and the concomitant integrity of the proxy solicitation process, injunctive relief should be more accessible to the aggrieved shareholder than is presently the case. Before testing this hypothesis, a brief discussion of the development of the right of individuals to sue for proxy rule violations and an analysis of the elements necessary to state a cause of action under section 14(a) are warranted.

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for damages or rescission by an individual shareholder for violations of section 14(a). Section 27 grants to the district courts jurisdiction of "all suits in equity and actions at law to enforce any liability or duty created by this title or the rules and regulations thereunder."

11. 377 U.S. at 433-35. Implicit in its holding that retrospective relief should be available to redress violations of the rules was the Court's realization that inadequate disclosure could not be prevented in every instance.

12. The Court in *Borak* observed that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." *Id.* at 433.

13. Although the primary thrust of this Note will be an analysis of the efficacy of these remedies, the possibility of awarding punitive damages or attorneys' fees in actions for proxy rule violations will also be considered. *See* notes 101-25 *infra* & accompanying text.

14. From 1934 through 1971, the SEC brought 1,993 injunctive actions against 7,600 named defendants for various securities law violations. In 92 percent of these cases, the Commission was successful against at least one of the named defendants. SECURITIES & EXCHANGE COMM'N, THIRTY-SEVENTH ANNUAL REPORT 226 (1971).

15. *See* notes 155-67 *infra* & accompanying text.

## ESTABLISHMENT OF A PRIVATE RIGHT OF ACTION

The Securities Exchange Act of 1934 was enacted to prevent a recurrence of the financial devastation suffered by private investors in the wake of the 1929 stock market crash.[16] Full disclosure to the investor of all material facts surrounding securities transactions was envisioned as the primary means of protection. One commentator has characterized the proxy rules promulgated by the SEC under section 14(a) as "very likely the most effective disclosure device in the SEC scheme of things." [17] Specifically, SEC Rule 14a-9 proscribes the solicitation of proxies by means of a proxy statement which is materially false or misleading. Although the Commission was statutorily empowered to enforce its rules through actions for injunctions[18] or criminal sanctions,[19] the existence of private enforcement rights remained unsettled in the federal courts until *Borak*.[20]

The leading case denying the existence of such rights was *Howard v. Furst*,[21] in which the Court of Appeals for the Second Circuit reasoned

16. *See, e.g.*, Hanna & Trulington, *Protection of the Public Under the Securities Exchange Act*, 21 VA. L. REV. 251 (1935); Tracy & MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025 (1934); 51 IOWA L. REV. 515 (1966).

17. 2 L. LOSS, SECURITIES REGULATION 1027 (2d ed. 1961). Professor Loss observes: "The proxy literature, unlike the application for registration and the statutory reports, gets into the hands of investors. Unlike the Securities Act prospectus, it gets there in time. It is more readable than any of these other documents. And it gets to a good many people who never see a prospectus." *Id.*

18. Securities Exchange Act § 21(e), 15 U.S.C. § 78u(e) (1970), provides:

> Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond . . . .

19. Securities Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1970), provides for a maximum $10,000 fine and/or two years' imprisonment upon conviction for willful violation of any provision of the Act, or any rule or regulation thereunder. *See* note 8 *supra.*

20. Cases prior to *Borak* which recognized a right to private enforcement of the proxy rules include Union Pac. R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400 (N.D. Ill. 1964); Central Foundry Co. v. Gondelman, 166 F. Supp. 429 (S.D.N.Y. 1958); Curtin v. American Tel. & Tel. Co., 124 F. Supp. 197 (S.D.N.Y. 1954); Dunn v. Decca Records, Inc., 120 F. Supp. 1 (S.D.N.Y. 1954); Phillips v. United Corp., 5 S.E.C. Jud. Dec. 445 (S.D.N.Y. 1947); Tate v. Sonotone Corp., 5 S.E.C. Jud. Dec. 310 (S.D.N.Y. 1947). A private right of action was denied in Howard v. Furst, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957); Subin v. Goldsmith, 224 F. Supp. 753 (S.D.N.Y.), *cert. denied*, 350 U.S. 883 (1955).

21. 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957).

that congressional failure to articulate specifically a substantive civil right on behalf of a corporation enforceable in a derivative action by a shareholder negated its existence. Rejecting this rationale, the Supreme Court held in *Borak* that private enforcement was indispensable to fulfillment of the "broad remedial purposes" of the legislation.[22] Referring to the congressional intent as expressed in the legislative history,[23] the Court observed that one of the primary purposes of section 14(a) was the protection of investors, "which certainly *implies* the availability of judicial relief where necessary to achieve that result." [24] Prior to the passage of the Act, Congress had recognized that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange." [25] The Supreme Court found private enforcement rights implicit in the Act as a necessary supplement to the enforcement mechanism articulated therein. The threat of private action was envisioned as an additional deterrent to proxy violations. The Court also recognized that since substantive and procedural roadblocks inhibit effective stockholder action in state courts,[26] the full power of the federal judiciary acting under section 14(a) is required to provide necessary relief.[27]

Despite the seemingly broad mandate in *Borak*, individuals, whether bringing suit in a derivative or representative capacity, have, with few exceptions, been unable to establish a violation or, having proved a violation, to secure an appropriate remedy. Failure to state a cause of

22. 377 U.S. at 431-32.

23. *See* H.R. REP. No. 1383, 73d Cong., 2d Sess. 13-14 (1934); S. REP. No. 792, 73d Cong., 2d Sess. 12 (1934).

24. 377 U.S. at 432 (emphasis supplied).

25. H.R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934). As enacted in 1934, the Act applied only to companies whose securities were registered on the national exchanges. The coverage was broadened by the Securities Act Amendments of 1964 to include all companies having assets in excess of $1,000,000 and a class of equity security held of record by 500 persons or more. Securities Exchange Act § 12(g), 15 U.S.C. § 781(g) (1970).

26. State procedural rules concerning joinder of necessary parties and requiring security for expenses often present insurmountable obstacles. Moreover, the plaintiff bringing suit under section 14(a) arguably has a lighter burden of proof than does his counterpart relying on a common law or state statutory cause of action. "Apparently a stronger showing of fraud may be required when an injunction is sought under state law than when it is sought for a violation of SEC Proxy Rule 14a-9 forbidding false or misleading statements." E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 485 (2d ed. 1968).

27. 377 U.S. at 433-35.

action has often precluded trial on the merits, and summary judgment for defendant on the pleadings has been a typical result.[28]

## THE SECTION 14(A) CAUSE OF ACTION

Elements frequently articulated as necessary to state a cause of action under section 14(a) include a solicitation,[29] a false or misleading statement or omission,[30] materiality, and causation. Although there have been occasional difficulties in applying the first two of these elements, the meaning and interrelationship of materiality and causation have been particularly troublesome to the courts. An examination of recent developments with respect to these two elements provides a helpful background for a discussion of remedies.

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28. *See In re* Penn Cent. Sec. Litigation, 347 F. Supp. 1327 (E.D. Pa. 1972); Washburn v. Madison Square Garden Corp., 340 F. Supp. 504 (S.D.N.Y. 1972); Prettner v. Aston, 339 F. Supp. 273 (D. Del. 1972); Ross v. Longchamps, Inc., 336 F. Supp. 434 (E.D. Mo. 1971); Smith v. Murchison, 310 F. Supp. 1079 (S.D.N.Y. 1970); Kaminsky v. Abrams, 281 F. Supp. 501 (S.D.N.Y. 1968); Robbins v. Banner Indus., Inc., 285 F. Supp. 758 (S.D.N.Y. 1966); Hoover v. Allen, 241 F. Supp. 213 (S.D.N.Y. 1965); Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965).

29. SEC Rule 14a-1, 17 C.F.R. § 240.14a-1 (1973), defines solicitation as "(i) any request for a proxy whether or not accompanied by or included in a form of proxy; (ii) any request to execute or not to execute, or to revoke, a proxy; or (iii) the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." In order for a solicitation to be subject to the proxy rules, the jurisdictional requirements of section 12 must be met. Securities Exchange Act § 12, 15 U.S.C. § 78l (1970). For cases construing the term "solicitation," see Brown v. Chicago, Rock I. & Pac. R.R., 328 F.2d 122 (7th Cir. 1964); Washburn v. Madison Square Garden Corp., 340 F. Supp. 504 (S.D.N.Y. 1972); Allied Artists Pictures Corp. v. D. Kaltman & Co., 283 F. Supp. 763 (S.D.N.Y. 1967); Union Pac. R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400 (N.D. Ill. 1964); Mills v. Sarjem Corp., 133 F. Supp. 753 (D.N.J. 1955).

30. Whether a proxy statement is false or misleading normally depends upon the facts of each case. In a note appended to rule 14a-9, the SEC indicates the following examples of what may be considered misleading:

> (a) Predictions as to specific future market values, earnings, or dividends. (b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation. (c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter. (d) Claims made prior to a meeting regarding the results of a solicitation.

17 C.F.R. § 240.14a-9 (1973).

*Materiality*

Only those statements or omissions which render a proxy solicitation *materially* false or misleading violate section 14(a).[31] The materiality of a defect is normally a determination of fact, but if reasonable minds could not reach different conclusions, a court may find a defect to be material as a matter of law.[32] What actually constitutes a material defect, however, has been a matter of dispute. Addressing this issue in *Mills v. Electric Auto-Lite Co.*,[33] the Supreme Court employed the following frequently cited[34] language: "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."[35] Other courts have stated that a material defect is one which "would influence the stockholder's vote,"[36] or which "would normally be expected to influence a reasonable stockholder in voting."[37] Also frequently quoted is the articulation by the Court of Appeals for the Second Circuit that materiality is established when, "taking a properly realistic view, there is a substantial likelihood that the misstatement or omission may have led a stockholder to grant a proxy to the solicitor or to withhold one

31. Material defects have been found in Henwood v. SEC, 298 F.2d 641 (9th Cir.), *cert. denied*, 371 U.S. 814 (1962); SEC v. May, 229 F.2d 123 (2d Cir. 1956); Beatty v. Bright, 318 F. Supp. 169 (S.D. Iowa 1971); Colonial Realty Corp. v. Baldwin-Montrose Chem. Co., 312 F. Supp. 1296 (E.D. Pa. 1970); Berman v. Thomson, 312 F. Supp. 1031 (N.D. Ill. 1970); SEC v. Gondelman, 166 F. Supp. 429 (S.D.N.Y. 1958). For cases finding the defects not to be material, see Sunray DX Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447 (10th Cir. 1968); Ross v. Longchamps, Inc., 336 F. Supp. 434 (E.D. Mo. 1971); Miller v. Steinbach, 268 F. Supp. 255 (S.D.N.Y. 1967).

32. Johns Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967); Berman v. Thomson, 312 F. Supp. 1031 (N.D. Ill. 1970); Weitzen v. Kearns, 271 F. Supp. 616 (S.D.N.Y. 1967).

