# COMMENT

## *VIRGINIA BANKSHARES v. SANDBERG*: THE SUPREME COURT INJECTS FEDERALISM INTO THE IMPLIED PRIVATE RIGHT OF ACTION FOR BREACH OF SECURITIES AND EXCHANGE COMMISSION RULE 14a-9. A TASTE OF THINGS TO COME?

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> I bought this with the idea that I could keep it as long as I wanted it, and they are taking it away from me. And as I said, I don't know what you call it in the corporate world, but if you put this out, say, in the school yard, if you see some great big high school kid taking away a kindergartner's lunch and saying I'll give you a nickel for it, you would call it bullying. And I felt that they were bullying.[1]

## I. INTRODUCTION

In *Virginia Bankshares, Inc. v. Sandberg* (*Virginia Bankshares*),[2] the United States Supreme Court declined to allow the holders of minority shares to seek damages from their corporation for soliciting misleading proxies in a parent-subsidiary freeze-out merger. This case represents a major refinement of the cause of action originally established in *J.I. Case Co. v. Borak*,[3] in which the Court first recognized an implied private right of action for breach of section 14(a)[4] of the Securities

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1. Excerpt from deposition of Doris I. Sandberg, June 21, 1988. Joint Appendix at 54, Virginia Bankshares, Inc. v. Sandberg (*Virginia Bankshares*), 111 S. Ct. 2749 (1991) (No. 89-1448).

2. 111 S. Ct. 2749 (1991).

3. 377 U.S. 426 (1964).

4. 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 § 12 of this title [15 U.S.C. § 78*l*].

15 U.S.C. § 78n(a) (1990) (original version at ch. 404, tit. I, § 14, 48 Stat. 895 (1934)).

Exchange Act of 1934 (1934 Act)[5] through Securities and Exchange Commission (SEC) Rule 14a-9.[6]

As time progressed, the cause of action first recognized in *Borak* was refined by the Court.[7] In *Mills v. Electric Auto-Lite Co.*,[8] the Court developed the test for determining the causal relationship of a private cause of action for breach of Rule 14a-9.[9]

The *Mills* decision is undeniably one of the most important cases in section 14(a) jurisprudence. It is, however, as equally well known for a factual situation that it did not explicitly address. In its infamous "footnote 7," the *Mills* Court did not discuss whether causation could be demonstrated by a minority block that did not have enough votes to defeat the transaction at issue.[10] Although the Court in *Mills* did not mention the freeze-out merger in footnote 7, it is axiomatic that a freeze-out merger presents such a situation.[11]

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5. 15 U.S.C. §§ 78a-78*ll* (1990).

6. Section 12(i) of the 1934 Act vests in the Federal Deposit Insurance Corporation (FDIC) "the powers, functions, and duties . . . to administer and enforce section[ ] . . . 14(a) . . . ." 15 U.S.C. § 78*l*(i) (1990) (original version at ch. 404, tit. I, § 12, 48 Stat. 892 (1934)). This section also provides: "In carrying out [its] responsibilities under this subsection, the [FDIC] shall issue substantially similar regulations to regulations and rules issued by the [SEC]." *Id.* Section 240.14a-9 provides:

> 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.

17 C.F.R. § 14a-9 (1991). Because the freeze-out merger which took place in the topic case of this comment, *Virginia Bankshares*, involved banks, the "substantially similar" FDIC regulation applies. *See* 12 C.F.R. § 335.206 (1989).

7. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

8. 396 U.S. 375 (1970).

9. *See infra* text accompanying note 35.

10. *Mills*, 396 U.S. at 385 n.7; *see infra* text accompanying note 36 (providing pertinent text of footnote 7).

11. Generally speaking, a "freeze-out" merger occurs when the majority block of shareholders in a corporation forces the minority block to sell its ownership in the concern. Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1357 (1978). "Freeze-out" is one of many terms used to describe a merger which exterminates the holders of minority shares. Others include "take-out," "cash-out," and "squeeze-out." Richard A. Booth, *The New*

The Court did not address the issue left open in *Mills'* footnote 7 until its decision in *Virginia Bankshares*. In *Virginia Bankshares*, the Court held that causation could not be established in an implied private right of action for a violation of Rule 14a-9 where the minority block could not thwart the transaction on which the claim was brought.[12]

The subject of this comment is *Virginia Bankshares*. Part II briefly discusses the statutory scheme of section 14(a). This part provides background information about the proxy system and the protections of Rule 14a-9 and traces the history of the cause of action first established in *Borak* to the advent of *Virginia Bankshares*. Lastly, this part considers the benefits and detriments of freeze-out mergers and examines several of the generally accepted methods of valuing the minority block interests in a freeze-out.

Part III of this comment chronicles the litigation in *Virginia Bankshares* from its inception to its resolution at the Supreme Court. This part provides the facts underlying the claim, traces the litigation through each level of the state and federal judicial systems and discusses the judgments of each court.

Part IV evaluates the decision of the Supreme Court in light of the findings below and the background material provided in Part II. This part also offers an alternative resolution to this case by analyzing the fairness of the freeze-out merger in *Virginia Bankshares* from a purely economic standpoint. Part V concludes this comment.

## II. BACKGROUND

### A. *The Federal Regulatory Scheme*

In response to the stock market crash of 1929, Congress enacted the Securities Act of 1933[13] and the more expansive Securities Ex-

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*Law of Freeze-out Mergers*, 49 MO. L. REV. 517, 517 (1984). "Freeze-out" also refers to transactions where the majority: (1) eliminates the voting power or claims to corporate assets of the minority block, or (2) divests the minority of profits or other rights and privileges. 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 8.07, at 63 (3d ed. 1987).

12. *Virginia Bankshares*, 111 S. Ct. at 2761-66.

13. 15 U.S.C. §§ 77a-77bbbb (1990). This act had three specific objectives: (1) to provide investors with full disclosure of material information about security distribution, (2) to protect purchasers of securities against fraud, and (3) to promote general standards of ethics in the investment industry. *See* S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933). *See, e.g.*, THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 1.2, at 7 (1985).

change Act of 1934.[14] The 1934 Act enlarged the scope of the federal regulatory scheme of its older sibling by monitoring the secondary trading of securities on national exchanges and requiring companies listed on such exchanges to chronicle their performance, and as a result:

> [t]he static disclosure of the 1933 Act was thus transposed into a philosophy of continuous disclosure through the registration of all securities traded on exchanges, with rule-making authority in the commission to require the filing of periodic reports by both issuers and certain insiders . . . as well as to regulate the solicitation of proxies.[15]

Contemporary federal securities law originated in these two statutory schemes.

### B. *The Proxy Statement and Rule 14a-9*

#### 1. The Proxy Machinery

Two fundamental tenets of corporate law are that shareholders own their corporation[16] and that the board of directors and corporate officers receive and retain their positions by the grace of the share-

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14. 15 U.S.C. §§ 78a-78*ll* (1990).

> The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.
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> The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933).

15. LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION at 39 (1983). The SEC was created by the 1934 Act and given the responsibility to administer regulations provided by the federal securities acts. 15 U.S.C. § 78d(a) (1983) (original version at ch. 404, tit. I, § 4, 48 Stat. 885 (1934)). The SEC secures most of its power through a congressional delegation of its law making authority. *See, e.g.*, 15 U.S.C. § 78n(a) (1990) (full text provided *supra* note 4).

16. *See, e.g.*, WILLIAM L. CLARK, HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS 1 (I. Maurice Wormser ed., 3d ed. 1916).

holders.[17] In a publicly held corporation, however, it is relatively difficult for a single shareholder to express effectively his sentiments concerning a managerial decision. This difficulty could result in a concentration of control in a comparatively small group of shareholders who hold a large number of the corporation's shares.

The proxy system developed to facilitate shareholder expression.[18] Under the proxy system, the voice and vote of shareholders are pooled together and given to an agent, the proxy holder, who is chosen by the shareholders to represent their views on corporate matters.[19] In a standard solicitation,[20] the proxy holder presents a statement to the shareholders, providing the necessary information so that they can make an informed decision about a pending corporate issue. The proxy holder, if sanctioned by the shareholders, is given the right to represent them in a vote for, or against, certain transactions. An unethical proxy holder could misrepresent, or omit altogether, certain material facts not available to the minority shareholders, thereby betraying the trust accorded to him by his principals.

To curb these abuses, Congress enacted section 14(a) of the 1934 Act,[21] which authorized the SEC to adopt rules for the solicitation of proxies. Pursuant to this grant of authority, the SEC published Rule 14a-9, which prohibits the use of proxies that are false or misleading as to a material fact.[22]

### 2. *Borak* and its Progeny

In *J.I. Case Co. v. Borak*,[23] the United States Supreme Court held that section 27[24] of the 1934 Act established an implied private

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17. *See, e.g.*, 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.1, at 4-10 to 4-13 (1990).

18. "The term proxy includes every proxy, consent or authorization within the meaning of section 14(a) of the [1934] Act. The consent or authorization may take the form of failure to object or to dissent." 17 C.F.R. § 240.14a-1(f) (1991).

19. *See* BALOTTI & FINKELSTEIN, *supra* note 17, §§ 7.15-.18.

20. SEC rules define "solicitation" as:

> (i) Any request for a proxy whether or not accompanied by or included in a form of proxy;
> (ii) Any request to execute or not to execute, or to revoke, a proxy; or
> (iii) The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

17 C.F.R. § 240.14a-1(*l*) (1991).

21. *See supra* note 4 (providing full text of § 14(a)).

22. *See supra* note 6 (providing full text of Rule 14a-9).

23. 377 U.S. 426 (1964).

right of action for a breach of the duties imposed by Rule 14a-9.[25] The Court stated that the purpose of section 14(a) of the 1934 Act was to "prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."[26] The Court drew this inference from the congressional belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange."[27] Although the Court conceded that this and other language[28] cited did not expressly provide for a private right of action, it held that the 1934 Act's purpose of protecting investors suggested judicially cognizable relief.[29] As a result, the causal relationship between the false and misleading proxy solicitation and the consummation of the merger was a fact-bound inquiry to be resolved at trial.[30]

The United States Supreme Court addressed the type of causal relationship between a false or misleading proxy statement and a merger necessary to warrant liability in *Mills v. Electric Auto-Lite Co.*[31] In this case, the respondent companies owned fifty-four percent of the outstanding shares of Electric Auto-Lite and an affirmative vote of two-thirds of the Electric Auto-Lite shares was required to effec-

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24. This section provides in pertinent part:

> The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.

15 U.S.C. § 78aa (1934) (original version at ch. 404, tit. I, § 27, 48 Stat. 902 (1934)).

25. The SEC's authority to enforce administrative Rule 14a-9 has never been questioned.

26. *Borak*, 377 U.S. at 431.

