Updates
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Ninth Circuit Establishes Negligence Standard for Section 14(e) Claims in Circuit-Splitting Decision

Rejecting the analysis of every other federal appellate court to consider the issue, the U.S. Court of Appeals for the Ninth Circuit recently held that most claims filed under Section 14(e) of the Securities Exchange Act of 1934 (the Exchange Act), 15 U.S.C. § 78n(e), do not require a showing of scienter. Instead, a showing of negligence is sufficient to state a claim. *See Varjabedian v. Emulex Corp.*, ___ F.3d ___, 2018 WL 1882905 (9th Cir. Apr. 20, 2018).

Factual Background

The *Emulex* case arose out of the merger of Emulex Corporation (Emulex) and Avago Technologies Wireless Manufacturing, Inc. (Avago). The merger was effected through a tender offer made to Emulex shareholders by a newly created Avago subsidiary. Based in part on a fairness opinion prepared by its financial advisor, Emulex's board of directors issued a Recommendation Statement that summarized the fairness opinion and provided nine reasons why Emulex shareholders should tender their shares. It did not, however, summarize a one-page chart, the so-called "Premium Analysis," that the financial advisor had prepared in formulating its fairness opinion. That analysis compared the premium offered to Emulex's shareholders to the premiums that other shareholders had received in 17 similar tender-offer transactions involving semiconductor companies, and found that, although the 24.6 percent premium offered to Emulex's shareholders fell within the range of premiums from those other transactions, it was "below average."

Contending that the Recommendation Statement's failure to discuss the Premium Analysis was a material omission that misleadingly caused Emulex shareholders to believe that the proposed merger was a better deal for them than it was, the shareholder plaintiffs alleged that Emulex, Avago, the Avago subsidiary and Emulex's board violated Section 14(e). The district court, following the decisions of five federal appellate courts which had held that scienter is an essential element of a Section 14(e) claim, dismissed the action on grounds that the plaintiffs had failed to adequately plead scienter. The Ninth Circuit reversed.

Prior to *Emulex*, Federal Circuit Courts Uniformly Held That Scienter Is a Required Element of All Section 14(e) Claims

Section 14(e), which was added to the Exchange Act in 1968 as part of the Williams Act, regulates the conduct of a broad range of persons with respect to the making or opposing of a tender offer. In pertinent part, Section 14(e) states:

It shall be unlawful for any person [1] 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 [2] to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . .

The first appellate decision to address the required state of mind for a Section 14(e) claim was *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973). In that case, the U.S. Court of Appeals for the Second Circuit concluded that the principles applicable to claims under SEC Rule 10b-5 also applied to claims under Section 14(e) because Rule 10b-5 and Section 14(e) contain similar language. Accordingly, the

Second Circuit held that, as in a Rule 10b-5 case, to prevail on a Section 14(e) claim a plaintiff must plead and prove that the defendants acted with scienter. The Second Circuit's holding was later adopted by the Third, Fifth, Sixth and Eleventh Circuits.

Ninth Circuit Holds That Negligence Standard, Not Scienter Standard, Applies to Section 14(e) Claims Based on Alleged False and Misleading Statements

Forty-five years after *Chris-Craft*, the Ninth Circuit decided that the Second Circuit's holding in *Chris-Craft* was no longer good law. At the heart of the Ninth Circuit's rejection of *Chris-Craft* and every other circuit court decision that has considered the issue is an assertion that all those other courts were mistaken in assuming that principles developed in Rule 10b-5 cases applied equally to Section 14(e) cases. In support of its position, the Ninth Circuit relied on two U.S. Supreme Court decisions that were issued after *Chris-Craft* was decided—*Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and *Aaron v. SEC*, 446 U.S. 680 (1980)—and contended that all the courts that have considered the matter since these Supreme Court decisions have failed to take these decisions into account.

As the Ninth Circuit explained, *Ernst & Ernst* acknowledged that the language of Rule 10b-5 that makes it unlawful "[t]o make any untrue statement of material fact or omit to state any material fact" can be viewed, in isolation, as proscribing both intentional and unintentional conduct. Consequently, the court further explained, *Ernst & Ernst*'s holding that scienter is an essential element of a Rule 10b-5 claim is not a result of Rule 10b-5's language, but rather derives from the fact that Rule 10b-5 was promulgated under Section 10(b) of the Exchange Act, which addresses only intentional wrongdoing. But unlike Rule 10b-5, Section 14(e) has no relationship to Section 10(b), and thus the rationale for requiring scienter under Rule 10b-5 does not apply to Section 14(e).