33. 396 U.S. 375 (1970).

34. *See* Gould v. American Hawaiian S.S. Co., 331 F. Supp. 981 (D. Del. 1971); Beatty v. Bright, 318 F. Supp. 169 (S.D. Iowa 1970); Berman v. Thomson, 312 F. Supp. 1031 (N.D. Ill. 1970). *See generally* Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 136 (1970); 21 CASE W. RES. L. REV. 787, 795 (1970).

35. 396 U.S. at 384 (emphasis supplied).

36. Miller v. Steinbach, 268 F. Supp. 255, 274 (S.D.N.Y. 1967). *See also* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969); Evans v. Armour, 241 F. Supp. 705 (E.D. Pa. 1965).

37. Richland v. Crandall, 262 F. Supp. 538, 553 (S.D.N.Y. 1967). The *Richland* court also phrased its definition of materiality in terms of information "that a stockholder might reasonably need in order to make an intelligent decision with respect to the proposal." *Id.*

from the other side, whereas in the absence of this he would have taken a contrary course."[38]

A majority of recent decisions, in testing the seriousness of an alleged misstatement in or omission from proxy materials, have relied upon the *Mills* language.[39] The Court of Appeals for the Second Circuit, however, has rejected the proposition that *Mills* contains a definition of materiality. In *Gerstle v. Gamble-Skogmo, Inc.*,[40] it was concluded that although the *Mills* Court held that a showing of materiality would establish the necessary causal connection between a proxy rule violation and shareholder injury without a further showing of causation in fact, no attempt had been made to define a standard by which materiality must be judged. The "might have been considered important" language in *Mills* was described as merely suggestive of the "minimum that all would agree was 'embodied' in the district court's conclusion that the defect was material."[41]

The *Gerstle* court suggested that the seriousness of a defect is more properly tested by a standard tending toward *probability* rather than mere *possibility*; accordingly, in the Second Circuit materiality is to be judged by whether a defect is such that a reasonable shareholder *would* consider it important.[42] The court added: "While the difference between 'might' and 'would' may seem gossamer, the former is too suggestive of mere possibility, however unlikely."[43] Other courts, however, draw no such distinction and, in fact, have termed the two tests indistinguishable.[44]

Notwithstanding the persuasive argument in *Gerstle* that no definition of materiality was attempted by the Supreme Court in *Mills*,[45] it is

38. General Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 162 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969). Two cases decided under SEC Rule 10b-5 applied substantially the same test. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

39. *See, e.g.*, Allen v. Penn Cent. Co., 350 F. Supp. 697 (E.D. Pa. 1972); Puma v. Marriott, 348 F. Supp. 18 (D. Del. 1972); Prettner v. Aston, 339 F. Supp. 273 (D. Del. 1972); Beatty v. Bright, 318 F. Supp. 169 (S.D. Iowa 1970); Colonial Realty Corp. v. Baldwin-Montrose Chem. Co., 312 F. Supp. 297 (E.D. Pa. 1970); Berman v. Thomson, 312 F. Supp. 1031 (N.D. Ill. 1970).

40. 478 F.2d 1281 (2d Cir. 1973).

41. *Id.* at 1301.

42. The *Gerstle* court adhered to the test for materiality articulated in General Time Corp. v. Talley Indus., Inc., 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969). *See* note 38 *supra* & accompanying text.

43. 478 F.2d at 1302.

44. *See, e.g.*, Berman v. Thomson, 312 F. Supp. 1031, 1033 (N.D. Ill. 1970).

45. The *Gerstle* court stated that the sole issue addressed in *Mills* was whether a

apparent that *Mills* did establish parameters within which a determination of materiality must be made. The Court rejected as unduly burdensome any approach which requires an affirmative showing that a defect in the proxy solicitation "actually had a decisive effect on the voting."[46] A test which focuses upon the seriousness of the defect itself rather than upon the effect of such defect on the outcome of the vote indeed appears more useful. As the Court observed in *Mills*: "This *objective test* will avoid the impracticalities of determining how many votes were affected and, by resolving doubts in favor of those the statute was designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions."[47]

Thus, although the Supreme Court may not have articulated a precise and authoritative definition of materiality, it has at least suggested the proper approach. Materiality does not encompass "trivial" defects but rather those which have a "significant *propensity* to affect the voting process . . . ."[48] A test which emphasizes the effect of a particular statement or omission upon a shareholder's decisionmaking process, and not the effect upon the decision itself, addresses the controlling issue of whether a shareholder has received sufficient information to make an intelligent decision. Framed differently, the ultimate issue is whether a solicitor of proxies has fully and accurately disclosed all facts necessary to enable the shareholder to exercise an informed vote. An approach which focuses upon the actual decision precludes a determination of materiality in situations in which a defective proxy statement did not *in fact* cause a shareholder to vote differently and disregards the thrust of section 14(a) and rule 14a-9, which mandate examination of the

shareholder must prove that a false or misleading statement in the proxy materials actually caused the shareholders to approve a merger. The *Mills* Court's holding was described as limited to a determination that causation in fact is not required under section 14(a) and that a finding that proxy materials were materially false or misleading establishes the requisite causation between a violation and shareholder injury. Thus, according to *Gerstle*, the Court in *Mills* never attempted to define the standard to be applied in measuring the seriousness of a defect.

46. 396 U.S. at 384-85; *accord*, Allen v. Penn Cent. Co., 350 F. Supp. 697, 702 (E.D. Pa. 1972) ("The central question is not whether the defect actually had a decisive effect, but rather whether it has a 'significant *propensity* to affect the voting process.' ").

47. 396 U.S. at 385 (emphasis supplied).

48. *Id.* at 384. In *Gerstle*, the court favored the "significant propensity" language as tending to a test of probability rather than possibility. However, the *Mills* Court employed this language to describe what was meant by the district court's use of the "might have been considered important" language. If judged by a significant propensity yardstick, the "might" and "would" tests are similar, if not identical.

*means* employed in seeking shareholder approval for a corporate transaction. Indeed, the teaching of *Mills* is that any approach to materiality which requires a showing of causation in fact must be avoided.

It is submitted that whether a test of materiality is phrased in terms of "might influence" or "would influence" is unimportant, so long as the focus of the inquiry is upon the significant propensity of a defect to affect the voting process. The materiality requirement should be satisfied if it is shown, by a preponderance of the evidence in a section 14(a) civil action at law or by clear and convincing evidence in a suit in equity, that defects in proxy materials would have a significant propensity to affect the decisionmaking process of the reasonable shareholder.

The success of shareholder actions for violations of proxy solicitation rules, however, has not depended entirely on a showing that a violation is material. Despite the significant inroads made by the Supreme Court in *Mills*, aspects of the issue of causation remain unsettled and troublesome.

### *Causation*

A "but for" test posits the most stringent standard of causation. Courts utilizing this approach prior to *Mills* required that a plaintiff allege and prove that *but for* the defective proxy statement, there would have been sufficient stockholder votes against the proposal to prevent approval of the transaction.[49] Other courts had held that the requisite causation was established if "substantial probability" existed that the proxy misstatements or omissions were determinative of the outcome of the vote;[50] the necessity of proving that a certain percentage of share-

49. *See, e.g.*, Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965). A distinction should be drawn between two types of causation. The first, reliance causation, goes directly to the cause of action, that is, a nexus must be shown between the proxy solicitation and the accomplishment of the transaction. The second, damage causation, speaks to remedy and requires a causal link between the defective solicitation and the damages which a shareholder is seeking to recover.

Sometimes, as in *Barnett*, the two types of causation are not distinguished, and the failure to show damages has defeated a cause of action. The fact that money damages cannot be shown, however, should not preclude a finding that a violation has occurred. Their absence in a particular case is, of course, significant in fashioning an appropriate remedy for a violation, but to equate all shareholder injury with monetary harm is unwarranted. *See* notes 88-89 *infra* & accompanying text. Given the above distinction, the textual discussion has been limited to the necessity of reliance causation in a section 14(a) cause of action.

50. *See, e.g.*, Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969), *modified*, 332 F. Supp. 644 (E.D.N.Y. 1971), *modified*, 348 F. Supp. 979 (E.D.N.Y. 1972), *aff'd as modified*, 478 F.2d 1281 (2d Cir. 1973); Union Pac. R.R. v. Chicago & N.W. Ry., 226 F. Supp. 400 (N.D. Ill. 1964).

holders in fact voted in reliance on the proxy statement was viewed as an impossible burden. A third test stated that the causal nexus was satisfied if the solicitation served some function in the transaction.[51]

*Mills v. Electric Auto-Lite Co.*[52] resolved the conflict over the causation element in cases in which a proposed transaction cannot be effected without solicitation of proxies. In *Mills*, shareholders of Electric Auto-Lite Company had sought to enjoin the voting of proxies in favor of a proposed merger with the Mergenthaler Linotype Company. The complaint, however, did not request a temporary restraining order, and the voting proceeded as scheduled. Upon approval by the necessary two-thirds vote, the merger was consummated. In an amended complaint, petitioners sought, *inter alia*, rescission of the merger. The complaint alleged that the proxy statement violated rule 14a-9 in failing to disclose that all of Auto-Lite's directors were nominated or controlled by Mergenthaler, which owned over 50 percent of the outstanding shares of the Auto-Lite common stock.

Although the Court of Appeals for the Seventh Circuit[53] agreed with the district court[54] that the proxy statement was materially defective, the appellate tribunal ruled that evidence of the fairness of the merger terms could be presented to demonstrate that the merger would have been approved regardless of defects in the proxy materials. The Supreme Court, rejecting this approach, held that a judicial determination of the fairness of the merger could not be substituted for the stockholders' informed vote. It was noted that to hold otherwise would obstruct the shareholders' right to challenge fraudulent proxies and would denigrate the congressional purpose of ensuring informed corporate suffrage.[55]

The Court held that in those instances in which the proxies solicited are necessary to obtain shareholder approval of the transaction, a finding of materiality need not be supplemented with proof that the defect affected the outcome of the vote. It was reasoned that "where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction."[56] The "but for"

51. Laurenzano v. Einbender, 264 F. Supp. 356 (E.D.N.Y. 1966).
52. 396 U.S. 375 (1970).
53. 403 F.2d 429 (7th Cir. 1968).
54. 281 F. Supp. 826 (N.D. Ill. 1967).
55. 396 U.S. at 381.
56. *Id.* at 385.

test was rejected, the Court observing: "Use of a solicitation that is materially misleading is itself a violation of law . . . ."[57]

*Mills* thus stands for the proposition that a cause of action under section 14(a) and rule 14a-9 is established upon a showing that a false or misleading statement or omission in a proxy statement is material. This holding, however, is limited to those instances in which approval of a corporate transaction is impossible without solicitation of additional votes.[58]

Two conflicting positions have developed with respect to the issue, explicitly left unanswered by the *Mills* Court,[59] whether it is possible to establish a causal connection between defective proxy materials and shareholder injury in those instances in which approval of a transaction could have been accomplished without soliciting proxies. Several courts have required mathematical proof of the causal nexus between a proxy violation and shareholder approval. Under this approach, if a defendant controls shares sufficient in number to accomplish a corporate transaction without soliciting minority shareholder approval, the fact that minority shareholders were solicited by means of a defective proxy statement is irrelevent. Thus, it has been held that if "the corporate action allegedly causing the damages would in any event have occurred regardless of the statements made in the proxy solicitation, the claim, insofar as it is based on § 14(a), must be dismissed."[60]

The leading case applying this mathematical "but for" test of causation is *Barnett v. Anaconda Co.*,[61] in which a private claim under rule 14a-9 was dismissed because plaintiff owned insufficient shares to alter

57. *Id.* at 383. For consideration of whether the *Mills* "presumption" of causation may be rebutted, see Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 135-38 (1970).