27. *Id.* (quoting H.R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934)).

28. The Court also found other congressional statements instructive: Section 14(a) was "intended 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.'" *Id.* (quoting H.R. REP. No. 1383, 73d Cong., 2d Sess. 14 (1934)); "'Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his votes is sought.'" *Id.* (quoting S. REP. No. 792, 73d Cong., 2d Sess. 12 (1934)).

29. *Id.*

30. *Id.* As this case came before the Court on a dismissal of the complaint for lack of jurisdiction, questions of fact were still unresolved.

31. 396 U.S. 375 (1970).

tuate the merger under the terms of the merger agreement.[32] Therefore, at least twelve percent of the outstanding shares had to approve of the proposal to attain the sixty-six percent of shares needed to authorize the merger.[33] Several shareholders filed a *Borak* action after the proxies had been obtained and the merger concluded.[34] This case established the test for determining the causal relationship that is necessary for a plaintiff to establish a private cause of action for breach of Rule 14a-9:

> Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if . . . he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions.[35]

The Court, in a footnote, implied that this holding was limited to those instances where one block of shares needed another block to effectuate a transaction: "We need not decide in this case whether causation could be shown where the management controls a sufficient number of shares to approve the transaction without any votes from the minority."[36]

The Court in *Mills* defined materiality as "embod[ying] 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."[37] The Court continued by stating that the:

> requirement that the defect have a significant *propensity* to affect the voting process is found in . . . Rule 14a-9, and

32. *Id.* at 379.
33. *Id.*
34. *Id.* at 378.
35. *Id.* at 385.
36. *Id.* at 385 n.7.
37. *Id.* at 384.

> it . . . serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial . . . or . . . 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 [section] 14(a).[38]

Materiality, however, was not integral to the Court's decision. The trial court below, the United States District Court for the Northern District of Illinois, construed *Borak* as requiring a hearing on the issue of the causal connection between the violation of section 14(a) and plaintiff Mills' alleged injury.[39] At this hearing, the trial court found that the requisite causal relationship had been demonstrated and granted an interlocutory judgment in favor of the plaintiff Mills.[40] Therefore, the materiality inquiry of the *Mills* Court was dicta.

Although the dicta in *Mills* did provide a cursory treatment of the materiality standard needed in a *Borak* action, the United States Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*[41] saw the failure of the *Mills* Court to apply its ersatz standard in considering the materiality of its omissions as a qualification of its applicability.[42] Consequently, the Court in *TSC* refined the standard of materiality to comport best with the administrative purpose of Rule 14a-9. Justice Marshall, writing for a unanimous Court, provided three standards of materiality:

> [1] An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . .
> [2] [T]he standard . . . contemplate[s] a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.
> [3] Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the original investor as having significantly altered the "total mix" of information made available.[43]

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38. *Id.*
39. *Id.* at 378-79.
40. *Id.* at 379.
41. 426 U.S. 438 (1976).
42. *Id.* at 447.
43. *Id.* at 449.

This was the last statement of the Supreme Court on the implied *Borak* cause of action for a breach of section 14(a) of the 1934 Act through Rule 14a-9 until *Virginia Bankshares*.[44]

### C. *The Freeze-Out Merger*

#### 1. Background Information

At common law, any change in the corporate entity, such as a merger or purchase of assets with corporate funds, demanded the unanimous consent of shareholders.[45] Therefore, any one shareholder could frustrate such corporate decisions.[46]

Under contemporary state corporation laws, however, a unanimous vote is no longer needed to effectuate such decisions.[47] Holders of minority shares can be placed in a disadvantageous predicament where a majority or super-majority can carry a corporate proposal. The minority can be forced to adopt a policy that it would never sanction in a balanced suffrage environment.

Generally speaking, a "freeze-out"[48] merger occurs when the holders of a majority of the shares in a corporation force the minority block to sell its ownership in the concern.[49] Regardless of the method by which the majority block acquires plenary power over the cor-

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44. 111 S. Ct. 2749 (1991)

45. Anne Jentry, Note, *The Developing Law of Corporate Freeze-outs and Going Private*, 7 LOY. U. CHI. L.J. 431, 431 (1976).

46. *Id.* The rule of Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 595-96 (1921), demonstrates this sentiment:

> It is, of course, a general rule of law that, in the absence of special authority so to do, the owners of a majority of the stock of a corporation have not the power to authorize the directors to sell all of the property of the company and thereby abandon the enterprise for which it was organized. . . .
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> The rule . . . rests upon the principle that exercise of such power would defeat the implied contract among the stockholders to pursue the purpose for which [the corporation] was chartered.

*Id.*

47. *See, e.g.*, VA. CODE ANN. § 13.1-718 (Michie 1985) (requiring two-thirds majority to approve a merger under Virginia law).

48. *See supra* note 11. "Freeze-out" is one of many terms used to describe a merger which exterminates minority shareholders. *See* Booth, *supra* note 11, at 517.

49. *See* Brudney & Chirelstein, *supra* note 11, at 1357.

poration,[50] the result has been the subject of much debate. Whereas some commentators find freeze-out mergers "coercive,"[51] others see freeze-outs as economically principled arrangements in which the holders of the majority of shares can increase the value of the concern through a judicious purchase of the minority block.[52]

### 2. Benefits of Freeze-Out Mergers

The advantages of "going private" through a freeze-out merger are substantial.[53] Once private, a corporation is no longer subject to the throng of SEC disclosure requirements[54] or required to hold annual shareholder meetings.[55] Where the majority purchaser of the minority block determines that he can more effectively manage the resulting concern without the minority, the purchaser will pay a premium over the market price of the equity to acquire this control.[56]

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50. Excluding the "freeze-out" merger, the most common methods by which a corporation "goes private" are the reverse stock split and the tender offer. *See, e.g.*, Mary C. Burson, Note, *Securities Law: An Argument for Recognition of an Implied Private Cause of Action for Shareholders Under Section 13(e) of the Securities Exchange Act of 1934 in the Context of Going Private*, 64 NOTRE DAME L. REV. 606, 609 (1989). In a reverse stock split, a corporation will exchange one share for a block of outstanding shares. *Id.* at 610. As a result, the holders of the minority shares will hold fractions of shares. *Id.* In those jurisdictions which forbid fractional holding of shares, the minority will be forced to sell their shares for cash to the insider majority. *Id.* In a tender offer, inside shareholders will make a tender offer for shares held by outside shareholders. *Id.* Such a purchase will render the insiders the majority, at which time they can implement a "freeze-out" merger or a reverse stock split. *Id.* (citations omitted).

51. *See, e.g.*, Brudney & Chirelstein, *supra* note 11, at 1357 ("Freeze[-]outs, by definition, are coercive: minority stockholders are bound by majority rule to accept cash or debt in exchange for their common shares, even though the price they receive may be less than the value they assign to those shares.").

52. *See* Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 706 (1982) ("[A] freeze[-]out of minority shareholders in a long standing subsidiary will produce gains if the value of the combined entity is greater than the sum of the separate values of the parent and the subsidiary.").

53. *But see* Note, *Going Private*, 84 YALE L.J. 903, 906-09 (1975) (arguing that any purported corporate justification for freezing out is a smoke screen for the real reason: "the upward revaluation of a company's own securities for use in various corporate transactions").

54. *See, e.g.*, Burson, *supra* note 50, at 610. In November 1974, SEC Commissioner A.A. Sommer, Jr., stated that this justification was not compelling enough to warrant a freeze-out merger. Other justifications that he cited as ineffectual included purchasing the corporation's stock because market price is less than book value and avoiding the threat of litigation under the federal securities laws. Jentry, *supra* note 45, at 440 (citation omitted).

55. *See, e.g.*, Burson, *supra* note 50, at 610.

56. *See* Easterbrook & Fischel, *supra* note 52, at 705.

This premium will be less than the increase in value of the concern after the acquisition.[57] Therefore, according to Judge Frank Easterbrook and Professor Daniel Fischel, "[t]here is a strong presumption . . . that free transferability of corporate control, like any other type of voluntary exchange, moves assets to higher valued uses."[58]

A freeze-out of the holders of minority shares in which a subsidiary is merged into a parent will provide benefits for the continuing enterprise where the value of the combined entity is greater than the value of the separate concerns.[59] Such gains accrue due to streamlined management, tax benefits, reduced competition, asset shifting, and overall economies of scale,[60] among others.[61]

Another benefit of a "freeze-out" transaction emanates from the law of agency. As firms go private, they eliminate the friction between the principal (the stockholder) and agent (the corporate directors).[62] This reduced friction translates into lower agency costs and, therefore, higher returns to the investor.[63]

### 3. Disadvantages of Freeze-Out Mergers

For every advantage of freeze-out mergers, there are corresponding disadvantages. The most obvious problem with freeze-out mergers is that those in the minority block are forced to sell their holdings without choice, leaving insiders in complete control of the corporation.[64] Otherwise, the holder of minority shares will face "the prospects of an illiquid market for his securities, termination of the protections under the federal securities laws and further efforts by the issuer or affiliate to eliminate his equity interest."[65] These con-

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57. *Id.*

58. *Id.*

59. *Id.* at 706.

60. Economies of scale are essentially decreasing long-run average costs of production. They are appreciated through: (1) specialization of resources, (2) better utilization of equipment, (3) decreased costs of inputs, (4) incorporation of by-products into production that would otherwise not be used, and (5) expansion of facilities. *E.g.*, RALPH T. BYRNS & GERALD W. STONE II, MICRO ECONOMICS 199 (2d ed. 1984); MILTON H. SPENCER, CONTEMPORARY ECONOMICS 372 (1971).

61. *E.g.*, Easterbrook & Fischel, *supra* note 52, at 706.

62. *Id.*

63. *Id.*

64. *See, e.g.*, Victor Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019, 1020 (1975).

65. *See* Burson, *supra* note 50, at 611 n.48 (quoting Going Private Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 14185 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,366, at 88,738 (Nov. 17, 1977)).

cerns are heightened in the context of a parent-subsidiary freeze-out, because the parent's directors are usually on both sides of the bargaining table.[66] This potential conflict of interest further weakens the bargaining position of the minority block when the insider majority does not seek other competitive offers.[67]

Just as some freeze-out mergers arguably increase the value of the resulting concern, some companies fail to appreciate the synergies which were purported to propel the arrangement in the first place.[68] This failure can be "attribut[ed] to self-aggrandizement of buyers rather than to gains in the use of the acquired firms' assets."[69]

Freeze-outs have also been criticized because the majority is seen as unfairly compensating and thus eliminating the minority through a shrewd purchase of its equity when the stock market is on a downswing.[70] This treatment of shareholders engenders allegations that the value received by the minority for its shares is much less than their actual worth.[71] Some argue that companies that issue equity when prices are high and purchase equity when prices are low reduce investor confidence in the secondary securities market as a whole.[72]

### 4. Valuation of the Minority Shares

Notwithstanding the disparate views about the virtues and vices of freeze-out mergers, they are well entrenched in contemporary corporate law. Both federal and state courts have consistently found that such mergers are valid, provided that the consideration given

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66. *See, e.g.*, Richard A. Davis, Note, *Enforcement of Proxy Regulations in Parent-Subsidiary Mergers*, 35 WASH. & LEE L. REV. 255, 264-65 (1978).

