

May 1970

## Corporation Law - Misleading Proxy Solicitations. *Mills v. Electric Auto-Lite Co.*, 90 S. Ct. 616 (1970)

Leonard F. Alcantara

Follow this and additional works at: <https://scholarship.law.wm.edu/wmlr>



Part of the [Business Organizations Law Commons](#)

---

### Repository Citation

Leonard F. Alcantara, *Corporation Law - Misleading Proxy Solicitations. Mills v. Electric Auto-Lite Co.*, 90 S. Ct. 616 (1970), 11 Wm. & Mary L. Rev. 1010 (1970), <https://scholarship.law.wm.edu/wmlr/vol11/iss4/11>

Copyright c 1970 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.

<https://scholarship.law.wm.edu/wmlr>

Corporation Law—MISLEADING PROXY SOLICITATIONS. *Mills v. Electric Auto-Lite Co.*, 90 S. Ct. 616 (1970).

Plaintiffs were shareholders of the Electric Auto-Lite Company until 1963 when it was merged into the Mergenthaler Linotype Company. Their complaint alleged that the proxy statement distributed by the Auto-Lite management to solicit shareholders' votes in favor of the merger was misleading, in violation of section 14(a) of the Securities Exchange Act of 1934.<sup>1</sup> The proxy solicitation stated that the Auto-Lite Board of Directors recommended approval of the merger, but failed to indicate that these directors were also nominees of Mergenthaler, and under its control. Under the terms of the merger agreement an affirmative vote of two-thirds of the Auto-Lite shares was required for approval, and the defendants controlled only fifty-four per cent of the stock. The assent of a substantial number of minority shareholders was indispensable for approval of the merger.

The district court concluded that a causal connection between the material error in the proxy solicitation and the merger had been demonstrated, and granted plaintiff's motion for summary judgment.<sup>2</sup> The Court of Appeals reversed on the causality issue. It held that if the defendants could demonstrate that the merger, in all probability, would have received a sufficient affirmative vote even if the proxy statement had not been misleading, the plaintiffs would not be entitled to relief.<sup>3</sup>

---

1. Section 14(a), 78 Stat. 569, 15 U.S.C. § 78n(a) (1964), provides that "[i]t shall be unlawful for any person . . . [to solicit any proxy] . . . in contravention of such rules and regulations as the Commission may prescribe . . . ." Rule 14(a)-9, 17 C.F.R. 240.14a-9 (1969), promulgated pursuant to the statutory authority contained in the section, provides that:

No solicitation subject to this regulation shall be made by means of any proxy statement . . . written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading . . .

2. *Mills v. Electric Auto-Lite Co.*, 281 F. Supp. 826 (N.D. Ill. 1967).

3. *Mills v. Electric Auto-Lite Co.*, 403 F.2d 429 (7th Cir. 1968). The Court of Appeals acknowledged that this test corresponds to the common law fraud test of whether the injured party relied on the misrepresentation. From this it concluded that "[r]eliance by thousands of individuals, as here, can scarcely be inquired into . . ." and held that the issue was to be determined by proof of the fairness of the terms of the merger. If the defendants could show that the merger had merit and was fair to the minority shareholders, the trial court would be justified in concluding that a sufficient number of shareholders would have approved the merger had there been no deficiency in the proxy statement.

The Supreme Court reversed, reaffirming the position of the district court on the causality necessary to support a section 14(a) action.<sup>4</sup>

The right of a shareholder to pursue a private cause of action against a corporation for a violation of a Securities and Exchange Commission rule is a relatively recent judicially created remedy.<sup>5</sup> In 1934 the Securities Exchange Act was enacted with the legislative intention of protecting investors.<sup>6</sup> Section 14(a) of the Act was created to regulate proxy solicitation practices, and Rule 14(a)-9 thereunder to prohibit false or misleading solicitations.<sup>7</sup> The congressional purposes of section 14(a), however, were not fully reflected in the remedies expressly created for its enforcement. Although provision was made for the Securities and Exchange Commission to enforce compliance with section 14(a), no private right of action was established for those injured by its violation.<sup>8</sup>

4. *Mills v. Electric Auto-Lite Co.*, 90 S. Ct. 616 (1970).

5. Although Congress prescribed rules to be adhered to in the issuance of proxy statements and provided fines for infractions of the rules, no right of action was given to a person injured by a defective proxy solicitation. This anomaly existed for thirty years, until 1964, when the Supreme Court provided for a private right of action in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964). Of paramount importance in the Court's reasoning was the fact that the Securities Exchange Commission was incapable of adequately policing the 2000 proxy statements that it approves each week. It was felt that creation of the right in the shareholder would provide a necessary supplement to Commission action. See, Comment, *Private Rights and Federal Remedies: Herein of J.I. Case v. Borak*, 12 U.C.L.A. L. REV. 1150 (1965); 1964 U. ILL. L.F. 838 (1964); 50 CORNELL L.Q. 370 (1965).