58. For example, if a favorable vote by two-thirds of the outstanding shares is required to obtain approval for a corporate transaction, *Mills* specifically applies only in cases in which the solicitor owns or controls less than two-thirds of the outstanding shares.

59. 396 U.S. at 385 n.7.

60. Weiss v. Sunasco, Inc., 295 F. Supp. 824, 828 (S.D.N.Y. 1969).

61. 238 F. Supp. 766 (S.D.N.Y. 1965). Plaintiff, minority shareholder of a corporation in which the defendant corporation had held 73 percent of the stock, alleged that the proxy statement used in the process of acquisition by defendant of the assets of his corporation was violative of rule 14a-9. The earnings and book value comparisons of the two companies were allegedly distorted so as to permit the acquisition of the assets for inadequate consideration. Plaintiff also alleged that the transaction caused the loss of stock appraisal rights. The complaint sought an accounting to determine true value of the shares and recovery of the amounts by which defendant had been unjustly enriched.

the outcome of the vote. Defendant proxy solicitor owned over 73 percent of the outstanding stock when only a two-thirds favorable vote was needed to obtain approval. In such circumstances, according to the *Barnett* court, "there is no question of fact as to causal relationship between the proxy material and the transaction under attack. The 'but for' element—the element of causation—does not, and indeed, could not exist." [62]

*Laurenzano v. Einbender*[63] is illustrative of the contrary view. Although the facts were similar to those in *Barnett* in that the solicitor owned sufficient shares to obtain approval of the transaction without soliciting additional votes, the court refused to dismiss the complaint for lack of causation, stating that causation is established upon a showing that the proxy materials have "a transactional function and [are] not merely . . . randomly present in the context of the transaction with respect to which a remedy is sought." [64] The fact that the outcome of a vote is mathematically inevitable was held not to be dispositive. The court observed: "Although the proxy solicitation was not a necessary or indispensable ingredient of the execution of the transactions, it was calculatedly infused into the matrix of the transactions; it cannot now be said as a matter of law that the solicitation was not an integral part of the transactions and that it was functionless in the consummation of the transaction." [65]

The *Barnett* approach has met with substantial criticism. In *Swanson v. American Consumer Industries, Inc.*,[66] the Court of Appeals for the Seventh Circuit rejected a mechanical test of causation, stating: "To apply the *Barnett* rationale . . . would be to sanction all manner of fraud and overreaching in the fortuitous circumstance that a controlling shareholder exists." [67] Indeed, there is some doubt whether the *Barnett*

62. *Id.* at 771.

63. 264 F. Supp. 356 (E.D.N.Y. 1966). Shareholders in Retail Centers of the Americas, Inc. brought suit alleging that the defendants employed deceptive proxy materials in obtaining shareholder approval for the sale of Retail's assets. It should be noted that *Laurenzano* and *Barnett* were decided by different district courts within the Second Circuit.

64. *Id.* at 360.

65. *Id.* at 361. The court added: "The meeting does not become nugatory and dispensable because one shareholder owns enough shares to carry any resolution and can be expected to vote in favor of his own resolutions. The vote is not legally predetermined simply because it is practically predictable." *Id.* at 362.

66. 415 F.2d 1326 (7th Cir. 1969).

67. *Id.* at 1331. The court in *Swanson* was dealing with an alleged violation of section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1970), and SEC Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1973).

approach remains valid in the Second Circuit.[68] The district court in *Laurenzano* had dismissed the action for failure to prove a material violation. The court of appeals, although affirming the trial court's finding of fact, rejected the contention that the accuracy of a proxy statement is not in issue when a solicitor has majority control, observing that "approval was not meaningless; minority shareholder approval has value whether or not it is strictly essential to the power to act." [69] Although the court did not explicitly reject *Barnett*, its language clearly appears at odds with the rationale of that case. Nevertheless, recent decisions evidence a continuing conflict within the Second Circuit between district courts in the Southern and the Eastern Districts of New York.[70]

Implicit in the holding in *Barnett* is the assumption that formal voting power is the only legal right at issue when a corporate vote is solicited. The decision overlooks the significant role which minority shareholders can play in preventing consummation of an objectionable transaction. Although minority votes may be numerically insufficient to alter the outcome of a vote, the minority shareholders have several means by which they may cause a proposed transaction to be modified or even abandoned. First, a dissident minority through the use or threat of unfavorable publicity may dissuade management from an undesirable course of action.[71] Second, through widespread exercise of appraisal rights,[72] minority shareholders can prevent a merger by depleting the corporate assets.[73] A third method available to the minority stockholder is legal action. Injunctions to preclude effectuation of a transaction

68. *See* Swanson v. American Consumer Indus. Inc., 415 F.2d 1326, 1332 n.6 (7th Cir. 1969); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968); Lewis v. Bogin, 337 F. Supp. 331, 337 (S.D.N.Y. 1972); Weber v. Bartle, 272 F. Supp. 201 (S.D.N.Y. 1967).

69. Laurenzano v. Einbender, 448 F.2d 1, 5 (2d Cir. 1971).

70. *See* Laufer v. Stranahan, CCH FED. SEC. L. REP. ¶ 92,617, at 98,774-75 (S.D.N.Y. 1970) (In the "absence of binding authority," *Barnett* will be followed.).

71. *See* Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 143 (1970).

72. Many states permit shareholders in merging corporations to compel the corporations to pay the cash value of their shares if they do not care to hold stock in the new corporation. *See, e.g.*, N.Y. BUS. CORP. § 910 (McKinney Cum. Supp. 1973).

73. Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 143-44 (1970). Moreover, a deceptive proxy may cause a shareholder to lose appraisal rights. Various states consider these rights lost if a shareholder votes in favor of a proposal or if written objection to the transaction is not filed prior to the vote. *Id.* at 144.

may be sought for violation of state laws[74] dealing with conflicts of interest and corporate waste.

Adoption of the *Barnett* rationale in effect sanctions violations of proxy rules in those instances in which a majority shareholder need not solicit additional votes. The language of section 14(a), however, proscribes defective solicitation in *all* cases, not merely in instances in which additional votes are needed to accomplish a corporate transaction. Limiting the plain meaning of the section is inconsistent with its underlying policy. It is therefore submitted that material infringement of shareholder suffrage rights should be subject to redress in every instance. The controlling issue is whether a proxy statement accurately and fully discloses the proposal to be voted upon, not whether a transaction could be accomplished in the absence of shareholder solicitation. An extension of *Mills* to encompass solicitations by controlling shareholders would effectuate the objectives of the Securities Exchange Act of 1934 and provide the protection to investors envisioned by the Supreme Court in *Borak*.

In summary, *Mills* clarified the prerequisites to establishment of a cause of action predicated on violations of section 14(a) and rule 14a-9. If proxies are solicited using means which render the proxy materials false or misleading, a cause of action is stated if the defect is material.[75] Materiality is established if a false or misleading statement or omission has a significant propensity to affect a reasonable shareholder who is in the process of deciding how to vote. This should be true whether or not a solicitor owns sufficient shares to approve a proposal.

Once a cause of action is stated, the issue becomes to what relief an aggrieved shareholder is entitled. Effectuation of the preventive and remedial purposes of the proxy rules requires that appropriate relief be available once conduct is found to contravene the rules.

74. E. Aranow & H. Einhorn, Proxy Contests for Corporate Control 481-88 (2d ed. 1968).

75. In Puma v. Marriott, 348 F. Supp. 18 (D. Del. 1972), the court stated that a violation is established when a proxy solicitation contains false or misleading statements or omits necessary facts, if such statements or omissions are material. Other courts still address the elements necessary to state a section 14(a) cause of action in pre-*Mills* terms, that is, materiality, damage, and causal connection between the proxy statement and damage. *E.g.*, Smith v. Murchison, 310 F. Supp. 1079 (S.D.N.Y. 1970). However, when the *Mills* criteria are applied, it becomes evident that materiality is the essence of a violation. *See, e.g.*, Beatty v. Bright, 318 F. Supp. 169, 173-74 (S.D. Iowa 1970).

## Fashioning Appropriate Relief

The Supreme Court in *Borak* sanctioned the use of retrospective (postvote) as well as prospective (prevote) relief for violations of the proxy rules. The forms of relief articulated most frequently are injunction, rescission, and compensatory damages. The latter two, which are, by definition, retrospective, will be tested in terms of their efficacy to redress a violation after proxies have been voted. Injunctive relief may be preventive, in the form of a prohibitory injunction, or reparative, as is the case with a mandatory injunction; thus, its utility must be analyzed in prevote and postvote contexts. In addition to these established forms of relief, punitive damages and an award of attorneys' fees will be discussed as potentially effective remedies.

### *The Limited Applicability of Damages*

*Norte & Co. v. Huffines*[76] is one of only two successful damage actions predicated on a violation of rule 14a-9. At issue in this derivative action was the fairness of the exchange ratio recommended by defendant in a proxy solicitation which sought shareholder approval of the exchange. The court, after a determination that stock valued at $70.51 per share in the proxy materials was worth only $40.58, ruled that the exchange ratio proposed in the proxy materials was materially misleading in contravention of section 14(a); damages in excess of three million dollars were awarded.

The other successful damage suit under section 14(a) is *Gerstle v. Gamble-Skogmo, Inc.*,[77] in which a minority stockholder of an outdoor advertising corporation which had been merged into its dominating majority shareholder brought suit for an accounting and restitution. The liquidating value of the acquired corporation was significantly higher than its net book value. The district court held that omission of the appraised value of the properties of the merged corporation from the proxy materials soliciting approval of the merger, coupled with defendant's failure to disclose its plans to liquidate the acquired corporation soon after consummation of the merger, violated section 14(a) and rule 14a-9. A special master was appointed to supervise the accounting.

76. 304 F. Supp. 1096 (S.D.N.Y. 1968), *aff'd*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

77. 298 F. Supp. 66 (E.D.N.Y. 1969), *modified*, 332 F. Supp. 644 (E.D.N.Y. 1971), *modified*, 348 F. Supp. 979 (E.D.N.Y. 1972), *aff'd as modified*, 478 F.2d 1281 (2d Cir. 1973).

