Proxy Regulation: Ensuring Accurate Disclosure Through a Negligence Standard

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PROXY REGULATION: ENSURING ACCURATE DISCLOSURE THROUGH A NEGLIGENCE STANDARD

INTRODUCTION

Scienter, the "hobgoblin of common law deceit," has become a household word for those involved in securities regulation. The question haunting both courts and practitioners is which sections of the securities acts require scienter and which do not. The answer to this question is crucial to the determination of the scope of liability and protection afforded by each provision of the securities laws.

The watershed of the scienter issue was reached in the Supreme Court decision in Ernst & Ernst v. Hochfelder. The Court in Hochfelder held that an implied private cause of action for damages under section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act), and rule 10b-5 promulgated by the Securities Exchange Commission (SEC), could only be maintained if the actionable conduct was performed with scienter. The Court defined scienter as "the intent to deceive, manipulate, or defraud." Hence, conduct that is merely the result of negligence does not constitute scienter.

1. 3 L. Loss, Securities Regulation 1729 (2d ed. 1961).
8. 425 U.S. at 193.
9. Id. at 194 & n.12.
10. Id. at 214. Scienter traditionally has been defined as an intent to mislead or deceive by the transmission of a false statement. W. Prosser, Handbook of the Law of Torts § 107, at 700-01 (4th ed. 1971). The Supreme Court redefined scienter as the
One question expressly left open by the *Hochfelder* Court is whether scienter is required in an implied private action for damages under the provision of the 1934 Act governing misstatements or omissions in proxy statements,\(^\text{11}\) section 14(a)\(^\text{12}\) and rule 14a-9 promulgated thereunder.\(^\text{13}\) This issue, although noted by the Supreme Court in a later decision,\(^\text{14}\) has never been decided.\(^\text{15}\) While the majority of the federal appellate courts have indicated that they favor a negligence standard,\(^\text{16}\) at least one circuit has held that a showing of scienter is necessary under the proxy rules.\(^\text{17}\)

This note analyzes the proxy provisions in an effort to determine the proper standard of culpability. Part I discusses the background of the proxy provisions and the elements of a cause of action under section 14(a). Utilizing the *Hochfelder* statutory construction analysis, Part II concludes that the proper standard of culpability under the proxy provisions should be one of negligence. Part III demonstrates that this conclusion is consistent with the important disclosure policies underlying the proxy rules and commensurate with the obligations of the various participants in a proxy solicitation.

\(^{11}\) 425 U.S. at 209 n.28.


\(^{13}\) 17 C.F.R. § 240.14a-9 (1981).


I. THE PROXY PROVISIONS

The use of proxies has become a practical necessity in modern corporate life. Shareholders in publicly held corporations are geographically dispersed throughout the country and thus are usually unable to attend a stockholder meeting. As a result, "'[a] shareholders' meeting [has become] a kind of ancient, meaningless ritual.'" Corporate decisions requiring shareholder approval, therefore, must be accomplished by proxy.

In order to make absentee voting a viable organizational tool, information disseminated by proxy must fully and accurately disclose the facts upon which a shareholder will base his voting decision. To ensure the free flow of honest, reliable information to shareholders,

18. "The proxy relationship is commonly defined as the agency created when a corporate shareholder authorizes the proxy holder to represent him at the shareholder meeting by casting the votes to which the shareholder is entitled by virtue of his stock ownership." Comment, Proxy Solicitations: The Need for Expanded Disclosure Requirements, 60 Marq. L. Rev. 1100, 1101 (1977). Under the securities laws, the word proxy is a term of art and includes every "proxy, consent, or authorization." 17 C.F.R. § 240.14a-1(d) (1981); see A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 6.5(321), at 136.21 (1981); 2 L. Loss, supra note 1, at 871.


20. Aranow & Einhorn, supra note 19, at 306; Brey, supra note 19, at 58; Shareholder Democracy, supra note 19, at 146; see 2 L. Loss, supra note 1, at 857-58.

21. 2 L. Loss, supra note 1, at 869 n.35 (quoting A. Berle, Economic Power and the Free Society 7 (1958)).

22. 2 L. Loss, supra note 1, at 857-58; Note, SEC v. Falstaff Brewing Corp.: Imposing a Stringent Duty of Care on Corporate Board Nominees Under Section 14(a) of the Securities Exchange Act of 1934, 74 Nw. U. L. Rev. 468, 469 (1978) [hereinafter cited as Board Nominees].

23. Shareholder Democracy, supra note 19, at 153; Board Nominees, supra note 22, at 469.

24. J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964); 2 L. Loss, supra note 1, at 857-58; Comment, Shareholders' Remedies for Violation of Proxy Rule 14a-9, 31 Sw. L. J. 1125, 1125 (1977) [hereinafter cited as Shareholders' Remedies]; Comment, Private Actions and the Proxy Rules: The Basis and the Breadth of the Federal Remedy, 31 U. Chi. L. Rev. 328, 333-34 (1963) [hereinafter cited as Private Actions]; Note, Causation and Liability in Private Actions for Proxy Violations, 80 Yale L.J. 107, 122 (1970) [hereinafter cited as Causation & Liability]; Board Nominees, supra note 22, at 469. Section 14(a) was enacted "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 not only as to the financial condition of the corporation, but also as to the major questions of policy which are decided at stockholders meetings. Too often proxies are solicited without explanations to the stockholders of the real nature of the questions for which authority to cast their vote is sought." S. Rep. No. 792, 73d Cong., 2 Sess. 12 (1934).
Congress enacted section 14(a) of the 1934 Act to deal specifically with proxy materials.\textsuperscript{25} Section 14(a) makes it unlawful to issue proxy materials in violation of the rules and regulations promulgated by the SEC.\textsuperscript{26} Pursuant to this broad rule-making authority,\textsuperscript{27} the SEC formulated rule 14a-9, which forbids the use of proxies containing false and misleading statements of fact, or omissions of fact, material to a shareholder's voting decision.\textsuperscript{28}

