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The Materiality Test - *Mills* Revisited

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The Materiality Test—*Mills* Revisited

I. INTRODUCTION

Hapless attorneys, accountants and other individuals whose efforts have been subjected to the 20/20 hindsight (or so it must seem to them) of federal courts through the mandates of section 14(a) of the Securities Exchange Act of 1934[1] and associated rule 14a-9[2] dealing with proxies, can often agree with the words of John Greenleaf Whittier, who wrote, "Of all sad words of tongue or pen, [t]he saddest are these: it might have been."[3] Tennyson, too, was aware of the futility implicit in the phrase when he wrote, "The world

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1. Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1970) reads as follows:
   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 78*l* of this title.
2. 17 C.F.R. § 240.14a-9 (1975) reads as follows:
   (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of 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 or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.
   (b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.
   NOTE: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section:
   (a) Predictions as to specific future market values, earnings, or dividends.
   (b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.
   (c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.
   (d) Claims made prior to a meeting regarding the results of a solicitation.
3. J.G. Whittier, *Maud Muller* (1854).

which credits what is done [i]s cold to all that might have been."[4]

"Might have been" has become a significant pitfall for those charged with producing proxies which meet the requirements of section 14(a) of the 1934 Act and its associated rules since the United States Supreme Court's decision in *Mills v. Electric Auto-Lite Co.*[5] Mr. Justice Harlan, writing for the Court, delivered—perhaps unwittingly—the critical phrase when discussing the interpretation of "material"[6] as contained in rule 14a-9. He wrote that where an omission or misstatement in a proxy statement had been found to be material, as in *Mills*, such determination automatically resulted in a conclusion that the defect *might have been* considered important by a reasonable shareowner who was attempting to decide how to vote on the issue for which his proxy was being solicited.[7] Justice Harlan went on to say in the next sentence that the requirement is that the defect have a significant propensity to affect the voting process in order to meet the terms of rule 14a-9.[8]

In *Northway, Inc. v. TSC Industries, Inc.*,[9] a federal court was again called upon to determine the materiality of particular facts omitted from a proxy statement. The requirements of *Mills* were found to be somewhat ambiguous in the sense that an omitted fact could more readily be considered material if it were necessary only to find that a single reasonable shareowner might have considered it important rather than to find that it had a significant propensity

4. A. Tennyson, *In Memoriam LXXV* (1850).

5. 396 U.S. 375 (1970).

6. BLACK'S LAW DICTIONARY 1128 (rev. 4th ed. 1968) defines "material" as, "Important; more or less necessary; having influence or effect; going to the merits; having to do with matter, as distinguished from form."

7. Justice Harlan stated:

> Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.

396 U.S. at 384.

8. Justice Harlan stated:

> This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).

Id.

9. 512 F.2d 324 (7th Cir. 1975).

to affect the entire voting process.[10] The court in *Northway* opted for the broader interpretation of materiality by adopting a test that includes all facts which a single reasonable stockholder might consider important.[11]

Because of the questions raised in the *Northway* case as to the proper test of materiality, the Supreme Court on October 6, 1975 granted certiorari to consider whether "materiality" under the prohibition against materially false and misleading statements or omissions requires only a showing of relevance to "some few shareholders," as indicated in *Northway*, or whether the "significant propensity" language of *Mills* is controlling.[12] In order to understand the basis on which the Court could decide the materiality issue, the case law leading up to *Mills* and the response of the various courts to the definition of materiality enunciated in *Mills* will be examined.