After two master's reports and two supplemental opinions by the district court,[78] plaintiff was awarded damages of twelve million dollars.[79]

The Court of Appeals for the Second Circuit disagreed with the district court's finding that failure to disclose the appraisal values violated section 14(a).[80] The appellate court, however, held that the proxy statements were materially misleading in failing adequately to disclose the intent of the acquiring corporation to sell the merged company's assets soon after consummation.[81] Although a violation was found, the formula approved by the district court to compute prejudgment interest on damages was rejected and the case remanded for final determination of the amount of damages consistent with guidelines outlined by the appellate court.[82] The ten years which have passed since consummation of the merger demonstrate the "endless delay" inherent in arriving at a damage figure, a factor which cannot be overlooked in considering the efficacy of compensatory damages as a remedy for violations of the proxy rules.[83]

78. For the district court's reaction to the master's first report, see Gerstle v. Gamble-Skogmo, Inc., 332 F. Supp. 644 (E.D.N.Y. 1971) (decree that a different accounting formula should be used). The second master's report, issued January 31, 1972, likewise failed to resolve the issue of damages. In an opinion modifying the master's findings, the court expressed its "disapproval and disappointment in the endless delay in the rendition by the defendant of the final accounting." The plaintiff was also reprimanded for "unreasonable, exaggerated and unsupportable claims." Gerstle v. Gamble-Skogmo, Inc., 348 F. Supp. 979, 987 (E.D.N.Y. 1972).

79. Both parties took exception to the formula approved by the district court judge for the computation of damages. For a summary of the progression of this litigation through the district court, see Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1289-91 (2d Cir. 1973).

80. The court made reference to established policy at the time of the 1963 merger and found that inclusion of asset appraisal in a proxy statement was consistently disapproved: "It has long been an article of faith among lawyers specializing in the securities field that appraisals of assets could not be included in a proxy statement." *Id.* at 1293.

81. *Id.* at 1295-98.

82. The district court had imposed prejudgment interest on the sum of the net proceeds on the sales of the merged company's plants and the value of the minority stockholders' shares in the unsold assets at the time of merger. The appellate court considered such an award too severe and reduced it by the sum of the value of the convertible preferred shares in the surviving corporation, dividends received on such shares, and five percent interest on the dividends. In effect, interest was to be computed only on the excess of the value of the share of the assets of the merged corporation held by its minority stockholders over the value of the convertible preferred stock of the surviving corporation from the date of merger to the date of judgment. *Id.* at 1307.

83. The court of appeals asserted that three separate district court opinions plus two reports by a special master concerning computation of the damage award "attest

Although *Gerstle* and *Huffines* represent successful damage actions for violations of the proxy rules,[84] they involved transactions unlawfully accomplished to the *financial detriment* of the plaintiff shareholders. In asserting in *Mills* that damages may be recovered only to the extent that they can be shown,[85] the Supreme Court suggested two situations in which monetary relief would be appropriate: first, when the defective proxy materials relate to specific terms in a proposed merger, and, second, when the merger reduces the earnings or earnings potential of a stockholder's investment.[86] The Court further noted that if, as a result of commingling of the assets and operations of the merged companies, the establishment of direct financial injury is impossible, "relief might be predicated on a determination of the fairness of the terms of the merger at the time it was approved." [87]

Inability to establish direct financial injury or to demonstrate that the terms of a transaction were unfair, however, need not preclude a determination that the shareholders have been injured. The Supreme Court has stated that fraudulent substitution of shareholder status in one corporation for an identical status in another "may constitute a cognizable legal injury in and of itself." [88] If false or misleading statements or omissions are used to obtain proxies in support of a merger, or, indeed, any corporate proposal, shareholders have been deprived of the full disclosure and informed vote which is their statutory right. It is submitted that inadequate disclosure which materially infringes upon a stockholder's suffrage rights is a cognizable legal injury, even though damage analysis may be inapplicable.[89]

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to the problems which the recognition of a private right of action for violation of § 14(a) in [*Borak*] have thrust upon the federal courts . . . ." *Id.* at 1284.

84. The two cases represent the *only* successful damage actions predicated on violations of section 14(a).

85. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 388 (1970).

86. *Id.* at 388-89.

87. *Id.* at 389. The Court emphasized that its "singling out of some of the possibilities is not intended to exclude others." *Id.* However, it appears clear that damages cannot be shown in transactions which are nonfinancial in nature or in those which are unlawfully consummated but financially "fair" to the stockholders.

88. SEC v. National Sec., Inc., 393 U.S. 453, 467 (1969). Although the defendant in this case was charged with violating SEC Rule 10b-5, it is submitted that the Court's rationale is applicable to section 14(a) actions.

89. The Supreme Court in *Mills* observed that "[u]se of a solicitation that is materially misleading is itself a violation of law . . . ." 396 U.S. at 383 (1970). The Court, although recognizing that private suits to enforce the proxy rules benefit the corporation, warned: "In many suits under § 14(a), particularly where the violation does not relate to the terms of the transaction for which proxies are solicited, it may be impossible to assign monetary value to the benefit." *Id.* at 396. Plaintiffs should

It appears that the appropriateness of compensatory relief is limited to those transactions which have direct adverse effects upon the financial concerns of the shareholder. When proxies are unlawfully solicited in support of liquidation, consolidation, merger, or sale, lease, or exchange of assets, damages may be recovered to the extent that they can be shown. In other situations, measurement of pecuniary loss to shareholders for violations of section 14(a) and rule 14a-9 is difficult, if not impossible.[90]

Proxy solicitations to obtain approval for nonfinancial proposals,[91] nevertheless, may deprive a shareholder of his right to exercise an informed vote if the facts of the proposal are not fully and accurately disclosed. Reliance on money damages to remedy proxy violations having no direct financial consequences, however, is misplaced;[92] more importantly, such reliance may frustrate the purpose of the proxy rules.[93]

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recognize the difficulty that inheres in measuring shareholder injury in monetary terms in situations which do not relate to the terms of a transaction or which do not reduce the shareholder's earnings or the earnings potential of his holdings. It is submitted that a damage suit is proper only in those instances in which the proxy violation is, or may be, financially detrimental to the plaintiff. In other situations, a suit for rescissional or injunctive relief is appropriate.

90. In Howard v. Furst, 140 F. Supp. 507 (S.D.N.Y.), *aff'd*, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957), the district court stated: "The damages the stockholder incurs in compelling rectification of a misleading statement would seem to be recoverable from the person who violated the federal statute, but in the absence of such an expense the intrusion of misleading statements into the process of stockholder suffrage is impossible to measure in monetary damages." 140 F. Supp. at 513. One commentator has suggested that the "likelihood of damage actions is probably more theoretical than real." Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 199, 248 (1969).

91. For purposes of this discussion, "nonfinancial" transactions refer to those proposals voted upon at a shareholder meeting which have only indirect financial consequences. Included are elections of directors, amendments to corporate charter, and changes in and additions to the corporation's by-laws. "Financial transactions" encompass those which may directly affect the equity holdings of a shareholder. Prime examples are corporate liquidations, consolidations, and mergers.

92. *See* note 89 *supra*.

93. The purpose of the proxy rules is to ensure the integrity of the proxy solicitation process by requiring full and accurate disclosure by the solicitor. *See* notes 4-5 *supra*. An attempt to recover compensatory damages in nonfinancial transactions will be defeated, whether or not a violation of the rules has been established. For example, a plaintiff may allege and prove a material violation of the proxy rules with respect to the election of a board of directors. Because the transaction unlawfully accomplished had no adverse financial effect on the plaintiff/shareholder, damages will not lie. Unless an alternative remedy is fashioned, an activity proscribed by the Act will in effect be sanctioned for lack of an appropriate remedy.

The questionable efficacy of compensatory damages in situations in which the plaintiff cannot establish that he was injured financially, together with the "endless delays" inherent in arriving at an award even when damage analysis is applicable, suggests the need for an alternative remedy to ensure a system of full and accurate disclosure. Within the context of those proposals which directly involve the finances of the corporation but do not adversely affect a shareholder's investment and hence provide no basis for a damage award, rescission may be a viable alternative. The prospects for such relief to unwind corporate financial transactions, however, is dismal.

*The Improbability of Rescissional Relief*

The availability of rescissional relief to remedy rule 14a-9 violations in the context of corporate mergers and acquisitions is firmly established.[94] The deterrent effect of such a remedy also is beyond dispute.[95] Unfortunately, the implications of these propositions are more theoretical than real; to date no merger has been rescinded to redress a violation of the proxy rules.

Although affirming that rescission is a possible remedy for violations of the proxy rules, the Supreme Court in *Mills* stated that a proven violation does not mandate automatic rescission of a merger: "[N]othing in the statutory policy 'requires the court to unscramble a corporate transaction merely because a violation occurred.'"[96] The Court noted that equitable principles must control the decision whether to rescind and that the fairness of the merger terms, although not a defense to a section 14(a) action,[97] is a determinative factor in fashioning an appropriate remedy.[98] On remand, the district court refused to rescind the

94. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); J.I. Case Co. v. Borak, 377 U.S. 426 (1964). The discussion of the availability of rescissional relief will be limited to the context of mergers, consolidations, and liquidations. In the case of nonfinancial transactions unlawfully consummated, the mandatory injunction is the appropriate equitable remedy.

95. The remedial effect of rescission is obvious. Transactions accomplished by unlawful means could be declared void and a resolicitation ordered. If a solicitor knew that mergers accomplished in contravention of rule 14a-9 would be declared void, more vigorous efforts would be made to ensure full and accurate disclosure in all solicitations.

96. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386 (1970) (citation omitted).

97. The holding of the Court of Appeals for the Seventh Circuit in *Mills* that fairness was a defense was reversed by the Supreme Court. *Id.* at 381-85.

98. *Id.* at 386-88. *See also* Swanson v. American Consumer Indus., Inc., 415 F.2d 1326 (7th Cir. 1969). In addition to the fairness of the merger terms, courts are likely to consider the time elapsed since the merger, the nature of the transaction, shareholder

merger, stating that "if it can be shown that plaintiffs suffered any injury by reason of the merger they may be adequately compensated by money damages." [99]

Ironically, the same "fairness" of the merger terms which contributes to the decision not to rescind will render proof of monetary loss virtually impossible. The practical effect of an emphasis on the damage/rescission analysis in many situations is preclusion of relief for a proven violation of the proxy rules. One commentator has suggested that "if the courts so employ their equitable discretion, *Mills* will have raised false hopes of greater protection for shareholders—having assured them a technical judgment of liability, it may be cited to support the denial of any tangible economic relief." [100]

It is submitted that the inevitable delay between consummation of a merger and judicial resolution of the controversy, as well as the practical difficulties inherent in unwinding a merger, will appear with sufficient frequency to ensure that rescission under section 14(a) remains only theoretically available. It can, of course, be argued that the improbability of rescission is irrelevant, since its threat sufficiently deters proxy abuse. Nevertheless, the potency of the threat is substantially diminished by the fact that rescission has yet to be employed as a remedy for section 14(a) violations. The failure of rescission as an effective remedy for proxy abuses further suggests the need to develop a new approach to enforcing the proxy solicitation rules.