67. *Id.* at 265.

68. *E.g.*, Easterbrook & Fischel, *supra* note 52, at 707.

69. *Id.*

70. James Robert Lyons, Jr., Note, *Fairness in Freezeout Transactions: Observations on Coping with Going Private Problems*, 69 KY. L.J. 77, 78 (1980).

71. "Market prices may be perceived to be inadequate as a measure of value in any particular merger by reason of the peculiarities affecting that merger or prior transactions in the merging companies' stocks—e.g. thin market, demonstrated manipulation or withholding or falsifying information." Victor Brudney, *Efficient Markets and Fair Values in Subsidiary Mergers*, 1978 J. CORP. L. 63, 64 (footnotes omitted).

72. "The spectacle of entrepreneurs inviting the public in when they can command high prices for their stock, and then squeezing them out with little or no practical choice in the matter at substantially reduced prices is hardly one to warm the soul of Thomas Aquinas or Aristotle." Burson, *supra* note 50, at 612 n.52 (quoting SEC Commissioner A.A. Sommer, Jr.) (citation omitted).

to the displaced minority equals the fair value of the shares on the merger date.[73] Adequate consideration is determined by calculating the fair value of the equity. This section will briefly provide several of the generally accepted valuation principles that have been recognized in enforcing a dissident shareholder's right to "fair" value for his shares.[74]

The first, and most obvious, source of value for any stock is its market value.[75] Market value is the best determinant of value when "it fairly reflects the opinion of informed buyers and sellers."[76] The market value can be easily ascertained by examining the particular secondary securities exchange in which the equity is traded.[77]

The discounted cash flow method is also an accepted method of estimating the value of a security.[78] This method of valuation is

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73. *See, e.g.*, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); Weinberger v. Universal Oil Products, 457 A.2d 701 (Del. 1983). Most states have statutes which provide shareholders a right to an appraisal if they choose. *See, e.g.*, VA. CODE. ANN. § 13-1-730 (Michie 1985) (pertinent text provided *infra* note 126).

74. *See* Ferdinand S. Tinio, Annotation, *Valuation of Stock of Dissenting Stockholders in Case of Consolidation or Merger of Corporation, Sale of its Assets, or the Like*, 48 A.L.R.3d 430 (1973). This article discusses the various methods by which the value of dissenting shares have been calculated. It is beyond the scope of this Comment to provide every judicially recognized valuation method. Instead, several valuation methods are presented in order to provide a representative sense of the valuation process as it now stands.

75. *E.g.*, Howard T. Macrae, Jr., *Dissenting Stockholders' Rights in Virginia: Exclusivity of the Cash-Out Remedy and Determination of "Fair Value,"* 12 U. RICH. L. REV. 505, 523 (1978).

76. *Id.* (citations omitted).

77. Though the market price may be easily found in any newspaper, the determination of this valuation is subject to much debate in corporate financial circles. The market price of any security is a function of the information available to the market. Professor Eugene Fama, a founding father of contemporary financial theory, espoused the efficient market hypothesis, in which he proposed that investors use three levels of information to evaluate a security's intrinsic value. These levels are:

(a) Weak form efficiency: this level assumes that investors use historical price and available financial data to value securities.

(b) Semi-strong form efficiency: in this level, investors are assumed to use all available financial information to value securities.

(c) Strong form efficiency: this level mandates that investors use all publicly available as well as inside information to value securities.

Donald E. Schlyer, Note, *"Fair Value" Determination in Corporate "Freeze-Outs," and in Security and Exchange Act Suits:* Weinberger, *Other, and Better Methods*, 19 VAL. U. L. REV. 521, 555 n.360 (1985) (citing Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 413-16 (May 1970)). In any of these levels, no investor can outperform the market because every investor has the same information. *Id.*

78. *Id.* at 557-64.

used to estimate stock price where the market value is not a good indicator of the true value of the stock.[79] The discounted cash flow method calculates share value by taking the present value of all future corporate disbursements.[80]

The net asset valuation method calculates share value by allocating to a particular share its pro-rata portion of the total assets of the concern.[81] Tangible asset value can be calculated from book value[82] or liquidation value.[83]

Whichever valuation method is sanctioned by a court to give dissident shareholders a "fair" value for their shares, Howard T. Macrae, Jr., provides two general propositions adaptable to any jurisdiction:

> First, any determination of "fair value" is a matter of judgment to be made upon the specific facts of the case in question, including the reason for the valuation, the type of business involved, the type of stock involved, any special circumstances applicable to the company and, perhaps, any circumstances that are applicable to the industry. . . . Secondly, as to appraisal rights, courts . . . are reluctant to

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79. *Id.*

> The efficient market method would not be applicable where there is a disparity of information. If an analyst were trying to determine the value of a firm to someone with undisclosed inside information, he must look somewhere other than the security's market price. Since the stock market price would not reflect the unknown information, the stock market price would not reflect the value to the insider.

*Id.* at 558 n.377.

80. *Id.* at 558. Such disbursements can be in the form of dividends, earnings, or net cash flows. *Id.* The equation for this model:

$$V = \Sigma\, CF_n/(1+r)^n$$

V = Value per share
n = number of periods
r = discount rate
CF = anticipated cash flow

*See, e.g.*, *id.* at 560 n.385.

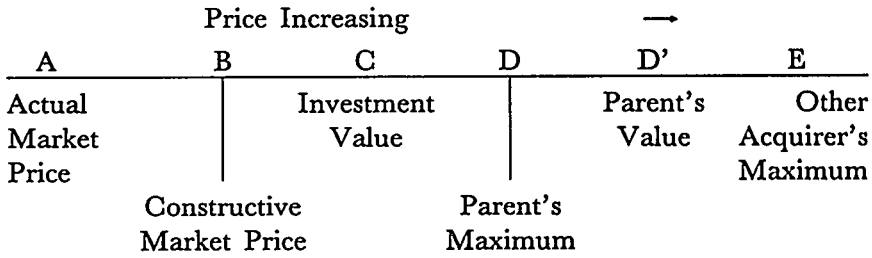
81. *E.g.*, Macrae, *supra* note 75, at 526-27.

82. Book value is the value of the assets from a company's balance sheet. *E.g.*, Schlyer, *supra* note 77, at 564 n.417. Because a corporation's books are kept pursuant to generally accepted accounting principals, which permit the overstating or understating of an asset's true value, book value is perceived as an ineffectual method of valuing a firm. *Id.* at 564.

83. Liquidation value is the amount that would be received if all corporate assets were sold on the open market. *Id.* at 564 n.418. Asset appraisals can be costly and time consuming. *Id.* at 564.

> get too involved with the actual mathematics of a stock appraisal. If the corporation's price offer is reasonable and is the result of a rational method of valuation, courts show great deference to appraisers' opinions in adopting them as the "fair value" of dissenters' stock.[84]

Professor Richard Booth has developed a line graph, along which the continuum of possible prices is placed, to provide an understanding of the forces at work in a conventional freeze-out merger:[85]




Price A is the actual market price of the subsidiary's stock and it is unrealistically low.[86] This low price is attributed to the market's fear of unfair treatment by the majority or the inadequacy of remedies if the majority takes advantage of its power over the minority.[87]

Price B is the constructive market price, or the price a willing buyer would pay to a willing seller under no compulsion, assuming no "depressing" factors similar to those in price A.[88] Such a price would be derived from an analysis of companies of similar size in the same industry or through the implementation of the discounted cash flow model.[89] Price B is characterized by Professor Booth as the "minimum fair price."[90] Shareholders will never receive a value above the "minimum fair price" in exchange for their shares.[91]

Price C is the "investment value" of the stock. The investment value is a price whose value cannot be calculated, but whose relative magnitude is unquestioned in any freeze-out.[92]

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84. Macrae, *supra* note 75, at 532-33.
85. Booth, *supra* note 11, at 548-49.
86. *Id.* at 548.
87. *Id.*
88. *Id.*
89. *Id.* at 548-49.
90. *Id.* at 549. This price is usually cited as presumptively close to the "true" value of the shares. *Id.*
91. *Id.*
92. *Id.*

Price D is the maximum price that a parent corporation would pay for its subsidiary's stock based on the parent's view of its subsidiary's potential for profitability.[93] "[P]rice D is by definition higher than [P]rice C since, unless there is some profit in the deal, the parent would not be interested."[94]

Price D' is the value that the parent attaches to the shares held by the minority block.[95] In a freeze-out merger, Price D' would never be paid by the parent because there would be no potential for profit in the transaction.[96]

Price E is the price that a person, other than the parent corporation, would pay for the minority shares.[97] This price may or may not exist, depending on the potential gains that could be realized through a better use of the subsidiary.[98]

Of all of the prices along this continuum, Professor Booth argues that price C is the only one that cannot be calculated with some degree of certainty.[99] This price ranges from the most "pessimistic" (Price B) to the most "optimistic" (Price D).[100] Therefore, if one value must be distilled from this continuum in an equity proceeding, Professor Booth contends that "it would seem most reasonable to choose some sort of average, either the median of all values or a weighted average."[101]

## III. ANALYSIS

### A. *The Facts*

In December 1986, a freeze-out merger was initiated between First American Bank of Virginia (Bank) and Virginia Bankshares, Incorporated (VBI). VBI was a wholly owned subsidiary of First American Bankshares, Incorporated (FABI), a bank holding company.[102] VBI owned eighty-five percent of the Bank's shares, and

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93. *Id.*
94. *Id.*
95. *Id.* Price D' is calculated through an analysis of the same factors used to calculate Price D, except that a lower interest rate identical to the parent's cost of capital is used in this calculation. *Id.* at 549 & n.168.
96. *Id.* at 549.
97. *Id.* at 549-50.
98. *Id.* at 550 n.169.
99. *Id.* at 550.
100. *Id.*
101. *Id.*
102. *Virginia Bankshares*, 111 S. Ct. at 2755.

approximately 2,017 holders of minority shares owned the remaining fifteen percent.[103]

FABI hired the investment banking firm of Keefe, Bruyette & Woods, Inc. (KBW)[104] to determine the appropriate price for the shares of the minority holders who stood to lose their interest in the Bank due to the merger.[105] In its determination, KBW considered many relevant factors, including the current and historical prices of the equity and that the Bank's stock had never traded for more than $32.50 per share.[106] KBW concluded that the current market price of the common stock reflected the true value of the shares.[107] In accordance with this appraisal, KBW issued an opinion letter stating, "[W]e are of the opinion that $42 per share represents a fair price for the shares of [the Bank] not currently owned by [FABI]."[108]

On January 15, 1987, FABI presented its proposal to the Bank's Board of Directors, who then instructed the board's executive committee to make a recommendation to the full board.[109] After KBW

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103. *Id.*

104. The proxy statement provided the terms of the compensation for KBW: "For rendering its opinion to FABI, [KBW] will be paid $25,000, and if the Merger is consummated, will be paid an additional fee of $75,000." Appendix to Petition for Cert. at 55a, *Virginia Bankshares* (No. 89-1448).