Section 14a was not designed to function as a prohibitory section,\textsuperscript{29} but rather to shed the "white light of publicity" on corporate transactions.\textsuperscript{30} The focus of section 14(a) and rule 14a-9 is to place upon those seeking shareholder consent the responsibility for any misrepresentations.\textsuperscript{31} Only secondarily are they meant to deter self-dealing and fraudulent practices by management.\textsuperscript{32} Section 14(a) and rule 14a-9 are thus essential tools used by the SEC for ensuring corporate disclosure\textsuperscript{33} and have "probably had a more beneficial effect on 'corporate democracy'... than any other of the numerous weapons in the SEC arsenal."\textsuperscript{34}

\textsuperscript{25} See 15 U.S.C. § 78n(a) (1976). The proxy rules also make it unlawful for a member of a national securities exchange or any broker to give or refrain from giving a proxy in violation of SEC rules. Id. § 78n(b). In addition, even if a proxy is not solicited, prior to an annual meeting, a shareholder must be provided with all the necessary information that would have been provided had a proxy been solicited. Id. § 78n(c). The proxy rules also cover tender offers and offers to make a tender offer, id. § 78n(d), and contain a prohibition against the use of fraud in a tender offer. Id. § 78n(e).

\textsuperscript{26} Id. § 78n(a). See infra note 70 for the text of section 14(a).


\textsuperscript{28} 17 C.F.R. § 240.14a-9 (1981).

\textsuperscript{29} Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1299 (2d Cir. 1973); see 2 A. Bromberg & L. Lowenfels, supra note 18, § 7.6 (121), at 134.7. The basic purpose of the proxy provisions is informed corporate suffrage. J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964); Howard v. Furst, 140 F. Supp. 507, 510 n.4 (S.D.N.Y.), aff'd, 238 F.2d 790 (2d Cir. 1956), cert. denied, 353 U.S. 937 (1957).

\textsuperscript{30} 78 Cong. Rec. 7925 (statement of Rep. Chapman), quoted in Causation & Liability, supra note 24, at 122; accord Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381-83 (1970); J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964); Private Actions, supra note 24, at 333. By compelling disclosure, § 14(a) was intended 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 the voting rights of stockholders." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934).

\textsuperscript{31} Causation & Liability, supra note 24, at 121-23.

\textsuperscript{32} 2 A. Bromberg & L. Lowenfels, supra note 18, § 6.5 (121), at 134.7.

\textsuperscript{33} J.I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964); K. Skousen, supra note 27, at 25; Board Nominees, supra note 22, at 469; Proper Standard, supra note 15, at 670-71; see H. Bloomenthal, Securities Law in Perspective 117 (1977).

\textsuperscript{34} 2 L. Loss, supra note 1, at 866.
The proxy provisions apply to any security that is either listed on a national exchange, or traded over-the-counter if the issuer has 500 or more shareholders of record and a million dollars or more in total assets. Section 14(a) applies to "any person [who] solicit[s] or [per-
mits] the use of his name to solicit any proxy"; therefore, liability may be imposed on a corporation, directors, outside directors, board nominees, and accountants.

The three major elements that a plaintiff must prove in a private action under section 14(a) are: (1) that the proxy materials contained a false or misleading statement of a material fact; (2) that the proxy solicitation was an essential link in effecting the proposed corporate transaction; and (3) that the defendant acted with some level of

35. 15 U.S.C. § 78l(g)(1) (1976); see 2 A. Bromberg & L. Lowenfels, supra note 18, § 6.5(311), at 135.
culpability. The test of materiality is whether "there is a substantial likelihood that a reasonable shareholder would consider [the misleading statement] important in deciding how to vote." This stringent test apparently subsumes the causation element: "So long as the misstatement or omission [is] material, the causal relation between violation and injury is sufficiently established... if 'the proxy solicitation itself... was an essential link in the accomplishment of the transaction.'

Determining the proper standard of culpability has proven to be most difficult. Several courts have stated that they favor the adoption of a negligence standard, one court has left open the possibility


45. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). The materiality standard announced in TSC was formulated to counterbalance what the Court assumed could be a low threshold of liability under § 14(a). Id. at 449 n.10. The Court asserted that the danger of unlimited liability under § 14(a), which could occur if a negligence standard were adopted, would be reduced by the onerous task of proving that a misstatement was material. See id.


of strict liability, and one court has held that scienter is required.

