Securities Regulation—Proof of Causation Under Section 14 of the Securities Exchange Act of 1934—*Mills v. Electric Auto-Lite Co.*[1]— Petitioners were shareholders of the Electric Auto-Lite Company who brought this action, both derivatively on behalf of Auto-Lite and as representatives of the class of all its minority shareholders, against Auto-Lite and Mergenthaler Linotype Company to prevent a proposed merger between the two. Petitioners sought an injunction to prevent the voting of allegedly misleading proxies solicited by the management of Auto-Lite in order to secure the approval of the proposed merger with Mergenthaler. The injunction was not granted and the necessary two-thirds vote needed for approval of the merger was secured from the solicited proxy votes.

Several months later petitioners amended their complaint and asked that the merger be rescinded and other appropriate relief be granted. The amended complaint alleged that the proxy statement sent by the Auto-Lite management violated Section 14(a)[2] of the Securities Exchange Act of 1934 and Rule 14a-9[3] promulgated thereunder, because it failed to disclose material facts necessary to prevent the statements made from being misleading. Petitioners alleged that the Auto-Lite board of directors recommended approval of the merger proposal, but neglected to indicate that all of the directors were nominees of Mergenthaler, which owned 50 percent of the outstanding common stock of Auto-Lite.[4] There was no allegation that the specific terms of the merger agreement were inadequately disclosed or unfair.

The District Court for the Northern District of Illinois, ruling on plaintiff's motion for summary judgment, held that the nondisclosure constituted a material omission in light of all the circumstances surrounding the merger.[5] Since the proxy votes of the minority shareholders were necessary to procure the needed two-thirds shareholder authorization, the district court concluded that a causal relationship had been shown by the plaintiffs.[6]

The Court of Appeals for the Seventh Circuit affirmed the conclusion that the nondisclosure was a material omission,[7] but reversed on the issue of causation. The court noted that the defendant-corpora-

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1 396 U.S. 375 (1970). Mr. Justice Harlan delivered the opinion of the Court.

2 15 U.S.C. § 78n(a) (1964) states:

> 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.

3 17 C.F.R. § 240.14a-9(a) (1969).

4 Ultimately, control during this period rested in American Manufacturing Co. since it held voting control of Mergenthaler.

5 Mills v. Electric Auto-Lite Co., No. 63-C-1138 (N.D. Ill. Feb. 14, 1966).

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

7 Mills v. Electric Auto-Lite Co., 403 F.2d 429, 435 (7th Cir. 1968).

tions had presented evidence indicating the fairness of the merger terms, and held that this evidence, if proven, would constitute a defense.[8] Accordingly, the court stated that the case should be remanded and the defendants given the opportunity to prove that the minority shareholders would have voted for the merger proposal even if the material omission had been revealed.[9] Recognizing that "[r]eliance by thousands of individuals, as here, can scarcely be inquired into,"[10] the court held that the defendants would satisfy their burden by simply establishing the fairness of the merger terms.[11]

The issue before the Supreme Court was whether petitioners were entitled to summary judgment if a material omission was made in the proxies and they were necessary to secure approval of the merger. On this issue the Supreme Court HELD: Upon a finding that the proxy statement contains a material misstatement or omission, a petitioner has established the substantive elements of a claim under Section 14 of the Securities Exchange Act of 1934 if the proxies solicited are essential for the accomplishment of the transaction.[12] Though the issue of relief was left to the determination of the district court, the Court elaborated the relevant factors which should be considered in granting relief. In particular, the Court held that petitioners would be entitled to interim attorneys' fees from the defendants.[13] In addition, the Court indicated that the fairness of the merger should be considered in determining whether the merger should be dissolved and whether damages should be awarded.[14]

This casenote will examine the Supreme Court's holding in two respects. The issue of causation will be examined, and the proper relationship of the fairness of the merger to the claim for relief will be analysed.

