

CAN SHAREHOLDERS REALLY TRUST PROXY STATEMENTS?: A
NEGLIGENCE STANDARD FOR SECTION 14(a) OF THE SECURITIES
EXCHANGE ACT OF 1934

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INTRODUCTION

By 2015, Towers, Watson & Co. was one of the world's premier professional services firms. Willis Group Holdings, PLC, an underperforming insurance brokerage shop, approached Towers and proposed a merger to create Willis Towers Watson, an advisory, broking, and solutions conglomerate.¹ The proposal would give Towers shareholders a minority interest in the conglomerate even though Towers was the more valuable company.² The average premium paid to acquisition targets in similar deals at the time was 30.7%, but Towers CEO John Haley agreed to make the deal at a 9% *discount*.³ After secret meetings, confidential negotiations, and undisclosed agreements, Haley filed a proxy statement with the Securities and Exchange Commission (SEC) in late October 2015, and Towers shareholders voted to approve the merger by the end of the year.⁴

Section 14(a) of the Securities Exchange Act of 1934 (1934 Act) creates liability for any person who solicits a proxy, consent, or authorization regarding a registered security in contravention of any rules and regulations that the SEC may prescribe.⁵ To further regulate fraud in this area, the SEC wrote Rule 14a-9, which requires that no solicitation shall be made by any proxy statement that “omit[s] to state any material fact necessary in order to

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¹ *In re Willis Towers Watson PLC Proxy Litig.*, 937 F.3d 297, 300 (4th Cir. 2019).

² *Id.* at 300–01.

³ *In re Willis Towers Watson PLC Proxy Litig.*, 2018 WL 3423859, at *4 (E.D. Va. July 11, 2018).

⁴ *Willis Towers Watson*, 937 F.3d at 301.

⁵ 15 U.S.C. § 78n(a)(1).

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make the statements therein not false or misleading.”⁶ In Towers’ initial proxy statement, Haley noted that he would take over as Willis Towers Watson’s CEO, but Haley excluded the fact that he would earn \$165 million over three years in his new role, which was more than double his annual salary as CEO of Towers.⁷ After learning about this omission, Towers shareholders filed a putative class action against the conglomerate to hold the directors and officers liable for omitting material details from the proxy statement that would have exposed Haley’s self-interested motivation for negotiating the merger.⁸

The corporation and its officers argue that the shareholders’ Section 14(a) claim sounds in fraud and therefore requires a particularized pleading of scienter.⁹ In contrast, the shareholders argue that this claim sounds in negligence.¹⁰ The Fourth Circuit refused to directly address this dispute on appeal,¹¹ denied the defendants’ request for interlocutory appeal,¹² and remanded this case for the district court to make an initial determination because the issue raises two questions of first impression for the court:

- (1) Can a Section 14(a) claim sound in negligence instead of fraud?
- (2) If a Section 14(a) claim can sound in negligence, must the complaint include particularized allegations of negligence?¹³

The Second, Third, and Seventh Circuits have concluded that negligence is enough to support liability.¹⁴ The Sixth and Eighth Circuits have required something more for certain defendants, and the Supreme Court has reserved this question.¹⁵ If the Fourth Circuit determines that a Section 14(a) claim can

⁶ 17 C.F.R. § 240.14a-9 (2022).

⁷ *Willis Towers Watson*, 937 F.3d at 301.

⁸ *See id.* at 301–02.

⁹ *Id.* at 307.

¹⁰ *Id.*

¹¹ *Id.* at 308.

¹² *Id.*

¹³ *Id.*

¹⁴ *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987 (2d Cir. 1988); *Herskowitz v. Nutri/Sys., Inc.*, 857 F.2d 179 (3d Cir. 1988); *Beck v. Dobrowski*, 559 F.3d 680 (7th Cir. 2009).

¹⁵ *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir. 1980); *SEC v. Shanahan*, 646 F.3d 536 (8th Cir. 2011).

sound in negligence, a circuit split still exists as to whether the complaint must include particularized allegations of negligence.

This article will explain why the Fourth Circuit should read Section 14(a) and the applicable regulations as allowing shareholders to pursue Section 14(a) claims sounding in negligence when they do not have evidence to plead particularized scienter. All in all, if the parties present this issue to the Fourth Circuit again on appeal, the court should allow Towers shareholders to assert a Section 14(a) claim because a negligence standard would further protect shareholders, ensure fair competition in the marketplace, and limit executive suite conflicts of interest. Nevertheless, the court should still require shareholders to comply with the Private Securities Litigation Reform Act's (PSLRA) heightened pleading standard that requires plaintiffs to allege facts that create a strong inference of negligence.

First, Part I will address the purpose and history of Section 14(a) to shed light on how the statute was intended to be enforced. Next, Part II will compare Section 14(a) to similar securities claims to support the position that a negligence standard is consistent with general securities regulations. Lastly, Parts III and IV will discuss the different approaches that each circuit court has taken on the negligence standard and the heightened pleading requirement.

