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Ninth Circuit Splits from Five Other Circuits; Requires Only a Showing of Negligence for Claims Under Section 14(e) of the Exchange Act

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On April 20, 2018, in *Varjabedian v. Emulex Corp.*,[1] the Ninth Circuit held that Section 14(e) of the Securities Exchange Act of 1934 requires only a showing of negligence, rather than scienter, in connection with a disclosure claim. In reversing the district court's decision dismissing the complaint, the Ninth Circuit split from five other circuits, including the Second, Third, Fifth, Sixth, and Eleventh Circuits.

Background

In the case below, the U.S. District Court for the Central District of California rejected a stockholder plaintiff's claim that Emulex Corporation, a Delaware-incorporated technology company, violated the federal securities laws by issuing a false and misleading Schedule 14D-9 Recommendation Statement in support of Avago Technologies Wireless (U.S.A.) Manufacturing Inc.'s tender offer for all of the outstanding shares of Emulex's common stock in 2015.[2]

Avago had offered to pay $8.00 per share for Emulex's stock, reflecting a premium of 26.4% over Emulex's pre-announcement stock price. The plaintiff asserted that Emulex's Schedule 14D-9 was false and misleading because it omitted a description of a one-page premiums paid analysis that Emulex's financial advisor had prepared for the Emulex Board of Directors. The premiums paid analysis related to acquisitions of seventeen semiconductor companies between 2010 and 2014, and showed that, while Emulex's 26.4% premium fell within the range of the semiconductor merger premiums for these companies, it was below average. In connection with the deal, Emulex's financial advisor opined that the consideration to be received in the merger was fair, despite this below-average premium, and Emulex elected not to summarize the premiums paid analysis in its Schedule 14D-9. In granting the defendants' motion to dismiss, the district court held that Section 14(e) required a showing of scienter and that the plaintiff failed to meet his burden to show that Emulex and its directors had engaged in intentional wrongdoing in omitting the premiums paid analysis from the Schedule 14D-9.

Section 14(e) of the Exchange Act

Section 14(e), which regulates the conduct of a broad range of persons with respect to the making or opposing of a tender offer, has three principal parts. First, in language similar to clause (b) of Rule 10b-5, 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. Second, in language similar to clause (a) of Rule 10b-5, Section 14(e) prohibits any fraudulent, deceptive, or manipulative acts or practices in connection with any tender offer. Third, under Section 14(e), the SEC is authorized to define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative.

[1] *Varjabedian v. Emulex Corp.*, No. 16-55088, 2018 WL 1882905 (9th Cir. Apr. 20, 2018).
[2] *Varjabedian v. Emulex Corp.*, 152 F. Supp. 3d 1226 (C.D. Cal. 2016).

Ninth Circuit Decision

The Ninth Circuit observed that the district court had relied on decisions from five other circuits, all of which had previously held that Section 14(e) disclosure claims require the complaint to plead facts supporting an inference of scienter, or intentional wrongdoing. However, the Ninth Circuit found the rationale underpinning those five circuit courts' decisions unpersuasive. In distinguishing those decisions, the Court noted that the other circuits' decisions were based on the shared text found in both Rule 10b-5 and Section 14(e), as described above. However, based on what it considered to be important distinctions between the two provisions, the Supreme Court's decisions in *Ernst & Ernst v. Hochfelder*[3] and *Aaron v. SEC*,[4] and the legislative history and purpose of the Williams Act, the Court concluded the first clause of Section 14(e) requires only a showing of negligence, not scienter. The Court reasoned that the Supreme Court concluded in its *Ernst & Ernst* decision that Rule 10b-5(b) required a showing of scienter because of the relationship between Rule 10b-5 and its authorizing legislation, but that no similar statutory limitation applied to Section 14(e). The Court also reasoned that, in *Aaron*, the Supreme Court held that Section 17(a)(2) of the Securities Act of 1933 – which contains nearly identical text to the first clause of Section 14(e) – does not require a showing of scienter. The Court also found the legislative history of the Williams Act, which added Section 14(e) to the Exchange Act, supported a negligence standard.

Implications

Given the split that now exists between the Ninth Circuit and a host of other circuits, the decision in *Emulex* and the negligence/scienter issue that it raises under Section 14(e) may be ripe for review by the Supreme Court. Absent reversal, the Ninth Circuit's decision could result in an increased number of class action suits involving disclosure claims under Section 14(e) in federal district courts in the Ninth Circuit in connection with tender offers. This would follow an increase in Section 14(a) disclosure claims being filed in federal courts across the country following the near elimination of disclosure-only settlements in the Delaware Court of Chancery.

On the merits of the claim, the Ninth Circuit noted that the district court did not reach the question as to whether the omission of a summary of the premiums paid analysis from the Schedule 14D-9 constituted an omission of a material fact in the context of the entire transaction. However, in remanding the case for further consideration by the district court, the Court stated that it will be "difficult to show that this omitted information was indeed material." In this regard, we note that while a premiums paid analysis is included in many financial advisor presentations providing an analysis of the merger consideration, a premiums paid analysis is generally not considered by financial advisors to be a fundamental valuation analysis for purposes of a fairness opinion. In addition, the Ninth Circuit's comment regarding materiality underscores that defendants will continue to have additional, potential dismissal arguments in Section 14(e) disclosure actions.

[3] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).
[4] *Aaron v. SEC*, 446 U.S. 680 (1980).