105. *Virginia Bankshares*, 111 S. Ct. at 2755.

106. Petitioners' Brief at 3, *Virginia Bankshares* (No. 89-1448).

> KBW first examined a variety of factors relating to the financial strength of the Bank, including "the condition of the company; whether it was "competitive in its market"; and whether its "financial ratios" were "acceptable within the framework of normal performance of a Virginia bank." KBW then looked at the market for the stock and concluded that it "was a valid market. That is to say, that the price level of the stock prior to the offering being made, approximately $32 to $33 a share, did represent a price that took into account all available information that the public would need to establish a price level."

*Id.* at 3-4 (citations omitted).

107. *Id.* at 4.

108. Appendix to Petition for Cert. at 75a-76a, *Virginia Bankshares* (No. 89-1448).

> As KBW Vice President Michael Connor testified, KBW "looked at the fact that the company wanted to . . . make an offer that was unassailable from a reasonable standpoint. It was clearly part of our charge from the company to arrive at a price that would be fair." Hence, KBW suggested that FABI offer $42 per share, "a price that will show those minority shareholders that we are being fair, that we are offering them a substantial premium that isn't technically required but is being offered out of good faith."

Petitioners' Brief at 4, *Virginia Bankshares* (No. 89-1448) (citation omitted).

109. Petitioners' Brief at 5-6, *Virginia Bankshares* (No. 89-1448).

made a presentation explaining its opinion before the executive committee, the committee decided that $42 was a fair price and that it was unnecessary to engage the services of a second investment bank to appraise the value of the minority block's interest.[110] Upon receiving the executive committee's approval, the full board of directors unanimously agreed on February 12, 1987, that "the Agreement and Plan of Merger is hereby approved and found to be in the best interests of [the Bank's] shareholders and directed to be submitted for consideration by [the Bank's] shareholders with the recommendation of the Board of Directors that it be approved by them."[111]

Even though VBI's ownership of eighty-five percent of the Bank's stock was sufficient to effectuate the merger,[112] Virginia law mandated that the Bank's directors present the merger to all stockholders for a vote.[113] The method by which the Bank chose to inform the holders of the minority shares was a proxy solicitation.[114] The proxy statement stated that the merger:

> has been approved by the Board of Directors because it provides an opportunity for the Bank's public shareholders to achieve a high value for their shares. The price to be paid is about 30% higher than the $32.50 per share at which the Bank's common stock traded on February 8,

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110. *Id.*

111. *Id.* at 8 (citation omitted).

112. The Virginia Code Annotated provides in pertinent part:

> E. Unless this chapter or the board of directors, acting pursuant to subsection C of this section, requires a greater vote, the plan of merger or share exchange to be authorized shall be approved by each voting group entitled to vote on the plan by more than two-thirds of all the votes entitled to be cast by that voting group.

VA. CODE ANN. § 13.1-718 (Michie 1985).

113. *Id.* Virginia law requires:

> B. For a plan of merger or share exchange to be approved:
>
> 1. The board of directors shall recommend the plan of merger or share exchange to the shareholders unless the board of directors determines that because of conflict of interests or other special circumstances it should make no recommendation and communicates the basis for its determination to the shareholders with the plan; and
>
> 2. The shareholders shall approve the plan as provided in subsection E of this section.

*Id.*

114. Sandberg v. Virginia Bankshares, Inc. (*Sandberg*), 891 F.2d 1112, 1117 (4th Cir. 1989).

> 1987, the last trading day prior to announcement of the proposal.[115]

The proxy statement also stated that the board had evaluated several objective economic factors to support its conclusion that the $42 per share offer was fair to its shareholders.[116] Additionally, the proxy statement asserted that "FABI's Board of Directors commissioned [KBF], an independent investment banking firm, to pass on the fairness of the Merger from a financial point of view."[117]

At the April 21, 1987, meeting of the shareholders, 97.3% of all shareholders voted in favor of the transaction.[118] Additionally, 72.3% of the minority shareholders voted to approve the merger.[119]

### *B. The State Court Litigation.*

#### 1. The Virginia Corporation Commission

About two weeks prior to the April 21, 1987, shareholder meeting, a group of fifteen shareholders, led by respondent Paul H. Weinstein, protested before the Virginia Corporation Commission.[120] In their complaint, Weinstein alleged that the $42 price per share was unfair and that the Bank's directors had breached their fiduciary duty to the stockholders by recommending the merger.[121]

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115. Appendix to Petition for Cert. at 53a-54a, *Virginia Bankshares* (No. 89-1448).

116. *See id.* at 37a, 53a-54a.

117. *Id.* at 38a. *See supra* note 104 (providing the terms of KBW's compensation in the proxy statement).

118. Joint Appendix at 66, *Virginia Bankshares* (No. 89-1448).

119. *Id.*

120. Petitioners' Brief at 10, *Virginia Bankshares* (No. 89-1448).

121. Joint Appendix at 30, *Virginia Bankshares* (No. 89-1448). The opposition statement provided:

> This breach of fiduciary duty is clearly established by this record in which (1) there is no valid corporate purpose for the freeze-out merger other than to bestow a windfall on the 85% majority shareholder; (2) the purported fairness of the freeze-out price of $42.00 per share is based upon a conclusion of the majority shareholder's appraiser without independent investigation by the Board of Directors or appointment of an independent appraiser; (3) the $42.00 price per share imposed by the majority shareholder is inadequate and unfair because it fails to take into account the significant past growth and the anticipated future growth of the Bank, and sales prices of comparable institutions with equivalent operating results.

*Id.* at 30-31.

On May 11, 1987, the Virginia Corporation Commission dismissed these claims, citing the "benefit to the public's interest may result therefrom and no detriment to the public may ensue, the Commission is of the opinion and finds that granting the required certificates [of authority to engage in the banking business] will be in the public interest."[122]

2. The Circuit Court of Fairfax County

On April 16, 1987, while the Virginia Corporation Commission action was pending, Mr. Weinstein and his contingent sought injunctive relief in the Circuit Court of Fairfax County to prevent the effectuation of any merger which did not provide a "fair price per share" to the holders of the minority shares.[123] This motion for temporary injunction was denied.[124]

On May 1, 1987, Mr. Weinstein and the other plaintiffs amended their initial complaint, adding to it a claim for damages against VBI and the Bank's directors for breach of fiduciary duties under state law.[125] This amended complaint also petitioned for an equitable appraisal pursuant to Virginia law.[126]

In dismissing this claim, the court provided two justifications. First, the court relied on the legislative directive that exempts a holder of bank shares from the statutory right to appraisal found in Virginia's statutory scheme.[127] Second, the court dismissed complainants' argument that there remained a common law complement to statutory appraisal,[128] and held:

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122. *Id.* at 38-39.

123. *Id.* at 19; *Sandberg*, 891 F.2d at 1117.

124. Joint Appendix at 20, *Virginia Bankshares* (No. 89-1448).

125. *Id.* at 6; *Sandberg*, 891 F.2d at 1117.

126. Virginia law provides in pertinent part:

> A. A shareholder is entitled to dissent from, and obtain payment of the fair value of his shares in the event of, any of the following corporate actions:
>
> 1. Consummation of a plan of merger to which the corporation is a party (i) if shareholder approval is required for the merger by § 13.1-718 or the articles of incorporation and the shareholder is entitled to vote on the merger . . . .

VA. CODE ANN. § 13.1-730 (Michie 1985).

127. "Banks may merge upon compliance with the provisions of Article 12 (§ 13.1-716-et seq.) of the Virginia Stock Corporation Act. However, . . . the provisions of § 13.1-730 shall not apply to a merger under this section." VA. CODE ANN. § 6.1-43 (Michie 1985).

128. Joint Appendix at 25, *Virginia Bankshares* (No. 89-1448).

> While the result may seem harsh, this is how the General Assembly chose to balance the competing interests of minority stockholders versus those of the depositing public. Investors who opt to purchase stock in a bank do so with the knowledge that [section] 13.1-730 is not available to them in the event of a freeze-out.[129]

The court added that the complainants might have had an action at law if they could have demonstrated a breach of fiduciary duty or fraud by the board.[130] However, the "[c]omplainants may not obtain that which the legislature has taken away by masking their request as the enforcement of an equitable duty."[131] The Supreme Court of Virginia refused to review this ruling and the merger proceeded.[132]

### C. *The Federal District Court Litigation*

On March 14, 1988, after the merger was consummated, another shareholder, Doris I. Sandberg, filed a class action suit in the United States District Court for the Eastern District of Virginia against VBI, FABI, and individual directors of the Bank. She alleged violations of the federal securities laws (Count I)[133] and a breach of fiduciary duties imposed by Virginia law (Count II).[134] The complaint was

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129. *Id.*
130. *Id.* at 26.
131. *Id.*
132. *Id.*
133. *See* Joint Appendix at 49-51, *Virginia Bankshares* (No. 89-1448).
134. *Id.* at 51-53. Specifically, Count II was grounded on alleged contraventions of Virginia Code § 13.1-690, which provides:

> A. A director shall discharge his duties as a director, including his duties as a member of a committee, in accordance with his good faith business judgment of the best interests of the corporation.
>
> B. Unless he has knowledge or information concerning the matter in question that makes reliance unwarranted, a director is entitled to rely on information, opinions, reports or statements, including financial statements, and other financial data, if prepared or presented by:
>
> 1. One or more officers or employees of the corporation whom the director, believes in good faith, to be reliable and competent in the matters presented;
> 2. Legal counsel, public accountants, or other persons as to matters the director believes, in good faith, are within the person's professional or expert competence; or
> 3. A committee of the board of directors of which he is not a member if the director believes, in good faith, that the committee merits confidence.