The common law action of misrepresentation required the plaintiff to prove both defendant's fraudulent intent and plaintiff's justifi-

8 Id. at 436.

9 Id.

10 Id. at n.10.

11 See id. at 436.

12 396 U.S. at 385. The Court indicated that it was not faced with the question whether § 14 would be violated if materially deficient proxies were solicited yet were not needed to approve the transaction. Id. at n.7. Since the Court's holding does not eliminate causation as a material element of a § 14 claim, but only the requirement of proof thereof, it is arguable that in cases where the votes of the solicited shareholders could not affect the outcome, there should be no violation of § 14. Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965), takes this position. The Supreme Court suggested, however, that causation might be shown even if the necessary votes for approval of the corporate transaction are controlled by management. To support this statement, the Court cited a comment where the author argues that causation could be found in *Barnett* because the proxy misrepresentations were used to deceive the shareholders so as to prevent them from contesting breaches of fiduciary duty under state law. Comment, Shareholders' Derivative Suits To Enforce A Corporate Right of Action Against Directors Under SEC Rule 10b-5, 114 U. Pa. L. Rev. 578, 582-3 (1966).

13 396 U.S. at 389.

14 Id. at 386-389.

able reliance upon the misrepresentation.[15] The federal courts, however, have construed the misrepresentation provisions of the federal securities laws as requiring less than the traditional elements of common law fraud.[16] In the *Mills* case, the Court was faced with the question whether section 14(a) required the plaintiff to prove a causal relationship between the proxy omission and the shareholders approval of the merger. The evidentiary problems involved in proving reliance by shareholders have arisen in a number of securities cases.

In contrast to *Mills*, earlier cases have required the plaintiff to prove a causal nexus between the proxy omission and the corporate action. For example, in *Hoover v. Allen*,[17] the plaintiff alleged that a false proxy statement had caused some shareholders to sell their shares to the defendants, thus giving defendants control. The complaint asserted that the defendants then mismanaged the corporate assets. The court noted that the purpose of section 14 was to insure the fair disclosure of information to solicited shareholders, and that to establish a claim for relief under section 14, the plaintiff must establish a causal relationship between the proxy violation and the shareholders' approval of a corporate transaction. The court stated:

> In the absence of some allegation of infringement upon corporate suffrage rights or some corporate action taken as a result of such infringement, no cause of action under section 14(a) has been made out.[18]

As the plaintiff could not establish this causal relationship, his claim for relief on this ground was dismissed.

Barnett v. Anaconda Co.[19] affirms the proposition that a causal nexus between the proxy violation and shareholder approval of the corporate transaction must be shown by the plaintiff. In *Barnett* the plaintiff alleged a violation of section 14 in a derivative action brought on behalf of Wire & Cable Co., the acquired corporation. Before the merger, defendant Anaconda owned 73 percent of the outstanding stock of the acquired company. In granting defendant's motion to dismiss, the court held that since only a two-thirds vote was needed to approve the merger and defendant owned more than two-thirds of the outstanding stock, the "but-for element—the element of causation—does not and, indeed, could not exist."[20] Although the *Mills* case is distinguishable because there the proxy votes were necessary for approval of the merger, *Barnett* clearly indicates that a but-for test of causation should

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15 W. Prosser, Law of Torts 700 (3d. ed. 1964).

16 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855-56 (2d Cir. 1968); 2 L. Loss, Securities Regulations 917 (2d ed. 1961); Ruder, Civil Liability Under 10b-5: Judicial Revision of Legislative Intent, 57 Nw. U.L. Rev. 627, 677-80 (1963).

17 241 F. Supp. 213 (S.D.N.Y. 1965).

18 Id. at 230; cf. Lapchak v. Sisto, [1952-1956 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,721 (S.D.N.Y. July 20, 1955).

19 238 F. Supp. 766 (S.D.N.Y. 1965).

20 Id. at 771.

be applied. Thus, a plaintiff would be required to show that the merger would not have been approved but for the omission or misstatement.

The but-for test which *Barnett* espouses may result from an interpretation of the Supreme Court's opinion in *J.I. Case Co. v. Borak*.[21] The case was cited by the court in *Barnett* to support its conclusion on the issue of causation. The court in *Barnett* distinguished *Borak* on the basis that the complaint in *Borak* asserted that the merger would not have been approved but for the false and misleading proxy statements. Since the Supreme Court stated in *Borak* that "the causal relationship of the proxy material and the merger are questions of fact to be resolved at trial,"[22] the court in *Barnett* reasoned that the plaintiff had the burden of proving the but-for element of causation.[23] The Supreme Court's holding in *Mills* indicates that such an interpretation of *Borak* was not correct.[24]