These dissimilar conclusions can be attributed to the nature of section 14(a) as an implied remedy. Like other sections that do not expressly create a cause of action, section 14(a) does not "spell out the extent to which traditional fraud elements—such as scienter . . . are required." Moreover, the diverse classes of defendants that may be liable under section 14(a) exacerbate the task of setting a uniform standard of culpability.

Proper determination of the standard of culpability under section 14(a) is crucial because it defines the scope of section 14(a) and, consequently, of rule 14a-9. Imposition of a scienter standard serves to shield defendants from potentially egregious liability, whereas the imposition of a negligence standard would more fully encourage accurate disclosure in proxy solicitations.


52. See Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 428 (6th Cir.), cert. denied, 449 U.S. 1067 (1980); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1298-99 (2d Cir. 1973); Liability, supra note 15, at 744; Proper Standard, supra note 15, at 670-71; Misleading Proxy, supra note 27, at 579. Although § 14(a) does not provide for agency enforcement, the SEC has express authority under § 21(d) of the 1934 Act to seek injunctive relief whenever it appears that a person is engaged or about to engage in acts or practices constituting a violation of [the Act].” 15 U.S.C. § 78u(d) (1976).

53. H. Bloomenthal, supra note 33, at 74.

54. See supra notes 36-41 and accompanying text.

55. Liability, supra note 15, at 757-58. Commentators have suggested differing standards for each class of defendants. E.g., Proper Standard, supra note 15, at 688-90 (modified scienter standard for outside directors); Board Nominees, supra note 22, at 486-89 (gross negligence standard for board nominees); Misleading Proxy, supra note 27, at 586-87 (negligence standard for accountants).


57. Misleading Proxy, supra note 27, at 585-86; Federal Securities, supra note 48, at 577-79; see Board Nominees, supra note 22, at 483-89 (contending that a standard more stringent than gross negligence would discourage people from serving as outside directors).

II. The Proxy Provisions: What Standard of Culpability?

The formula for determining the standard of culpability for an implied cause of action under the securities laws was set forth by the Supreme Court in *Ernst & Ernst v. Hochfelder*. The Court employed a three-step analysis, which included an examination of the section's language, legislative history, and relationship to other securities provisions.

A. Statutory Language

As the Supreme Court in *Hochfelder* stated, “[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [securities acts] must . . . rest primarily on the language of that section.” For example, the *Hochfelder* Court determined that language in section 10(b) such as “manipulative,” “device” and “contrivance” was strong evidence of a congressional intent to proscribe only intentional conduct. Indeed, the Court found that the use of such words, standing alone, could be dispositive on the issue of culpability. Conversely, the absence of language evincing a congressional prohibition on only fraudulent conduct is indicative of a lesser culpability standard. Thus, in *Aaron v. SEC*, the Supreme Court determined the standard of liability under the three subparagraphs of section 17(a) of the Securities Act of 1933 (1933 Act) on the basis of the presence or absence of the language found in section 10(b). The Court held that a scienter requirement was intended by Congress under subparagraph 1, which contains the terms “device,” “scheme” and “artifice,” but not intended under subparagraphs 2 and 3, which contain no such language connoting culpability.

60. *id.* at 197-211. In *Aaron v. SEC*, 446 U.S. 680 (1980), the Supreme Court followed a similar analysis in determining whether scienter was required under the various subdivisions of § 17(a) of the 1933 Act, 15 U.S.C. § 77q (1976), *id.* at 695-700, but used only two steps because it found the legislative history and the language to be determinative on the culpability issue. *id.* at 700 n.19.
67. 446 U.S. at 696-97.
68. *id.* at 696-97.
“knowing or intentional practices.” In effect, the Court presumed that when Congress desired to impose a scienter standard under the securities laws, it knew what words to put into the statute.

Section 14(a) unlike section 17(a)(1) and section 10(b), is devoid of language indicating a scienter requirement. In fact, as the Second Circuit has observed, the language of section 14(a) is extremely “broad, extending to all proxy regulation 'necessary or appropriate in the public interest or for the protection of investors' and not limited [as in section 10(b)] by any words connoting fraud or deception.” Such language quite plainly evidences a congressional focus upon the effect of misstatements on the protected class rather than upon the extent of liability of the responsible individuals. The plain meaning of section 14(a), like that of sections 17(a)(2) and (3), “does not require a 'showing [of] deliberate dishonesty as a condition precedent to protecting investors.’” Thus, consonant with the general principle of

69. Id. at 696.

70. Gould v. American-Hawaiian S.S. Co., 535 F.2d 761-777 (3d Cir. 1976); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1298-99 (2d Cir. 1973); see Proper Standard, supra note 15, at 676; Board Nominees, supra note 22, at 477-80; Liability, supra note 15, at 745. Section 14(a) 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.” 15 U.S.C. § 78n(a) (1976).

71. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1299 (2d Cir. 1973) (quoting §14(a)).


