

May 16, 2018

CLIENT ALERT

In a Break from Other Circuits, the Ninth Circuit Holds that Section 14(e) of the Exchange Act Requires Only a Showing of Negligence, Setting the Stage for Potential Supreme Court Resolution

Summary

- On April 20, 2018, the Court of Appeals for the Ninth Circuit held in *Varjabedian v. Emulex Corp.*ⁱ that plaintiffs need only to show negligence to support a claim under Section 14(e) of the Securities Exchange Act of 1934 (the “Exchange Act”), which governs tender offers.
- The Ninth Circuit’s opinion is a departure from the five other Circuit Courts (the Second, Third, Fifth, Sixth and Eleventh Circuits) that previously ruled on this issue, each of which concluded that plaintiffs must establish scienter (the intent to defraud) to support claims under Section 14(e).ⁱⁱ
- *Varjabedian* is likely to encourage the securities class action bar to seek out Ninth Circuit courts for class action suits relating to tender offers.
- In response to *Varjabedian*, purchasers in tender offers are likely to increase information and detail included in tender offer documentation, which already are often hundreds of pages long.
- The circuit split increases the likelihood that the Supreme Court will ultimately be petitioned to resolve the issue of whether scienter is required to sustain a claim under Section 14(e).

Case Background

In February 2015, Emulex Corp. (“Emulex”) and Avago Technologies Wireless Manufacturing, Inc. (“Avago”) announced that Avago would offer to pay \$8.00 for each outstanding tendered share of Emulex, which represented a premium of 26.4% of the value of Emulex shares as of the day prior to the announcement. Emulex received a fairness opinion from its investment bank in connection with the tender offer. After the tender offer was launched, Emulex filed a 48-page Recommendation Statement with the SEC in support of the offer. The Recommendation Statement included a summary of the fairness opinion and a nine-factor analysis supporting the appropriateness of various key components of the tender offer, including, among other things, the offer price, the termination fee, Emulex’s ability to shop the deal and the closing conditions.

The investment bank’s fairness opinion also included a one-page “Premium Analysis.” This Premium Analysis stated that while the 26.4% premium was within the normal range of semiconductor company premiums, it was below average. The summary of the fairness opinion contained in the Recommendation Statement failed to reference the Premium Analysis.

After the merger of the companies was consummated, certain former shareholders of Emulex brought a class action suit against Emulex, Avago, the merger subsidiary used for the merger and the Emulex Board of Directors alleging, among other things, that the defendants violated Section 14(e) by omitting the Premium Analysis from the Recommendation Statement. The District Court for the Central District of California dismissed the complaint with prejudice on the basis that Section 14(e) requires a showing of scienter and that plaintiff’s claim was deficient because it failed to plead that the alleged misstatement or omission was made “intentionally or with deliberate indifference.”ⁱⁱⁱ Following the dismissal, plaintiffs appealed to the Ninth Circuit.

Ninth Circuit Ruling

On appeal, the Ninth Circuit reversed the District Court and remanded the matter to the District Court to determine if the omission of the Premium Analysis from the Recommendation Statement is material. In reversing the District Court, the Ninth Circuit observed that Section 14(e) consists of two distinct clauses: (1) prohibition of making a material misstatement of a fact or omitting a material fact and (2) and prohibition of engaging in any fraudulent, deceptive or manipulative acts or practices in connection with a tender offer.^{iv} The Ninth Circuit reasoned that the two clauses must proscribe different types of behavior because otherwise they would be redundant.^v The Ninth Circuit further noted that the lower court’s and the sister circuits’ prior decisions that scienter is required for Section 14(e) claims were predicated on the similar phrasing of Section 14(e) and Rule 10b-5 of the Securities Exchange Act.^{vi} According to the

Ninth Circuit, the similar language shared by these two provisions induced these courts to conclude that just as Rule 10b-5 claims require a showing of scienter so too should claims under Section 14(e). In refuting this reasoning, the Ninth Circuit asserted that comparing Section 14(e) and Rule 10b-5 reflects a misunderstanding of the plain language of Section 14(e). The Ninth Circuit observed that the Supreme Court in *Ernst & Ernst v. Hochfelder*, which established that scienter is the mental state requirement for 10b-5 claims, indicated that the language of 10b-5 on its face is not limited to proscribing only intentional conduct.^{vii} Despite acknowledging that Rule 10b-5's language could be construed as prohibiting negligent conduct, the Supreme Court in *Hochfelder* still concluded that intentional wrongdoing is required for 10b-5 claims because the SEC in promulgating Rule 10b-5 was constrained by Congress' authorizing legislation contained in Section 10(b) of the Exchange Act, which allowed the SEC to regulate only "manipulative or deceptive device(s)."^{viii} Thus, the Ninth Circuit concluded that notwithstanding the similarities in language, Section 14(e) cannot be properly analogized to Rule 10b-5 because the former is a statute whereas the latter is a regulation that must be read and interpreted within the bounds and contours of its authorizing statute. As such, 10b-5's scienter requirement should not be imputed to Section 14(e). Moreover, according to the Ninth Circuit, the plain reading of Section 14(e) is broad enough to proscribe negligent conduct.

In addition, the Ninth Circuit observed that Section 14(e) has nearly identical language to Section 17(a)(2) of the Securities Act, which applies to offers and sales of securities. The Supreme Court in *Aaron v. SEC* held that Section 17(a)(2) requires only a pleading of negligence.^{ix} The Ninth Circuit found that the Supreme Court's interpretation of Section 17(a)(2), which, in the Ninth Circuit's view, serves a similar purpose to Section 14(e), compels the conclusion that Section 14(e) claims require only a showing of negligence.