### *Other Potential Forms of Relief*

Although there are no cases on point under section 14(a), the issue of punitive damages[101] has been discussed with respect to other sections of

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preference, delay in instituting suit, and the adverse effect of rescission on innocent third parties. For a detailed discussion of these factors, see Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 128 n.86 (1970). For a discussion of the difficulties that inhere in unwinding a merger, see Basch v. Talley Indus. Inc., 53 F.R.D. 9, 14 (S.D.N.Y. 1971).

99. CCH FED. SEC. L. REP. ¶ 93,354, at 91,900 (N.D. Ill. 1972).

100. *The Supreme Court, 1969 Term*, 84 HARV. L. REV. 211, 214 (1970).

101. Punitive or exemplary damages are generally defined or described as damages allowed or awarded as a punishment to the defendant and as an example to deter him and others from committing similar offenses in the future. W. PROSSER, THE LAW OF TORTS § 2 (4th ed. 1971).

The possibility of punitive damages should be limited to those violations of section 14(a) and rule 14a-9 which involve *financial* proposals and for which rescission and damages are inappropriate. Violations involving nonfinancial proposals may be adequately redressed by mandatory injunction. *See* note 180 *infra* & accompanying text.

the securities acts.[102] Recent opinions have cited section 28 of the Securities Exchange Act[103] and policy considerations underlying the securities legislation[104] as factors militating against the awarding of punitive damages for securities law violations.

In *Green v. Wolf Corp.*,[105] an action under SEC Rule 10b-5[106] alleging the use of false and misleading prospectuses, the Court of Appeals for the Second Circuit held that punitive damages may not be recovered for any claim arising under the Securities Exchange Act. The court relied upon the express language of section 28,[107] which provides: "[N]o person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages . . . ."[108]

In *deHaas v. Empire Petroleum Co.*,[109] however, the trial court held that section 28 precludes the recovery of exemplary damages only in suits involving causes of action specifically authorized by the Securities Exchange Act. Where the cause of action is one which is implied from the Act, such as that in *deHaas* under rule 10b-5, the court reasoned that general tort principles should apply.[110] Although reversing the

102. Cases denying punitive damages include Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967) (dictum); Pappas v. Moss, 257 F. Supp. 345 (D.N.J. 1966); Mills v. Sarjem Corp., 133 F. Supp. 753 (D.N.J. 1955). The possibility of exemplary relief was recognized in Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968) (dictum); Nagel v. Prescott & Co., 36 F.R.D. 445 (N.D. Ohio 1964) (dictum).

103. 15 U.S.C. § 78bb(a) (1970).

104. For an extensive analysis of policy considerations, see Hirsch & Lewis, *Punitive Damage Awards Under the Federal Securities Acts*, 47 NOTRE DAME L. REV. 72, 82-87 (1971); Note, *Punitive Damages In Implied Private Actions for Fraud Under the Securities Laws*, 55 CORNELL L. REV. 646 (1970). *See also* Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 YALE L.J. 107, 130-35 (1970), in which the author suggests that the Supreme Court in *Mills* was arguing against the use of exemplary damages when it stated that "damages should be recoverable only to the extent that they can be shown." 396 U.S. at 389.

105. 406 F.2d 291 (2d Cir. 1968).

106. 17 C.F.R. § 240.10b-5 (1973).

107. Commentaries favoring this approach include Note, *Remedies for Private Parties Under Rule 10b-5*, 10 B.C. IND. & COM. L. REV. 337 (1969); Comment, *Punitive Damages in Implied Civil Actions Under the Securities Acts*, 74 DICK. L. REV. 466 (1970); Comment, *Private Remedies Available Under Rule 10b-5*, 20 SW. L.J. 620 (1966). *But see* Note, *Punitive Damages In Implied Private Actions For Fraud Under the Securities Laws*, 55 CORNELL L. REV. 646 (1970).

108. 15 U.S.C. § 78bb(a) (1970).

109. 435 F.2d 1223 (10th Cir. 1970), *rev'g* 302 F. Supp. 647 (D. Colo. 1969).

110. A similar approach has been taken under other federal statutes. *See, e.g., In re*

decision of the lower court, the Court of Appeals for the Tenth Circuit declined to rule that section 28 is a bar to punitive damages,[111] choosing instead to base disallowance on policy considerations. The factors which the court found to militate against allowance of punitive damages were similar to those considered by the Court of Appeals for the Second Circuit in *Globus v. Law Research Service, Inc.*[112] in holding that an action under section 17(a) of the Securities Act[113] could not support an award of punitive damages. Although recognizing that exemplary relief would deter violations, the *Globus* court observed that plaintiffs under the securities acts "already possess an extensive 'arsenal of weapons' which serve to perform the functions of retribution and deterrence."[114] It was noted that private actions for compensatory damages "often lead to sizable recoveries and to considerable deterrent clout."[115] To add punitive damages to this arsenal, the court suggested, would provide only a marginal deterrent effect but result in potentially extensive hardship to the defendant.

A similar balancing approach was utilized in *deHaas*. The court noted that sanctions for violation of the Securities Exchange Act include a maximum fine of $10,000,[116] two years' imprisonment, or both,

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Den Norshe Amerikanlinje A/S, 276 F. Supp. 163 (N.D. Ohio 1967) (Jones Act); Wills v. Trans World Airlines, 200 F. Supp. 360 (S.D. Cal. 1961) (Federal Aviation Act).

111. In a subsequent decision, the court held that section 28 does not bar punitive damages where a common law fraud claim is joined under the doctrine of pendent jurisdiction to an action under the securities acts. In Young v. Taylor, 466 F.2d 1329 (10th Cir. 1972), the court sustained a punitive damage award in a suit brought under rule 10b-5, Utah blue sky laws, and common law fraud theories, stating:

> By so construing the statute, effect is given both to the statute's policy for preserving state remedies and to some limitation on damages recoverable. A reasonable limiting effect is given by interpreting § 28(a) as meaning that if a federal claim is maintained as here, recovery of actual damages twice on separate claims in the action is prohibited, but that if the elements of a state claim are necessarily found to exist, punitive damages and attorney's fees allowed under state law are not barred.

*Id.* at 1338.

112. 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

113. 15 U.S.C. § 77q(a) (1970).

114. 418 F.2d at 1285.

115. *Id.*

116. Several authors, however, have argued that such penalty is insignificant, noting that when a violation results in large gains, a $10,000 fine is a small cost to pay. 2 A. BROMBERG, SECURITIES LAW: FRAUD § 10.3 (1971); Comment, *Fashioning a Lid For Pandora's Box: A Legitimate Role for Rule 10b-5 in Private Actions Against Insider Trades on a National Stock Exchange*, 16 U.C.L.A.L. REV. 404 (1969).

for willful violations,[117] as well as possible suspension of trading[118] or expulsion from a national securities exchange.[119] A factor emphasized in *deHaas* was the liberalization of class actions,[120] with the result that "the overall size of compensatory damages alone may constitute a significant deterrent." [121]

These basic policy considerations, especially the last, although perhaps applicable in other contexts of securities law violations, do not appear to have the same force with respect to section 14(a). The civil suit for compensatory damages provides one of the weakest deterrents to violations of the proxy rules. Only when a transaction proves financially detrimental to the shareholders are substantial money damages recoverable. Consequently, courts seeking to realize the full deterrent potential of the section 14(a) private remedy should not overlook the possibility of awarding punitive damages in limited circumstances.

Another form of relief, and one applied by the Supreme Court in *Mills*, is the awarding to plaintiff of his attorneys' fees. Theorizing that the corporation as a whole benefitted from plaintiff's suit and accordingly should share in the cost of the litigation, the *Mills* Court, on its own initiative, held that plaintiff could recover his attorneys' fees from the defendant corporation upon establishing a violation of section 14(a) by the corporation and its officers.[122] Whether such an approach redresses the actual violation or deters future abuses, however, is doubtful. It is submitted that a stronger deterrent to future proxy abuse would obtain if the solicitor were held personally liable for the costs incurred by the shareholder in bringing the action. Although few courts have considered the standard to be applied in determining personal culpability for violations of section 14(a), the trend is toward one of negligence. In *Gould v. American Hawaiian Steamship Co.*,[123] for example, the court rejected tests involving scienter and strict liability in favor of a negligence standard.[124] Directors of the corporation were held per-

117. Securities Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1970).

118. *Id.* §§ 15(b)(5)-(7), 15 U.S.C. §§ 78o(b)(5)-(7) (1970).

119. *Id.* § 19(a)(1), 15 U.S.C. § 78s(a) (1970).

120. *See generally* 2 A. BROMBERG, SECURITIES LAW: FRAUD § 11.6 (1971); 6 L. LOSS, SECURITIES REGULATION 3938-70 (1969 Supp. to 2d ed.); Comment, *Adequate Representation, Notice and the New Class Action Rule: Effectuating Remedies Provided by the Securities Laws*, 116 U. PA. L. REV. 889 (1968).

121. 435 F.2d at 1231.

122. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 389-97 (1970).

123. 351 F. Supp. 853 (D. Del. 1972).

124. The negligence standard has been approved in at least three other jurisdictions. *See* Berman v. Thomson, 312 F. Supp. 1031 (N.D. Ill. 1970); Gerstle v. Gamble-

sonally liable for shareholder injury resulting from defects in proxy materials attributable to their negligence.[125]

A logical extension of *Gould* is to charge attorneys' fees to anyone directly responsible for an unlawful solicitation if, due to his negligence, the proxy statement was materially false or misleading. To hold a solicitor to strict liability would actually discourage full and accurate disclosure, since liability might attach regardless of how conscientious the effort to comply with the proxy rules. To require actual knowledge of misstatements or omissions would prompt the solicitor to remain uninformed as to the completeness or accuracy of the proxy literature, with the result that the quality of the materials would suffer for lack of effective supervision in their preparation. The negligence standard would thus appear preferable; nevertheless, the efficacy of an award of attorneys' fees to redress proxy solicitation abuses and to deter future violations remains questionable.

In summary, neither compensatory damages nor rescission has proved an effective remedy for violations of the proxy rules. The possibility of punitive damages appears slight, in light of the judicial reluctance to award them in other contexts of securities law violations; an award of attorneys' fees would be of questionable efficacy either as a remedy or as a deterrent.[126] It is apparent that the injunction remains the potentially most effective means of protecting the rights of shareholders to the full disclosure and intelligent suffrage which section 14(a) was designed to ensure.[127]

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Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969), *aff'd*, 478 F.2d 1281 (2d Cir. 1973); Norte & Co. v. Huffines, 304 F. Supp. 1096 (S.D.N.Y. 1968), *aff'd*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

125. In *Gould*, proxies solicited to gain shareholder approval for a merger of McLean Industries into R.J. Reynolds Tobacco Co. were alleged to be false and misleading in their failure to disclose that certain "favored" shareholders had veto power over the merger. The materials had stated falsely that these favored shareholders, who were to receive cash while the other stockholders were to receive securities, had agreed to vote in favor of the merger.