VA. CODE ANN. § 13.1-690 (Michie 1985).

filed on behalf of a class of 2,017 shareholders.[135] The district court denied class certification and the case proceeded to trial.[136]

Sandberg alleged that the proxy solicitation "contained misstatements of material fact and failed to disclose material facts,"[137] in violation of section 14(a) of the 1934 Act through Rule 14a-9.[138] More particularly, Sandberg alleged that FABI and VBI conspired to eliminate all of the holders of the minority shares through a freeze-out merger,[139] that the submissive Bank's Board of Directors "rubber-stamped" the $42 per share price as "fair" without conducting an independent investigation as to its fairness,[140] and that the $42 per share offered was "grossly unfair and far less than the value of the shares."[141]

By invoking the language of the United States Supreme Court in *Mills v. Electric Auto-Lite Co.*,[142] Sandberg obtained a jury instruction that the jury could find for her without any showing of her own reliance on the purported misstatements, provided that the misstatements were material[143] and the proxy solicitation was an "essential link"[144] in the merger.[145] The jury found that the proxy solicitation contained misrepresentations of material facts in violation of Rule 14a-9 and that the Bank's directors breached their fiduciary duties to Sandberg.[146] The jury further found that the shares were actually worth $60 each, awarding Sandberg $18 per share for a total of $43,956.[147]

While the Sandberg suit was pending in the Eastern District of Virginia, respondent Paul H. Weinstein led a contingent of sixty-seven plaintiffs into the United States District Court for the District

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135. *Sandberg*, 891 F.2d at 1117.

136. *Id.*

137. Joint Appendix at 49, *Virginia Bankshares* (No. 89-1448).

138. *Virginia Bankshares*, 111 S. Ct. at 2756. *See supra* notes 4 & 6 (providing the full text of the § 14(a) and Rule 14a-9).

139. Joint Appendix at 45, *Virginia Bankshares* (No. 89-1448).

140. *Id.* at 47.

141. *Id.* at 46.

142. 396 U.S. 375 (1970).

143. *See supra* text accompanying note 43 (providing the full text of the *TSC* materiality standards).

144. *See supra* text accompanying note 35 (providing the full text of the *Mills* "essential link" test).

145. *Virginia Bankshares*, 111 S. Ct. at 2756.

146. *Id.*

147. Petitioners' Brief at 12, *Virginia Bankshares* (No. 89-1448). Sandberg's motion for attorneys' fees was denied. *Sandberg*, 891 F.2d at 1117.

of Columbia and filed a separate action based upon similar allegations.[148] The court moved this suit to the Eastern District of Virginia and the Weinstein complaint was amended to mirror the Sandberg complaint.[149]

After the jury delivered its verdict for Sandberg, the Weinstein plaintiffs pleaded the doctrine of offensive collateral estoppel and moved for summary judgment.[150] On November 15, 1988, the district court granted the motion and entered judgment for the plaintiffs in the amount of $18 for each Bank share owned by the members of the group at the time of the merger.[151] As a result of these two proceedings, VBI, FABI and individual directors of the Bank were exposed to liability of $3,336,292 for misrepresentations of material facts in violation of Rule 14a-9 and a breach of fiduciary duties.[152]

### *D. The Fourth Circuit Opinion*

In *Sandberg v. Virginia Bankshares, Inc.*, the United States Court of Appeals for the Fourth Circuit provided an opinion divided into nine parts, considering several appeals and cross-appeals.[153]

The court first considered appellants VBI, FABI, and the individual directors' contention that only a presumption of reliance by the plaintiff stockholder was created by the proxy statement's misrepresentations of material fact in violation of Rule 14a-9.[154] The

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148. Petitioners' Brief at 12, *Virginia Bankshares* (No. 89-1448).

149. *Sandberg*, 891 F.2d at 1118.

150. *Id.*

151. Appendix to Petition for Cert. at 28a-29a, *Virginia Bankshares* (No. 89-1448).

152. *Sandberg*, 891 F.2d at 1117-18. The district court reduced the liability of the individual Bank directors pursuant to Virginia law which provides:

> A. In any proceeding brought by or in the right of a corporation or brought by or on behalf of shareholders of the corporation, the damages assessed against an officer or director arising out of a single transaction, occurrence or course of conduct shall not exceed the lesser of:
>
> 1. The monetary amount, including the elimination of liability, specified in the articles of incorporation or, if approved by the shareholders, in the bylaws as a limitation on or elimination of the liability of the officer or director; or
>
> 2. The greater of (i) $100,000 or (ii) the amount of cash compensation received by the officer or director from the corporation during the twelve months immediately preceding the act or omission for which liability was imposed.

VA. CODE ANN. § 13.1-692 (Michie 1985).

153. *Sandberg*, 891 F.2d at 1118-26.

154. *Id.* at 1119.

appellants argued that this presumption was categorically rebutted by Sandberg's confessed dearth of reliance on the alleged misrepresentations.[155]

The Fourth Circuit rejected this contention. Citing *Mills v. Electric Auto-Lite Co.*,[156] the court stated that the "essential link"[157] standard dispensed with the cumbersome task of determining the extent of reliance by thousands of stockholders.[158] The court stated that the appellants' reliance on *Basic, Inc. v. Levinson*[159] to support a rebuttable presumption of reliance in proxy cases was misplaced.[160] The court found that *Basic* created a rebuttable presumption of reliance only for violations of section 10(b) of the 1934 Act and not for violations of section 14(a).[161]

The appellants also maintained that liability should not attach because *Mills* explicitly left open the question of "whether causation could be shown where management controls a sufficient [number] of shares to approve the transaction without any votes from the minority."[162] The court, in response, adopted the reasoning of *Schlick v. Penn-Dixie Cement Corp.*[163] In *Schlick*, the United States Court of Appeals for the Second Circuit cited the broad remedial purpose of the 1934 Act as justification for holding that reliance is not a requisite element of causation in such circumstances.[164] The court stated that to hold otherwise "would sanction all manner of fraud and overreaching in the fortuitous circumstance that a controlling shareholder exists."[165]

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155. *Id.* at 1119.

156. 396 U.S. 375 (1970).

157. *See supra* text accompanying note 35 (providing the full text of the *Mills* "essential link" test).

158. *Sandberg*, 891 F.2d at 1120.

159. 485 U.S. 224 (1988).

160. *Sandberg*, 891 F.2d at 1120.

161. *Id. See also Basic*, 485 U.S. at 243 (providing that "[t]here is . . . more than one way to demonstrate the causal connection").

162. *Sandberg*, 891 F.2d at 1120 (citing *Mills*, 396 U.S. at 385 n.7).

163. 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

164. *Sandberg*, 891 F.2d at 1120-21 (referring to Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974)).

165. *Id.* at 1121 (quoting *Schlick*, 507 F.2d at 383 (quoting Swanson v. American Consumer Indus., Inc., 415 F.2d 1326, 1331 (7th Cir. 1969))).

> We adopt the reasoning in *Schlick* and hold that reliance, even when the minority's voting strength is insufficient to halt a merger, is not an element of causation in a § 14(a) action. Thus, if the proxy statement contained material misrepresentations and was an essential link in the merger, § 14(a) liability may be established.

*Id.*

The court then examined the materiality of the misrepresentations of facts in the proxy solicitation. After providing the objective standard of materiality established by the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*,[166] the court held that no less than two of the allegations of misrepresentation were "sufficiently strong" enough to require the jury to assess the inferences drawn by a reasonable shareholder such as Sandberg.[167]

The court found that the representation in the proxy solicitation that the Bank's directors approved of the merger because it offered an opportunity for the minority shareholders to receive a "high"[168] value for their holdings could have been construed by the jury as a material misrepresentation upon the presentation of evidence that the Bank directors' real reason for approving the merger was a fear of replacement on the board.[169] The jury was also justified in concluding that KBW's valuation of the shares held by the minority block of $42 per share was not an independent determination when confronted with KBW's compensation package[170] and admission that they only consulted the market price in valuating the stock price.[171] The jury's conclusion was also buttressed by the introduction of testimony by Sandberg's expert which established that the market value of the equity was $18 higher per share than that offered by FABI.[172]

In further support of its holding, the court dismissed appellants' contention that it was reversible error for the court to have submitted to the jury any alleged misrepresentation that was not material as a matter of law, holding that "the submission of both correct and incorrect factual bases supporting a single theory of recovery is not grounds for reversal of a judgment on a general verdict."[173] As long

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166. *Id.* (referring to TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976)). *See supra* text accompanying note 43 (providing the full text of the *TSC* materiality standards).

167. *Sandberg*, 891 F.2d at 1121.

168. *See supra* text accompanying note 40 (providing the pertinent text of the proxy solicitation concerning the "high value" to be received for the shares).

169. *Sandberg*, 891 F.2d at 1121.

170. The proxy statement provided the following terms of the compensation for KBW: "For rendering its opinion to FABI, [KBW] will be paid $25,000, and if the merger is consummated, will be paid an additional fee of $75,000." Appendix to Petition for Cert. at 55a, *Virginia Bankshares* (No. 89-1448).

171. *Sandberg*, 891 F.2d at 1122.

172. *Id.*

173. *Id.*

as one allegation was material as a matter of law, a general jury verdict must stand.

The court also affirmed the jury's finding that the individual directors breached their fiduciary duty of good faith owed to stockholders under Virginia law.[174] Based on the evidence that the individual directors failed to make a good faith effort to apprise themselves of the adequacy of the merger proposition and that they failed to demand a higher price per share for the Bank stock, the court felt that the jury had reason to believe that these directors "rubber[-]stamped everything placed before them."[175]

The appellants also contended that Sandberg's expert completely ignored the market price of the stock in violation of a Virginia law requiring a damage determination to consider market price.[176] In addition, the appellants also questioned the methods employed by the expert to evaluate both the majority and minority blocks.[177]

The court found no flaws in either of the two valuation methods employed by Sandberg's expert witness. First, the expert employed the dividend discount method, which considered the present value of future dividends from the Bank. Second, the expert analyzed the stock prices of similar banks in the Virginia area through ratio analysis.[178] Both methods generated a stock price of approximately $60 per share.[179] Because eighty-five percent of the shares were held by one party, the stock had a thin market. Therefore, the market price of the stock was not a sufficient indicator of its true value.[180] The court concluded that this expert's opinion satisfied the requirement of Rule 703 of the Federal Rules that the opinion be based on information reasonably relied upon by experts in the financial field.[181]

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174. *Id.* at 1123. *See supra* note 134 (providing Virginia's statutory requirement that each director act in good faith on behalf of the corporation).

175. *Sandberg*, 891 F.2d at 1123.

176. *Id.*

177. *Id.*

178. *Id.* The ratios used were price to earnings and price to book multiples. *Id.*

179. *Id.*

180. *Id.*

181. *Id.* Rule 703 of the Federal Rules of Evidence provides:

> The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence.

FED. R. EVID. 703.