II. Proxy Rule Violations Prior to *Mills*

The private right of action for violation of section 14(a) of the Securities Act was first recognized by the Supreme Court in *J. I. Case Co. v. Borak*,[13] where the Court considered the question whether, under section 27 of the Act,[14] a federal cause of action was created for rescission or damages to a stockholder with respect to a completed merger authorized through the use of proxy solicitations containing false or misleading information.[15] The Court recognized that Congress made no reference to a private right of action under section 14(a)[16] but found in the Act's legislative history the intent to " 'control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of stockholders.' "[17] It found this intent expressed in section 14(a) by the language "[a]s necessary or appropriate in the public interest or for the protection of investors."[18] The Court did more than merely au-

10. *Id.* at 330.
11. *Id.*
12. TSC Indus., Inc. v. Northway, Inc., 423 U.S. 820 (1975).
13. 377 U.S. 426 (1964).
14. Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa (1970).
15. 377 U.S. at 428.
16. *Id.* at 431.
17. *Id.*, *quoting* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934).
18. 377 U.S. at 432 (emphasis omitted).

thorize a private right of action for alleged proxy violations by refusing to limit the remedies in such actions to prospective relief.[19] The explicit establishment of a private right of action for alleged violations and the Court's refusal to so limit the remedies thus foreshadowed *Mills*.[20]

III. THE *Mills* CASE

The plaintiffs in *Mills* had been shareowners of the Electric Auto-Lite Company until 1963 when it merged into Merganthaler Linotype Company. They had unsuccessfully sought to enjoin the merging companies and a third company, American Manufacturing Company, Inc., from voting proxies obtained through an allegedly misleading proxy statement. An amended complaint was later filed, seeking, *inter alia*, to have the merger set aside. The essence of the complaint was that the proxy solicitation to Auto-Lite shareholders failed to disclose that Merganthaler controlled over 50% of the outstanding Auto-Lite shares and that American, in turn owned 33% of Merganthaler; and while the proxy disclosed that all eleven of Auto-Lite's directors favored the merger, it failed to mention that the eleven were all nominees of Merganthaler. The complaint was asserted both derivatively and on behalf of the class of all Auto-Lite minority shareholders.

The district court found as a matter of law that the omission from the proxy statement was material and ordered a hearing to determine whether there was a causal connection between the section 14(a) violation and plaintiffs' alleged injuries.[21] From the evidence presented at the hearing, the court found the existence of the causal relationship, granted an interlocutory judgment and referred the case to a master to determine appropriate relief.[22] The Court of

19. *Id.* at 434.

20. For development of the private right to relief from damages resulting from misleading proxy statements during the period between J.I. Case Co. v. Borak, 377 U.S. 426 (1964), and Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) see Weiss v. Sunasco, Inc., 295 F. Supp. 824 (S.D.N.Y. 1969); Kaminsky v. Abrams, 281 F. Supp. 501 (S.D.N.Y. 1968); Globus, Inc. v. Jaroff, 266 F. Supp. 524 (S.D.N.Y. 1967); Cohen v. Colvin, 266 F. Supp. 677 (S.D.N.Y. 1967); Robbins v. Banner Indus., Inc., 285 F. Supp. 758 (S.D.N.Y. 1966); Laurenzano v. Einbender, 264 F. Supp. 356 (E.D.N.Y. 1966); Eagle v. Horvath, 241 F. Supp. 341 (S.D.N.Y. 1965); Hoover v. Allen, 241 F. Supp. 213 (S.D.N.Y. 1965); Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965). *See also* 2 L. LOSS, SECURITIES REGULATION 916-24 (2d ed. 1961).

21. 396 U.S. at 378-79.

22. Mills v. Electric Auto-Lite Co., 281 F. Supp. 826, 830-31 (N.D. Ill. 1967).

Appeals for the Seventh Circuit agreed as to the material deficiency of the proxy statement but reversed as to causation.[23] The court of appeals, while acknowledging the futility of inquiring into the "[r]eliance by thousands of individuals,"[24] nevertheless required a test corresponding to the common law fraud test of reliance on the misrepresentation.[25] Because of this, defendants were required only to prove that the merger had merit and was fair to minority shareholders in order for the trial court to conclude that the merger would have been approved even in the absence of any misleading statements in the proxy.[26] At this point the Supreme Court granted certiorari to consider the Seventh Circuit's interpretation of the proxy rules.[27]