In further support of its conclusion that Rule 10b-5 jurisprudence should not apply to Section 14(e), the Ninth Circuit noted the fundamental difference between Section 14(e) and Section 10(b). Whereas Section 10(b) focuses solely on preventing the use of "manipulative or deceptive device[s] or contrivance[s]" in connection with the sale or purchase of a security, Section 14(e) regulates a broader array of conduct. Section 14(e) gives the SEC power to prohibit acts that are not themselves fraudulent "if the prohibition is reasonably designed to prevent . . . acts and practices [that] are fraudulent." 2018 WL 1882905, at *7 (quoting *United States v. O'Hagan* , 521 U.S. 642 (1997)). The Ninth Circuit thus concluded that, "[i]f the SEC can prohibit 'acts themselves not fraudulent' under Section 14(e), then it would be somewhat inconsistent to conclude that Section 14(e) itself reaches only fraudulent conduct requiring scienter." *Id.*

In addition to distinguishing Section 14(e) from Rule 10b-5, the Ninth Circuit compared Section 14(e)'s language to that of Section 17(a)(2) of the Securities Act of 1933. It focused on *Aaron*, in which the Supreme Court held that Section 17(a)(2) does not require a showing of scienter. This holding was important, the Ninth Circuit explained, because Section 17(a)(2)'s language is "nearly identical" to the language in the first clause of Section 14(e), which addresses the making of untrue statements of material fact or the omission of material facts.

After a brief discussion of the legislative history and purpose of the Williams Act, which the court concluded also supported a negligence standard, the Ninth Circuit completed its analysis, stating that "because the text of the first clause of Section 14(e) is devoid of any suggestion that scienter is required, we conclude that the first clause of Section 14(e) requires a showing of only negligence, not scienter."

Limitations on Ninth Circuit's Decision

The negligence standard that the Ninth Circuit established for claims arising under the first clause of Section 14(e) will not be a simple one for plaintiffs to satisfy on the merits, even if it may be easier than a scienter standard—which is subject to the specificity requirements of the Private Securities Litigation Reform Act of 1995—for plaintiffs to satisfy at the pleading stage. In remanding the case to the district court to decide whether

omission of the Premium Analysis from the Recommendation Statement constituted an actionable omission of a material fact under the new negligence standard, the court made clear that plaintiffs will need to "plead a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." 2018 WL 1882905, at *8 (quoting *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 989-90 (9th Cir. 2009)).

Furthermore, the Ninth Circuit's adoption of a negligence standard expressly pertains only to the first clause of Section 14(e), which concerns material misstatements and omissions. The court did not hold that a negligence standard applies to claims arising under Section 14(e)'s second clause, which prohibits the use of "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." While the second clause was not at issue in *Emulex*, it is likely that pleading and proof of scienter will still be required, even within the Ninth Circuit, for claims asserted under that clause, given how closely its language tracks the language of Section 10(b). This likely exception to the Ninth Circuit's negligence standard may not be meaningful, however, as in practice Section 14(e) claims almost always are based on an alleged violation of its first clause and not the second.

Implications of *Emulex* Decision

Ninth Circuit may not have the last word. The Ninth Circuit's decision in *Emulex* is in direct conflict with the decisions of five other federal circuit courts of appeals. This circuit split potentially makes the case worthy of U.S. Supreme Court review, if the defendants choose to seek review. Yet, even if the defendants in this case elect not to seek *certiorari* review, it seems inevitable that the issue will be brought before the Supreme Court for resolution at some time.

Until the Supreme Court weighs in, expect a shift of Section 14(e) filings to district courts within the Ninth Circuit. Section 14(e) claims are common whenever a merger is effected via tender offer. Even though the negligence standard that the Ninth Circuit established is not an easy one to satisfy, it is still easier to satisfy than a scienter standard. The *Emulex* decision thus provides plaintiffs' counsel substantial incentive, where they base their Section 14(e) claim on an alleged materially false or misleading statement or omission, to file as many of these tender-offer challenges as they can in district courts that lie within the Ninth Circuit. The ability to pursue Section 14(e) claims on a negligence theory may also mean that more Section 14(e) claims are filed overall, especially within the Ninth Circuit and in district courts that lie within circuits where the court of appeals has not yet addressed the negligence versus scienter issue.

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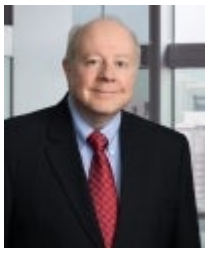

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