I. PURPOSE AND HISTORY OF SECTION 14(a)

A. *The SEC regulates proxy statements to protect shareholders.*

In accordance with Section 14(a), the SEC authored Rule 14a-3 to require reporting companies to file proxy statements.¹⁶ A proxy statement is a document that companies provide to shareholders so they can make informed decisions about matters that will be introduced at shareholder meetings.¹⁷ The SEC expects these companies to disclose all important facts about the issues on which shareholders are asked to vote in these written statements prior to any shareholder meeting.¹⁸ Proxy statements must be filed with the SEC and distributed to shareholders before soliciting a shareholder vote on certain

¹⁶ 17 C.F.R. § 240.14a-3(a) (2022).

¹⁷ Alicia Tuovila, *What is a Proxy Statement? Definition, What's in it, and Voting*, INVESTOPEdia (Aug. 8, 2021), <https://www.investopedia.com/terms/p/proxystatement.asp>.

¹⁸ *Proxy Statements*, U.S. SEC. & EXCH. COMM'N (Sept. 9, 2011), <https://www.sec.gov/answers/proxy.htm>.

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fundamental business transactions, such as mergers and asset sales.¹⁹ The SEC requires the filing and distribution of proxy statements for the central purpose of protecting uninformed shareholders. Thus, the purpose of litigating Section 14(a) claims involving misleading proxy statements should also be to protect shareholders.

B. Section 14(a) requires that corporate executives provide accurate information.

According to the Supreme Court, Section 14(a) “was intended to promote the free exercise of the voting rights of stockholders by ensuring that proxies would be solicited with explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.”²⁰ Additionally, the Senate Report to the Securities Exchange Act of 1934, commonly known as the Fletcher Report, discussed “the sort of proxy abuse that Congress was trying to stop, that of corporate officers using the proxy mechanism to ratify their own frauds upon the shareholders, or outsiders soliciting shareholders’ approval to plunder a ripe company.”²¹ Congress passed Section 14(a) to ensure that all shareholders have access to accurate, material information before voting on important corporate actions.²² This principle should apply whether corporate executives were actively formulating a scheme to defraud shareholders or negligently rushing to close a deal without understanding the true impact on shareholders. Either way, Section 14(a) should protect uninformed shareholders from digging their own graves.

C. A negligence standard would best reflect Section 14(a)’s purpose and history.

To establish liability under Section 14(a), plaintiffs must allege and prove that a proxy statement contains “material misrepresentations or omissions,” which arise from statements of fact or expressions of opinion.²³ Directors and officers are allowed to make common mistakes, but they cannot make material misrepresentations or omissions that infringe upon the right of the shareholders to be accurately informed.²⁴ However, neither Section 14(a) nor

¹⁹ *Id.*

²⁰ *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 (1976).

²¹ See S. REP. NO. 73-1455, at 75 (1934).

²² *TSC Indus., Inc.*, 426 U.S. at 444.

²³ *Hayes v. Crown Cent. Petroleum Corp.*, 78 F. App’x 857, 861 (4th Cir. 2003).

²⁴ *Id.*

the applicable regulations specify the culpable state of mind required for liability under Section 14(a)—intentional fraud or negligence.²⁵

Other securities litigation claims, such as Rule 10b-5 claims, aim to punish wrongdoers and discourage fraudulent actions. The Supreme Court ruled that these claims require proof of scienter through evidence of a defendant's intent or knowledge of the wrongdoing.²⁶ This standard makes sense for these types of claims because, generally, plaintiffs must allege fraud with particularity.²⁷ However, Section 14(a) claims protect shareholders who have reasonably relied on company executives and were detrimentally affected by their misstatements or omissions.²⁸ Section 14(a) should not only safeguard shareholders that are victims of fraudulent schemes but also protect shareholders who have fallen victim to the negligent but material missteps of corporate executives.

In the *Willis Towers Watson* case, Towers shareholders likely knew that they did not have the facts to plead a Section 14(a) claim without access to discovery if the court required a scienter allegation. However, the shareholders argue that John Haley was negligent in leaving gaping holes in the information he chose to include in the proxy statements.²⁹ The shareholders admit that they knew that Haley would be CEO of the combined company and that he stood to make more money after the merger, and the appellate court recognized that “those facts alone would not have supported this suit.”³⁰ Instead, the basis of this suit is that Haley's secret dealings with other parties to the plan of merger created a conflict of interest that led Haley to negotiate the merger on less favorable terms for Towers shareholders.³¹

A conflict of interest is not per se a breach of a director's fiduciary duties to the company.³² However, a conflict of interest between corporate executives and shareholders is information that could fundamentally impact a shareholder vote of approval of a potential merger. If the SEC requires proxy statements to inform shareholders and protect them from issues that

²⁵ See 15 U.S.C. § 78n(a)(1); 17 C.F.R. § 240.14a-9(a) (2022).

²⁶ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

²⁷ FED. R. CIV. P. 9(b).

²⁸ *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1118 (1991).

²⁹ *In re Willis Towers Watson PLC Proxy Litig.*, 937 F.3d 297, 307 (4th Cir. 2019).

³⁰ *Id.* at 304.

³¹ *Id.*

³² Byron F. Egan, *How to Deal with Fiduciary Duties in Conflict Transactions In Texas and Delaware*, 15TH ANN. MERGERS & ACQUISITIONS INST. (Oct. 10, 2019) <https://www.jw.com/wp-content/uploads/2019/10/Egan-Conflict-Transactions-Oct-2019-23552271.pdf>.