73. Aaron v. SEC, 446 U.S. 680, 697 (1980) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 200 (1963)). The Supreme Court, in determining the proper standard of culpability, has tried to divine whether the language of a section in question was designed to regulate a particular type of conduct or to provide relief for certain classes of protected individuals. Aaron v. SEC, 446 U.S. 680, 697 (1980); see SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 200 (1963). In both Aaron and Capital Gains, the Supreme Court was faced with statutes that contained the words “fraud” and “deceit.” Aaron v. SEC, 446 U.S. 680, 696-97 (1980) (§ 17(a)(3) of the 1933 Act, 15 U.S.C. § 77q(a)(3) (1976)); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) (§ 206(2) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (1976)). In both cases, however, the Court found that the word “operate” preceding “fraud” and “deceit” signaled that Congress was focusing on the effect of the wrongful conduct rather than the state of mind of the defendant. Aaron v. SEC, 446 U.S. 680, 694 (1980); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 197-201 (1963). Because of this focus, the Court held in both cases that scienter was not required. Aaron v. SEC, 446 U.S. 680, 697
affording the securities laws a meaning as broad as their language will permit, no such requirement should be inferred unless the legislative history contains "a very clear expression . . . of congressional intent to the contrary." 

B. Legislative History

The legislative history of the securities laws has generally been considered by the courts as less than helpful in divining the intent of Congress, and that of section 14(a) is no exception. In Adams v. Standard Knitting Mills, Inc., however, the Sixth Circuit concluded that the legislative history of section 14(a) was convincing evidence of a congressional design to prohibit only intentional fraud. The court reached this conclusion after reviewing "one example" in the Senate report, as well as the "few times the proxy section was discussed in debate." Although language contained in these "informative sections" illustrated a congressional concern with "promiscuous solici-
tation of . . . proxies” 83 and “unscrupulous corporate officials . . . concealing and distorting facts,” 84 the legislative history never mentions a culpability standard. 85

The absence of any such statement in the debates or reports has led another court to conclude that “the legislative history . . . provides no significant assistance” in determining a culpability standard. 86 At best, the legislative materials are ambiguous on this issue and clearly do not mandate a scienter requirement. 87 In determining the culpability standards of other sections of the securities laws, the Supreme Court has ruled that “[i]n the absence of a conflict between reasonably plain meaning and legislative history, the words of the statute must prevail.” 88 Because the legislative history can also be read consistently with a negligence standard, the plain meaning of section 14(a) should control. 89 Moreover, such a standard is consistent with Congress’s desire “to substitute a philosophy of full disclosure for the philosophy of caveat emptor” 90 by placing the responsibility for misrepresentations on those in control of the information.

C. The Statutory Scheme

Although the 1933 and 1934 Acts have different objectives, 91 they should be construed in pari materia as a comprehensive scheme of

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83. Id. at 429 (emphasis omitted) (quoting S. Rep. No. 1455, 73d Cong., 2d Sess. 77 (1934)).
84. Id.
85. See Misleading Proxy, supra note 27, at 584-85; Board Nominees, supra note 22, at 462; Liability, supra note 15, at 755-56; Proper Standard, supra note 15, at 677-80.
87. Misleading Proxy, supra note 27, at 585; Board Nominees, supra note 22, at 462; Liability, supra note 15, at 756; Proper Standard, supra note 15, at 680.
securities regulation. As the Supreme Court has noted, "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen." An examination of the culpability standard under other sections of the securities laws similar in purpose to section 14(a) is important in determining whether the adoption of a particular standard is compatible with the entire scheme of securities regulation.

By comparing section 14(a) with other provisions of the 1934 Act that deal with misstatements and omissions, it is evident that section 14(a) is unlike sections such as 10(b), 14(e) and 18, which require proof of scienter. Section 18 expressly creates a cause of action for damages on behalf of buyers and sellers of securities for false and misleading statements in documents that are required to be filed with the SEC. Section 10(b) applies to any fraudulent conduct in connection with the purchase or sale of corporate securities. Unlike these two broad sections, which encompass activity in numerous areas


96. Id. § 78n(e).

97. Id. § 78r.


99. 15 U.S.C. § 78r (1976); see Ross v. A.H. Robins Co., 607 F.2d 545, 551-52 (2d Cir. 1979), cert. denied, 446 U.S. 946 (1980); Heit v. Weitzen, 402 F.2d 909, 915-16 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969); Jacobson v. Peat, Marwick, Mitchell & Co., 445 F. Supp. 518, 525 (S.D.N.Y. 1977); Note, Section 18 and the Securities Exchange Act of 1934: Putting the Bite Back Into the Toothless Tiger, 47 Fordham L. Rev. 115, 115 (1978) [hereinafter cited as Bite Back]. Section 18 expressly provides for a good faith defense; the defendant is liable unless he proves "that he acted in good faith and had no knowledge that such statement was false or misleading." 15 U.S.C. § 78r(a) (1976). In essence, the good faith standard is a scienter standard and will not be satisfied by a showing of ordinary negligence. 3 L. Loss, supra note 1, at 1752 (Good faith "seems to be [a] first cousin to scienter."); see Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 & n.12 (1976).

of securities regulation, section 14(a) deals only with the solicitation of proxies. Unlike proxy statements, most of the documents within the scope of section 10(b) or section 18 are not distributed to shareholders with the intention of inducing either action or inaction by them. The imposition of a more demanding standard of conduct under section 14(a) than that imposed under sections 10(b) and 18 is a reasonable interpretation of the heightened need for adequate disclosure in proxy solicitations.