126. To shareholders with sufficient financial resources to render the threat of prolonged litigation believable, the motion for summary judgment may prove an effective means of achieving redress. If a violation is established, the defendant in many instances will choose to settle the case rather than suffer unfavorable publicity and additional expense in further litigation. This procedure, however, seemingly circumvents the mandate of the Supreme Court in *Borak* that the *courts* fashion appropriate remedies for violations of the proxy rules. *See* note 12 *supra*. Moreover, any deterrent effect on future abuses is doubtful.

127. Undoubtedly, rescission and damages have theoretical potential as means of redressing proxy rule violations. It is the limited circumstances in which such remedies have proved applicable and their inability to forestall abuses which must be recognized.

*The Need for a Realistic Approach to Injunctive Relief*

Variously classified according to the nature of the decree[128] and the stage of litigation at which issuance occurs,[129] the injunction has been recognized as the primary enforcement device of the securities laws.[130] Section 21(e) of the Securities Exchange Act authorizes the SEC to bring suit in the federal district courts to enjoin activities which "constitute or will constitute" violations of the Act.[131] Although the SEC has proven itself a formidable litigator in obtaining injunctions,[132] courts have been reluctant to afford relief in a similar form to individuals. Traditional judicial reluctance to invoke the extraordinary remedy of injunction is nowhere more apparent than in private actions to enjoin threatened violations of rule 14a-9.[133]

The present state of the law is indeed troubling. Although the Supreme Court has held that private rights exist to prevent abuse in proxy solicitations, subsequent decisions have demonstrated the limited availability of damages and the improbability of rescissional relief. The reluctance to afford injunctive relief renders private enforcement rights practically nugatory.[134]

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128. Injunctions are either preventive or reparative. The preventive (prohibitory) injunction orders a defendant to refrain from pursuing a course of conduct or to abstain from the accomplishment of an act. Reparative (mandatory) injunctions require a defendant to take some affirmative action. *See generally* W. DEFUNIAK, HANDBOOK OF MODERN EQUITY 16-17 (1950); Note, *Interlocutory Injunctions and the Injunction Bond,* 73 HARV. L. REV. 333, 334 (1959).

129. The preliminary or temporary injunction attempts to preserve the status quo pending final determination of the parties' rights. Issuance occurs after notice to the adverse party and an initial hearing not on the merits. The temporary restraining order serves a purpose similar to that of the temporary injunction but issues ex parte. Permanent relief is afforded only after a full hearing on the merits. W. DEFUNIAK, *supra* note 128, at 17-19. *See also* FED. R. CIV. P. 65.

130. *See, e.g.,* SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972), in which the court observed that the securities laws are "a classic example of modern utilization of traditional equity jurisdiction for the enforcement of a congressionally declared public policy administered by a regulatory agency established for that purpose." *Id.* at 53.

131. 15 U.S.C. § 78u(e) (1970).

132. *See* note 14 *supra.*

133. *See, e.g.,* Sherman v. Posner, 266 F. Supp. 871, 873 (S.D.N.Y. 1966); Kauder v. United Board & Carton Corp., 199 F. Supp. 420, 423 (S.D.N.Y. 1961).

134. It should be noted that the inability of the SEC to deal effectively with the rapidly increasing number of proxy statements filed annually was recognized by the Supreme Court in *Borak* as one reason why private enforcement was necessary. *See* note 9 *supra.*

*Present Availability*

Courts faced with the question whether an injunction should issue for violations of the securities laws have distinguished actions brought by the SEC from those instituted by individual shareholders[135] on the basis that Commission actions protect the public interest while shareholder suits seek to protect interests jeopardized in private controversies.[136] It is clear that when the public interest is involved, the equitable powers of a court are more flexible than in a private dispute.[137] It is not surprising, therefore, that a stricter burden of proof is required of the private plaintiff seeking injunctive relief. To prevail, an individual must establish the common law elements of threatened irreparable harm and the absence of an adequate remedy at law. The SEC, on the other hand, need meet only the statutory requirement of a "proper showing." The stricter standard applied by courts when the plaintiff is a private party

135. The fundamental distinction is that between statutory and common law injunctions. If an action is instituted pursuant to a statutory right, only the statutory requirements need be met. The typical statutory requirement of a "proper showing" thus does not include the need to establish the common law elements of threatened irreparable harm or the absence of an adequate remedy at law. *See* SEC v. Lake Havasu Estates, 340 F. Supp. 1318, 1324 (D. Minn. 1972) (irreparable injury not required for a statutory injunction); SEC v. Liberty Petroleum Corp., CCH FED. SEC. L. REP. ¶ 93,209 (N.D. Ohio 1971) (no need to show irreparable harm or inadequacy of other remedies).

In United States v. Diapulse Corp. of America, 457 F.2d 25 (2d Cir. 1972), the court construed the injunction section of the Federal Food, Drug, and Cosmetic Act, which requires the same "proper showing" found in the Securities Exchange Act. It was observed that "[n]o specific or immediate showing of the precise way in which violation of the law will result in public harm is required. . . . [The defendant's] claim that . . . there was no showing of irreparable injury . . . is beside the point." *Id.* at 28. For a discussion of the use of the statutory injunction, see Note, *The Statutory Injunction as an Enforcement Weapon of Federal Agencies*, 57 YALE L.J. 1023 (1948). For a detailed discussion of SEC enforcement activities, see Pitt & Markham, *SEC Injunctive Actions*, 6 REV. OF SEC. REG. 955 (1973).

136. The differences between public and private injunctive actions are widely acknowledged. *See, e.g.*, SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972); Mitchell v. Pidcock, 299 F.2d 281, 287 (5th Cir. 1962). In United States v. Diapulse Corp. of America, 457 F.2d 25, 27 (2d Cir. 1972), the court observed that "the function of a court in deciding whether to issue an injunction authorized by a statute of the United States to enforce and implement Congressional policy is a different one from that of the court when weighing claims of two private litigants." *But see* Comment, *Private Rights and Federal Remedies: Herein of J.I. Case v. Borak*, 12 U.C.L.A.L. REV. 1150, 1174 (1965).

137. *See* Bradford v. SEC, 278 F.2d 566 (9th Cir. 1960); SEC v. Liberty Petroleum Corp., CCH FED. SEC. L. REP. ¶ 93,209 (N.D. Ohio 1971); SEC v. Broadwall Sec., Inc., 240 F. Supp. 962 (S.D.N.Y. 1965). *See generally* 3 L. LOSS, SECURITIES REGULATION 1979 (2d ed. 1961).

partially explains the limited success of shareholders who have sought injunctive relief for alleged violations of proxy solicitation requirements.

*SEC Actions*

In instituting an action for a permanent injunction, the SEC need only "establish that the acts or practices are in contravention with the statute . . . ."[138] It has been stated that an "affirmative showing of threatened irreparable injury to the plaintiff or the public is not essential beyond that which will be implied as a natural result from any failure to appropriately prevent threatened violations."[139] What is essential is a showing that there exists a reasonable likelihood of future violations.[140] Moreover, it has been held that previous violations give rise to an inference that future violations may be likely; mere cessation of unlawful conduct will not dispel this inference.[141]

When preliminary relief is sought, the SEC must establish a "strong prima facie case."[142] In *SEC v. Lake Havasu Estates*,[143] this vague standard was clarified somewhat by the court's observation that a violation itself "establishes a *prima facie* case for the issuance of a preliminary injunction."[144] The crucial inquiry in the establishment of a prima facie

138. SEC v. Liberty Petroleum Corp., CCH Fed. Sec. L. Rep. ¶ 93,209, at 91,347 (N.D. Ohio 1971).

139. SEC v. Mono-Kearsarge Consol. Mining Co., 167 F. Supp. 248, 261 (D. Utah 1958). That irreparable harm need not be established is clear from the case law. *E.g.*, United States v. Diapulse Corp. of America, 457 F.2d 25, 28 (2d Cir. 1972); Bradford v. SEC, 278 F.2d 566, 567 (9th Cir. 1960); SEC v. Torr, 87 F.2d 446, 450 (2d Cir. 1937); SEC v. Lake Havasu Estates, 340 F. Supp. 1318, 1324 (D. Minn. 1972); SEC v. Liberty Petroleum Corp., CCH Fed. Sec. L. Rep. ¶ 93,209, at 91,347 (N.D. Ohio 1971); SEC v. Northeastern Financial Corp., 268 F. Supp. 412, 414 (D.N.J. 1967); SEC v. Broadwall Sec., Inc., 240 F. Supp. 962, 967 (S.D.N.Y. 1965).

140. In SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100 (2d Cir. 1972), it was noted: "The critical question for a district court in deciding whether to issue a permanent injunction in view of past violations is whether there is a reasonable likelihood that the wrong will be repeated." *See also* SEC v. Liberty Petroleum Corp., CCH Fed. Sec. L. Rep. ¶ 93,209, at 91,347 (N.D. Ohio 1971).

141. SEC v. MacElvain, 417 F.2d 1134, 1137 (5th Cir. 1969), *cert. denied*, 397 U.S. 972 (1970); SEC v. Culpepper, 270 F.2d 241, 249-50 (2d Cir. 1959). For cases holding that an inference of future violations is properly drawn from the finding of past misconduct, see SEC v. Keller Corp., 323 F.2d 397, 402 (7th Cir. 1963); SEC v. Boren, 283 F.2d 312, 313 (2d Cir. 1960).

142. SEC v. Boren, 283 F.2d 312, 313 (2d Cir. 1960); SEC v. Lake Havasu Estates, 340 F. Supp. 1318, 1324 (D. Minn. 1972); SEC v. Broadwall Sec., Inc., 240 F. Supp. 962, 967 (S.D.N.Y. 1965).

143. 340 F. Supp. 1318 (D. Minn. 1972).

144. *Id.* at 1324.

case is whether there is reasonable likelihood that the defendant's actions would thwart the policy of the securities laws.[145]

For various reasons, including liberal statutory requirements and the public nature of the action, courts have received favorably SEC enforcement actions.[146] Injunctions have been granted to prevent the solicitation of proxies,[147] to enjoin the use of unlawfully solicited proxies,[148] to postpone and adjourn annual shareholder meetings,[149] to declare proxies void and order a resolicitation,[150] and to enjoin future violations.[151] These actions clearly illustrate the flexibility of injunctive relief[152] and the protection it can afford to the integrity of the voting process. That this salutory effect could be enhanced if individual shareholders were afforded the same ready access to injunctive relief is apparent.