Stressing from the outset that the question of materiality was not under review by the Supreme Court,[28] Justice Harlan left no doubt of the Court's disapproval of the Seventh Circuit's causation test by noting that substitution of the merits of a merger for informed stockholders' votes would preclude certain proxy violations from private redress as provided in section 14(a) of the 1934 Act and articulated in *Borak*.[29] Since, however, the questions of fact relating to the causation issue were not under review in *Borak*, and because similar facts were in fact under review in *Mills*, Justice Harlan undertook to define the elements of the cause of action and thus forged the language which has since that time caused significant confusion among the courts attempting to follow its dictates.[30]

Even though he had noted that the issue of materiality was not under review, Justice Harlan interwove a definition of materiality inextricably into his test for causation. This test embodied three elements: a shareowner; an issue on which the shareowner's vote is solicited; and a proxy statement containing material omissions or misstatements which may be expected to influence the shareowner's vote. Justice Harlan stated that a finding of materiality *embodies* a conclusion that the defect *might have been* considered important by a reasonable shareowner in deciding how to vote. Although this

23. Mills v. Electric Autolite Co., 403 F.2d 429, 436 (7th Cir. 1968).
24. *Id.* at 436 n.10.
25. *Id.* at 436.
26. *Id.*
27. Mills v. Electric Autolite Co. 394 U.S. 971 (1969).
28. 396 U.S. at 381 n.4.
29. *Id.* at 381-82.
30. *Id.* at 384. *See* note 7 *supra*.

has been interpreted by some commentators to mean that a finding that a reasonable shareowner might have considered an omission to be important would not be conclusive of materiality,[31] it is difficult to read this language otherwise. If a reasonable shareowner would have found omitted language important it was material; if it was material a reasonable shareowner would have found it important. Further, the materiality of the defect is essential in the link between the shareowner and his vote in order to find causation. Even if the materiality of a specific claimed defect was not under review in *Mills*, an understanding of materiality was essential to the development of a test for causation. Certainly a better definition of materiality under rule 14a-9 has not been articulated elsewhere. It is not surprising that later courts faced with the issue of materiality have looked to this language and adopted it with regularity as their own test.

However, Justice Harlan continued and further required that the defect have a *significant* propensity to affect the voting process.[32] This inevitably raises questions of the apparent dichotomy of an omission considered important by a single reasonable shareowner deciding how to vote on the one hand, and an omission having a significant propensity to affect the entire voting process on the other hand. Did the "significant propensity" requirement apply to an individual shareowner's voting, or to the voting process as a whole?[33] Justice Harlan went on to conclude that causation was sufficiently proved upon the finding of a material defect or omission in a proxy solicitation which was an essential link in the transaction.[34]

IV. Consideration of the Materiality Issue Since *Mills*

Although Justice Harlan may not have intended to formulate a materiality test in his *Mills* opinion, courts have since consistently relied on his language as a standard for the evaluation of allegedly

31. *See, e.g.*, R. Jennings & H. Marsh, Securities Regulation 1354 (3d ed. 1972).

32. 396 U.S. at 384.

33. One way of resolving the apparent paradox of these two adjacent sentences in Harlan's opinion would be to consider the reasonable shareowner as typical of the entire body of shareowners (although there is no need to assume that *all* shareowners in any particular corporate universe are reasonable). Thus, an omission which might have been considered important by a large segment of the shareowners in deciding how to vote might be an omission considered important by a "reasonable shareowner." The omission would therefore have a significant propensity to affect the entire voting process.

34. 396 U.S. at 384.

false and misleading or omitted material in proxies. At least four circuit courts of appeals (in addition to the Seventh Circuit in *Northway*) have formulated a materiality test based on *Mills* or formed their own test after deciding that *Mills* was not controlling.