As alternate means of achieving corporate control, proxies and tender offers have been subject to similar abuse and, consequently, to analogous regulation. Section 14(a) should, therefore, be compared to section 14(e), which regulates tender offers. Due to the language of section 14(e), which "sounds essentially in fraud," much like sections 10(b) and 18, courts have interpreted section 14(e) as requiring proof of scienter.

between tender offers and proxy solicitations to mandate the adoption of an analogous scienter standard under section 14(a).\textsuperscript{111}

Although the tender offer provisions should be construed to operate in harmony with the proxy provisions,\textsuperscript{112} it must be recognized that regulation of takeover bids presents different policy concerns.\textsuperscript{113} Congress was aware that tender offers are often beneficial to shareholders\textsuperscript{114} and that regulation discouraging their use could harm, rather than protect, investors.\textsuperscript{115} Thus, in enacting section 14(e), Congress avoided "tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid."\textsuperscript{116} As the Supreme Court has noted, Congress phrased section 14(e) in a manner that gives both the target's management and the offeror an opportunity to express and explain their positions without making the section a weapon against takeover bids.\textsuperscript{117}

Consistent with this philosophy,\textsuperscript{118} Congress specifically inserted words such as "fraudulent," "manipulative" and "deceptive,"\textsuperscript{119} thus

\textsuperscript{118} See 113 Cong. Rec. 24,665 (1967) (Statement of Sen. Williams) ("There is no intention in any way to prohibit tender offers. As a matter of fact, I think it might encourage them.").
evincing an intent to limit liability under section 14(e) to conduct made with some degree of scienter. To do otherwise, and make those involved in tender offers liable for every detail, would defeat the countervailing interest in encouraging beneficial takeover bids. Unlike takeover bids, proxies need not be encouraged: Management must by necessity utilize the proxy system. Much like the differing standards under the three paragraphs of section 17, there is nothing anomalous about having a negligence standard under section 14(a), and a scienter standard under section 14(e).

Section 14(a) can be better analogized to section 11 of the 1933 Act, which, in dealing with misstatements and omissions in registration statements, provides for a negligence standard. Both section 14(a) and section 11 apply to single documents that are "direct . . . impersonal [and] aimed at large groups of persons who are expected to act [or refrain from acting] on the basis of the information pre-


120. See supra note 110 and accompanying text.


122. See supra note 72 and accompanying text.

123. See supra notes 19-23 and accompanying text.


These sections were designed to ensure adequate and reliable disclosure in two important areas of securities regulation—the buying and voting of shares. The sole difference between the two sections lies in the status of the plaintiff; the plaintiff under section 11 is a securities investor, while the plaintiff under section 14(a) is a voting shareholder. Because both have similar disclosure needs, it is highly unlikely that Congress intended to afford an individual less protection as a shareholder than he received as a purchaser. Indeed, due to the similarity of sections 14(a) and 11, it is very likely that Congress assumed that the SEC would adopt a standard in section 14(a) analogous to that in section 11.

Section 11 expressly provides a "due diligence" defense for all defendants other than the corporate issuer. To establish the due diligence defense, the defendant must show that he exercised the degree of care of "a prudent man in the management of his own property." The defense varies depending upon the status of the


132. See Lederman, Preparation of Securities Acts Registration Statements and Reports: Meeting the Obligation to Provide a Basis for Appraising the Prospective Impact of Historical Financial Information, 42 Fordham L. Rev. 770, 770 (1974).


defendant as an "expert" or a "nonexpert":\footnote{135} A nonexpert may reasonably rely on the expertise of those employed to prepare any specialized portion of the registration statement.\footnote{136}

The adoption of a due diligence standard of care similar to that of section 11 would be consistent with the regulatory scheme and would not render superfluous other sections of the securities laws that were designed to address different problems.\footnote{137} For example, a false or misleading proxy solicitation that occurs in connection with a merger may be actionable under both section 10(b) and section 14(a).\footnote{138} The question then becomes whether an action can be maintained under section 14(a) if such an action could not be maintained under section 10(b) without proof of scienter. The Supreme Court answered this question affirmatively in \textit{SEC v. National Securities, Inc.},\footnote{139} when it