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could arise from their uneducated votes, then proxy statement regulations were likely designed for circumstances just like this. Thus, a corporate executive's negligent decision to omit material conflicts of interest from a proxy statement should be grounds for a lawful Section 14(a) claim.

II. COMPARING SECTION 14(a) CLAIMS TO OTHER SECURITIES CLAIMS

Although the statute is unique, Section 14(a) shares important similarities and differences with other securities regulations. Courts should consistently interpret Section 14(a) and Section 14(e) of the 1934 Act because each statute regulates a different form of transaction that leads to the same result: the acquisition of a corporation. Additionally, Section 14(a) claims are the same in nature as claims stemming from Section 11 of the Securities Act of 1933 because both statutes protect shareholders from misleading information in SEC filings. Thus, all these securities claims should consistently incorporate a negligence standard to prove liability. On the other hand, there are distinct differences between the language, purpose, and target of Section 14(a) and Section 10(b) of the 1934 Act that show the need for a different state-of-mind requirement to prove liability under each claim.

A. Courts should consistently interpret Section 14(a) and Section 14(e).

In *A Negligence Approach to Section 14(e) Violations*, Jessica Pekins explains the jurisprudential and policy reasons behind applying a negligence standard to Section 14(e) claims regarding tender offers.³³ Pekins points out that a negligence standard would increase the number of lawsuits against corporate executives by making it easier for plaintiffs to prove a violation of Section 14(e).³⁴ From a policy perspective, shifting the standard from scienter to negligence would ensure that courts could hold executives accountable to “focusing more on the shareholders’ interests than on their own interests in evaluating tender offers.”³⁵ By applying this same reasoning to the argument for a negligence standard for Section 14(a) claims, corporate executives would be incentivized to take the same shareholder-first approach in negotiating mergers and acquisitions.

³³ Jessica Pekins, Comment, *A Negligence Approach to Section 14(e) Violations*, 69 EMORY L. J. 519, 523 (2019).

³⁴ *Id.*

³⁵ *Id.*

Further, Pekins discusses that, similar to mergers and acquisitions, tender offers are often laden with conflicts of interest between company executives and acquiring corporations that potentially harm existing shareholders.³⁶ Pekins supports her argument for applying a negligence standard to Section 14(e) claims by detailing how the change would further protect shareholders, ensure fair competition in the marketplace, and limit the impact of executive conflicts of interest.³⁷ Section 14(a) targets misleading proxy statements to achieve these same goals, so courts should consistently interpret these two statutes.

In fact, the Sixth Circuit has stated that “[i]n passing the Williams Act of 1968 governing tender offers, Congress expressed the desire that proxy statements and tender offers be governed by the same rules and regulations.”³⁸ Practically, tender offers and reverse triangular mergers are two means to achieve an identical end. A tender offer is a public solicitation to all shareholders requesting that they tender their stock for sale at a specific price, meaning that one corporation can acquire the majority of shares of another while avoiding a shareholder vote or director approval.³⁹ A reverse triangular merger can result in the same acquisition but requires directors to file proxy statements and obtain a shareholder vote of approval before implementing the plan of merger.⁴⁰ Thus, Section 14(a) and Section 14(e) differ in the form of the transaction rather than the substance.

As Pekins mentions, the Ninth Circuit only requires a showing of negligence to assert Section 14(e) claims.⁴¹ As discussed below, the Second, Third, and Seventh Circuits all recognize Section 14(a) claims sounding in negligence.⁴² Therefore, recent opinions show a trend toward encouraging corporate executives to keep shareholder interests at the forefront of corporate transactions by allowing more shareholder claims to sound in negligence. Overall, Pekins’s argument for a modern negligence approach to

³⁶ *Id.* at 519.

³⁷ *Id.* at 560.

³⁸ *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 430 (6th Cir. 1980).

³⁹ Adam Hayes, *Tender Offer Definition: How It Works, With Example*, INVESTOPEDIA (Apr. 15, 2022), <https://www.investopedia.com/terms/t/tenderoffer.asp>.

⁴⁰ Will Kenton, *Reverse Triangular Merger Overview and Examples*, INVESTOPEDIA (Nov. 30, 2020), <https://www.investopedia.com/terms/r/rtm.asp>.

⁴¹ Pekins, *supra* note 33, at 522; *See Varjabedian v. Emulex Corp.*, 888 F.3d 399, 408 (9th Cir. 2018).

⁴² *See* discussion *infra* Part III.

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Section 14(e) claims reinforces the case for the Fourth Circuit to allow Section 14(a) claims to sound in negligence.

B. Section 14(a) claims are the same in nature as Section 11 claims.

Section 11 provides a cause of action for investors to sue parties responsible for preparing SEC registration statements.⁴³ Under this statute, purchasers can hold individuals liable for any untrue statements or misleading omissions of material facts in effective registration statements.⁴⁴ Similar to Section 14(a) claims, plaintiffs, typically shareholders of the registered corporation, assert Section 11 claims against individuals they rely on for information, such as directors, experts, or underwriters. Plaintiffs only have to prove that a violation exists to hold a defendant liable, making Section 11 a strict liability statute.⁴⁵ However, defendants can raise a due diligence affirmative defense, so Section 11 more closely resembles a negligent standard for non-issuer defendants.⁴⁶

Overall, Section 14(a) claims are the same in nature as Section 11 claims because each statute serves the purpose of protecting shareholders from misleading information related to a specific transaction. Under Section 11, all signers of an effective registration statement must provide complete and accurate information to shareholders before registering the corporation with the SEC.⁴⁷ Under Section 14(a), contributors to a proxy statement must provide complete and accurate information to shareholders each time a shareholder vote is necessary to take some corporate action.⁴⁸ In each case, the statutes were created to ensure that shareholders are not left in the dark on fundamental corporate actions that will ultimately drive the value of their equity up or down. Thus, employing these sections with the same reasonableness inquiry, whether through a negligence standard or available due diligence defense, is natural and logical.