In the Third Circuit, courts have confronted the question frequently since 1970. In *Robinson v. Penn Central Co.*[35] the Federal District Court for the Eastern District of Pennsylvania cited the *Mills* language and included the "significant propensity" portion. The opinion distinguished the sophisticated analyst, who may be able to glean material facts from proxy statements which would not be apparent to the reasonable stockholder.[36] The standard against which the statements must be measured was that of the "reasonable shareowner."[37]

The Court of Appeals for the Third Circuit in *Kohn v. American Metal Climax, Inc.*[38] applied the *Mills* standard of "might have been considered important by the reasonable shareholder who was in the process of deciding how to vote" to test materiality in a section 10(b)[39] action, finding the standard equally applicable in 14a-9 and 10b-5 actions. Thus the Third Circuit appeared to have adopted the broader "might have been" standard as its test of materiality in both 10b-5 and 14a-9 situations. In his dissenting opinion,[40] Judge Adams noted the almost identical nature of the *Mills* materiality test (for a section 14(a) action) and that enunciated in *SEC v. Texas Gulf Sulphur Co.*[41] (for a section 10(b) action). Both tests are to the

35. 336 F. Supp. 655 (E.D. Pa. 1971).

36. *Id.* at 657.

37. *Id.*

38. 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

39. Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j (1970) reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, 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.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance 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.

40. 458 F.2d at 270 (Adams, J., dissenting).

41. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005, *rehearing denied*, 404 U.S. 1064 (1971).

effect that the question is whether a reasonable man would attach importance to the misrepresented fact in determining his choice of action. The two tests were used jointly by Judge Adams in his discussion. While the majority and the dissent disagreed on the materiality of particular facts, they were using the same test.

A later district court case in the Third Circuit, *Puma v. Marriott*,[42] adopted the *Kohn* test while citing *Mills*, rather than *Kohn*, for the appropriate language. The court[43] again recognized the identical nature of the legal standards for materiality under sections 10(b) and 14(a), and decided to make factual determinations and evaluations of the materiality issue simultaneously for both sections.

But the Third Circuit has not been unanimous in falling into line behind *Kohn*. In three subsequent decisions[44] district courts in the Third Circuit all included the "significant propensity" language of *Mills* as part of their materiality test, thus appearing to adopt a stricter interpretation than that of *Kohn*. Subsequently, in *Rochez Bros. v. Rhoades*,[45] a section 10(b) action, the Third Circuit Court of Appeals stated that the test is whether a reasonable man would attach importance to the misrepresentations or omissions in determining his choice of action, citing *List v. Fashion Park, Inc.*[46] but mentioning neither *Mills* nor *Kohn*. The test appears nearly identical to the *Mills*-based test of *Kohn*, but the Third Circuit now appears to be in a state of confusion over its materiality test for actions under sections 10(b) or 14(a). For example, in *Mayer v. Development Corporation of America*,[47] the District Court for the District of Delaware compared the *Mills*-based "might have been" test and found it less strict than the "would have been" test stated in *Rochez*. The court then opted for the stricter test.

Judge Friendly, writing for the Second Circuit in *Gerstle v.*

42. 348 F. Supp. 18 (D. Del. 1972) (denying motion for summary judgment); 363 F. Supp. 750 (D. Del. 1973) (finding that any misstatements or omissions in proxy statement were not significant, or too remotely related to the acquisition to have been material violations of the security laws).

43. Puma v. Marriott, 363 F. Supp. 750 (D. Del. 1973).

44. Chris-Craft Indus. v. Independent Stockholders Comm., 354 F. Supp. 895 (D. Del. 1973); Lyman v. Standard Brands, Inc., CCH SEC. REP. ¶ 94,153 (E.D. Pa. 1973); Allen v. Penn Cent. Co., 350 F. Supp. 697 (E.D. Pa. 1972).

45. 491 F.2d 402 (3d Cir. 1974).

46. 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811, *rehearing denied*, 382 U.S. 933 (1965).

47. 396 F. Supp. 917 (D. Del. 1975).

