CORPORATE LITIGATION:

'VARJABEDIAN V. EMULEX': SUPREME COURT SET TO DECIDE WHETHER §14(E) OF THE EXCHANGE ACT REQUIRES SCIENTER

JOSEPH M. MCLAUGHLIN AND SHANNON K. MCGOVERN*
SIMPSON THACHER & BARTLETT LLP

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Section 14(e) of the Securities Exchange Act prohibits material misstatements or omissions, and other "fraudulent, deceptive, or manipulative acts or practices," in connection with tender offers. For decades, the Second Circuit has held that an implied private cause of action under §14(e) requires a showing of scienter, consistent with the elements required for a private securities fraud cause of action under §10(b) and Rule 10b-5 of the Securities Exchange Act. Four additional Circuit Courts to address the issue are in accord. Last year, the Ninth Circuit diverged from this nearly 50-year consensus, holding in *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018), that mere negligence is enough to plead and prove a claim for a material misstatement or omission under §14(e). The Supreme Court recently granted certiorari to resolve this Circuit split, the resolution of which will surely affect the number of federal securities lawsuits challenging mergers consummated through tender offers. The importance of this question is magnified by the widespread migration of "merger objection" suits to federal court under §14 of the Exchange Act, in response to Delaware law hostility to disclosure-only merger settlements. See *In re Trulia, Inc. S'holder Litig.*, 129 A.3d 884 (Del. Ch. 2016). With "merger objection" litigation increasingly a part of the federal court docket, allowing stockholder plaintiffs to bring §14(e) disclosure claims on a showing of mere negligence would result in still more lawsuits and make them more challenging to resolve.

Background

In 2015, Emulex Corp. was acquired by a subsidiary of Avago Technologies Wireless Manufacturing Inc. Pursuant to the merger agreement, Avago launched a tender offer to acquire Emulex's stock at $8 per share, reflecting a 26.4 percent premium over market price. Emulex's investment bankers issued an opinion to Emulex that the sum was fair to Emulex shareholders, and Emulex filed a Schedule 14D-9 with the Securities and Exchange Commission recommending that its shareholders tender their shares at the offered price. A putative class of shareholders filed suit in the Central District of California under §14(e) of the Securities Exchange Act of 1934, alleging that Emulex's recommendation statement failed to disclose that its investment bank found that the 26.4 percent premium its shareholders would receive was below average vis-à-vis a sample of 17 recent representative transactions.

The district court dismissed the complaint, adopting out-of-Circuit authority requiring allegations of scienter to maintain a §14(e) suit, and observing that *no* federal court had interpreted §14(e) to require mere

Joseph M. McLaughlin *is a Partner and* **Shannon K. McGovern** *is an Associate at Simpson Thacher & Bartlett LLP.*

negligence. The district court further concluded that plaintiff had failed to plead an intent to defraud, as "[w]hat to include in a fairness opinion summary is a judgment call." 152 F. Supp. 3d 1226, 1237 (C.D. Cal. 2016).

'Varajabedian v. Emulex'

On appeal, the Ninth Circuit reversed, holding that the relevant language of §14(e) does not require any showing of scienter, and rejecting case law from five other Circuit Courts that §14(e) should be interpreted in a manner consistent with §10(b) and Rule 10b-5. The Ninth Circuit did not address the separate question whether Emulex's omission was material, leaving that issue for remand.

The Ninth Circuit's decision centered on the language of §14(e). The first clause of §14(e) encompasses material omissions, on which Emulex's shareholders based their claim. It states: "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." 15 U.S.C. §78n(e). The second clause further proscribes "fraudulent, deceptive, or manipulative acts or practices." Id. The Ninth Circuit concluded that the first clause, unlike the second, is "devoid of any suggestion that scienter is required." 888 F.3d at 408. In the Ninth Circuit's view, plaintiff's allegation that Emulex negligently omitted the comparison to certain other representative transactions adequately pleaded a material omission.

In declining to interpret §14(e) to require scienter for material misstatements or omissions, the Ninth Circuit rejected the reasoning of five other Circuits, beginning with decisions by the Second and Fifth Circuits issued within a few years of the 1968 addition of §14(e) to the Securities Exchange Act. See *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1975). The *Chris-Craft* court saw "[n]o reason" to apply a different scienter standard to private suits under §14(e) than to private suits under §10(b) and Rule 10b-5, "the language of which is substantially the same." Id. at 397.

