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NINTH CIRCUIT HOLDS THAT SECTION 14(E) OF THE EXCHANGE ACT REQUIRES A SHOWING OF NEGLIGENCE, NOT SCIENTER

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On April 20, 2018, in *Varjabedian v. Emulex Corp.* ("*Emulex*"),[1] the Ninth Circuit split from five other circuit courts in holding that Section 14(e) of the Securities Exchange Act of 1934 ("Exchange Act"), governing tender offers, does not require a showing of scienter. The decision may have significant implications for investors litigating, or considering pursuing, claims under Section 14(e) both in terms of what they need to prove and relevant limitations period considerations.

Section 14(e) regulates the conduct of people who could influence the outcome of a tender offer and makes it unlawful for any such person to make material misstatements or omissions, or to engage in fraudulent acts or practices, in connection with a tender offer.[2] Prior to *Emulex*, five circuit courts—the Second, Third,[3] Fifth, Sixth, and Eleventh—that addressed what is required to successfully plead a Section 14(e) case had held that Section 14(e) claims require proof of scienter. Those holdings compel the application of a longer limitations period requiring litigants to bring suit within the earlier of five years of defendants' last culpable act, or two years from discovery of the violation, or the suit will be time-barred. These dual limitations periods are applicable to a private right of action that involves a claim of fraud.[4]

In *Emulex*, the Ninth Circuit has now held that Section 14(e) claims premised on misstatements and omissions of fact only require a showing of negligence, not scienter. This is significant because (1) at least in the Ninth Circuit, plaintiffs will be subject to a lower hurdle to recovery by only needing to show negligence, and (2) there is an argument that defendants could advance in such cases that these claims are no longer "fraud" based, and they are therefore subject to a shorter limitations period requiring plaintiffs to bring suit within the earlier of three years of defendants' last culpable act, or one year from discovery of the violation.[5] The decision is also notable in that the analysis of the Ninth Circuit in *Emulex* is extensive and well-reasoned, which could lead either to other circuits revisiting their prior decisions or to the Supreme Court needing to resolve this circuit split.

Background

Emulex arose from the merger between, and tender offer involving, Emulex Corp. ("Emulex") and Avago Technologies Wireless Manufacturing, Inc. ("Avago"). Shareholders claiming they were misled by Emulex, Avago

[1] No. 16-55088, --- F.3d---, 2018 WL 1882905 (9th Cir. Apr. 20, 2018).

[2] *See* 15 U.S.C. § 78n(e).

[3] *See In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004) (joining "those circuits that hold that scienter is an element of a Section 14(e) claim").

[4] 28 U.S.C. §1658(b); *see also, e.g.*, *Dekalb County Pension Fund v. Transocean Ltd.*, 817 F.3d 393, 398-407 (2d Cir. 2016) ("agree[ing] with Third and Fourth Circuits that, at a minimum, Congress clearly intended [§1658(b)] to apply to 'claims requiring proof of fraudulent intent'").

[5] *See, e.g.*, *In re Exxon Mobil Corp. Sec. Litig.*, 500 F.3d 189, 196-97 (3d Cir. 2007) (holding a claim under §14(a) of the Exchange Act, which requires proof of negligence—not scienter—is governed by the dual one/three year limitations and repose periods, not the dual limits in §1658(b)).

and certain of their affiliates into believing that the merger was better than it was filed a class action against Emulex and other defendants for violating Sections 14(e) and 20(a) of the Exchange Act.[6] The district court dismissed the complaint with prejudice, relying on decisions from five other circuits to conclude that Section 14(e) requires a showing of scienter, which plaintiff failed to plead.[7] To that point, all five circuit courts that addressed the issue held that all Section 14(e) claims require proof of scienter, not mere negligence, generally because Section 10(b) and Rule 10b-5 claims require scienter, and Section 14(e) largely mirrors Rule 10b-5.[8] Plaintiff appealed the Court's decision to the Ninth Circuit.

On appeal, the Ninth Circuit found that Section 14(e) claims require proof of negligence, not scienter, and it reversed the district court's decision vis-à-vis the Section 14(e) claim given that the lower court employed a scienter, not negligence, standard in analyzing that claim.[9] Specifically, the Ninth Circuit held that "because the text of the first clause of Section 14(e) [banning misstatements and omissions of fact] is devoid of any suggestion that scienter is required, the first clause of Section 14(e) requires a showing of only negligence, not scienter."[10] According to the Ninth Circuit, the other circuit courts did not consider certain intervening Supreme Court precedents and "important distinctions exist[ing] between Rule 10b-5 and Section 14(e)…that strongly militate against importing the scienter requirement from the context of Rule 10b-5 to Section 14(e)." *Id.* at *4. In particular, the Supreme Court's decision in "*Ernst & Ernst* provides that the scienter requirement is rooted not in the text of Rule 10b-5, but rather in the relationship between Rule 10b-5 and its authorizing legislation [that allows the SEC to regulate only manipulative or deceptive devices]" while its decision in *Aaron* held "that the plain language of Section 17(a)(2), which is largely identical to the first clause of Section 14(e), requires a showing of negligence, not scienter."[11] Additionally, the Court found that the legislative history and purpose of Section 14(e) and the Williams Act, which enacted it, support a negligence standard given that "[t]he legislative history suggests that the Williams Act places more emphasis on the quality of information shareholders receive in a tender offer than on the state of mind harbored by those issuing a tender offer."[12]

Implications & Key Takeaways

Emulex gives rise to interesting and important implications for direct and class actions alleging Section 14(e) claims, including where to bring suit for Section 14(e) violations, what plaintiffs will need to plead in a complaint concerning

[6] Plaintiff also asserted claims under Section 14(d)(4).

[7] *Varjabedian v. Emulex Corp.*, 152 F. Supp. 3d 1226, 1233 (C.D. Cal. 2016) ("[N]o federal court has held that § 14(e) requires only a showing of negligence. Considering the wealth of persuasive case law to the contrary, the Court concludes that the better view is that the similarities between Rule 10b–5 and § 14(e) require a plaintiff bringing a cause of action under § 14(e) to allege scienter."); *see also infra* n.9 (addressing rejection of Section 14(d)(4) claims).

[8] *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 at 328; *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).

[9] *Id.* at*3-7, 9. The Ninth Circuit affirmed the dismissal of Section 14(d)(4) claims as it did not create an implied right of action. *See id.*

[10] *Id.* at *7. Section 14(e) contains a second clause prohibiting any person from engaging in any "fraudulent, deceptive, or manipulative acts or practices" in a tender offer, which Congress separated from the first clause prohibiting misstatements and omissions with a disjunctive ("or"). *Emulex* found that "[o]nly the second clause of § 14(e) contemplates a scienter requirement," given that "when Congress uses a disjunctive, a single statutory provision can call for more than one level of scienter," and that "a heightened showing of culpability is required" where Congress prohibits "fraudulent" or "deceptive" practices. *Id.* at *10-11 (citations omitted).

[11] *Emulex*, 2018 WL 1882905, at *6 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976); *Aaron v. Securities & Exchange Commission*, 446 U.S. 680, 696-97 (1980)).

[12] *Id.* at 7.

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scienter, and how that implicates applicable limitations periods. It also creates a noticeable circuit split that could prompt Supreme Court review, and we cannot predict when or how such review would be resolved, or whether it would touch upon related questions concerning Section 14(e) and what else is required in terms of proof.

Labaton Sucharow attorneys are available to address any questions you may have regarding these developments and any specific securities actions.

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