ALERT MEMORANDUM

Ninth Circuit Holds That Section 14(e) of the Exchange Act Requires a Showing of Mere Negligence, Not Scienter

May 8, 2018

In *Varjabedian v. Emulex*, the Ninth Circuit recently held that plaintiffs bringing claims under Section 14(e) of the Securities Exchange Act of 1934 ("Exchange Act")—which prohibits misstatements, omissions or fraudulent conduct in connection with a tender offer—need only show that defendants acted negligently, rather than with scienter.[1]

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This decision marks a conspicuous divergence from the decisions of every other circuit court to consider the issue. Those other courts have uniformly held that Section 14(e) claims require a plaintiff to demonstrate that defendants acted knowingly or with a reckless disregard of the truth, a significantly higher burden. The Ninth Circuit's ruling, thus, sets up a clear circuit split that may necessitate resolution by the Supreme Court. In the meantime, however, it remains to be seen whether there will be a migration of tender-offer litigation to the Ninth Circuit.

[1] No. 16-55088, 2018 WL 1882905 (9th Cir. Apr. 20, 2018) (the "Opinion").

Case Background

In February 2015, Emulex Corp., a Delaware-incorporated technology company, and Avago Technologies Wireless Manufacturing jointly announced that Avago would offer to pay $8.00 for every share of outstanding Emulex stock, a premium of 26.4% on Emulex's stock price the day before the announcement. Following Avago's initiation of the tender offer, Emulex filed a "Recommendation Statement" with the SEC supporting the transaction, which included financial analyses and a fairness opinion from Emulex's investment bank.

Emulex did not include in the Recommendation Statement a "Premium Analysis" carried out by the investment bank, which determined that the 26.4% premium Avago was offering was within the normal range of premiums but below average as compared to 17 similar transactions. The investment bank nevertheless determined that the merger was fair.

After the merger was consummated, a class of former Emulex shareholders commenced a class action, alleging that the $8.00-per-share price offered by Avago was inadequate based on Emulex's recent and future prospects for growth. Plaintiffs subsequently amended their complaint to allege violations of Section 14(e) based on defendants' omission of the Premium Analysis from the Recommendation Statement.

The district court dismissed the complaint, holding, in relevant part, that Section 14(e) requires a showing of scienter and that plaintiffs had failed to plead that defendants acted with scienter in omitting the Premium Analysis. In reaching its conclusion, and in the absence of binding Ninth Circuit precedent, the district court looked to out-of-circuit precedents.

Out-of-Circuit Precedents Have Long Held Scienter Is Required Under Section 14(e)

Prior to *Varjabedian*, the Second, Third, Fifth, Sixth and Eleventh Circuits had all held that claims under Section 14(e) require allegations that defendants acted with scienter.

The Second Circuit was the first to address this issue in *Chris-Craft Indus. Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973). The Second Circuit held that Section 14(e), which was adopted by Congress in 1968 and, thus, had not yet been subject to extensive judicial interpretation, imposed a scienter requirement. In reaching that conclusion, the Court relied on the similarity of language between Section 14(e) and SEC Rule 10b-5, which provides "[i]t shall be unlawful ... [t]o make any untrue statement of a material fact or omit to state any material fact."[2] At that time, the Supreme Court had not yet weighed in on the scienter requirement of Rule 10b-5, but the rule had been construed by the Second Circuit, among others, to require more than mere negligence, including intent to defraud, knowledge of falsity or reckless disregard for the truth.[3]

The Fifth Circuit followed suit soon thereafter, citing the Second Circuit's reasoning in *Chris-Craft*, and noting that in importing the substantive language of Rule 10b-5 into Section 14(e), Congress "accepted the precedential baggage" of Rule 10b-5.[4] The Fifth Circuit noted that while "[s]ome culpability has consistently been required as an element of proof in this Circuit in cases alleging violations of Rule 10b-5…[t]he trend in the federal courts has been toward a more relaxed test."[5] Despite this "trend," the Court observed that "liability in a private action for damages has apparently never been imposed for negligent conduct under the Rule" and that "some culpability,