Implications

Varjabedian has several important implications, which may have broad significance on both securities and M&A litigation and tender offer disclosure practices:

- Defendants have already petitioned for a rehearing *en banc*,^x which will give the entire Ninth Circuit the opportunity to hear the case. Depending on whether the *en banc* petition is accepted and its ultimate outcome, the circuit split resulting from *Varjabedian* may lay the groundwork for an ultimate Supreme Court decision. It is unclear how sympathetic the Supreme Court will be to the Ninth Circuit's ruling. For instance, the Supreme Court may not agree with the Ninth Circuit's analogizing Section 14(e) to Section 17(a)(2) because the latter has not been recognized as including a private action.^{xi} In addition, the Supreme Court has recently taken to avoiding expanding the scope of securities litigation in the absence of express congressional authority to do so.^{xii}

- *Varjabedian* is likely to cause the Ninth Circuit to become the choice destination for claims challenging tender offers. Due to the broad latitude that Section 27(a) of the Exchange Act^{xiii} affords plaintiffs with respect to the jurisdictions where they can assert claims under Section 14(e), it is also likely to embolden plaintiffs to increase lawsuits challenging tender offers.
 - The ruling in *Varjabedian* creates a circuit split akin to the split that already exists for lawsuits involving misstatements and omissions contained in proxy statements used to solicit shareholder votes for mergers under Section 14(a) of the Exchange Act. The Ninth Circuit adopted a similar approach to *Varjabedian* in *Knollengberg v. Harmonic, Inc.* in which the Court held that Section 14(a) claims can be based on a showing of negligence.^{xiv} The parallel circuit splits that now exist with respect to Section 14(a) and Section 14(e) may increase the probability that the Supreme Court will accept the case.
 - Even though *Varjabedian* has reduced the scienter requirements for Section 14(e) claims, plaintiffs will still not be able to prevail if they cannot establish that the alleged misstatement or omission is material. In *Varjabedian*, the Court remanded the decision of materiality to the District Court and, in fact, expressed skepticism that the omission of the Premium Analysis is material, stating “it is difficult to show that this omitted information was indeed material.”^{xv}
 - In light of *Varjabedian*’s lowering of the bar for Section 14(e) claims, deal teams will have a strong incentive to incorporate additional information into tender offer disclosures, which are already lengthy. A prudent deal team will want to ensure that fairness opinions are thoroughly summarized. Particularly important is the need to closely review any information that can be perceived as unfavorable to a recommended tender offer and to assess its materiality with a view toward disclosure.
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Endnotes

ⁱ No. 16-55088, 2018 WL 1882905 (9th Cir. Apr. 20, 2018) (the “Opinion”).

ⁱⁱ See, e.g., *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*, 565 F.3d 200, 207 (5th Cir. 2009); *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); *Conn. Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 961 (2d Cir. 1987); *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 431 (6th Cir. 1980).

ⁱⁱⁱ *Varjabedian v. Emulex Corp.*, 152 F. Supp. 3d 1226, 1233 (C.D. Cal. 2016), *aff'd in part, rev'd in part and remanded*, No. 16-55088, 2018 WL 1882905 (9th Cir. Apr. 20, 2018). The District Court also dismissed a claim brought under Section 14(d)(4) of the Exchange Act because there is no private right of action under Section 14(d)(4). The Court of Appeals for the Ninth Circuit affirmed the District Court’s dismissal of the Section 14(d)(4) claim.

^{iv} Section 14(e) provides that: “It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation” 15 U.S.C. § 78n(e).

^v Opinion at *10-11.

^{vi} Rule 10b-5, which proscribes fraudulent conduct in connection with, among other things, securities offerings, provides that “It shall be unlawful ... [t]o make any untrue statement of a material fact or omit to state any material fact. The Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), concluded that scienter is the requisite mental state for 10b-5 claims.

^{vii} *Id.* at 193 (1976) (stating that Rule 10b-5 could be “read as proscribing, respectively, any type of material misstatement or omission ... irrespective of whether the wrongdoing was intentional or not.”)

^{viii} Opinion at * 12-13 (citing *Hochfelder*, 425 at 195-96).

^{ix} 446 U.S. 680 (1980).

^x Petition for Rehearing *En Banc* of Defendants-Appellees *Varjabedian v. Emulex*, No. 16-55088 (9th Cir. May 4, 2018), ECF No. 63-1.

^{xi} See, e.g., *Bateman v. Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 304 n.9 (1985)(reserving the issue of whether a private right of action exists under Section 17); *In re Wash. Pub. Power Supply Sys. Sec. Litig.*, 823 F.2d 1349, 1350-58 (9th Cir. 1987) (holding that Section 17 does not include a private right of action).

^{xii} See, e.g., *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011).

^{xiii} Section 27(a) in its relevant parts provides that any “suit or action to enforce any liability or duty” created by the Exchange Act may be brought in any district where the act or transaction constituting the violation occurred “or in the district wherein the defendant is found or is an inhabitant or transacts business.” 15 U.S.C. § 78aa.

^{xiv} 2005 U.S. App. LEXIS 24274 (9th Cir. Nov. 8, 2005). The Sixth Circuit has required scienter in a Rule 14a-9 action but only in connection with the liability of corporate outsiders. *Adams v. Standard Knitting Mills*, 623 F.2d 244, 428 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980). The Supreme Court has reserved judgment on this issue. See *Va. Bankshares Inc. v. Sandberg*, 501 U.S. 1083, 1090 n.5 (1991).

^{xv} Opinion at *18.

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