The court used this same basis to dismiss the appellants' reliance on a Virginia Supreme Court case, *Lucas v. Pembroke Water Co.*[182] The appellants argued that *Lucas* required consideration of market price in a damage determination.[183] The court, however, distinguished *Lucas* and held "[t]hat a court, as the fact[ ]finder in an equitable proceeding, is required to consider each element does not mean that a plaintiff seeking to show a stock's value in an action of law must similarly employ each valuation method."[184] The court held that it was sufficient that Sandberg's expert considered market value a weak indicator of value for the trial court to rely on other generally accepted valuation principles.[185]

The court next considered the appropriateness of the lower court's granting of offensive collateral estoppel, which permitted the Weinstein plaintiffs to recover an additional $18 per share without relitigating the issues decided in Sandberg.[186] To dismiss this contention, the court relied upon the general rule that offensive collateral estoppel should not be implemented when the plaintiff invoking the doctrine could simply have joined the defendant in the earlier suit or when it would be prejudicial to the defendant for other reasons.[187] The court held that the trial court did not abuse its broad discretion in applying offensive collateral estoppel in this case.[188]

The last, and most remarkable, holding of the court's opinion was the reversal of the trial court's order denying class certification.[189] The trial court below denied Sandberg's motion for class certification on four grounds:

> (1) Since Sandberg voted against the merger, she was not typical of the class (less than 15% of the minority shareholders voted against the merger);

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182. 135 S.E.2d 147 (Va. 1964).
183. *Sandberg*, 891 F.2d at 1123.
184. *Id.* at 1124.
185. *Id.*
186. *Id.*
187. *Id.* (referring to the standard established in Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979), which stated that possible reasons for unfairness might include an earlier suit of such small value that it provided little incentive for a vigorous defense, or a defendant having procedural advantages in the later action that were unavailable in the earlier suit and which might cause a different result, *id.* at 330-31).
188. *Sandberg*, 891 F.2d at 1124.
189. *Id.* at 1118-19.

> (2) the sixteen plaintiffs in [Weinstein's Virginia state court action] could not be members of the class;
> (3) a conflict of interest existed in that Sandberg's law firm had previously represented one of the defendant directors; and
> (4) other stockholders had shown little interest in the suit.[190]

In reversing the trial court's order denying class certification, the Fourth Circuit dismissed the third and fourth grounds summarily.[191] In responding to the first ground for denial of class certification, the court stated that Sandberg's failure to rely on the misrepresentations in the proxy solicitation did not affect her ability to prevail.[192] Insofar as reliance was not determinative in assigning culpability, the court held that Sandberg's "nay" to the merger proposal did not alienate her from the other compliant holders of the minority shares.[193] The court granted class certification on this ground, questioning why any other holders of minority shares would not "immediately embrace" Sandberg's attempt to advance their interests by possibly securing more money for their Bank shares.[194]

For the Fourth Circuit, the Weinstein plaintiffs' pursuit of a state court remedy did not provide a sufficient ground for denial of class certification.[195] The court held that to deny class certification on the remote chance that sixteen members of a class of approximately 2,000 might be barred by *res judicata* would be "clearly inimical to the purposes for which the class action procedure was intended."[196] As a result of this holding, the initial jury verdict of $43,956 to Sandberg could balloon on remand to over $13 million.[197]

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190. *Id.* at 1118.

191. The issue of alleged conflict of interest was moot because the director, Dwight Schar, who had been represented by Sandberg's law firm, had been dismissed as a party prior to the certification motion. Additionally, because he did not attend any of the "critical" board meetings, Schar had a "complete defense to both the federal and state claims." *Id.* at 1118-19. That other stockholders had shown little interest in the Sandberg suit had no independent legal significance. *Id.* at 1119.

192. *Id.* at 1118.

193. *Id.*

194. *Id.*

195. *Id.* at 1119.

196. *Id.*

197. Petitioners' Brief at 14, *Virginia Bankshares* (No. 89-1448). The court upheld the trial court's application of Virginia law limiting the liability of the defendant Bank directors in the Weinstein suit to $2,346,553.34. *Sandberg*, 891 F.2d at 1125. *See supra* note 152 and accompanying text (providing the full text of the Virginia

### *E. The Supreme Court Opinion*

On April 20, 1990, the Supreme Court of the United States granted a petition for writ of certiorari to the United States Court of Appeals for the Fourth Circuit.[198]

#### 1. The Opinion of the Supreme Court

In Part II[199] of the Supreme Court opinion, Justice Souter, writing for the Court, first considered the actionability of declarations of reasons, opinions, or beliefs.[200] The Court construed the jury verdict as finding that the directors did not furnish their true motives

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Code § 13.1-692 which limits director liability). The court also rejected the appellants' contention that the Weinstein plaintiffs were barred by *res judicata* because they sought an appraisal remedy in a Virginia state court, which was dismissed. This action, the court held, had no effect on the subsequent federal court litigation. *Sandberg*, 891 F.2d at 1125-26. Finally, finding no "special circumstances" in the Weinstein case, the court affirmed the trial court's denial of attorneys' fees. Because the Sandberg litigation was transformed into a class action, the order denying the motion for an award of attorney's fees was vacated and remanded for reconsideration. *Id.* at 1126. *See* Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714, 718-19 (1967) (stating a common law rule of awarding expenses where a plaintiff has successfully maintained a suit that benefits a group in the same manner as himself).

198. Virginia Bankshares, Inc. v. Sandberg, 495 U.S. 903 (1990). The grant was limited to Questions 1 and 2 presented by the petition:

> 1. Whether [§] 14(a) of the Securities Exchange Act of 1934 requires proxy statements not only to disclose material facts, but also to disclose alleged ulterior motivations of corporate directors and characterize disclosed facts in a pejorative manner.
>
> 2. Whether a plaintiff may invoke an implied cause of action for damages under [§] 14(a) of the Securities Exchange Act of 1934 when the allegedly misleading proxy statement could not possibly have affected the outcome of the proxy vote, and the plaintiff has not demonstrated causation in any other way. This is a question that the Court explicitly left open in *Mills v. Electric Auto-Life Co.*, 396 U.S. 375, 385 n. 7 (1970).

Petition for Cert. at i, *Virginia Bankshares* (No. 89-1448).

199. Part I of the opinion gave an account of the litigation up to the date of the opinion and the importance of the grant of certiorari in this case. *Virginia Bankshares*, 111 S. Ct. at 2755-56. It is not clear which Justices subscribed to this part of the opinion. At the introduction of the opinion, Justice Stevens did not join with Chief Justice Rehnquist and Justices White, Marshall, Blackmun, O'Connor, Scalia, and Kennedy as to Part I. *Id.* at 2754. However, at the introduction of his concurring opinion, Justice Stevens stated, "While I agree in substance with Parts I and II of the Court's opinion . . . ." *Id.* at 2767 (Stevens, J., concurring in part and dissenting in part). Chief Justice Rehnquist and Justices White, Marshall, Blackmun, O'Connor, and Kennedy joined as to Part II. *Id.* at 2756-61.

200. *Id.* at 2757.

for recommending the merger.[201] In reading this conclusion pragmatically, the Court held that there was "no room to deny" that a statement of opinion or belief could be material under the test of *TSC*.[202] This holding is fortified by the directors' superior knowledge, as compared to that of the typical investor, and the state law requirement that directors act in the best interests of their shareholders.[203]

Assuming materiality, the Court next considered whether such statements were statements "with respect to any material fact[s]," thereby falling within the purview of Rule 14a-9.[204] The Court balked at the petitioners' reliance on *Blue Chip Stamps v. Manor Drug Stores*[205] to place such expressions beyond the sweep of Rule 14a-9.[206] The Court distinguished *Blue Chip*[207] from the case at bar because the directors' statements were factual in two respects: first, as statements that the directors do act for the reasons given or hold the belief stated; and second, as statements about the subject matter of the reason or belief expressed.[208]

The Court considered the second of these factual distinctions and held that such statements about the directors' belief or reasons for directors' recommendations were easily verifiable matters of corporate record and could be supported or refuted by evidence in the petitioners' control.[209] The Court found it irrelevant that the cited statement on which the jury held the petitioners liable was subjective in nature, as such conclusory terms like "high" are comprehended to rest on factual grounds which can be supported or refuted by

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201. *Id.*

202. *Id. See supra* text accompanying note 43 (providing the full text of the *TSC* materiality standards).

203. *Virginia Bankshares*, 111 S. Ct. at 2757.

204. *Id.* at 2757 (quoting Rule 14a-9). *See supra* note 6 and accompanying text (providing the full text of Rule 14a-9).

205. 421 U.S. 723 (1975).

206. *Virginia Bankshares*, 111 S. Ct. at 2757.

207. In *Blue Chip*, the Court refused to extend the class of plaintiffs entitled to seek relief under an implied private cause of action pursuant to § 10(b) of the 1934 Act from actual buyers and sellers to those who relied on the fraudulent sales practices by doing nothing. *Id.* The Court refused to do so because such a recognition would have "exposed the courts to litigation unconstrained by any such anchor in demonstrable fact, resting instead on the plaintiff's 'subjective hypothesis' about the number of shares he would have sold or purchased." *Id.* at 2758 (quoting *Blue Chip*, 421 U.S. at 734-35).

208. *Id.*

209. *Id.*

evidence in the petitioners' control.[210] The Court held that whether $42 per share was "high" and the merger proposal "fair" to the minority block depended on whether the relevant underlying facts warranted a value above, below, or near the $42 quote when calculated using generally accepted valuation principles.[211] The facts presented by the respondents at trial supported the proposition that the statement in the proxy solicitation was misleading as to its contents and a false expression of the directors' true motives.[212] Therefore, respondents were permitted to present to a jury any concrete, objective evidence that would allow them to recover on the grounds that it was misleading to characterize $42 a share as "high."[213]

The Court then addressed the justiciability of the first of the two factual distinctions of the directors' statements: "[that they are factual] as statements that the directors do act for the reasons given or hold the belief stated."[214] The Court noted that the Fourth Circuit alluded to this distinction when it observed that "the jury was certainly justified in believing that the directors did not believe a merger at $42 per share was in the minority stockholders' interest but, rather, that they voted as they did for other reasons, *e.g.*, retaining their seats on the board."[215] The Court questioned whether such a disbelief or undisclosed belief, standing alone, should be a sufficient reason to sustain an action under section 14(a) where there is no concrete, objective evidence demonstrating that the statement was misleading or false as to its subject matter.[216] The Court responded by stating, "We think that proof of mere disbelief or belief undisclosed should not suffice for liability under [section] 14(a), and if nothing more had been required or proven in this case we would reverse for that reason."[217]

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210. *Id.*

211. *Id.* at 2759.

212. *Id. See supra* text accompanying notes 16-79 (providing evidence cited by the respondent Sandberg's expert at trial).

213. *Virginia Bankshares*, 111 S. Ct. at 2759.