As this article will discuss, circuit courts that have held that Section 14(a) claims must sound in fraud have only explicitly required scienter if the defendant was an outside director or accountant.⁴⁹ Courts have implied that

⁴³ See 15 U.S.C. § 77k.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004).

⁴⁷ See 15 U.S.C. § 77k(a).

⁴⁸ See *id.*; *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 381 (1970).

⁴⁹ See discussion *infra* Section II.C.

inside directors could be held to a negligent standard under Section 14(a) while claims against outside directors, accountants, and underwriters require scienter.⁵⁰ This closely follows the case law surrounding Section 11 claims. Courts have recognized that outside directors have a lower burden than inside or participating directors for proving reasonable investigation to support an affirmative due diligence defense, thus making it harder to hold outside directors or experts liable under Section 11 than inside directors.⁵¹ Additionally, courts have allowed accountants to prove a due diligence defense with evidence of good faith reliance on generally accepted accounting principles. Again, this has made it more difficult for a plaintiff to prove Section 11 liability for defendants who are not inside directors.⁵² Thus, the flexibility in Section 14(a) for claims asserted against inside directors to sound in negligence while claims against other contributors to proxy statements require scienter looks like the varying burden on Section 11 defendants to prove due diligence depending on their position. Therefore, courts should consider that both sections were intended to allow shareholders to assert valid statutory claims regarding SEC filings against negligent inside directors.

C. The distinctions between Section 14(a) and Section 10(b)/Rule 10b-5 reinforce the need for different standards.

In comparison, Section 10(b)/Rule 10b-5 claims require “intentional or willful conduct designed to deceive or defraud investors” in connection with the purchase or sale of a security.⁵³ There are three reasons these claims require evidence of scienter which differentiate Rule 10b-5 claims from Section 14(a) claims: language, purpose, and target. Thus, Section 14(a) claims should not be held to the same scienter standard as Rule 10b-5 claims.

First, the language of Section 10(b) restricts the scope of the SEC’s statutory authority in ways that Section 14(a) does not. “Section 10(b) only prohibits the use of ‘manipulative or deceptive’ devices and grants the SEC the power to ‘prescribe [rules and regulations] as necessary or appropriate in the public interest or for the protection of investors.’”⁵⁴ Thus, Section 10(b) limits the SEC’s rulemaking power to restricting conduct involving scienter.

⁵⁰ *Infra* notes 79 & 85.

⁵¹ See *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

⁵² See *Monroe v. Hughes*, 31 F.3d 772 (9th Cir. 1994).

⁵³ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 186 (1976).

⁵⁴ *Pekins*, *supra* note 33, at 557; 15 U.S.C. § 78j (2022).

Section 14(a) grants the SEC this same rulemaking power but does not limit the scope to manipulative or deceptive devices.⁵⁵ Thus, the SEC can target inherently innocent acts that have the effect of defrauding investors under its authority granted by Section 14(a). Since Section 14(a) does not impose the same limits as Section 10(b), any rules or regulations under Section 14(a) may incorporate a negligence standard.

Second, the purpose of Section 10(b) is to discourage and prevent fraudulent trading.⁵⁶ By punishing violators, the statute deters practices that enable investors to take advantage of other investors by buying and selling securities at distorted prices.⁵⁷ In essence, Rule 10b-5 attempts to maintain a securities market free from fraudulent practices by regulating the activities of any person involved in a securities transaction. This is innately different than Section 14(a)'s purpose of regulating the conduct of corporate executives in soliciting a shareholder vote. Section 14(a) was not designed to punish wrongdoers but instead to protect shareholders by holding parties accountable for actions that infringe upon the rights of shareholders to be accurately informed. Thus, requiring a different standard to prove liability under Section 10(b) and Section 14(a) is appropriate considering the unique purpose of each statute.

Third, Rule 10b-5 claims target any individual who violates the statute.⁵⁸ Potential Rule 10b-5 defendants include insiders and misappropriators, who can be outsiders to the company somehow involved in the fraud. Thus, a plaintiff can hold an outsider liable under Rule 10b-5 only if the plaintiff can prove particularized scienter. In contrast, Section 14(a) only targets individuals who solicit a shareholder vote through a proxy statement.⁵⁹ Only insiders or temporary insiders, like bankers or accountants, can contribute to proxy statements and, thus, be subject to Section 14(a) liability. Therefore, a negligence standard for Section 14(a) would not face the risk of holding corporate outsiders liable for negligent mistakes. Overall, Section 14(a) claims are distinct from Section 10(b)/Rule 10b-5 claims. Thus, courts should not require plaintiffs to prove a corporate executive's intent to defraud shareholders to assert a valid Section 14(a) claim for the omission of a material fact in a proxy statement.