Gamble-Skogmo, Inc.,[48] was among the first to do more than literally apply the *Mills* test for materiality. He recognized that the Harlan language is often regarded as a clear definition of materiality for the purpose of rule 14a-9 actions but pointed out that the language was not intended as such since the issue of materiality was not before the court. He characterized Harlan's "might have been" language as a minimum standard for supporting his holding that such showing of materiality was sufficient evidence of causation. Judge Friendly further noted Harlan's citation of Judge Waterman's opinion in *List v. Fashion Park, Inc.*[49] (that the basic test of materiality is whether a reasonable man would attach importance to the omitted fact in determining his choice of action)[50] and his own materiality test in *General Time Corp. v. Talley Industries, Inc.*[51] Both, in Judge Friendly's view, set a somewhat stricter standard of materiality than Justice Harlan's language. He found the "significant propensity" language of Harlan to be more appropriate as a test, concluding that a standard tending toward probability rather than mere possibility was preferred where significant damages hung in the balance. Because he believed that materiality was not at issue in *Mills* and the test formulated therein not controlling, Judge Friendly adhered to his own test as formulated in *General Time*.[52]

Two other circuit courts of appeals have relied on Judge Friendly's test enunciated in *General Time*. In the Ninth Circuit, *Jansky v. Miller*[53] presented a situation in which the proxy solicitation mentioned the intention of the plaintiff to present two proposals at the annual meeting, but details of the nature of the proposals were omitted. The court found that the omission of these details did not have, in the language of *Mills*, "a significant propensity to affect the voting process."[54] The court here used the *General Time* test to supplement *Mills, i.e.*, that the test of materiality is whether there is a substantial likelihood that the omission might have led a stock-

48. 478 F.2d 1281 (2d Cir. 1973).

49. 340 F.2d 457 (2d Cir. 1965).

50. RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (1965).

51. 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

52. Other decisions of the Second Circuit have adopted substantially the same test. *See, e.g.*, Laurenzano v. Einbender, 448 F.2d 1 (2d Cir. 1971); Lewis v. Dansker, 357 F. Supp. 636 (S.D.N.Y. 1973); Browning Debenture Holders' Comm. v. DASA Corp, 357 F. Supp. 1010 (S.D.N.Y. 1972).

53. 474 F.2d 365 (9th Cir. 1973).

54. *Id.* at 367.

holder to grant a proxy contrary to what he would have done in the absence of the omission. The Fifth Circuit, in *Smallwood v. Pearl Brewing Co.*,[55] responded to plaintiff's appeal of the trial court's definition of materiality contained in its charge to the jury. The trial court had used the Restatement of Torts based test of "whether a reasonably prudent person *would* attach importance to the information in determining his course of action."[56] Plaintiff wanted the court to use *Mills* type language by substituting, in effect, the word "might" for the word "would." Judge Wisdom noted the Fifth Circuit's recent adoption in *John R. Lewis, Inc. v. Newman*[57] of a test similar to that used by the trial court.[58] In considering the language of the *Mills* test, Judge Wisdom took note of Judge Friendly's rather thorough examination of the Harlan opinion in *Gamble-Skogmo* and embraced it as the opinion of the Fifth Circuit.[59]

Thus the Second, Third, Fifth and Ninth Circuits have all adopted a stricter test of materiality than would be inferred from the *Mills* language. The Seventh Circuit stands alone with the broad test formulated in *Northway*. While the Court of Appeals for the Eighth Circuit has not been confronted with the materiality issue, two district court decisions in that circuit took an approach similar to that of the Seventh Circuit.[60]

Meanwhile, the Supreme Court spoke again on the issue of materiality under the Act of 1934 in *Affiliated Ute Citizens v. United States*.[61] The context in this case was that of an alleged section 10(b) violation and the Court stated that the test for materiality requires only that "a reasonable investor might have considered [the facts] important in the making of this decision."[62] *Mills* was cited by the Court in support of this language in spite of its application to section 14(a).[63] Two conclusions can arise from the citation to *Mills* in *Affiliated Ute*: (1) that the court considers materiality for purposes of sections 10(b) and 14(a) of the 1934 Act to be identical and, (2)