[2] *Id.* at 362.
[3] *Id.*
[4] *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 605 (5th Cir. 1974). Other courts, however, had held that Section 10(b) and Rule 10b-5 required a mere showing of negligence. *See, e.g.*, *Myzel v. Fields*, 386 F.2d 718, 735 (8th Cir. 1967); *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963). In 1976, the Supreme Court resolved the issue, holding that scienter was the requisite mental state for 10b-5 claims. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).
[5] *Smallwood*, 489 F.2d at 606.

beyond mere negligence, is required" under both Rule 10b-5 and Section 14(e).[6]

The Third and Eleventh Circuits followed and, in reaching the same conclusion, likewise relied on the similarity to the language of Rule 10b-5.[7] The Sixth Circuit, in turn, also concluded that Section 14(e) requires allegations of scienter, but based its decision squarely on the text of Section 14(e), which it found demonstrated congressional intention to impose a scienter requirement: "The language of the Williams Act clearly demonstrates that Congress envisioned scienter to be an element of 14(e). Congress used the words 'fraudulent,' 'deceptive,' and 'manipulative.' This language indicates, in light of [the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*], that 14(e) requires scienter. Although *Ernst & Ernst* was decided several years after the enactment of 14(e), we are bound by its holding that Congress intends scienter when it uses the above quoted language."[8]

Thus, for the last 45 years, the law has been clear that scienter is an element of Section 14(e).

The Ninth Circuit's Divergent Holding in *Varjabedian*

In April 2018, the Ninth Circuit reversed and remanded the Section 14(e) claims in *Varjabedian*, holding that Section 14(e) requires plaintiffs to prove only that defendants acted negligently, not with scienter, in making alleged material misstatements or omissions in tender offer disclosures. In reaching this conclusion, the Ninth Circuit considered both the plain language and the purpose of the statute, analogizing to Supreme Court precedent addressing the scienter requirements of other sections of the Exchange Act and of the Securities Act of 1933 ("Securities Act").

Regarding the text of Section 14(e), the Ninth Circuit emphasized the disjunctive construction of the statute, noting that while the second clause prohibits "fraudulent, deceptive, or manipulative acts or practices"—words that facially suggest intent or knowledge—the first clause is devoid of any such suggestion of scienter.[9] The Ninth Circuit reasoned that the two clauses of Section 14(e) must be separate and proscribe different conduct to avoid redundancy.[10]

While the Ninth Circuit acknowledged that the lower court's holding was based on longstanding out-of-circuit precedent, it rejected the district court's analysis that the "shared text" between Section 14(e) and Rule 10b-5 justified reading a scienter requirement into the first clause of Section 14(e) due to what the Ninth Circuit found to be "important distinctions" between the context of Rule 10b-5 and Section 14(e).[11]

The Court pointed to the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which held that claims under Section 10(b) of the Exchange Act and Rule 10b-5 require allegations of scienter. The Ninth Circuit emphasized that the Court in *Hochfelder* did not limit its reasoning to the plain language of Rule 10b-5, which it noted did not, on its face, clearly proscribe only intentional wrongdoing, but also looked at the authorizing legislation of and the purpose underlying Rule 10b-5.[12] The Court determined that because this rule was promulgated under Section 10(b) of the Exchange Act, which regulates only "manipulative or deceptive device[s]," it too only proscribes conduct carried out with scienter.[13] "[T]his rationale" the Ninth Circuit determined, "does not apply to Section 14(e), which is a statute, rather than an SEC rule."[14]

The Ninth Circuit also looked to the Supreme Court's decision in *Aaron v. SEC*, 446 U.S. 680 (1980), holding Section 17(a)(2) of the Securities Act does not require a showing of scienter. Section 17(a)(2) contains similar language to the first clause of Section 14(e) but applies more broadly to a company's offers

[6] *Id.*
[7] *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *SEC v. Ginsburg*, 362 F.3d 1292, 1297 (11th Cir. 2004).
[8] *Adams v. Standard Knitting Mills Inc.*, 623 F.2d 422, 431 (6th Cir. 1980).
[9] Opinion at *10-11.
[10] *Id.*
[11] *Id.* at *11.
[12] *Id.* at *12-13 (citing *Hochfelder*, 425 at 195-96).
[13] *Id.* at *13 (citing 15 U.S.C. § 78j(b)).
[14] *Id.* at *14.