⁵⁵ 15 U.S.C. § 78n(a)(1).

⁵⁶ 79A C.J.S. *Securities Regulation* § 200, Westlaw CJS SECURITIES § 200 (database updated 2022).

⁵⁷ *Id.*

⁵⁸ 17 C.F.R. § 240.10b-5 (2022).

⁵⁹ *Id.* § 240.14a-9 (2020).

III. CAN SECTION 14(a) CLAIMS SOUND IN NEGLIGENCE?

The Fourth Circuit has refused to explicitly answer whether Section 14(a) claims can sound in negligence.⁶⁰ Other circuit courts have ruled on the matter since the Fourth Circuit first avoided the issue in 2003, but the Supreme Court has expressly declined to address the topic.⁶¹ Thus, the *Willis Towers Watson* case is an appropriate opportunity for the Fourth Circuit to take a stance on an issue that the Supreme Court has continually left to the circuit courts.

A. *Some courts have held that negligence is sufficient to support Section 14(a) liability.*

The Second, Third, and Seventh Circuits have all indicated that negligence is sufficient to support Section 14(a) liability.⁶² These courts all refuse to require shareholders to prove that proxy statement drafters had an intent to defraud shareholders to assert a Section 14(a) claim.

In *Wilson v. Great American Industries, Inc.*, minority shareholders filed a Section 14(a) claim against the corporation and its directors and officers for failing to disclose material facts regarding the two parties to a merger.⁶³ The directors and officers failed to provide the financial condition of the companies and the relationships between the directors and officers of both companies.⁶⁴ Among other omissions, the directors failed to disclose the previous social and business relationships between Company A's General Counsel, who was also a shareholder, director, and the Secretary of Company A, and the three brothers who controlled Company B.⁶⁵ Company A's General Counsel had legally represented the brothers' family companies for over fifty years and had entered into side business deals with members of the

⁶⁰ *Knurr v. Orbital ATK Inc.*, 276 F. Supp. 3d 527, 535 (E.D. Va. 2017).

⁶¹ *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 n.7 (1976) ("Our cases have not considered, and we have no occasion in this case to consider, what showing of culpability is required to establish the liability under § 14(a) . . ."); *Hayes v. Crown Cent. Petroleum Corp.*, 78 F. App'x 857, 864 n.1 (4th Cir. 2003) ("We note, however, that the Supreme Court has not determined whether it is necessary to demonstrate scienter to satisfy the "knowing" element of a Section 14(a) claim.").

⁶² *Supra* note 14.

⁶³ 855 F.2d 987, 994–95 (2d Cir. 1988).

⁶⁴ *Id.* at 989.

⁶⁵ *Id.* at 993.

family.⁶⁶ The court stated that “[t]he relevant inquiry is not whether an actual conflict of interest existed, but rather whether full disclosure of potential conflicts of interest has been made. The omission proven here deprived the [minority] shareholders of the opportunity to judge for themselves what significance to attribute to [the General Counsel’s] representation of the [merging company’s executives].”⁶⁷

In *Wilson*, the Second Circuit held that all the omissions, including the omitted facts pertaining to the conflict of interest, violated Section 14(a).⁶⁸ The court stated that “[u]nder Rule 14a–9, plaintiffs need not demonstrate that the omissions and misrepresentations resulted from knowing conduct undertaken by the director defendants with an intent to deceive.”⁶⁹ Instead, “liability can be imposed for negligently drafting a proxy statement.”⁷⁰

In *Beck v. Dobrowski*, a shareholder of a real estate investment trust (REIT) asserted a Section 14(a) claim in a derivative action against the trust’s directors for filing a misleading proxy solicitation.⁷¹ Two potential buyers were in a bidding war for the REIT, whose directors timely filed a proxy statement each time a new offer came to the table.⁷² Ultimately, the REIT directors recommended that shareholders approve the \$55.5 million all-cash offer from Buyer A instead of the \$56 million mixed cash and stock offer from Buyer B.⁷³ The shareholder claims that if more information had been included in the proxy statements, such as details of top executives’ benefits in each potential deal, the shareholders would have voted against Buyer A’s offer.⁷⁴

In *Beck*, the Seventh Circuit stated that “[t]here is no required state of mind for a violation of Section 14(a); a proxy solicitation that contains a misleading misrepresentation or omission violates the section even if the issuer believed in perfect good faith that there was nothing misleading in the

⁶⁶ *See id.*

⁶⁷ *Id.* at 994 (citation omitted) (citing *Kas v. Fin. Gen. Bankshares*, 796 F.2d 508, 513 (D.C. Cir. 1986)).

⁶⁸ *Id.* at 989.

⁶⁹ *Id.* at 995 (citing *Gerstle v. Gamble–Skogmo, Inc.*, 478 F.2d 1281, 1298–1301 (2d Cir. 1973)).

⁷⁰ *Id.*

⁷¹ 559 F.3d 680, 681 (7th Cir. 2009).

⁷² *Id.* at 683.