214. *Id.* at 2758. *See supra* text accompanying note 208 (providing the two factual senses of the directors' statements).

215. *Id.* at 2759 (quoting *Sandberg*, 891 F.2d at 1121).

216. *Id.* In this case there was objective evidence presented to challenge the validity of the directors' statements as to the "high" value of $42. *See supra* text accompanying notes 164-69 (discussing same).

217. *Virginia Bankshares*, 111 S. Ct. at 2760. As a practical matter, it would be rare to find a case consisting solely of evidence of belief or undisclosed belief without additional proof that the statement was defective as to its subject matter. *Id.*

The petitioners' last argument was that even if the directors' statements were actionable under section 14(a), they were neutralized because the proxy statement disclosed the offending statement's factual basis. In this case, shareholders would not be entitled to judicial relief because they were provided evidence that a professed reason for the proxy endorsement was misleading and the opportunity to infer this themselves.[218] Although the Court agreed with the general proposition that disclosing accurate facts can negate the misleading aspects of a statement too insignificant (i.e., not material) to warrant liability, it established the following rule to be applied in such cases: "Only when the inconsistency would exhaust the misleading conclusion's capacity to influence the reasonable shareholder would a [section] 14(a) action fail on the element of materiality."[219] In this case, the disclosures that the directors provided were merely "half-truths" which did not sway the jury from its finding that the materiality of the statement was not neutralized.[220]

In Part III[221] of the opinion, the Court addressed the issue left unresolved in *Mills*,[222] "whether causation of damages compensable through the implied private right of action under [section] 14(a) can be demonstrated by a member of a class of minority shareholders whose votes are not required by law or corporate bylaw to authorize the transaction giving rise to the claim."[223] Although *Borak* first

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218. *Id.* at 2761.

219. *Id.*

220. *Id.* The "half-truths" that the Court cited were:

> The directors claim, for example, to have made an explanatory disclosure of further reasons for their recommendation when they said they would keep their seats following the merger, but they failed to mention what at least one of them admitted in testimony, that they would have had no expectation of doing so without supporting the proposal. . . . And although the proxy statement did speak factually about the merger price in describing it as higher than share prices in recent sales, it failed even to mention the closed market dominated by FABI. . . . The claim that the merger price exceeded book value was controverted . . . by evidence of a higher book value than the directors conceded, reflecting appreciation in the Bank's real estate portfolio. Finally, the solicitation omitted any mention of the Bank's value as a going concern at more than $60 a share, as against the merger price of $42. There was, in sum, no more of a compelling case for the statement's immateriality than for its accuracy.

*Id.* (citations omitted).

221. Chief Justice Rehnquist and Justices White, O'Connor, and Scalia joined as to Part III. *Id.* at 2761-66.

222. *See Mills*, 396 U.S. at 385 n.7.

223. *Virginia Bankshares*, 111 S. Ct. at 2761.

recognized the implied private right of action for the breach of section 14(a) through Rule 14a-9, it did not address the standards of causation or define the class of potential plaintiffs authorized to sue.[224] The causation element of the cause of action was certainly addressed by *Mills*.[225] In *Mills*, the Court found that the proxy solicitation was "an essential link in the accomplishment of the transaction."[226] The *Mills* court did not answer the question of whether causation could be demonstrated in a case where the holders of the minority shares could not thwart the merger through the voting process.[227]

The respondents offered two arguments for their contention that the proxy solicitation presented to them was an "essential link" pursuant to the *Mills* causation test.[228] First, they posited that the requisite link existed because the principals, VBI and FABI, would not have consummated the merger without the approval of the minority block.[229] Second, they argued that the proxy statement was an essential link between the Bank directors' proposal and the merger because Virginia law required the proxy statement to inform the minority shareholders that one of the Bank's directors, Jack Beddow, was also a director at FABI.[230] Therefore, respondents claimed that this transaction was voidable by the minority shareholders due to the board's failure to notify them of this conflict of interest.[231]

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224. *Id.*

225. *Id. See supra* text accompanying notes 31-40 (providing the facts of the case and the full text of the *Mills* "essential link" test).

226. *Virginia Bankshares*, 111 S. Ct. at 2762 (quoting *Mills*, 396 U.S. at 385).

227. *Id.* (referring to *Mills*, 396 U.S. at 385 n.7).

228. *Id.*

229. *Id.*

230. *Id.* This position was grounded on alleged violations of Virginia Code § 13.1-691, which provides:

> A. A conflict of interests transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect personal interest. A conflict of interests transaction is not voidable by the corporation solely because of the director's interest in the transaction if any one of the following is true:
>
> 1. The material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction;
>
> 2. The material facts of the transaction and the director's interest were disclosed to the shareholders entitled to vote and they authorized, approved, or ratified the transaction; or
>
> 3. The transaction was fair to the corporation.

VA. CODE. ANN. § 13.1-691 (Michie 1985).

231. *Virginia Bankshares*, 111 S. Ct. at 2762.

In response, the Court held that neither theory established the necessary causal nexus between the proxy solicitation and the merger.[232] The Court reiterated that, under the *Mills* standard, the proxy "solicitation links a directors' proposal with the votes legally required to authorize the action proposed."[233] If sanctioned by the Court, these theories would "extend the scope of *Borak* actions beyond the ambit of *Mills*, and expand the class of plaintiffs entitled to bring *Borak* actions to include shareholders whose initial authorization of the transaction prompting the proxy solicitation is unnecessary."[234]

In so denying the existence of a causal nexus, the Court applied the rule of law governing the recognition of an implied right of action for federal statutes that evolved subsequent to both *Borak* and *Mills*.[235] In *Touche Ross & Co. v. Redington*,[236] the Court restricted the availability of redress in private causes of action to those statutes where Congress intended to provide a private remedy.[237]

In this case, the Court found no congressional directive warranting the expansion of the *Borak* cause of action to the theory of causation proposed by the respondents.[238] Although the *Borak* Court did discuss the 1934 Act's purpose of "protect[ing] investors," as implying a congressional design to provide judicial relief when "necessary," citing legislative history in support of this end, the Court concluded that the *Borak* Court never expressly considered the availability of a private right of action.[239]

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232. *Id.* at 2763.

233. *Id.*

234. *Id.*

235. *Id.*

236. 442 U.S. 560 (1979). This case refined the holding of Cort v. Ash, 422 U.S. 66 (1975), in which the Court developed a four-part test to determine whether a private right of action can be implied in a statute not explicitly providing one:

> First, is the plaintiff "one of the class for whose *especial* benefit the statute was enacted"? . . . Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? . . . Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? . . . And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?

*Id.* at 78 (citations omitted).

237. *Virginia Bankshares*, 111 S. Ct. at 2763 (citing *Touche Ross*, 442 U.S. at 575).

238. *Touche Ross*, 442 U.S. at 560.

239. *Virginia Bankshares*, 111 S. Ct. at 2763 (quoting *Borak*, 377 U.S. at 432). *See supra* note 28 (providing the pertinent legislative statement). Justice Harlan, a

The Court found that the text of the 1934 Act and its legislative history were not instructive in assessing whether Congress intended to create a private cause of action in a case such as that of the respondents.[240] Although it was clear, in both the language of the 1934 Act and its legislative history, that Congress intended to defend investors from misleading statements and their effects, the Court felt that it was equally true that Congress did not provide clues as to how far an implied private cause of action could venture in this regard.[241]

The Court refused to infer any congressional sanction of an implied private right of action to enforce section 14(a), especially when Congress expressly provided such rights to private redress in other sections of the 1934 Act.[242] In doing so, the Court rebutted the claim that section 14(a) cannot be effectively enforced without an implied private enforcement supplementing the SEC's role.[243]

The Court held, however, that this silence was not an "insurmountable barrier" to the expansion of a *Borak* action.[244] The Court then cited *Blue Chip*, which first outlined the judiciary's role with respect to the dynamic character of a cause of action not provided by Congress.[245] In the case where a cause of action has arisen absent congressional license, "the contours of that structure need not be frozen absolutely when the result would be demonstrably inequitable to a class of would-be plaintiffs with claims comparable to those previously recognized."[246] In such a case, the policies of the underlying private right of action are explored to determine the perimeters of the proposed right.[247]

The Court looked at these policies in light of the two theories that respondents claimed established the requisite causality.[248] The Court held that the first theory, that the proxy statement was an

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member of the *Borak* Court, later portrayed this implied private right of action as emanating from the Act's "exclusively procedural provision affording access to a federal forum." *Virginia Bankshares*, 111 S. Ct. at 2763 (quoting Bivens v. Six Unknown Fed. Narcotics Agents, 403 U.S. 388, 403 n.4 (1971) (Harlan, J., concurring in judgment)).

240. *Virginia Bankshares*, 111 S. Ct at 2764.

241. *Id.*

242. *Id.* (referring to §§ 9(e), 16(b), and 18(a) of the 1934 Act).

243. *Id.* (referring to *Borak*, 377 U.S. at 423).

244. *Id.*

245. *Id. See Blue Chip*, 421 U.S. at 737, 748-49.

246. *Virginia Bankshares*, 111 S. Ct. at 2764.

247. *Id.*

248. *Id.* at 2764-66.

"essential link" in the merger process because the directors wished to avoid the dissatisfaction of the holders of the minority shares, was untenable because suits permitted on these grounds would engender "speculative claims and procedural intractability."[249]

The Court then found that the respondents' second theory, that section 14(a) should provide a statutory remedy for any false or materially misleading proxy solicitation which causes a plaintiff to forfeit a remedy under state law, was equally suspect as there was no evidence in law or fact that the proxy statement caused such a loss.[250] Assuming, *arguendo*, that the respondents' characterization of the proxy solicitation as materially misleading was accurate (i.e., the material facts of the merger and Jack Beddow's interests were not accurately disclosed), the Court held that once the minority had received all of the material facts about the merger proposal and the directors' conflict of interest, the applicable Virginia law[251] prohibited these shareholders from voiding the merger due to that conflict.[252] The proxy solicitation in this case did not harm the holders of the minority shares by depriving them of a state law remedy for material misrepresentation.[253]

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249. *Id.* at 2764-65. In expounding this view, Justice Souter continued:

> Causation would turn on inferences about what the corporate directors would have thought and done without the minority shareholder approval unneeded to authorize action. A subsequent dissatisfied minority shareholder would have virtual license to allege that managerial timidity would have doomed corporate action but for the ostensible approval induced by a misleading statement, and opposing claims of hypothetical diffidence and hypothetical boldness on the part of directors would probably provide enough depositions in the usual case to preclude any judicial resolution short of the credibility judgments that can only come after trial. Reliable evidence would seldom exist. Directors would understand the prudence of making a few statements about plans to proceed even without minority endorsement, and discovery would be a quest for recollections of oral conversations at odds with the official pronouncements, in hopes of finding support for *ex post facto* guesses about how much heat the directors would have stood in the absence of minority approval. The issues would be hazy, their litigation protracted, and their resolution unreliable. Given a choice, we would reject any theory of causation that raised such prospects, and we reject this one.