6. S. REP. No. 792, 73rd Cong., 2d Sess. 12 (1934):

In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened . . . as to the major questions of policy, which are decided at stockholders meetings. Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.

H.R. REP. No. 1383, 73rd Cong., 2d Sess. 13-14 (1934):

Fair corporate suffrage is an important right that should attach to every . . . security . . . . For this reason the proposed bill gives the . . . Commission power to control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of voting rights of stockholders.

See *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201, 207-08 (1961).

7. See note 1 *supra*.

8. The three sections expressly providing for private remedies are: § 9(e), 48 Stat. 889 (1934), 15 U.S.C. § 78i(e) (1964) (on price manipulations); § 16(b), 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964) (on insiders' profits); § 18, 48 Stat. 897 (1934), 15 U.S.C. § 78(r) (1964) (on misleading statements). There is no express remedy provision made for section 14(a). The Court in *Borak* in creating a private right of action ignored the *expressio unis est exclusio alterius* argument, i.e., that no private right was intended by Congress under section 14(a) because none was expressly provided.

This condition existed until 1964 when the Supreme Court, in *J. I. Case Co. v. Borak*,<sup>9</sup> held that relief was available in a private action by a shareholder against a corporation for violation of section 14(a). *Borak* did not delineate the causal relationship between statutory violation and injury which must be demonstrated to support the action.<sup>10</sup> The lower courts, in effect, were given a mandate to further develop the growing body of the "Federal Common Law of Corporations".<sup>11</sup>

Since *Borak* the lower courts have interpreted the causality requirement in two ways. One group of cases suggests a "but for" test for causation,<sup>12</sup> while the other suggests merely that some causal nexus or "transactional function" be present.<sup>13</sup> The "but for" standard requires the plaintiff to demonstrate that the merger was effected by the misleading proxy statement through influence on the voting results, while the other standard requires only that there be a "transactional function" between the defective proxy statement and the alleged corporate injury.

The "but for" test was applied in *Barnett v. Anaconda Company*,<sup>14</sup> the court holding that the complaint failed to assert a causal connection between the defective proxy and the merger because approval of the merger was a foregone conclusion. The defendant, in that instance, owned more than the necessary number of shares to complete the merger. Conversely, on similar facts, *Laurenzano v. Einbender*<sup>15</sup> applied the "transactional function" test, determining that if the management of the corporation found it necessary for legal or practical reasons to solicit proxies, the solicitation was sufficiently related to the merger to satisfy the causation requirement.

---

9. 377 U.S. 426 (1964).

10. *Id.* at 431. The Court referred to the causality question as an issue to be decided at trial, however, it failed to provide any guidelines for use by the trial court in determining what is sufficient causality. For a definitive treatment of cases involving the "causal connection" requirement, see L. LOSS, SECURITIES REGULATION 2433-39 (Supp. 1969).

11. *Mills v. Electric Auto-Lite Co.*, 281 F. Supp. 826, 829 (N.D. Ill. 1967). See Friendly, *In Praise of Erie—And of the New Federal Common Law*, 39 N.Y.U.L. REV. 383, 412-414 (1964). Judge Friendly foresaw the development of federal common law of corporate responsibility already underway in decisions by federal courts.

12. See, *Barnett v. Anaconda Co.*, 238 F. Supp. 766 (S.D.N.Y. 1965); *Hoover v. Allen*, 241 F. Supp. 213, 231 (S.D. N.Y. 1965); cf. *Robbins v. Banner Indus., Inc.*, 285 F. Supp. 758 (S.D.N.Y. 1966).

13. See *Laurenzano v. Einbender*, 264 F. Supp. 356 (E.D. N.Y. 1966); *General Time Corp. v. Talley Indus., Inc.*, 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1027 (1969); cf. *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326 (7th Cir. 1969).

14. 238 F. Supp. 766 (S.D. N.Y. 1965).

15. 264 F. Supp. 356 (E.D. N.Y. 1966).

In *Mills v. Electric Auto-Lite Co.*, the Supreme Court repudiated the rigid "but for" test because it defeats the purpose for which the private right of action was initially granted in *Borak*.<sup>16</sup> The plaintiff does not have to prove that any injury was caused by the misleading proxy solicitation. He need only demonstrate that the proxies were needed for completion of the merger and that the proxy solicitation contained a material defect.<sup>17</sup> The Court left open for lower court resolution the type of relief which might be granted to the plaintiff, but clearly indicated that damages are recoverable only to the extent shown.<sup>18</sup> The

---

16. *Mills v. Electric Auto-Lite Co.*, 90 S. Ct. 616, 620 (1970). The Supreme Court rejects the Court of Appeals' attempt to employ the "but for" test by using a judicial appraisal of the merits of the merger.

