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Corporations - Nominee Voting in a Proxy Contest

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CORPORATIONS

Nominee Voting in a Proxy Contest

Early in 1963 a minority stockholder group led by plaintiffs attempted to elect as their representative one member of the five man board of directors of the *Peoria and Eastern Railway Company*.[1] In order to accomplish this plaintiffs solicited proxies from stockholders. Fifty of the stockholders were brokerage houses which held the stock as nominees for the beneficial owners who were their clients. Plaintiffs sent one solicitation to each house. The custom in the brokerage business is for the house upon receipt of one solicitation to request enough solicitations so that the house can forward one copy to each beneficial owner with the cost defrayed by the solicitor. Twenty-one of the houses did not request additional solicitations. At the annual stockholders meeting on April 12, 1963, eighteen of the twenty-one houses voted the stock to which they held legal title as nominees against the plaintiffs.

The plaintiffs initiated this action to set aside the election of the board of directors and compel the twenty-one houses to send solicitations to the beneficial owners. The case was dismissed, without prejudice to the plaintiffs, for failure to join the twenty-one houses and the board of directors as indispensable parties to the suit.

This case will have an important effect upon two areas in proxy contests because it reopens two questions which the courts had previously considered settled and closed. The first is under what conditions will a nominee be allowed to vote the stock he holds, and what effect the unlawful voting of that stock by the nominee will have upon the outcome of corporate elections? The second question is, does a private individual have a cause of action against a firm which is a member of a national securities exchange when the member firm has violated the regulations of the exchange and thereby caused injury to the private individual?

Previous to 1956 it had been held that when a stock is sold and not transferred on the books of the corporation the record holder has the right to vote the stock.[2] Similarly when stock is

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[1] Walsh and Levine v. Peoria and Eastern Railway Company, 222 F.Supp. 516 (S.D.N.Y. 1963).

held by a brokerage house as nominee the house has the right to vote the stock.[3] When stock is held in the name of a nominee the fact that the nominee votes the stock is prima facie evidence that the beneficial owner authorized the nominee to vote, and the only person who could question such an authorization was the beneficial owner.[4] Even where the voting of the stock had violated the proxy regulations of the New York Stock Exchange, the court refused to allow the injured private party in the proxy contest a cause of action against the nominee under the theory that the nominee brokerage firm and the New York Stock Exchange were parties to a contract, and the injured party had no rights to sue upon that contract because it was not a party to it. The only cause of action in such a case would be by the exchange against the member firm.[5] These decisions placed both the beneficial owner and the contestant in a proxy contest at a disadvantage. Unless the nominee forwarded the solicited material on his own initiative, the beneficial owner would not necessarily know the true state of affairs in the corporation, and the contestant would not be able to reach the beneficial owner because the nominee was under no duty to forward the material or to disclose the names of the beneficial owners.

Pursuant to the duties of the Securities and Exchange Commission to protect the public interest and to act as an impartial referee between proxy contestants, the commission in 1956 revised it rules dealing with proxy contests. The *Peoria* case is only the most recent decision that reverses the old rule of evidence that the voting by a nominee is prima facie evidence that the nominee had the authorization of the beneficial owner to vote.[6] Under the revised rules if a nominee unlawfully votes its stock, an injured third party may now question the authorization of the nominee to vote and make additional proof necessary by the nominee.

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2 Thompson v. Blaisdell, 107 A. 405, 93 NJL 31 (1919); Wick v. Youngstown Sheet & Tube Co., 188 N.E. 514, 46 OA 253 (1932); In re Giant Portland Cement, 21 A.2d 697, 26 DCh 32 (1941).

3 In re Pressed Steel Car Co., 16 F.Supp. 329 (W.D.Pa. 1936); Atterbury v. Consolidated Copper Mines Corp., 20 A.2d 743, 26 DCh 32 (1941); McLain v. Lanova Corp., 29 A.2d 209, 28 DCh 176 (1944); Tracy v. Brentwood Village Corp., 59 A.2d 708, 30 DCh 406 (1948).