*Id.* at 2765.

250. *Id.* at 2765-66.

251. *See supra* note 230 and accompanying text (providing the language of § 13.1-691(A)(2) of the Virginia Code).

252. *Virginia Bankshares*, 111 S. Ct. at 2766.

253. *Id.*

In Part IV, the judgment of the Court of Appeals was reversed.[254]

2. Justice Scalia's Concurrence in Part and Concurrence in the Judgment

While concurring with the judgment of the Court, Justice Scalia did not join as to Part II of the majority opinion.[255] Whereas the Court interpreted the statement, "The Plan of Merger has been approved by the Board of Directors because it provides an opportunity for the Bank's public shareholders to achieve a high value for their shares," as mandating liability on both a factual basis and as an inaccurate manifestation of the directors' true belief; Justice Scalia interpreted the statement as "affirming *separately* both the fact of the Directors' opinion *and* the accuracy of the facts upon which the opinion was assertedly based."[256] The facts that immediately followed the statement at issue supported the truthfulness of the "because" clause.[257] Therefore, had this case proceeded, Justice Scalia would have applied the standard principles of misrepresentation of fact under section 14(a).[258]

Justice Scalia continued his concurrence by conceding that the Court's application of the law of misrepresentation rejected contemporary tort theory.[259] However, this detour was warranted where the cause of action at issue was never explicitly sanctioned by Congress.[260] Therefore, Justice Scalia concluded, "[T]he more narrow we make

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254. *Id.* Chief Justice Rehnquist and Justices White, O'Connor, and Scalia joined as to Part IV. *Id.*

255. *Id.* at 2767 (Scalia, J., concurring in part and concurring in the judgment).

256. *Id.* Justice Scalia also held that "[the statement] asserts both that the Board of Directors acted for a particular reason *and* that that reason is correct." *Id.*

257. *Id.* The facts that Justice Scalia provided in support of this interpretation were:

> The price to be paid is about 30% higher than the [last traded price immediately before the announcement of the proposal]. [T]he $42 per share that will be paid to the public holders of the common stock represents a premium of approximately 26% over the book value. [T]he bank earned $24,767,000 in the year ended [sic] December 31, 1986. . . ."

*Id.* (quoting Appendix to Petition for Cert. at 53a-54a, *Virginia Bankshares* (No. 89-1448)).

258. *Id.* (Scalia, J., concurring in part and concurring in the judgment).

259. *Id.* (referring to Vulcan Metals Co. v. Simmons Mfg. Co., 248 F. 853, 856 (2d Cir. 1918); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 109 (5th ed. 1984)).

260. *Virginia Bankshares*, 111 S. Ct. at 2767. *See* Thompson v. Thompson, 484 U.S. 174, 190-92 (1988) (Scalia, J., concurring in judgment).

[the cause of action] (within the bounds of rationality) the more faithful we are to our task."[261]

3. Justice Stevens' Concurrence in Part and Dissent in Part

Justice Stevens "agreed in substance" with Parts I and II of the Court's opinion, and disagreed with the reasoning of the Court in Part III.[262] He reiterated that this merger was found by the jury to be unfair.[263] This consideration made the availability of the remedy that the respondents sought more important than in *Mills*.[264] Justice Stevens relied on the precise language of *Mills*' footnote 7, "[even where management needs no votes from the majority to effectuate a transaction,] if management [finds] it necessary—whether for 'legal or practical reasons' to solicit proxies from the minority shareholders," to conclude that it would be consistent with the spirit of the *Mills* rationale to hold that the proxy solicitation in this case "was an essential link in the accomplishment of the transaction."[265] Therefore, any time a proxy solicitation contains materially false or misleading statements, an action for damages under section 14(a) of the 1934 Act, through Rule 14a-9, may be brought.[266]

4. Justice Kennedy's Concurrence in Part and Dissent in Part

Justice Kennedy concurred with Parts I and II of the Court's opinion and disagreed with the opinion of the Court in Part III.[267]

Justice Kennedy agreed with the Court that caution must be exercised in creating an implied private right of action and that congressional intent is paramount in this determination.[268] The result of the Court's analysis of the purpose of section 14(a), Justice Kennedy continued, is "a sort of guerilla warfare to restrict a well-established implied right of action."[269]

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261. *Virginia Bankshares*, 111 S. Ct. at 2767 (Scalia, J., concurring in part and concurring in the judgment).

262. *Id.* (Stevens, J., concurring in part and dissenting in part). Justice Marshall joined in this opinion.

263. *Id.* at 2768.

264. *Id.*

265. *Id.* (quoting *Mills*, 396 U.S. at 385 & n.7).

266. *Id.*

267. *Id.* (Kennedy, J., concurring in part and dissenting in part). Justices Marshall, Blackmun, and Stevens joined in this opinion.

268. *Id.* at 2769. *See supra* notes 165-67 and accompanying text (providing the chronology of the development of the recognition of implied private rights of action).

269. *Virginia Bankshares*, 111 S. Ct. at 2770 (Kennedy, J., concurring in part and dissenting in part).

Justice Kennedy rejected the Court's holding that the respondents should shoulder a heightened burden to establish causation because the dissident minority held only fifteen percent of the Bank's stock.[270] VBI and FABI's reservation of the right to rescind the merger agreement unless approved by the minority block had a bearing on this transaction.[271] VBI could have chosen not to ratify the merger, rendering questionable the Court's differentiation between instances where the "minority" block could have prevented the merger and those where causation must be demonstrated.[272] Justice Kennedy concluded that because the holders of minority shares emerge only after the fact, "[t]he real question ought to be whether an injury was shown by the effect the nondisclosure had on the entire merger process, including the period before votes are cast."[273]

Assuming, *arguendo*, the existence of a distinction between voting and nonvoting causation, the essential question for Justice Kennedy was whether the *Mills* essential link test applies to those merger transactions where the majority block can effectuate the merger without minority support.[274] The purpose of the essential link test is that it removes the need for proof of causation. Therefore, causation can be demonstrated whenever a proxy solicitation is an essential link in the transaction even in cases where the minority lacks the power to prevent a merger.[275]

Justice Kennedy continued by stating that the recognition of the respondents' implied private cause of action would not engender suits which would be unmanageable, as the Court suggested.[276] In any suit under section 14(a), regardless of the causation inquiry, a court must "consider a hypothetical universe in which adequate disclosure is made [and] to compare what was with what ought to have been."[277]

Justice Kennedy found no authority for limiting section 14(a)'s protection to only those minority shareholders who could vote down a merger proposal.[278] A primary purpose of section 14(a) was to

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270. *Id.*
271. *Id.*
272. *Id.*
273. *Id.*
274. *Virginia Bankshares*, 111 S. Ct. at 2771.
275. *Id.*
276. *Id.*
277. *Id.*
278. *Id.*

protect investors.[279] A holder of minority shares who cannot prevent a merger proposal is in more need of the protection of full disclosure than a shareholder with the power to prevent a merger.[280] In this case, the respondents argued that if there had been full disclosure, FABI or the Bank would have revised or even withdrawn the merger proposal.[281] Though FABI did have more than enough votes to consummate the merger, it wanted to show the minority the fairness of the offer and receive a favorable response from it.[282] Justice Kennedy cited trial testimony and the Bank's board meeting minutes to demonstrate that FABI would not have consummated the merger if complete disclosure had been given.[283]

The year before the merger in this case, FABI failed in an almost identical freeze-out of the holders of minority shares of its Maryland subsidiary.[284] The investment banking firm of KBW was also commissioned to give its professional opinion of the value of the desired minority block.[285] However, in the Maryland case, the subsidiary's board of directors engaged the services of another adviser that led them to conclude that FABI's offer was insufficient.[286] As a result, the Maryland proposal perished when the Maryland bank's board of directors failed to sanction the merger.[287] The minority in the Maryland merger would also have been unable to thwart the merger if it had been compelled by FABI.[288]

The Virginia transaction, Justice Kennedy continued, mirrored the Maryland proposal in all but three ways: (1) Director Jack Beddow, who sat on both the FABI and Bank boards and who feared a repeat of the Maryland failure, dissuaded the Bank in the Virginia merger from commissioning its own adviser; (2) the directors of the Bank testified that they would not have approved the proposal had they known that the price was unfair to the minority; and (3) FABI represented to the Bank's board of directors that the merger proposal

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279. *Id.* (referring to *Borak*, 377 U.S. at 432).
280. *Id.*
281. *Id.*
282. *Id.* at 2771-72.
283. The Bank's board meeting discussion concerned "how to keep [public relations] afloat" and "how to prevent adverse reac[tion]/perception." *Id.* at 2772 (quoting Joint Appendix at 454, *Virginia Bankshares* (No. 89-1448)).
284. *Id.*
285. *Id.*
286. *Id.*
287. *Id.*
288. *Id.*

would be approved by the holders of the minority shares in the Virginia merger.[289]

Justice Kennedy argued that this case presented ample reason why nonvoting causation theories are possible where material misstatements or omissions cause serious damages for holders of minority shares.[290] Justice Kennedy then quoted Professor Loss' views on the issue of the rights of the holders of minority shares:

> [M]inority stockholders will be in a better position to protect their interests with full disclosure and . . . an unfavorable minority vote might influence the majority to modify or reconsider the transaction in question. In [*Schlick*,] where the stockholders had no appraisal rights under state law because the stock was listed on the New York Stock Exchange, the court advanced two additional considerations: (1) the *market* would be informed; and (2) even "a rapacious controlling management" might modify the terms of a merger because it would not want to "hang its dirty linen out on the line and thereby expose itself to suit or Securities Commission or other action—in terms of reputation and future takeovers."[291]

In conclusion, even where the minority does not possess the requisite votes to prevent the merger, Justice Kennedy found that causation can be established where the proxy solicitation is an essential link in the completion of the transaction.[292]

In the last part of his dissent, Justice Kennedy questioned the Court's conclusion that the respondents suffered no loss of state law remedy. He argued that assuming that less than full disclosure was given regarding material facts of the transaction and Jack Beddow's dual capacity interest, the minority votes could not ratify the merger under Virginia law.[293] This conclusion requires that the Virginia statute covering director conflicts of interest[294] have an identical

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289. *Id.*

290. *Id.*

291. *Id.* at 2772-73 (footnote omitted) (quoting LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1119-20 (1983)).

292. *Id.* at 2773.

293. *Id.*

294. *See supra* note 230 (providing the text of the applicable section, VA. CODE ANN. § 13.1-691(A)(2) (Michie 1985)).