55. 489 F.2d 579 (5th Cir. 1974), *cert. denied*, 419 U.S. 873 (1975).
56. 489 F.2d at 603.
57. 446 F.2d 800 (5th Cir. 1971).
58. *Id.* at 804.
59. 489 F.2d at 604.
60. Ross v. Longchamps, Inc., 336 F. Supp. 434 (E.D. Mo. 1971); Beatty v. Bright, 318 F. Supp. 169 (S.D. Iowa 1970).
61. 406 U.S. 128 (1972).
62. *Id.* at 153-54.
63. *Id.* at 154.

whether or not Justice Harlan intended his language to be a formal test for materiality, there can now be little doubt that it has been established as such. It should also be noted that there is no specific citation in *Affiliated Ute* to the "significant propensity" language of *Mills*. In fact, inclusion of the "significant propensity" language as a part of the *Mills* test, referring as it does to the entire voting process in a proxy contest, would tend to make the *Mills* test incompatible with the test for materiality under section 10(b) which involved activities by individuals. This may be an indication that the Supreme Court did not consider the "significant propensity" language to be a limitation on the materiality test stated in *Mills*.

V. The *Northway* Case

The *Northway* case presented a factual situation similar in many ways to *Mills*. Defendants, TSC Industries and National Industries, issued a joint proxy statement to TSC shareowners, of which plaintiff Northway was one, requesting approval of liquidation and sale of all TSC assets to Northway. Although sufficient proxies were received to effect approval of the merger and the transaction was in fact completed, the proxy statement failed to disclose a change in the control of TSC Industries resulting from a sale of their interests by the controlling shareowners, the Schmidts, to National Industries. This information was required by rule 14a-3 and schedule 14A.

The district court[64] and the Seventh Circuit agreed that the issue of control was a factual issue for which the district court properly denied summary judgment. The Seventh Circuit, however, reversed the district court's denial of summary judgment for Northway on its rule 14a-9 claim that the proxy statement failed to include a material fact.[65] The Seventh Circuit ruled that Northway, in order to prevail, had to establish facts showing that an omitted item was material as a matter of law. It was suggested that to establish materiality as a matter of law, a demonstration that reasonable minds could not differ on the materiality question was required.[66] The question of the proper test to apply in determining the materiality of an omitted fact was then considered. The apparent dichotomy of "might have been considered important by a reasonable share-

64. Northway, Inc. v. TSC Indus., Inc., 361 F. Supp. 108 (N.D. Ill. 1973).
65. Northway, Inc. v. TSC Indus., Inc., 512 F.2d 324, 327 (1975).
66. *Id.* at 329.

owner" as against "a significant propensity to affect the voting process" was examined, with the conclusion that the first test would classify more omissions as material, thus better serving the intended purpose of the disclosure provisions. Judge Swygert then went on to examine the specific facts omitted from the TSC proxy statement in light of the stated test and found that the district court's denial of summary judgment as to the liability of defendants was improper.[67]

VI. Conclusion

The Supreme Court is now faced with the task of clarifying the test for materiality under section 14(a) and rule 14a-9 as formulated in *Mills* and as divergently interpreted in *Northway* and *Gamble-Skogmo*. The late Justice Harlan can shed no light on what he really meant to say in *Mills* and the Court's makeup has undergone a significant change since *Mills* was decided. The door would appear to be open to the formulation of an entirely new, more clearly articulated test, since in Harlan's own words, the question of materiality was not at issue in *Mills*.

The Supreme Court will find the history of the materiality test for section 14(a) to be entirely consistent, if not helpful in defining the test itself. Without exception, courts faced with the question since *Mills* have looked to its language in formulating their own tests. Because of its susceptibility to varying interpretations, however, the result of the courts' reliance has been the development of at least two divergent approaches, of which *Northway* and *Gamble-Skogmo* are leading examples.