\footnote{135. 15 U.S.C. § 77k(b)(3) (1976). The Act provides for three different standards of liability. \textit{Id.} The defendant who makes a misstatement and did not rely on the authority of an expert can escape liability by showing that he had "after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." \textit{Id.} § 77k(b)(3)(A). If the defendant himself is the expert, then he must show that "he had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or [that] such part of the registration statement did not fairly represent his statement as an expert." \textit{Id.} § 77k(b)(3)(B). The defendant who himself is not the expert, but relied on the opinion of an expert, must prove that "he had no reasonable ground to believe and did not believe . . . that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert." \textit{Id.} § 77k(b)(3)(C). There is also a provision for reliance on statements by public officials. \textit{Id.} § 77k(b)(3)(D) (1976).\footnote{136. F. Bloomenthal, supra note 33, § 11.03, at 67-68; W. Knepper, supra note 133, § 10.03, at 250-51; J. Wiesen, The Securities Acts and Independent Auditors: What Did Congress Intend? 21-22 (1978).\footnote{137. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1299 & n.18 (2d Cir. 1973); see Gould v. American Hawaiian S.S. Co., 351 F. Supp. 853, 863 (D. Del. 1972); A. Bromberg & L. Lowenfels, supra note 18, § 8.4(430), at 204.71; Board Nominees, supra note 22, at 479. The SEC has long favored the adoption of a negligence standard under § 14(a). Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 446-47 (6th Cir.) (Weisk, J., dissenting from order denying rehearing en banc), cert. denied, 449 U.S. 1067 (1980). As the dissent in \textit{Adams} pointed out, "it is well settled that the interpretation of a statute by the agency charged with its administration is entitled to considerable weight." \textit{Id.} at 447; \textit{acord} United States v. National Ass'n of Sec. Dealers, 422 U.S. 694, 719 (1975).\footnote{138. SEC v. National Sec., Inc., 393 U.S. 453, 467-69 (1969); Dasho v. Susquehanna Corp., 461 F.2d 11, 29 n.42 (7th Cir. 1972), cert. denied, 408 U.S. 925 (1972); A. Bromberg & L. Lowenfels, supra note 18, § 6.5(313)(3), at 136.5; W. Painter, supra note 27, § 9.03; at 370-72; \textit{False & Misleading}, supra note 124, at 165; see Swanson v. American Consumer Indus., 415 F.2d 1326, 1330-31 (7th Cir. 1969).\footnote{139. 393 U.S. 453 (1969).}}
held that the existence of an action under section 14(a) would not affect section 10(b).140 The Court reasoned that the two sections apply to different aspects of securities regulation, section 10(b) to the purchase and sale of securities, and section 14(a) to the solicitation of proxies;141 thus, any overlap is "neither unusual nor unfortunate." 142

Although the overlap of two implied remedies posed no problem in National Securities, the Hochfelder Court expressed concern that a judicially created remedy under one section could allow plaintiffs to circumvent the express statutory provisions of another section.143 Thus, one reason for requiring a scienter standard for actions under section 10(b) was to prevent the disruption of the express, carefully drafted procedural protections of sections 11 and 12 of the 1933 Act.144

It has been argued that the adoption of a negligence standard under section 14(a) would undercut the express remedy of section 18,145 because a plaintiff could bring an action under section 14(a) without proving reliance.146 There is some overlap between section 14(a) and section 18 because the proxy, as a filed document,147 comes within the ambit of section 18.148 The two sections, however, address different aspects of securities regulation.149 Section 18 is a regulatory gap-filler designed to promote the reliability of documents filed with the SEC.150 The majority of documents covered by section 18 are not

140. Id. at 468.
141. Id.
142. Id.
144. Id. Among the procedural restrictions mentioned were the provision for posting a bond to cover attorney's fees and the provision for a short statute of limitations. Id. at 209-10.
147. 17 C.F.R. § 240.14a-6 (1981). Proxies must be filed with the SEC 10 days in advance of their distribution. Id.
150. See Bite Back, supra note 99, at 116, 128. There are a vast number of documents which come under § 18, but most of them go unread. Id. A plaintiff must,
distributed to shareholders.\textsuperscript{151} The usefulness of section 18 depends on the extent to which the public actually seeks out and uses the documents stored in the SEC files.\textsuperscript{152} The only document covered by section 14(a), however, is the proxy statement,\textsuperscript{153} which is sent out to shareholders with the intention of inducing action in reliance on the statements contained therein.\textsuperscript{154} There is, therefore, nothing unusual about having a higher standard of care under a section that regulates documents which invite shareholder reliance, and a lower standard of care under a section that deals with documents which often merely collect dust in the SEC archives.\textsuperscript{155} Thus, the imposition of a negligence standard, similar to section 11, would be compatible with the regulatory scheme.\textsuperscript{156}

III. Policy Concerns

The proper standard of culpability under section 14(a) and rule 14a-9 must effectuate the broad remedial purposes and policies of proxy regulations.\textsuperscript{157} The importance of the proxy provisions to ensuring informed voting by shareholders\textsuperscript{158} implies the need to impose a

\begin{itemize}
\item Cohen, supra note 151, at 1360; Bite Back, supra note 99, at 116, 128.
\item See Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 777-78 (3d Cir. 1976); Board Nominees, supra note 22, at 479 n.55.
\item This fourth step in the statutory construction analysis, the examination of the policy considerations that may have influenced Congress in the formulation of the securities laws, was not undertaken in either Hochfelder or Aaron because in each of these cases the Court found the language and the legislative history dispositive on the culpability issue. Aaron v. SEC, 446 U.S. 680, 700 n.19 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976). An examination of the policies underlying § 14(a), however, further illuminates the propriety of a negligence standard. Indeed, the Sixth Circuit found policy considerations dispositive on the culpability issue. Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 428-31 (6th Cir.), cert. denied, 449 U.S. 1067 (1980).
\item See Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 777 (3d Cir. 1976); Klaus v. Hi-Shear Corp., 528 F.2d 225, 232 (9th Cir. 1975); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1300 (2d Cir. 1973); Perelman v. Pennsylvania Real
\end{itemize}
high standard of care on all individuals involved in the preparation of proxy materials.  Analysis of the obligations of the different classes of defendants responsible for the accuracy of proxy materials reveals that a negligence standard is neither unwarranted nor unexpected.