*Shareholder Injunctive Actions*

In most cases in which individual shareholders allege violation of the proxy rules, interlocutory relief is sought.[153] To be successful, the plaintiff must establish three elements: that a fair probability of success on the merits exists, that the threatened harm is irreparable, and that the harm sought to be averted by the plaintiff is commensurate with the resultant harm to the defendant should relief be granted.[154]

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145. SEC v. Culpepper, 270 F.2d 241, 249 (2d Cir. 1959); SEC v. Commonwealth Security Investors, Inc., CCH FED. SEC. L. REP. ¶ 92,859 (E.D. Ky. 1970).

146. Statistics illustrating the Commission's success are provided in note 14 *supra*.

147. *See, e.g.*, SEC v. Okin, 139 F.2d 87, 89 (2d Cir. 1943).

148. SEC v. May, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123, 124 (2d Cir. 1956); SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948); SEC v. O'Hara Re-election (or Proxy) Committee, 28 F. Supp. 523 (D. Mass. 1939).

149. Henwood v. SEC, 298 F.2d 641 (9th Cir.), *cert. denied*, 371 U.S. 814 (1962).

150. *See, e.g.*, SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).

151. *See, e.g.*, SEC v. Rusco Indus., Inc., CCH FED. SEC. L. REP. ¶ 93,144 (S.D.N.Y. 1971).

152. It should be noted that SEC injunctive actions, although at times reparative, usually are preventive in effect.

153. It is not uncommon for an action to be brought less than a week prior to the shareholder meeting at which the solicited proxies are to be voted. Insufficient time to resolve the issues on the merits prior to the meeting date necessitates a request for threshold relief. *See, e.g.*, Committee for New Management of Butler Aviation v. Widmark, 335 F. Supp. 146 (E.D.N.Y. 1971) (action brought on the "eve" of the meeting).

154. *See, e.g.*, Sherman v. Posner, 266 F. Supp. 871 (S.D.N.Y. 1966).

Although failure to demonstrate a fair probability of success on the merits occasionally has precluded issuance of an injunction,[155] refusal to enjoin more often is predicated upon an absence of irreparable harm.[156] One authority defines irreparable harm as "that which cannot be repaired, restored or adequately compensated in money or where the compensation cannot be safely measured." [157] Notwithstanding the limited applicability of damages and the improbability of rescissional relief as a means of redressing section 14(a) violations,[158] the availability and efficacy of such remedies apparently is frequently assumed by courts in finding an absence of irreparable harm.[159] One commentator, discussing the implications of *Borak*, has suggested that the "practical difficulties encountered in awarding postconsummation relief may lead to greater leniency in the awarding of temporary injunctive relief . . . . However, the availability of postconsummation relief may as plausibly lead to reluctance to enjoin corporate activity." [160]

It would appear that the theoretical availability of rescission has contributed to judicial reluctance to enjoin the use of proxies solicited in support of corporate merger. In *Sherman v. Posner*,[161] for example, the court declined to enjoin consummation of an exchange offer approved at a shareholder meeting allegedly as a result of an unlawful solicitation. It was reasoned that the threatened harm was far from irreparable since retrospective relief was available, the court stating that "there is sufficient authority in this District which would permit the setting aside of the merger and consolidation and re-solicitation to be had with a new vote held thereon." [162] The authorities referred to by the court had not actually afforded rescission but only stated that such relief was possible. Although reasoning which establishes the existence of a remedy in terms

155. *See, e.g.*, Rosenblatt v. Northwest Airlines, Inc., 435 F.2d 1121 (2d Cir. 1970); Twentieth Century Fox Film Corp. v. Lewis, 334 F. Supp. 1398 (S.D.N.Y. 1971); Stedman v. Storer, 308 F. Supp. 881 (S.D.N.Y. 1969).

156. *See, e.g.*, Sargent v. Genesco, Inc., 458 F.2d 9 (5th Cir. 1972); Greater Iowa Corp. v. McLendon, 378 F.2d 783, 799 (8th Cir. 1967); Abramson v. Nytronics, Inc., 312 F. Supp. 519 (S.D.N.Y. 1970); Mack v. Mishkin, 172 F. Supp. 885, 888 (S.D.N.Y. 1959); Weeks v. Alpert, 131 F. Supp. 608 (D. Mass. 1955).

157. W. DeFuniak, *supra* note 128, at 35.

158. *See* notes 84-93 & 94-100 *supra* & accompanying text.

159. *E.g.*, Sargent v. Genesco, Inc., 458 F.2d 9 (5th Cir. 1972).

160. Note, *Shareholder Derivative Suits Under Sections 10(b) and 14(a) of the Securities Exchange Act*, 18 Stan. L. Rev. 1339, 1347 (1966). *See also* Note, *Private Remedies Available Under Section 14(a) of the Securities Exchange Act of 1934*, 55 Iowa L. Rev. 657, 664 (1970).

161. 266 F. Supp. 871 (S.D.N.Y. 1966).

162. *Id.* at 873-74.

of its permissibility is often sound, such an approach is tenuous in this context. The fact that rescission has never been employed to redress a violation of section 14(a) suggests that its availability is more illusory than real.[163]

Frequently coinciding with a finding of an absence of threatened irreparable harm is the belief that there exists an adequate remedy at law. "By adequate remedy at law is meant one which is as speedy, efficient and complete as that which equity can afford, or in other words, as practical and efficient to the ends of justice and its prompt administration as the remedy in equity." [164] Even beyond the limited applicability of pecuniary relief in the context of proxy violations,[165] the protracted *Mills* and *Gerstle* litigations raise serious doubts concerning the speediness of the remedy.[166] Therefore, although the remedy may be adequate in a particular case, a detailed examination must be made in each instance to determine its applicability.

A final determinant in the decision to grant the shareholder interlocutory relief is a finding that the threatened harm which the plaintiff alleges is commensurate with the resulting harm to defendant should injunctive relief be granted. In *Committee for New Management of Butler Aviation v. Widmark*,[167] for example, plaintiff sought to enjoin the use of proxies solicited to elect a board of directors. In denying relief, the court stated that if preliminary relief were granted on the

163. This is not to suggest that denial of rescissional relief has been an incorrect result in any particular case. Reliance on an "illusory" remedy, however, to "enforce" the disclosure requirements of the proxy rules frustrates the avowed remedial purpose of the Act.

164. W. DEFUNIAK, *supra* note 128, at 11.

165. *See* notes 84-93 *supra* & accompanying text.

166. In both cases, although the mergers at issue were consummated in 1963, the seemingly endless litigation continues a decade later.

167. 335 F. Supp. 146, 152 (E.D.N.Y. 1971). In this case, the fact that issuance of a temporary injunction might prejudice the stockholders against the defendant was determinative in the decision not to enjoin the use of proxies which it was alleged were solicited unlawfully. Other courts have balanced the respective pecuniary harms which would result to the parties if an injunction were granted or denied. One commentator, however, warns that too strict an application of a doctrine of balancing the respective harms to the parties may lead to "placing the plaintiff's right to relief upon a dollars and cents basis, whereby what to the plaintiff is a substantial right is lost or irreparably injured simply because it does not approach in pecuniary amount the loss or hardship that the defendant will suffer if relief is granted." W. DEFUNIAK, *supra* note 128, at 49.

"eve" of the election, the harm to defendant would outweigh that to plaintiff since issuance would be viewed by shareholders as a final determination of defendant's wrongdoing. Although possible shareholder prejudice should be considered, the court could have postponed the meeting and, should the defendant have been subsequently vindicated, ordered corrective measures if necessary to alleviate shareholder fears. To deny injunctive relief on the basis of a contingency which might never occur seems unwarranted.

Although the majority of shareholder suits for injunctive relief have been unsuccessful, relief occasionally has been afforded. In *Union Pacific Railroad v. Chicago & Northwestern Railway*,[168] shareholder vote on a proposed merger was enjoined, the meeting postponed for at least 60 days, a new record date set, and a resolicitation ordered. Even though plaintiff's demand was for a preliminary injunction, both parties were afforded full opportunity to present their cases on the merits. Upon finding that section 14(a) had been violated, the court, acting before the Supreme Court decision in *Borak*, expressed doubt concerning its ability to set aside a completed vote. It concluded, however, that even if such a remedy were possible, plaintiff had shown irreparable harm warranting immediate relief.[169]

*Union Pacific* is the leading pre-*Borak* case affording injunctive relief to a shareholder. After the decision in *Borak*, it was assumed that ready access for individuals to various remedies would follow. It has been shown that this hope did not materialize in the form of damages or rescission. Shareholder success in obtaining injunctive relief has been little better.

Since *Borak*, few cases have been reported granting relief in shareholder injunction actions. In *Cooke v. Teleprompter Corp.*,[170] the failure of the defendant corporation to disclose, in proxy solicitation materials utilized to gain approval for the reelection of the board, that its chief officer had been convicted of bribery was found materially misleading and therefore violative of section 14(a). Accordingly, the annual meeting was adjourned to permit a resolicitation with the appropriate dis-

168. 226 F. Supp. 400 (N.D. Ill. 1964).

169. In *Union Pacific*, plaintiff had argued that to permit the use of the illegally obtained proxies would result in the defeat of the proposed merger. The court stated: "To confirm this result and then set it aside would gain nothing." *Id.* at 413.

170. 334 F. Supp. 467 (S.D.N.Y. 1971).

closure.[171] In *Dillon v. Scotten, Dillon Co.*,[172] it was held that solicitation materials were materially false and misleading as to the status of two members elected to the board of directors. In a reparative decree, the proxies used at the meeting at which the directors were elected were declared void and the former directors reinstated.

*Dillon* and *Cooke* illustrate the flexibility of the injunction; such custom-made relief serves both the preventive and remedial purposes of the proxy rules. Nevertheless, a more typical result is the denial of injunctive relief for failure to establish one or more of the common law requirements. The argument may be advanced, however, that holding the shareholder to a stricter burden than that required of the SEC is unwarranted when enforcement of the proxy rules is at issue. As the Supreme Court recognized in *Mills*, the shareholder suit often benefits the corporation as a whole. Accordingly, the distinction between public and private interests is frequently tenuous when the shareholder seeks to enforce compliance with the disclosure requirements of section 14(a). In addition, if the individual's implied right to sue under section 14(a) derives from the statute itself rather than the common law,[173] the standards articulated in the injunction section of the Act arguably should control, and the plaintiff should prevail upon the same "proper showing" required of the SEC.