The decision below, by permitting all liability to be foreclosed on the basis of a finding that the merger was fair, would allow the stockholders to be bypassed, at least where the only legal challenge to the merger is a suit for retrospective relief after the meeting has been held. A judicial appraisal of the merger's merits could be substituted for the actual and informed vote of the stockholders.

The result would be to insulate from private redress an entire category of proxy violations—those relating to matters other than the terms of the merger. Even outrageous misrepresentations in a proxy solicitation, if they did not relate to the terms of the transaction, would give rise to no cause of action under § 14(a). Particularly if carried over to enforcement actions by the Securities and Exchange Commission itself, such a result would subvert the congressional purpose of ensuring full and fair disclosure to shareholders.

Further, recognition of the fairness of the merger as a complete defense would confront small shareholders with an additional obstacle to making a successful challenge to a proposal recommended through a defective proxy statement. The risk that they would be unable to rebut the corporation's evidence of the fairness of the proposal, and thus to establish their cause of action, would be bound to discourage such shareholders from the private enforcement of the proxy rules that "provides a necessary supplement to Commission action."

For an interesting criticism of the Seventh Circuit's decision in *Mills* written by the counsel for the plaintiff in *Borak* see Elson, *The Meaning of J.I. Case Co. v. Borak—Remedies Available for Violations of Proxy Rules Under the Federal Securities Act*, 23 Sw. L.J. 609, 614 (1969).

17. The Court does not decide whether sufficient causation would be present where the management controls a sufficient number of shares to approve the transaction without any votes from the minority. However in footnote 7, 90 S. Ct. at 622, the Court cites the *Laurenzamo* case as one which has found sufficient causality on such facts. Whether this is tantamount to approval of the case can only be conjecture, of course.

18. 90 S. Ct. at 624. The Court further discussed the effect of the finding on the merger itself and concluded that the merger was not void but rather voidable at the option of the plaintiff. In addition the Court held that the plaintiffs were entitled to reimbursement from the corporation for the costs of establishing the cause of action. The fact that no monetary award for the injury might be forthcoming in the lower

decision has resolved all doubts concerning section 14(a) violations in favor of the shareholders that the statute was designed to protect. The Congressional policy of insuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions is thereby reinforced.

LEONARD F. ALCANTARA

**Armed Services—THE RIGHT TO PRE-INDUCTION JUDICIAL REVIEW.**  
*Breen v. Selective Service Local Board No. 16*, 90 S. Ct. 661 (1970).

Petitioner Breen was given a II-S, student deferment, pursuant to the provisions of the MILITARY SELECTIVE SERVICE ACT OF 1967.<sup>1</sup> Subsequently, Breen's local board declared him a delinquent and reclassified him I-A.<sup>2</sup> Breen appealed the reclassification and sought an injunction in the district court to prevent possible induction. The court of appeals affirmed<sup>3</sup> the district court's dismissal of the suit for lack of jurisdiction.<sup>4</sup>

On certiorari,<sup>5</sup> the Supreme Court held that a student deferment is guaranteed by statute and cannot be revoked as a punitive measure.<sup>6</sup> Therefore, when the local board violated its statutory authority, pre-induction judicial review should have been available to test the legality

---

courts and the absence of express statutory authorization for reimbursement was not a bar to recovery of costs.

1. Pub. L. No. 90-40, § 6, 81 Stat. 102 *amending* 50 APP. U.S.C. § 456(h) (1964) (codified at 50 APP. U.S.C. § 456(h)(1) (Supp. IV, 1969)).

2. Petitioner Breen surrendered his registration certificate to protest the United States' involvement in Viet Nam. Every registrant must carry his draft card at all times. 32 C.F.R. § 1617.1 (1969). Breen's local board declared him delinquent and reclassified him for failure to perform his duty.

3. 406 F.2d 636 (2d Cir. 1969).

4. 284 F. Supp. 749 (D. Conn. 1968). The district court relied on 50 APP. U.S.C. § 460(b)(3) (Supp. IV, 1969), *amending* 50 APP. U.S.C. § 460(b)(3) (1964), which states that:

No judicial review shall be made of the classification or processing of any registrant by local boards, appeal boards, or the President, except as a defense to a criminal prosecution instituted under section 12 of this title [section 462 of this Appendix], after the registrant has responded either affirmatively or negatively to an order to report for induction . . . . *Provided*, that such review shall go to the question of the jurisdiction herein reserved to local boards, appeal boards, and the President only when there is no basis in fact for the classification assigned to such registrant.

5. *Breen v. Selective Service Local Bd. No. 16*, 394 U.S. 997 (1969) (order granting certiorari). While the case was pending in the court of appeals, a petition to the appropriate selective service appeal board for review of the local board's action was denied, and Breen was ordered to report for active duty.

6. *Breen v. Selective Service Local Bd. No. 16*, 90 S. Ct. 661 (1970).