⁷³ *Id.*

⁷⁴ *Id.* at 684.

proxy materials.”⁷⁵ The court added that “Section 14(a) requires proof only that the proxy solicitation was misleading, implying at worst negligence by the issuer.”⁷⁶ However, there was no suggestion that the executive benefits were more significant in one offer than the other existing offer, so there was no evidence of loss or materiality.⁷⁷ Thus, the omission was not factually misleading, but the court implied that if it was factually misleading, then the negligent omission itself, without fraudulent intent, would be enough to hold the directors liable under Section 14(a).⁷⁸

In *Herskowitz v. Nutri/System, Inc.*, shareholders brought a class action against the company challenging the terms of a leveraged buyout and adequacy of a proxy statement.⁷⁹ The shareholders’ pleading included a Section 14(a) claim against the investment banker who rendered the fairness opinion in connection with the leveraged buyout.⁸⁰ The court acknowledged that an investment banker “knows full well that [his fairness opinion] will be used to solicit shareholder approval, and is well paid for the service it performs[. So], we see no convincing reason for not holding it to the same standard of liability as the management it is assisting.”⁸¹ The court reversed and remanded the case for multiple reasons, including that the banker could be held liable without any evidence of intent to deceive or cheat.⁸²

In *Herskowitz*, the Third Circuit stated that “[t]he test under Section 14(a) is materiality of the disclosure.”⁸³ “A material misrepresentation even when made negligently rather than intentionally or recklessly, can still inflict the anticipated harm, and is thus deemed actionable.”⁸⁴ Additionally, the court acknowledged that it “is bound by *Gould v. American–Hawaiian S.S. Co.*, . . . which rejected the scienter requirement in cases under Section 14(a),” so the court applied a negligence standard to third parties like investment bankers and accountants as well.⁸⁵

⁷⁵ *Id.* at 682 (citing *Kennedy v. Venrock Assocs.*, 348 F.3d 584, 593 (7th Cir. 2003)).

⁷⁶ *Id.*

⁷⁷ *Id.* at 685.

⁷⁸ *Id.*

⁷⁹ 857 F.2d 179, 189–90 (3d Cir. 1988).

⁸⁰ *Id.* at 182.

⁸¹ *Id.* at 190.

⁸² *Id.* at 189.

⁸³ *Id.* at 190 (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)).

⁸⁴ *Id.*

⁸⁵ *Id.* (citing 535 F.2d 761 (3d Cir.1976)).

In summary, each of these circuit courts applied a negligence standard to Section 14(a) claims. Whether the omission included terms of executive compensation, executive conflicts of interest, or a third party's fairness opinion, the courts all concluded that the proxy statements were subject to Section 14(a) liability if the omissions were proven to be material to the transaction regardless of the intent of the author. Thus, shareholders were protected from directors who negligently left material information regarding significant corporate actions out of proxy statements.

B. Other courts have held that scienter is an element of Section 14(a) claims asserted against outside directors or third parties.

In contrast, the Sixth and Eighth Circuits have held that negligence is insufficient to support Section 14(a) liability in some circumstances.⁸⁶ These courts have indicated that a plaintiff must prove that any proxy statement drafters intentionally or knowingly omitted information to defraud shareholders to bring a Section 14(a) claim. However, the courts differentiate between inside directors and outside directors or interested third parties regarding which standard—negligence or scienter—should be used.

In *SEC v. Shanahan*, a public company utilized the practice of back-dating “in the money” stock options to effectively grant immediate compensation to employees without the company having to recognize a cost outlay.⁸⁷ Although back-dating is not inherently fraudulent, the SEC alleged that this practice was fraudulent because it violated the company's “unambiguous representation in its proxy statements and financial-statement footnotes that all options had been and would continue to be granted at an exercise price equal to the fair-market price of [the company's] stock on the date of the grant.”⁸⁸ The court affirmed the dismissal of a Section 14(a) claim against the outside director because the SEC “failed to prove scienter,” but the court also discussed that the SEC also “failed to prove a negligent violation of Section 14(a).”⁸⁹ Undisputed evidence was presented that the director did not draft the proxy statements and believed that the statements were truthful and accurate, leading the court to believe that he could not be

⁸⁶ *Supra* note 15.

⁸⁷ 646 F.3d 536, 540 (8th Cir. 2011).

⁸⁸ *Id.*

⁸⁹ *Id.* at 547.

held liable for the omission of the back-dating practice in the proxy statement even under a negligent standard.⁹⁰

In *Shanahan*, the Eighth Circuit recognized and agreed with district courts that have required scienter as an element of Section 14(a) claims, “at least for claims against outside directors and accountants.”⁹¹ However, the discussion of a negligence standard implies that directors that are heavily involved in a company’s business, such as structuring and negotiating a merger, might be liable under a less strict standard than outside directors or accountants.