The difficulties of proving actual causation have also been considered by the courts in actions brought under Section 10 of the Securities Exchange Act of 1934[25] and Rule 10b-5.[26] For example, in the case of *List v. Fashion Park, Inc.*,[27] the plaintiff-seller sought damages under Rule 10b-5 from the defendant-buyers claiming that certain material facts had not been disclosed to him. The court recognized the evidentiary problem involved when a plaintiff is forced to prove his reliance upon a fact unknown to him. Accordingly, it held that in such cases "the proper test [of reliance] is whether the plaintiff would have been influenced to act differently than he did if the defendant had disclosed to him the undisclosed fact . . . ."[28] Since the court defined a material misstatement or material omission as information which would affect the judgment of a reasonable investor, the application of this test would generally lead to the conclusion that the plaintiff would have acted differently if the facts had been disclosed.

In the recent case of *SEC v. Texas Gulf Sulphur Co.*,[29] a similar test was employed to establish Rule 10b-5 liability for failure to disclose the contents of one sample drill hole which ultimately led to a major ore discovery. The court emphasized that a reasonable investor

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21 377 U.S. 426 (1964).

22 Id. at 431.

23 See 238 F. Supp. at 770-71.

24 396 U.S. at 383-4.

25 15 U.S.C. § 78j(b) (1964).

26 17 C.F.R. § 240.10b-5 (1969).

27 340 F.2d 457 (2d Cir. 1965).

28 Id. at 463. However, the court required the plaintiff to show his reliance upon any material misrepresentation. It noted:

> Assuredly, to abandon the requirement of reliance would be to facilitate outsiders' proof of insiders' fraud. . . . But this strikes us as an inadequate reason for reading out of the rule so basic an element of tort law as the principle of causation in fact.

Id.

29 401 F.2d 833 (2d Cir. 1968).

would likely attach importance to this information pertaining to the sample drill hole in deciding whether to purchase or sell his securities in Texas Gulf Sulphur Co.[30] Accordingly it held that such information was material.

The existence of a material omission in *List* did not automatically establish causation, for the defendants were allowed to introduce evidence indicating that the plaintiff would have bought or sold his stock even if the truth had been revealed to him. Thus, for example, the court of appeals in *List* held that the evidence supported the finding of the district court that the plaintiff would have sold his securities even if the material information had been disclosed to him.

In *Mills*, the Supreme Court and the court of appeals were in agreement that the party alleging a proxy violation should not have the burden of proving the extent to which any material omission would have affected the judgment of those shareholders whose votes were solicited. The courts' disagreement, however, centered on the relevance of the fairness of the merger to the issue of causation.

The court of appeals held that the fairness of the merger was relevant to the issue of causation.[31] On remand, the respondent-corporations were to be given the opportunity and the burden of proving that the merger proposal was fair and reasonable. Proof of the fairness of the merger would negate the presumption of a causal relationship between the proxy omission and approval of the merger proposal. By requiring the defendant to rebut the presumption of causation, the court of appeals adopted an approach similar to that offered by the court of appeals in *List*. The court of appeals raised the fairness of the merger itself to the level of an affirmative defense to the presumption of causality, reasoning that the fairness of the merger was a practical and equitable means of resolving the issue of causation. The plaintiffs would not be required to establish reliance, but rather the burden of negating the presumption of reliance would be on the party responsible for the proxy violation. Nonetheless, by permitting the fairness of the merger terms to serve as a defense to a claim under section 14, the court of appeals assumed that shareholders would accept a fair merger proposal even if the material omission had been revealed to them.

The Supreme Court's holding in *Mills* that causation is conclusively presumed as a result of the solicitation of proxies containing material omissions which are necessary to secure approval of the corporate proposal, rejects as irrelevant, evidence of the fairness of the merger terms. Neither the statute nor Rule 14a-9 contain the requirement that causation be proven by the plaintiff, and the Supreme Court reasoned from the stautory language and from the purposes of section 14 as enunciated in *J.I. Case Co. v. Borak*,[32] that the policy of Con-