The Supreme Court subsequently held in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), that §10(b) and Rule 10b-5 claims require a showing of scienter because §10(b) prohibits "any manipulative or deceptive device or contrivance." The Supreme Court acknowledged that the language in Rule 10b-5 proscribing the making of a material misstatement or omission could be interpreted to proscribe both intentional and unintentional conduct, but the rule could only prohibit misstatements or omissions made with scienter, as it would otherwise exceed the statutory authority granted to the SEC by §10(b). Construing the statute as creating "two different offenses," the Ninth Circuit concluded that "because the text of the first clause of §14(e) is devoid of any suggestion that scienter is required, we conclude that the first clause of §14(e) requires a showing of only negligence, not scienter."

The Supreme Court has also held that §17(a) of the Exchange Act requires a showing of scienter to establish that a defendant has "employ[ed] any device, scheme, or artifice to defraud," but *not* to show the defendant has "obtain[ed] money or property by means of any untrue statement of a material fact" or material omission. *Aaron v. Securities & Exchange Commission*, 446 U.S. 680 (1980). *Aaron* concerned an express right of action by the SEC for injunctive relief, not an implied private right of action for damages. Nonetheless, the Supreme Court's interpretation of §17(a) to impose different levels of culpability for distinct violations in a single statutory provision is arguably consistent with the reading of §14(e) urged by plaintiff and adopted by

the Ninth Circuit. In the Ninth Circuit's view, none of the decisions by its sister Circuits have considered §14(e) in light of these binding Supreme Court precedents. While it ultimately rejected plaintiff's arguments regarding these Supreme Court precedents in light of the absence of case law supporting them, the *Emulex* district court nonetheless acknowledged that they had some merit, although characterizing them as "elaborate." 152 F. Supp. 3d at 1232.

The Ninth Circuit found further support for its statutory construction of §14(e) in the Williams Act's legislative history, which added the provision to the Exchange Act as part of its broader regulation of tender offers. In the Ninth Circuit's view, the purpose of the Williams Act was to require all interested parties to fully disclose material information to ensure that shareholders have adequate information when deciding whether to tender their shares—not to regulate fraud.

Petition for Writ of Certiorari

Last month, the Supreme Court granted Emulex's petition for certiorari. In its petition, Emulex emphasized the purpose and structure of the federal securities laws, and the flexible venue rules of the securities laws would result in forum shopping exploiting the Circuit split. In contrast to the Ninth Circuit, which approached its analysis of legislative history and purpose of §14(e) by examining the Williams Act, Emulex argued that reading §14(e) to require mere negligence upsets the broader statutory scheme reflected in the 1933 Securities Act and 1934 Securities Exchange Act and is at odds with the Supreme Court's historic reserve when inferring private rights of action not expressly authorized by the statutory text. The Supreme Court has already held that the first sentence of §14(e) was "modeled on the antifraud provisions of §10(b) of the Act and Rule 10b-5," *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 10 (1985), and "prohibits fraudulent acts in connection with a tender offer," *United States v. O'Hagan*, 521 U.S. 642, 667 (1997).

While the Supreme Court has long recognized a private right of action for §10(b) claims, it has never done so for §14(a) claims. Emulex's petition therefore urged the Supreme Court to limit any private damages actions under §14(e) to those remedying material misstatements or omissions made with scienter. Otherwise, Emulex argued, frivolous suits challenging mergers will flood the courts under a lenient, and unwarranted, pleading standard.

Conclusion

The five Circuit Courts adopting a scienter standard for §14(e) claims have correctly emphasized the similarities between §10(b), which requires scienter, and §14(e). The Ninth Circuit's holding that the implied §14(e) private right of action requires a stockholder only to plead and prove ordinary negligence, rather than scienter, is of questionable validity as a textual interpretive matter and under the Supreme Court's longstanding approach to the parameters of implied rights of action. As Delaware merger litigation has cooled in light of increasing skepticism by the Delaware courts, shareholders have increasingly turned to the federal courts to challenge merger terms and seek a better price. The Supreme Court's resolution of the standard to be applied in pleading §14(e) claims will, as Emulex's petition warned, affect the extent to which federal courts remain an attractive forum for merger strike suits.