The *Northway* court interpreted the *Mills* language as susceptible of two different results depending on whether the "might have been" or the "significant propensity" portions are selected. Since it cannot reasonably be supposed that Harlan intended to articulate two different standards—he may in fact not have intended to articulate any—it would seem that the *Northway* court, and other courts

67. *Id.* at 342.

Since the decision of the Seventh Circuit in *Northway*, another court has already recognized the conflict between the test articulated therein and the materiality test followed in Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973), both of which were derived from the same paragraph in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970). In Ash v. Baker, 392 F. Supp. 368 (E.D. Pa. 1975), the court did not choose between the two approaches, however, because on the facts no materiality under either test was found.

faced with the same problem, should have made an effort to devise a test which could reasonably be interpreted as consistent with both segments of the Harlan language. As suggested above, this task is made somewhat easier by constructing a hypothetical universe of shareowners, all or most of whom qualify as Harlan's "reasonable shareholder." Such an assumption would make possible the conclusion that what a single reasonable shareholder finds material could affect the voting process as a whole. In order to complete this test it is necessary to reconcile the possible differences created by the words "might" and "significant." "Might" implies a fairly low probability of actuality; but what level of probability must be associated with "might" before it reaches the level of "significant"? The word "might" is probably the largest stumbling block in the Harlan language. Perhaps the word was not used to imply a low probability of actuality but to convey a sense of unsureness—one does not know if a misrepresentation was material, but it arguably "might have been." Even if only ten percent of our universe of reasonable shareowners actually would have found materiality, this would be "significant" where a very small shift in votes would have changed the result. However, according to *Mills*, only the existence of the materiality and not a change in result need be proved. If, therefore, a reasonable shareowner, one of a finite group of reasonable shareowners, might have found an omission or misrepresentation to be material, there is a strong likelihood that it would have a significant propensity to affect the voting process and thus there is no inconsistency in the two apparently contradictory sentences.

How would such an interpretation of the *Mills* test have affected *Northway* and *Gamble-Skogmo*? Judge Swygert in *Northway* wanted a test that would include all facts which a reasonable stockholder might consider important.[68] The suggested interpretation of *Mills* does exactly that. Judge Friendly in *Gamble-Skogmo* thought the use of the word "might" implied too low a probability, or rather possibility, to use such a test as a basis for imposing large damages.[69] Yet had the word "might" been viewed in a context of an entire universe of shareowners, Judge Friendly may have had less difficulty in recognizing a probability that a material omission would "have a significant propensity to affect the voting process." Both

68. 512 F.2d at 330.
69. 478 F.2d at 1302.

judges could have reached what was for them a satisfactory result without the necessity to dissect the *Mills* language again and again.

One barometer of the Supreme Court's approach to the question presented in *Northway* is its decision in *Blue Chip Stamps v. Manor Drug Stores*,[70] a case in which the class of plaintiffs who may maintain a private cause of action for damages under rule 10b-5 was at issue. A rule enunciated in *Birnbaum v. Newport Steel Corp.*[71] stated that only a person who is either a purchaser or a seller of securities may bring an action under section 10(b) of the 1934 Act or rule 10b-5. Because the Supreme Court denied certiorari in *Birnbaum*,[72] the Second Circuit's examination of the issues raised therein had been the most authoritative statement prior to the Supreme Court's decision in *Blue Chip Stamps*. Meanwhile, the *Birnbaum* doctrine had generated extensive academic comment,[73] often critical, and later judicial opinions from the Second Circuit[74] had created enough exceptions to the doctrine to have nearly emasculated it by the time the Ninth Circuit handed down its decision in *Blue Chip Stamps*.[75]

The Supreme Court's decision in *Blue Chip Stamps* has vindicated the *Birnbaum* doctrine and given it new vitality, thus spawning in all likelihood a new generation of criticism from commentators who disliked the *Birnbaum* decision itself. The Court's decision in *Blue Chip Stamps* can be characterized as a move toward a stricter interpretation of the 1934 Act. Where *Birnbaum* had severely restricted the parties with standing to maintain a private cause of action under rule 10b-5, subsequent decisions (prior to *Blue Chip Stamps*) had tended to give a more prophylactic effect to the Act by allowing numerous exceptions. *Blue Chip Stamps* reinstated the narrow qualifications for standing to sue under rule 10b-5. Dissenters in *Blue Chip Stamps* included Justices Blackmun, Douglas and Brennan, who argued for a broad interpretation of such regulatory statutes so as to protect as many parties as possible.[76]

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70. 421 U.S. 723 (1975).

71. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

72. *See* note 71 *supra*.

73. *See, e.g.*, Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 833 (1956); Note, *Civil Liability under Rule X-10b-5*, 42 VA. L. REV. 537, 570 (1956).

74. *See, e.g.*, Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967); Symington Wayne Corp. v. Dresser Indus., Inc., 383 F.2d 840 (2d Cir. 1967); A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967).

75. Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136 (9th Cir. 1973).

76. 421 U.S. at 761 (Blackmun, Douglas, Brennan, JJ., dissenting.)

The decision in *Blue Chip Stamps* suggests a generally stricter approach by the Supreme Court to the interpretation of the 1934 Act. The Court could therefore choose to enunciate a test in clarification of *Mills* which comes closer to Judge Friendly's test in *Gamble-Skogmo* than to the *Northway* standard. It can be hoped, however, that the Supreme Court will not specifically lean toward either view but rather restate the test formulated in *Mills* while keeping in mind that a stricter approach to materiality under rule 14a-9 would have a tendency to undermine the test for materiality under rule 10b-5 as enunciated in *Affiliated Ute Citizens*. The Supreme Court's biggest problem in enunciating any test will be, as it always is, finding language which will facilitate interpretation by future courts confronted with a similar issue. A test which embodies the hypothetical "reasonable man" is theoretically an objective test, but the use of such words as "might" and "significant" necessarily undermine its objectivity, and give it more the appearance of a subjective standard. The Court is asked to choose between two divergent approaches, but its ability to articulate its test will transcend the importance of the approach it takes.

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AUTHOR'S NOTE

Subsequent to the preparation of this comment, on June 14, 1976, the Supreme Court handed down its decision in *TSC Industries, Inc. v. Northway, Inc.*[1] As suggested above, the Court rejected the Seventh Circuit test of materiality and remanded the case for new proceedings consistent with its newly formulated test of materiality.

The Court noted that in *Mills*, the discussion of materiality was only preliminary to a consideration of the necessity for reliance on a material omission, and that even if the *Mills* materiality language were controlling, its "significant propensity" phrase came closer to the mark.[2] Further, it narrowed the meaning of the materiality language in *Affiliated Ute* sufficiently to destroy its usefulness as a definition.[3] Having thus cleared the way for an authoritative defini-

1. 96 S. Ct. 2126 (1976).
2. 96 S. Ct. at 2132.
3. *Id.* n.9.

tion of materiality, the Court took a position somewhere between the "might have" language of *Northway* and the "would have" (conventional Restatement of Torts test) language of *Gamble-Skogmo* in enunciating the following test: an omitted fact is material if there is a *substantial likelihood* that a reasonable shareholder would consider it important in deciding how to vote.[4]

Such a definition would seem to require a result similar to the interpretation of the *Mills* language suggested above[5]—such substantial likelihood would cause some reasonable shareowners to change their vote, possibly affecting the outcome.

It remains to be seen whether the substitution of "substantial likelihood" for "significant propensity" and "would" for "might" will make the courts' task of applying words to factual situations any less confusing. What does seem clear is that the Supreme Court's disposition of the *Northway* case, along with its decision in *Blue Chip Stamps*, will stand as a significant impediment to the free-wheeling approach taken in recent circuit court decisions giving relief to disgruntled shareholders.

R.H.P.

4. *Id.* at 2133.
5. *See* note 33 and accompanying text *supra*.