or sales of securities. Although the Ninth Circuit acknowledged the different contexts of these statutes, it noted that they had "nearly identical text" and "similar purposes," as both "govern[ed] disclosures and statements made in connection with an offer of securities."[15] Thus, the Ninth Circuit found, these "statutes dealing with similar subjects should be interpreted harmoniously."[16]

Potential Implications of *Varjabedian*

Following the Ninth Circuit's decision, defendants filed a petition for rehearing *en banc*, which, if accepted, will give the entire Ninth Circuit the chance to consider the issue.[17] As of now, however, the Ninth Circuit's decision in *Varjabedian* is noteworthy for a number of reasons.

First, as the Ninth Circuit now stands apart from five other circuits in holding that Section 14(e) claims require only a showing of negligence, this issue may be primed for review by the Supreme Court. Although the Ninth Circuit attempted to interpret Section 14(e) according to Supreme Court precedent, there are competing interpretations of the statute also grounded in well-accepted theories of statutory interpretation. In particular, while the Ninth Circuit relied on the maxim that statutes should be construed to avoid surplusage, this principle did not prevent the Supreme Court from finding in *Hochfelder* that the entirety of Rule 10b-5 requires scienter, although Rule 10b-5, like Section 14(e), contains separate clauses, two of which explicitly reference "fraud" or "deceit" and one of which does not. Moreover, under another maxim of statutory interpretation, which has been applied by other Circuits that have interpreted the language of Section 14(e) consistently with that of Rule 10b-5, courts generally seek to interpret similar or identical statutory language uniformly.[18] Given these competing interpretations and the importance of the issue, it remains to be seen whether the Supreme Court, should it hear a case on this issue, will be receptive to the Ninth Circuit's reasoning. Further, in the recent past, the Supreme Court has been wary to interpret the federal securities laws in ways that expand the scope of private litigation in the absence of explicit Congressional authority to do so.[19]

Second, there may well be an uptick in tender offer litigation brought in the Ninth Circuit, given that the Ninth Circuit's decision will make it considerably more difficult to dismiss Section 14(e) claims at the motion to dismiss stage in light of its relatively lenient negligence standard, thus increasing their settlement value. As the SEC can also bring claims under Section 14, this circuit split may lead to a variance in the liability standard for Section 14(e) SEC enforcement actions depending on the location of the relevant conduct or the forum where the SEC files suit.[20]

Finally, while *Varjabedian* is certainly significant, defendants in the Ninth Circuit and beyond can still challenge Section 14(e) claims on a number of other grounds, including the materiality of the alleged misstatements or omissions. Because the district court in *Varjabedian* did not reach the issue of whether the omission of the Premium Analysis from the Recommendation Statement was material, the Ninth Circuit did not address this question. It did note, perhaps somewhat tellingly, that, "it is difficult to

[15] *Id.* at *14-15.
[16] *Id.* at *14.
[17] Petition for Rehearing En Banc of Defendants-Appellees, *Varjabedian v. Emulex*, No. 16-55088 (9th Cir. May 4, 2018), ECF No. 63-1.
[18] *See, e.g.*, *Rodriguez de Quijas v. Shearson/Am. Exp., Inc.*, 490 U.S. 477, 484 (1989) (overturning prior Supreme Court decision construing federal securities statute governing arbitration agreements "to achieve a uniform interpretation of similar statutory language").
[19] *See, e.g.*, *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011). Moreover, Section 17(a)(2) has not been found to include a private right of action.
[20] It is also possible that the SEC will look to *Varjabedian* as giving it greater latitude in investigating and seeking settlements of Section 14(e) matters, which it can file through its own administrative processes. Indeed, recent Section 14 actions by the SEC suggest that it may intend to pursue increased enforcement in this area. *See, e.g.*, In the Matter of RBC Capital Mkts., LLC, Respondent., Release No. 78735, 2016 WL 4537669 (Aug. 31, 2016).

show that this omitted information was indeed material."[21]

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[21] Opinion at *18.