To require a shareholder to meet criteria which often preclude his efforts to prevent abuses in the proxy solicitation process seemingly frustrates the policy expressed by the Supreme Court in *Borak*. However, the possibility for abuse should the individual's burden be lessened

171. For a recent decision granting preliminary relief, see Coalition to Advocate Pub. Util. Responsibility v. Engels, CCH FED. SEC. L. REP. ¶ 93,972 (D. Minn. 1973), in which suit was brought to enjoin the defendant from changing a cumulative voting requirement. The court concluded that preliminary relief was proper since plaintiff had a fair chance of success on the merits, since there was a showing of threatened irreparable harm, and since the harm to the defendant resulting from issuance would be negligible because the status quo would be maintained pending resolution of the propriety of defendant's action. *See also* Dillon v. Berg, 326 F. Supp. 1214 (D. Del.), *aff'd*, 453 F.2d 876 (3d Cir. 1971) (proxies voided, meeting adjourned, and resolicitation ordered); Studebaker Corp. v. Allied Prods. Corp., 256 F. Supp. 173 (W.D. Mich. 1966) (production of shareholder list ordered, meeting postponed, and new record date set).

172. 335 F. Supp. 566 (D. Del. 1971).

173. *Compare* 5 L. Loss, SECURITIES REGULATION 2926 (1969 Supp. to 2d ed.) (a common law right) *with* Studebaker Corp. v. Gittlin, 360 F.2d 692 (2d Cir. 1966) (rights derive from the Act).

is evident. A striking example is the proxy contest, in which the self-interests of the opposing factions are manifest. Frivolous suits may be brought to enjoin the voting of proxies simply to enable the plaintiff to acquire additional shareholder support for his position. The possibility that delaying tactics will be employed thus weigh in favor of retaining the common law requirements for injunctive relief in private enforcement actions under section 14(a).

Assuming that the individual's right to enforce the proxy rules stems from the common law or that the possibility of nuisance suits necessitates the use of the stricter burden, a realistic appraisal and application of the common law elements should result in more frequent injunctive relief. That the harm may be irreparable is clear in light of the frequent unavailability of legal or other equitable remedies. Also evident is the fact that no meaningful generalization can be made with respect to the availability of a particular remedy; the determination must be made on a case-by-case basis.[174]

Implicit in a finding that the threatened harm to a plaintiff is not irreparable often is a refusal to recognize the loss of suffrage rights as a cognizable legal injury.[175] To disregard the seriousness of this injury, especially when other relief is ineffective, frustrates the congressional purpose of ensuring full disclosure. To permit accomplishment of corporate transactions by deceptive means for lack of an adequate remedy in effect validates activities proscribed by the statute.

Clearly, if the stockholder's right to informed suffrage is to be protected, appropriate enforcement measures must be available to prevent, whenever possible, abuse in the solicitation process. Whether the individual's right of action is viewed as statutory or derived from the common law, a basis for the issuance of an injunction arguably exists; without question, ready access to injunctive relief should exist.

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174. Similarly, no meaningful generalization can be made with respect to the severity of a defendant's injury should an injunction issue; such determination must be made on a case-by-case basis. Whatever harm is alleged by a defendant must be balanced against the threatened harm to plaintiff and his chances for success on the merits. In balancing the equities, little, if any, weight should be given the assertion by a defendant that the granting of preliminary relief would prejudice a significant number of shareholders into believing that the defendant was in fact guilty of wrongdoing. *See* note 167 *supra* & accompanying text. *But see* Sherman v. Posner, 266 F. Supp. 871, 874 (S.D.N.Y. 1966).

175. *See* notes 88-89 *supra* & accompanying text.

## A Suggested Approach in Private Enforcement Actions

Establishment of a cause of action predicated upon violation of section 14(a) or rule 14a-9 requires that a misrepresentation in or omission from a proxy statement be material. A finding of materiality should follow from a showing that the defect would have a significant propensity to influence a reasonable shareholder who is in the process of deciding how to vote. The Supreme Court has held that where solicitation of favorable proxies is necessary to gain approval for a proposal, no further showing of causal relationship between the violation and shareholder injury is required if "the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." [176] It is submitted that this rule should also encompass situations in which a proposal could have been adopted without the solicitation of proxies.[177]

The rights of the parties should be ascertained, whenever possible, before proxies are voted. Resolution of a controversy at this point avoids the protracted litigation characteristic of actions for postvote relief.[178] Expedited procedures should be available to determine, prior to a vote, the merits of allegations of proxy rule violations. If a violation is established, a permanent injunction should issue. Typically, a decree would enjoin future violations and the use of the questioned proxies, and a resolicitation would be ordered.

The equity of such an approach is obvious. The shareholder's right to be informed fully on matters requiring a corporate vote is guaranteed; the resulting burden to the solicitor in terms of additional solicitation costs is a direct result of his unlawful action. Disenfranchisement of innocent investors whose proxies have been illegally solicited would be improbable, since the decree can provide for postponement of the shareholder meeting and order a new record date if necessary.

This result requires that the shareholder action be instituted not only prior to the meeting at which the proxies are to be voted but sufficiently prior thereto to permit a trial on the merits. Frequently, however, an action seeking temporary relief will be brought immediately before a scheduled meeting. As previously noted,[179] courts have not been inclined

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176. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970).

177. *See* notes 59-74 *supra* & accompanying text.

178. Typically, litigation involving securities transactions is fully defended. Cases extending five, six, or even ten years are not uncommon. *See, e.g.*, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

179. *See* notes 155-67 *supra* & accompanying text.

to afford such interlocutory relief. Although it is not here suggested that particular results have been incorrect, the judicial reluctance to afford preliminary relief has made it unduly difficult to prevent the use of proxies pending a determination of the validity of their solicitation.

When interlocutory relief is sought, courts should differentiate between financial and nonfinancial proposals, making a realistic appraisal of the possibility in each case for effective relief after the proxies are voted. Financial transactions unlawfully accomplished *may* result in an action for damages but are exceedingly difficult to unwind. Nonfinancial proposals infrequently, if ever, will result in pecuniary loss but may be voided with relative ease.

A finding that a solicitation contravenes section 14(a) and rule 14a-9 warrants invalidation as a matter of course of a nonfinancial transaction approved with the use of the unlawfully solicited proxies.[180] Consequently, it would appear that irreparable harm generally will not result from a refusal to enjoin the voting of proxies on a nonfinancial proposal. In such case, mandatory injunctive relief invalidating the vote and ordering a resolicitation provides adequate protection to the proxy solicitation process.

It is the area of corporate financial proposals, particularly the merger situation, in which the need for a liberalized approach toward preliminary relief is most pressing. A merger consummated in contravention of the proxy rules is only voidable, not void. As Justice Harlan has observed: "[T]he merger should be set aside only if a court of equity concludes, from all the circumstances, that it would be equitable to do so."[181] The difficulties inherent in rescinding a merger, especially after the lapse of time generally required to try the case on the merits, renders the remedy practically nugatory.

If the shareholder has suffered direct financial injury as a result of the unlawfully consummated transaction or if he can demonstrate that the terms of the merger were unfair to him, he may be able to recover compensatory damages, although, as experience indicates, prolonged litigation likely will be required to arrive at an award. There are, how-

180. *See* Dillon v. Scotten, Dillon Co., 335 F. Supp. 566 (D. Del. 1971), in which proxies used to elect two members to a corporation's board of directors were declared null and void, the former directors reinstated, and a resolicitation ordered. *Dillon* represents the proper judicial response when proxies used to gain shareholder approval for nonfinancial transactions are found to have been solicited in contravention of section 14(a) and rule 14a-9.

181. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 388 (1970); *cf.* SEC v. National Sec., Inc., 393 U.S. 453, 463-64 (1969).

ever, numerous instances in which the shareholder will be unable to demonstrate the requisite financial injury. In such case, he will be left with the possibility of being awarded his attorneys' fees, a form of relief of doubtful efficacy either as a remedy for the infringement of his suffrage rights or as a deterrent to future abuses.[182] Although punitive damages would appear to be an appropriate remedy in such circumstances, the judicial reluctance to permit such awards under other provisions of the securities laws likely would preclude such relief for proxy rule violations.[183] The unattractive prospect for effective relief after consummation of a corporate financial transaction, and specifically of a merger, is a factor courts must take into account in considering whether the plaintiff has established that the threatened harm is irreparable.

It would appear that only infrequently will the possible harm to the defendant should preliminary injunctive relief be afforded outweigh the threatened harm to the plaintiff. In nonfinancial transactions, maintenance of the status quo pending a determination of the validity of a solicitation will not unduly injure the solicitor. Although where a proxy contest is involved the possibility that the suit has been brought for its nuisance value and as a delaying tactic must be considered, the requirement of an injunction bond[184] can be used to prevent frivolous suits and to afford adequate protection to the defendant.

Financial transactions involve the more serious question of whether delay at the preconsummation stage might result in abandonment of the proposal. The possibility that the opportunity for merger may be lost if consummation is temporarily enjoined should be given great weight, but this fact alone should not be dispositive. Differentiation between arm's-length and non-arm's-length merger proposals appears warranted, since it is unlikely that a brief delay in consummation of a non-arm's-length merger would result in the abandonment of the proposal. The possibility that time is of the essence in an arm's-length merger opportunity is greater; however, if the court finds sufficient probability that a defect in the proxy statement is material and if postconsummation relief is unlikely, an injunction should issue, notwithstanding possible loss of the merger opportunity. In any case, the solicitor should be required to make a clear and convincing showing that delay will in fact subvert the

182. *See* notes 122-25 *supra* & accompanying text.

183. *See* notes 101-21 *supra* & accompanying text.

184. Note, *Interlocutory Injunctions and the Injunction Bond*, 73 HARV. L. REV. 333 (1959).

proposal; a mere allegation that the merger opportunity will or may be lost should be insufficient to defeat the shareholder's action. Utilization of injunction bonds in such circumstances also merits consideration.

One commentator, analyzing the antitrust implications of corporate merger, has suggested that preliminary relief should be afforded whenever a proposed merger is challenged on antitrust grounds.[185] It is submitted that claimed abuse of the proxy solicitation process may require similar judicial response, in light of the difficulties inherent in obtaining relief once a merger is consummated. A restraining order, issued ex parte, or a temporary injunction would maintain the status quo pending the determination whether to require a resolicitation. Although each case must necessarily be decided on its facts and the discretion of the trial judge maintained, the need to enjoin seems compelling when the defective solicitation will not directly affect a stockholder's equity and therefore will not provide the basis for a subsequent damage award.

## Conclusion

A liberalized approach to injunctive relief does not dictate the result in a particular case; judicial discretion is maintained. Realistic appraisal of the equities, however, should result in greater access to temporary relief for the deserving shareholder while simultaneously providing the flexibility necessary effectively to distinguish frivolous and nuisance suits. The basic suggestion is for a change in emphasis; traditional reluctance to enjoin must be replaced with a cognizance of the need for relief at the prevote stage to prevent the use of proxies allegedly solicited in violation of section 14(a) and rule 14a-9. Preliminary relief results in maintenance of the status quo pending a determination of the materiality of the alleged defects. Consequently, inequitable results can be minimized while shareholder protection is enhanced.

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185. Note, *"Preliminary Preliminary" Relief Against Anticompetitive Mergers*, 82 Yale L.J. 155 (1972).