30 Id. at 848-53.
31 See p. 1025 supra.
32 377 U.S. 426 (1964).

gress would be best served by eliminating the necessity of specifically establishing causation.[33] In *Borak* a shareholder of J.I. Case Co. brought an action seeking damages and recision of the consummated merger between J.I. Case and American Tractor Corporation on the grounds that proxies had been solicited in violation of the statute. The Court reasoned that the purpose of section 14 was to provide adequate disclosure of information to shareholders, and that a private right of action should be implied as being necessary to SEC enforcement of proxy violations.[34] The Court expanded this theory in *Mills*, reasoning that if liability were foreclosed because of a finding that the terms of the merger were fair, then outrageous misrepresentations not relating to the merger proposal would be condoned[35] and private actions discouraged.[36] Moreover, the Court rejected the assumption of the court of appeals that the shareholders would accept any fair merger.[37] Thus, the plaintiff must now show only that the misstatement or omission was material, that is, whether the information would be likely to influence the judgment of a reasonable investor in determining whether to buy or to sell securities. Under this test, the determination of reliance is inherent in the determination of materiality.

Clearly, the elimination of the requirement that causation be proven by the plaintiff, and the exclusion of evidence which might negate the presumption of causality encourage full disclosure of material information to the shareholders and facilitate private redress of proxy violations.

It is only when the holding of the Supreme Court is viewed in the context of the peculiar facts of *Mills* that difficulties are raised. In *Mills* a claim for relief was readily established yet no remedy could be afforded to the complaining party. Recision of the merger, the Court suggested,[38] is unlikely since there was no allegation that the merger was unfair. It is improbable that money damages would be granted on remand, since the merger was apparently fair and monetarily beneficial to the shareholders.[39] Indeed, the recognition by the Supreme Court that the shareholders might not receive any money damages did not alter the Court's willingness to allow the plaintiffs to recover interim attorneys' fees.[40] In granting such an award, the

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33 396 U.S. at 381-83.

34 For a discussion of the bases for implying a private remedy under § 14, see Note, 59 Nw. U.L. Rev. 809 (1965).

35 396 U.S. at 382.

36 Id.

37 Id. at n.5.

38 The Court noted:

> Possible forms of relief will include setting aside the merger . . . but, as the Court of Appeals below noted, nothing in the statutory policy "requires the court to unscramble a corporate transaction merely because a violation occurred."

396 U.S. at 386.

39 Id.

40 Id. at 392.

Supreme Court departed, without specific statutory authority, from the traditional common law rule against granting attorneys' fees. Justice Black objected to the Court's implying a right of recovery of attorneys' fees,[41] but without the granting of such fees the policy of private enforcement would not be encouraged.

The most important issue in *Mills* is whether private actions should be fostered in cases where the shareholders have not been monetarily damaged as a result of a corporate merger or transaction for which deficient proxies have been solicited. It may be argued that the approach of the court of appeals gives due consideration to the interests of all the parties, particularly as it allows proof of the fairness of the merger terms by the defendant to defeat a claim for relief. However, the SEC might still have the authority to redress violations of the proxy rules in cases where a private action is foreclosed.[42]

It is submitted, however, that the Supreme Court's holding will more aptly insure adequate disclosure of information to the shareholders whose votes are solicited and encourage private suits to redress proxy violations. If fairness were a defense to maintaining a claim under section 14, not only would possibly gross misrepresentations be tacitly condoned, but shareholders would be deterred from suing to test the validity of a merger or other transaction in cases where it is doubtful whether the merger terms were unfair. Thus, the approach adopted by the Supreme Court is preferable to the rationale of the court of appeals.

The purposes of section 14 cannot be fostered when a wrongdoer can concede his wrongdoing, yet plead immunity from liability on the ground that profit was made for the benefit of all. Indeed, the logical extension of permitting fairness to serve as a defense is that no material information need be disclosed to the shareholders if the merger increases the fair market value of their stock. The Supreme Court's holding in *Mills* supports the policy of the 1934 Act of assuring full and fair disclosure by indicating that a private right of action exists regardless of proof of injury. This interpretation of section 14 should have a profound effect on full and fair disclosure not only under that section, but also under the disclosure sections of the 1934 Act.

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[41] Justice Black reasoned that

> [t]he courts are interpreters, not creators, of legal rights to recover and if there is a need for recovery of attorneys' fees to effectuate the policies of the Act here involved, the need should in my judgment be met by Congress, not by this court.

Id. at 397.

[42] The Securities Exchange Act of 1934, § 32, 15 U.S.C. § 78ff (1964), provides for civil penalties of $10,000 and/or imprisonment for "wilfully and knowingly" making a false or misleading statement in any application, report or document required to be filed under this title.