4 In re Canal Const., 182 A. 545, 21 DCh 155 (1936); In re Giant Portland Cement, *supra;* In re Pressed Steel Car Co., *supra.*

5 In re Pressed Steel Car Co., *supra.*

6 Dann v. Studebaker-Packard Corp., 288 F.2d 201 (6th Cir. 1961).

A nominee may still vote but strict limitations have been placed upon this right. The revised rules give the nominee two alterative courses of action. Under the first alternative the nominee may conform to the new rules and file a declaration of information on schedule 14B as an interested party to the contest. The nominee is then free to choose sides in the contest, solicit proxies, and vote them. But part of the information required in schedule 14B makes the nominee disclose the amount of stock he holds as nominee and the names of the beneficial owners.[7] Thus the records of the brokerage firm would become a matter of public record assuring both contestants a chance to reach the beneficial owners with their solicitation material. But because the firm's records will become a matter of public record it will be only under very unusual circumstances that this alternative will be followed.

The second alternative allows the nominee to exempt himself from conforming to the new rules if he meets certain requirements.[8] The nominee must forward all information to the beneficial owner without compensation except for the defrayment of costs by the person making the solicitation. Upon forwarding this information the nominee must instruct the beneficial owner to send the proxy to the solicitor or to return it to the nominee who will vote it in accordance with the instructions of the beneficial owner, and if the beneficial owner does neither of

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[7] S.E.C. Rule 14a-11 (c3), (17 C.F.R. #240.14a-11 (c3), Supp. 1963).

"(b) State the amount of each class of securities of the issuer which you own of record by not beneficially."

"(f) State the amount of securities of the issuer owned beneficially, directly or indirectly, by each of your associates and the name and address of each such associate."

[8] S.E.C. Rule 14a-2, (17 C.F.R. #240.14a-2, Supp. 1963).

"(b) Any solicitations by a person in respect to any securities carried in his name or in the name of his nominee . . ., if such person:

"(1) Receives no commission or remuneration . . ., other than reimbursement of reasonable expenses;

"(2) Furnishes promptly to the person solicited a copy of all solicited material . . .;

"(3) . . . does no more than impartially instruct the person solicited to forward a proxy to the person, if any, to whom the person solicited desires to give a proxy, or impartially request from the person solicited instructions as to the authority to be conferred by the proxy and state that a proxy will be given if no instructions are received by a certain date."

these within a stated time before the election, the nominee then has the implied authority of the beneficial owner to vote the stock as he feels is in the best interests of the beneficial owner. Because only the nominee knows how many beneficial owners for whom he holds stock, the *Peoria* case logically interprets the revised rules so as to place a duty upon the nominee to request from the solicitor enough solicitations so that one copy can be forwarded to each beneficial owner. And if the nominee votes the stock without following either of these two alternatives, the *Peoria* case strongly suggests that the results of an election would be set aside by the court if the contested votes would change the results of the election.

In 1961 the federal courts allowed injured private parties to bring suit against companies that violated the Securities and Exchange Commission regulations without waiting for the commission to bring the action.[9] The next logical step would be for the courts to allow injured private parties to bring suit against brokerage firms which violate the rules of the national exchange of which the firms are members. The *Peoria* case does not directly decide this issue, but in very cautious language it suggests that the court may in the future uphold such an action by a private party, stating; ". . . by reason of the regulated nature and the regulatory function of the national securities acts, [the rules of the national securities exchanges] establish public duties on the part of the brokers which may give rise to private suits cognizable by this court." [10] The reasoning of the court seems to be that while a contract exists between the national securities exchanges and their member firms, private parties are also parties to that contract as third party beneficiaries. This slight suggestion reopens the question previously decided in 1936 by a federal court when it stated positively that a private party has no cause of action against a firm which violates the rules of the exchange of which it is a member.[11] If this suggestion in the case should become a general policy of the courts, it will undoubtedly increase self-regulation and stricter control by the individual firms in all phases of their securities practice, and a new area of litigation will be opened up for the courts.

J. L. V.

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[9] Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961); Dann v. Studebaker-Packard Corp., *supra.*

[10] Walsh and Levine v. Peoria and Eastern Railway Company, *supra,* p. 519.

[11] In re Pressed Steel Car Co., *supra.*