In *Adams v. Standard Knitting Mills, Inc.*, shareholders brought a Section 14(a) claim against an outside accounting firm for an alleged false proxy solicitation issued to gain shareholder approval of a merger between two corporations.⁹² The accountants failed to fully disclose the restrictive effect of a loan agreement on preferred stock in the financial statement.⁹³ The court held that the location of explicit statements that the loan agreement restricted payment of dividends on common stock did not indicate that any restrictions also applied to preferred stock when, in fact, they did.⁹⁴ However, the Sixth Circuit ultimately concluded that “scienter should be an element of liability in private suits under the proxy provisions as they apply to outside accountants,” and “the facts demonstrate that [the accountants’] omissions were the result of negligence but did not arise from an intent to deceive.”⁹⁵

In *Adams*, the Sixth Circuit discussed the fact that “[f]ederal courts created the private right of action under Section 14, and they have a special responsibility to consider the consequences of their rulings and to mold liability fairly to reflect the circumstances of the parties.”⁹⁶ Although the court refused to decide the standard of liability of the corporate issuer of proxy material, the court admitted that it was “influenced by the fact that the accountant here, unlike the corporate issuer, does not directly benefit from the proxy vote and is not in privity with the stockholder.”⁹⁷ The court’s discussion implies that a director who would directly benefit from the proxy vote that he is soliciting might be liable under a negligence standard.

⁹⁰ *Id.*

⁹¹ *Id.* at 546–47.

⁹² 623 F.2d 422, 428–30 (6th Cir. 1980).

⁹³ *Id.* at 426.

⁹⁴ *Id.* at 427.

⁹⁵ *Id.* at 428.

⁹⁶ *Id.*

⁹⁷ *Id.*

In both cases, the courts required an allegation of scienter as an element of a Section 14(a) claim when asserted against either an outside director or accountant.⁹⁸ Section 14(a) should protect third parties from liability for negligent mistakes if they are compensated for their body of work independent from the results of a shareholder vote. Instead, these parties should face potential liability under the common law doctrine of negligent misrepresentation, which faces its own duty issues. However, directors and officers who are heavily intertwined in corporate affairs and stand to benefit from the results of a shareholder vote should face a tougher standard. Both circuit courts discuss that the policy behind protecting shareholders from misleading proxy statements authored by interested parties could support reading in a negligent standard to Section 14(a) claims instead of the strict scienter requirement.⁹⁹ Therefore, courts should allow Section 14(a) claims asserted against inside directors like Towers CEO John Haley to sound in negligence.

IV. SHOULD COURTS HOLD SECTION 14(a) CLAIMS TO A HIGHER PLEADING STANDARD IN ACCORDANCE WITH THE PSLRA?

Congress passed the Private Securities Litigation Reform Act in 1995 to moderate abusive securities litigation practices.¹⁰⁰ Due to the heightened pleading standard required by the PSLRA, plaintiffs must allege facts that create a strong inference that the defendant acted with the required state of mind.¹⁰¹ Some courts have indicated that the PSLRA does not raise the pleading requirement for Section 14(a) claims.¹⁰² Still, other courts have rationalized a negligence standard with the PSLRA by requiring shareholders to plead facts that create a strong inference of negligence.¹⁰³

A. Some courts have held that Section 14(a) claims must only allege the omission of a material fact.

In *Beck* and *Wilson*, the courts applied a negligence standard to Section 14(a) claims and stated that the omission of a material fact could be enough

⁹⁸ *Id.*; SEC v. Shanahan, 646 F.3d 536, 546–47 (8th Cir. 2011).

⁹⁹ *Adams*, 623 F.2d at 429.

¹⁰⁰ S. REP. NO. 104-98, at 689 (1995).

¹⁰¹ 15 U.S.C. § 78u-4(b)(2).

¹⁰² *Infra* note 105.

¹⁰³ *Infra* note 107.

evidence to support liability.¹⁰⁴ The *Wilson* court stated that “[a]s a matter of law, the preparation of a proxy statement by corporate insiders containing materially false or misleading statements or omitting a material fact is sufficient to satisfy the *Gerstle* negligence standard.”¹⁰⁵ The courts’ conclusions suggest that if the omitted fact is determined to be material, then the omission of that fact is a negligent act that can be the basis of liability under Section 14(a). Thus, under this interpretation, there is no higher standard of particularized negligence that the plaintiff must plead to assert a successful Section 14(a) claim.

B. Other courts have held that Section 14(a) claims sounding in negligence should be held to a higher pleading standard.

Pursuant to the PSLRA, to state a claim, a complaint must “1) specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading, and 2) state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹⁰⁶

In *California Public Employees’ Retirement System v. Chubb Corp.*, the Third Circuit stated that “[w]hile claims brought pursuant to Section 14(a) of the 1934 Act do not require that scienter be pleaded, any claims brought under the 1934 Act must meet the PSLRA particularity requirements quoted above if a plaintiff elects to ground such claims in fraud.”¹⁰⁷ The court discussed that Congress “expressly intended” to “substantially heighten” the existing pleading requirements by passing the PSLRA.¹⁰⁸ Thus, any action falling under the broad category of securities fraud should be subject to the pleading standard, even if the specific claim does not require scienter or fraudulent intent.

In *Little Gem Life Sciences LLC v. Orphan Medical, Inc.*, the plaintiff argued that the heightened pleading standards of the PSLRA did not apply to

¹⁰⁴ *Beck v. Dobrowski*, 559 F.3d 680, 682 (7th Cir. 2009); *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987, 995 (2d Cir. 1988).

¹⁰⁵ *Wilson*, 855 F.2d at 995 (citing *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298–1301 (2d Cir. 1973)).

¹⁰⁶ *In re NVE Corp. Sec. Litig.*, 527 F.3d 749, 751 (8th Cir. 2008) (alteration in original) (citation omitted) (internal quotation marks omitted).

