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Ninth Circuit Rejects Decisions of Five Others: Exchange Act Section 14(e) Does Not Require Scienter

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Scienter has been a critical element of a claim based on Exchange Act Section 10(b) in an SEC enforcement action since the Supreme Court's decision in *Aaron v. SEC*, 446 U.S. 680 (1980). It has also been a key element in private damage actions based on the cause of action implied under Section 10(b) and Rule 10b-5 since *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Both decisions were based largely on the text and language of Section 10(b).

Section 14(e), added to the Exchange Act by the Williams Act in 1968, has also been held to explain proof of scienter by the Circuit Courts – the Supreme Court has not considered the questions. *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*, 565 F. 3d 200 (5th Cir. 2009); *SEC v. Ginsburg*, 362 F. 3d 1292 (11th Cir. 2004); *Aaron, Adams v. Standard Knitting Mills, Inc.*, 623 F. 2d 422 (6th Cir. 1980); *Smallwood v. Pearl Brewing Co.*, 489 F. 2d 579 (5th Cir. 1974); *Chris-Craft Indus. Inc. v. Piper Aircraft Corp.*, 480 F. 2d 341 (2nd Cir. 1973).

However, now the decisions by the five Circuit Court regarding Section 14(e) are being called into question by the Ninth Circuit. That Circuit recently examined the statutory language of Section 14(e) as well as its purpose and history, all of which lead the Court to conclude that the clause prohibiting a misrepresentation/omission only requires proof of negligence. *Variabedian v. Emulex Corporation*, No. 16-55099 (9th Cir. Filed April 20, 2018).

The decision

Variabedian is a securities class action based on Exchange Act Section 14(e) and Section 20(a) centered on the tender offer by Avago Technologites Wireless Manufacturing, Inc. for Emulex Corporation, announced on February 25, 2015. Following the deal announcement a punitive class action based was brought alleging that the tender offer materials contained a material omission because they did not summarize a Premium Analysis prepared by one of the investment bankers in the deal which would have shown that the premiummarket offered was below market. The District Court dismissed the complaint with prejudice, concluding that Section 14(e) required scienter which plaintiff failed to plead.

The Circuit Court reversed, concluding that one of the two parts of Section 14(e) only requires that a securities law plaintiff plead and prove a cause of action based on negligence: "We now hold that Section 14(e) of the Exchange Act requires a showing of negligence, not scienter.

The Ninth Circuit's decision is based on the statutory text, bolstered by its purpose and history. The statute states in pertinent part: "It shall be unlawful for any person (1) to make any untrue statement of a material fact or omit to state any material fact . . . *or* (2) to engage in any fraudulent, deceptive, or manipulative acts or practices . . ." (emphasis added). The use of the word "or" separates the two clauses of the Section, the Court stated. This shows that there are two different offenses proscribed by the statute. The first focuses on misstatements and omissions. The second, on manipulative acts and practices.

Careful consideration of the Supreme Court's decisions parsing the language of Section 10(b) of the Exchange Act demonstrates that there are important distinctions between that provision and Section 14(e). When the Supreme Court began its examination of rule 10b-5's language in *Hochfelder* it initially focused on the phrase stating that "It shall be unlawful . . . [t]o make any untrue statement of a material fact or omit to state any material fact . . ." That passage, the Court allowed, could be read as proscribing any type of material misstatement, regardless of intention. In *Hochfelder* the Court held, however, that Section 10(b) and the rule require proof of scienter. That conclusion was based on the fact that the rule could not be broader than the Section which in fact requires scienter: "Rule 10b-5 requires a showing of scienter because it is a regulation promulgated under Section 10(b) of the Exchange Act, which allows the SEC to regulate *only* 'manipulative or deceptive device[s].'"

Three years later the Supreme Court decided *Aaron* which considered the knowledge requirement of Section 10(b) and Securities Act Section 17(a) in the context of an SEC enforcement action. There the Court reaffirmed its decision in *Hochfelder* as to Section 10(b). As to Securities Act Section 17(a)(2) however, the Court reached a different conclusion. That subsection prohibits "'any untrue statement of a material fact or any omission to state a material fact . . .'" In view of this language the *Aaron* Court held "that Section 17(a)(2) does *not* require a showing of scienter." (emphasis original).

The language of Section 17(a)(2) is substantially similar to that of the first part of Section 14(e). Both prohibit misrepresentations and omissions. Under these circumstances *Aaron* compels the conclusion that the first part of Section 14(e) requires proof of negligence.

The Court bolstered its conclusion, citing the purpose and history of Section 14(e). Under this Section the SEC has the authority to prohibit acts which are not fraudulent, in contrast to Section 10(b) which requires proof of fraud. The broader reach of Section 14(e) suggests that it not be limited to prohibiting fraud like Section 10(b). This conclusion also finds "some support" in the legislative history which reflects the fact 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."

Finally, while five other circuits reached the opposite conclusion, at least three did not have the benefit of *Aaron* at the time of decision.

Chris-Craft and *Smallwood*, for example, were both decided before *Hochfelder*. While the Sixth Circuit's *Standard Knitting Mills* was decided after *Hochfelder* but just before *Aaron* and thus did not have the benefit of that decision.

Despite *Hochfelder* and *Aaron*, however, the circuit courts have continued to conclude that Section 14(e) requires proof of scienter. *Flaherty* however relied on *Smallwood*. *Ginsburg* relied on another Eleventh Circuit case which based its conclusion on a comparison of the Section 14(e) language to that of Rule 10b-5 but did not mention the limitation on the rule from Section 10(b). Thus with the benefit of *Hochfelder* and *Aaron* it is clear that one portion of the Williams Act provision only requires proof of negligence, the Court concluded.

Comment

Varjabedian is based squarely on the language of the statute. While the Court sought additional support from the purpose of the statute as well as the legislative history, the opinion leaves doubt that it is the statutory text which compelled the decision. The fact that the negligence conclusion is based on a comparison of an Exchange Act provision to one from the Securities Act is of little real moment given the virtually identical statutory language from two securities statues.

Perhaps more importantly, the mode of analysis fits squarely with the approach being used by the Supreme Court. In *Digital Realty Trust, Inc. v. Somers*, No. 16-1276 (S.Ct. Feb. 21, 2018), for example, the Court resolved a question regarding the whistleblower provisions of the Exchange Act and the Sarbanes-Oxley Act by construing the text of the o statute, citing the purpose of the provisions only to bolster its conclusion. Five members of the Court joined Justice Ginsberg's majority opinion. Justice Thomas, however, joined by Justices Alito and Gorsuch concurred only in the judgment but declined to join the majority opinion because of its citation to the Senate Report, deeming that inappropriate.

Each member of the Court joined Justice Kagan's majority opinion in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, Case No. 15-1439 (S.Ct. Decided March 20, 2018) which relied solely on the statutory text in construing a section of SLUSA, the Securities Litigation Uniform Standards Act. Viewed in this context, if *Varjabedian* reaches the High Court – and it might given the clear circuit split – it may well be affirmed – but without any references to the legislative materials.