A. Directors and Corporation

Even at common law, directors have a fiduciary duty to the shareholders of a corporation to exercise reasonable care in the discharge of their duties. The imposition of a negligence standard under section 14(a), therefore, merely requires directors to perform in a similar manner when soliciting the votes of their shareholders. Moreover, a high standard of care under the proxy rules would not be onerous. Directors are not required to include every detail about the corporation, because such a barrage of information would defeat the disclosure purposes of section 14(a). “Fair accuracy and not perfec-
tion.”164 would not be an overly difficult standard for a circumspect businessman to meet.165

Indeed, in Gerstle v. Gamble-Skogmo, Inc.,166 the Second Circuit left open the possibility that the correct standard for a corporation should be one of strict liability as it exists under section 11.167 The imposition of a strict liability standard, however, should not be inferred without clear evidence of congressional intent.168 The absence of evidence of such intent with respect to section 14(a) argues in favor of a negligence standard.169 Directors should be held accountable for their failure to use reasonable diligence in light of the particular circumstances of the case.170 It follows that the corporation will be similarly liable for the negligence of its directors.171

B. Accountants

In enacting the securities laws, Congress placed the accountant in an important position in the scheme of securities regulation.172 As the


165. It has been argued that outside directors and board nominees should be held to a lesser standard of culpability because they are not involved in the day-to-day operation of the corporation. Berman v. Thomson, 403 F. Supp. 695, 699 (N.D. Ill. 1975); Proper Standard, supra note 15, at 688-90; see Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 777 (3d Cir. 1976); Board Nominees, supra note 22, at 486-89. Courts have held, however, that outside directors must be held to the same standard as inside directors, because it is the adequacy of disclosure, not the extent of liability, that is of paramount importance under the proxy rules. Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 777-78 (3d Cir. 1976); Berman v. Thomson, 403 F. Supp. 695, 699 (N.D. Ill. 1975). But see Board Nominees, supra note 22 at 486-89 (gross negligence standard for board nominees).

166. 478 F.2d 1281 (2d Cir. 1973).

167. Id. at 1300-01; accord Federal Securities, supra note 48, at 571-72 & n.28; see R. Jennings & H. Marsh, Securities Regulation Cases and Materials 1023-24 (4th ed. 1977); supra note 133 and accompanying text.


170. The court in Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973), mentioned that in determining negligence under § 14(a), a court may take into account the need for haste when the proxy was prepared “in the hurly-burly of election contests.” Id. at 1300 n.19; see General Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 162 (2d Cir. 1968).


172. W. Knepper, supra note 133, at 377-78; J. Wiesen, supra note 136, at 21-23; Bradley, The Public Auditor, in Accountants’ Liability 76-77 (J. McCord ed. 1969);
"watchdog" of the public interest, the accountant is in a strategic spot to detect fraud and incorrect statements in financial reports.\textsuperscript{173} Congress specifically rejected the utilization of government accountants to implement the financial disclosure rules of the securities laws and instead relied on independent public accountants to fulfill this essential function.\textsuperscript{174} In effect, Congress granted an "exclusive franchise," to the accounting profession: Those seeking access to the securities markets are required to utilize its services.\textsuperscript{175}

Charged with protecting the public interest, an accountant's professional obligations under the securities laws are broader than those imposed at common law.\textsuperscript{176} These obligations are owed "not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies."\textsuperscript{177} The accountant's role, therefore, is not collateral to a securities transaction—he is a full participant in any such undertaking in which his reports are used.\textsuperscript{178}

When accurate financial disclosure has been deemed crucial to implementing the policies of the securities laws, the accountant has been held to a professional standard of due care.\textsuperscript{179} Thus, the express provisions of the securities acts that deal with accountant liability, sections 11 and 12 of the 1933 Act, explicitly provide for a negligence standard.\textsuperscript{180} The most important data in registration statements and prospectuses are the financial statements prepared by the accountant.\textsuperscript{181}


175. H. Kripke, supra note 173, at 276-77.

176. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968) (en banc); see Mess, supra note 172, at 855-56.


180. 15 U.S.C. §§ 77k(c), 77l (1976); Newly Registered Securities, supra note 133, at 305-12.

The policies underlying the proxy rules are the same as those that apply to the registration and prospectus provisions. Although the status of the plaintiff changes from "buyer" to "shareholder," his disclosure needs are the same. Congress, in enacting section 14(a), made no provision for the accountant's duty of care, but the congressional policies behind proxy regulation indicate that a standard of due care was envisioned by the drafters.

Concluding that an accountant should be liable under the proxy provisions only upon a showing of scienter, however, the Sixth Circuit based its decision on a different policy argument. Because no privity is required between an accountant and a shareholder under section 14(a), the court reasoned that a low standard of culpability would result in unlimited liability for the accountant. This argument is essentially a restatement of the old common-law doctrine espoused by Judge Cardozo in Ultramares Corp. v. Touche Niven & Co., when he refused to hold accountants liable to third parties for a "thoughtless slip or blunder."

The Ultramares view, however, is too narrow to comply with the concept of accountants liability under the federal securities laws.


182. Compare In re Gap Stores Sec. Litig., 79 F.R.D. 283, 297 (N.D. Cal. 1978) (Section 11 "was designed to protect the investing public by compelling detailed disclosure of facts."); with J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) ("[A]mong § 14(a)'s chief purposes is the 'protection of investors.'" (quoting 10 U.S.C. § 78n(a) (1976))). Like §§ 11 and 12, the proxy provisions are designed to regulate the distribution of a key document that, to be effective, must be accurate and not misleading. Board Nominees, supra note 22, at 469; see Misleading Proxy, supra note 27, at 586; Shareholder Democracy, supra note 19, at 153; supra note 23 and accompanying text.