¹⁰⁷ 394 F.3d 126, 144–45 (3d Cir. 2004) (citing *In re NAHC Sec. Litig.*, 306 F.3d 1314, 1329 (3d Cir. 2002) (applying PSLRA particularity standards to section 14(a) claims)).

¹⁰⁸ *Id.* at 145.

negligent misrepresentation actions because negligence is not a state of mind.¹⁰⁹ However, the Eighth Circuit found this argument “unpersuasive and unsupported by precedent.”¹¹⁰ The court emphasized the goal of the PSLRA to raise the pleading standard for all securities fraud claims, including claims sounding in negligence.¹¹¹

In *Knollenberg v. Harmonic, Inc.*, the Ninth Circuit expressly held that “[t]he PSLRA pleading requirements apply to claims brought under Section 14(a) and Rule 14a-9.”¹¹² Accordingly, the court stated that “negligence is sufficient to support a claim for a violation of Section 14(a) for both forward looking and non-forward looking statements.”¹¹³ The court applied the PSLRA pleading standard to Section 14(a) claims that sound in negligence by requiring that “a Section 14(a) plaintiff must plead with particularity facts that give rise to a strong inference of negligence.”¹¹⁴

Therefore, courts that have allowed Section 14(a) claims to sound in negligence have not ignored the Legislature’s intent but incorporated the PSLRA pleading requirement into the negligent standard required for valid Section 14(a) claims.

C. The Fourth Circuit has already suggested that Section 14(a) claims should be held to the PSLRA pleading standard.

In *Hayes*, the court stated that “in any action requiring proof that the defendant acted with a particular state of mind, the facts alleged must give rise ‘to a strong inference that the defendant acted with the required state of mind.’”¹¹⁵ Although the court did not decide what standard was required for a successful Section 14(a) claim, the court implied that any allegation would still need to adhere to a heightened pleading standard. Thus, it is not contradictory for a court to recognize Section 14(a) claims that sound in negligence but require that plaintiffs assert facts that give rise to a strong inference that the defendant acted negligently.

¹⁰⁹ 537 F.3d 913, 917 (8th Cir. 2008).

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² 152 F. App’x 674, 682 (9th Cir. 2005).

¹¹³ *Id.* at 682–83.

¹¹⁴ *Id.* at 683 (citing *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1267 (N.D. Cal. 2000)).

¹¹⁵ *Hayes v. Crown Cent. Petroleum Corp.*, 78 F. App’x 857, 861 (4th Cir. 2003) (citing 15 U.S.C. § 78u-4(b)(2)).

In *Willis Towers Watson*, the shareholders' suit would likely be dismissed for failure to plead particularized facts if all they could assert was the potential mishandling of merger negotiations that resulted in a bad deal for shareholders. Instead, the shareholders asserted their claim based on evidence of secret meetings, confidential negotiations, and previously undisclosed agreements that surrounded the final merger negotiations.¹¹⁶ Thus, the Towers shareholders' claim sounds in negligence and is supported by facts that give rise to a strong inference that John Haley, at the very least, acted negligently in failing to disclose his relationships and dealings with other executives in a proxy statement.

CONCLUSION

In conclusion, the fate of Willis Towers Watson, John Haley, and the other corporate executives involved in this lawsuit is in the hands of the factfinders. The facts presented—the comparable merger structures, the meetings behind closed doors, the confidential agreements kept off the record, and the substantial increase in executive salaries—could persuade the reasonable mind. This paper only argues that the facts presented should raise the question: “What would the reasonable CEO do in this scenario?” If courts require Section 14(a) claims to sound in fraud, this question will never be asked. However, if courts allow Section 14(a) claims to sound in negligence, shareholders will have the opportunity to hold executives accountable for unreasonable actions. Then, the factfinders will be able to decide whether the corporate decision-makers profited from rolling the dice while playing with the shareholders' chips.

The *Willis Towers Watson* case is a perfect opportunity for the Fourth Circuit to take a position on multiple significant circuit splits. This article explains why the Fourth Circuit should allow Towers shareholders to assert a Section 14(a) claim that sounds in negligence against Willis Towers Watson and its corporate executives. If this issue does not reach the Fourth Circuit again on appeal, or if the court decides not to invoke a negligence standard, the SEC or the Legislature should further refine Section 14(a) to include a negligence standard. The SEC should amend Rule 14a-9 to require that plaintiffs must only prove defendants acted negligently. Alternatively, the Legislature should vote to amend the statute and explicitly incorporate a negligence standard to ensure consistent interpretation of Section 14(a) going forward.

¹¹⁶*In re Willis Towers Watson PLC Proxy Litig.*, 937 F.3d 297, 307 (4th Cir. 2019).

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As this article discussed, the Legislature drafted Section 14(a) to serve as a safeguard for shareholders. Therefore, courts should allow Section 14(a) claims against corporations and inside directors to sound in negligence when shareholders do not have access to particularized evidence of fraud. The Fourth Circuit should adopt the view that Section 14(a) claims can sound in negligence even if the court holds plaintiffs to a higher pleading standard under the PSLRA. In the end, Towers shareholders should have their day in court to assert a Section 14(a) claim against Willis Towers Watson, John Haley, and other corporate executives involved in authoring the misleading proxy statements surrounding the most significant transaction in the company's history.