183. See supra note 131 and accompanying text.


186. Id. at 428-29; see Misleading Proxy, supra note 27, passim; Liability, supra note 15, at 754-55.


188. Id. at 179, 174 N.E. at 444.

189. North, Disclosure: A View From The SEC, in Accountants' Liability 98-99 (J. McCord ed. 1969); see Gruenbaum & Steinberg, Accountants' Liability and
Congress, in enacting the securities laws, chose to hold accountants liable for negligence to third parties despite the contrary common-law view.\(^9\) Justice William O. Douglas, one of the principal drafters of the 1933 Act,\(^9\) explained the liability of accountants under that Act:

To say the least the Act goes as far in protection of purchasers of securities as plaintiff in _Ultramares Corp. v. Touche_ unsuccessfully urged the New York Court of Appeals to go in the protection of a creditor. The change which that court thought so "revolutionary" as to be "wrought by legislation" has been made. And the duty placed on experts such as accountants has not been measured by the expert's relation to his employer but by his service to investors.\(^9\)

The proxy provisions, labeled by one commentator a "little Securities Act" due to their analogous disclosure requirements,\(^9\) are similarly an effort by Congress to hold the accountant to a standard of reasonable care.\(^9\)

Moreover, the _Ultramares_ concern that accountants would be liable "in an indeterminate amount for an indeterminate time to an indeterminate class,"\(^9\) is not present when the negligent misstatement occurs in a proxy solicitation.\(^9\) An accountant prepares a proxy state-


\(^{191}\) J. Wiesen, _supra_ note 136, at 1.


\(^{193}\) 2 L. Loss, _supra_ note 1, at 868.


\(^{195}\) 255 N.Y. at 179, 174 N.E. at 444.

\(^{196}\) _Misleading Proxy_, _supra_ note 27, at 585-86. The Supreme Court noted, in passing, that _Ultramares_ illustrated the potential for unlimited liability under § 10(b). Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976). The _Ultramares_ holding, however, has been eroded even at common law. Although several courts have reiterated the _Ultramares_ rationale, _e.g._, Shofstall v. Allied Van Lines, 455 F. Supp 351, 359-60 (N.D. Ill. 1978); Bunge Corp. v. Eide, 372 F. Supp. 1058, 1061-64 (D.N.D. 1974); Donovan Constr. Co. v. Woosley, 358 F. Supp. 375, 382-83 (W.D. Ark. 1973); Investment Corp. v. Buchman, 208 So. 2d 291, 293-96 (Fla. 1968); Bonhiver v. Graff, 311 Minn. 111, 128, 248 N.W. 2d 291, 301-303 (1976); Anderson v. Boone County Abstract Co., 418 S.W.2d 123, 127-28 (Mo. 1967), the trend has been toward expanding liability of accountants to third parties who are members of a foreseeable class of plaintiffs. Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847, 851 (4th Cir. 1972); Rusch Factors, Inc. v. Levin, 284 F.
ment with the knowledge that it will be circulated to all shareholders of record as of a given date. Although this group may occasionally be quite large, it is a finite group and distinguishable from the general investing public. The time for which an accountant may be sued is also determinable because under section 14(a) the relevant state statute of limitations applies. Finally, the amount of liability to third parties is limited to the actual loss caused by the accountant's negligence.

**CONCLUSION**

The ultimate goal of section 14(a) and rule 14a-9 is to ensure that shareholders receive a clean proxy, one that is free from misleading statements and omissions that may adversely affect their voting decisions. In enacting section 14(a), Congress, recognizing the importance of fair corporate suffrage, placed upon all those involved in the preparation of proxy materials the duty to exercise reasonable care in seeing that they reflect the true condition of the corporation. To require a scienter standard would be tantamount to condoning carelessness and would thwart the policy of full disclosure inherent in section 14(a). A negligence standard, however, fulfills the need for the free flow of information that is mandated by the realities of modern corporate life.

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197. The shareholders that receive a proxy are those owning stock as of the record date of the proxy. H. Henn, *supra* note 91, § 176, at 328-29. When a shareholder sells his stock to a third party, legal title passes to the transferee, but as far as the corporation is concerned, the record owner must be regarded as the real owner for several purposes, including the right to vote by proxy. H. Henn, *supra* note 91, § 176, at 327-29; N. Lattin, *Lattin on Corporations* § 89, at 356 (2d ed. 1971). The record date varies from jurisdiction to jurisdiction. In New York, the record date must be set at least ten days, but no more than fifty days, prior to the date of the shareholder meeting. N.Y. Bus. Corp. Law § 604 (McKinney 1964).

198. See Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1300-01 (2d Cir. 1973); Milliner v. Elmer Fox & Co., 529 P.2d 806, 808 (Utah 1974); *Misleading Proxy, supra* note 27, at 585-86.

199. 3 L. Loss, *supra* note 1, at 1771-74; Vernava, *supra* note 3, at 324; *False & Misleading, supra* note 124, at 172-73.