PUBLICATIONS

The Supreme Court and Securities Litigation: Emulex

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The Supreme Court may reshape SEC Enforcement by the end of this Term. The Court has already heard argument in *Lorenzo v. SEC*, No. 17-1077 where the critical issue is the scope of primary liability under Exchange Act section 10(b). That case is discussed here and was analyzed at the Fifth Annual Federal Enforcement Forum here.

Argument later this year will be held in *Emulex Corp. v. Varjabedian*, No. 18-459. There the key question is whether Exchange Act section 14(e) provides a negligence-based cause of action for damages.

Emulex

The issue for resolution centers on whether one component of section 14(e) imposes a negligence standard rather than scienter. The section provides in pertinent part that: "It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact . . . or to engage in any fraudulent, deceptive or manipulative act . . ." in connection with any tender offer.

Petitioner (defendant below) phrased the issue for resolution this way: "Whether the Ninth Circuit held, in express disagreement with five other courts of appeals, that Section 14(e). . . supports an inferred private right of action based on a negligent misstatement or omission made in connection with a tender offer."

Respondent (plaintiff below) phased the issue for resolution differently: ""Section 14(e) . . . sets out two distinct forms of liability . . ." one for materially untrue statements and a second for manipulative or deceptive devices. "The question presented is: Whether an action premised solely on section 14(e)'s first clause, not its second, requires a pleading of scienter to state a claim." Neither party specifically presented the question of whether a cause of action for damages could be implied under the section.

Background

The action is based on the merger of two technology companies. One is Emulex, a producer of equipment for data centers. The other is Avago Technologies Wireless (USA), a leading designer and developer of analog semiconductor devices. The two firms jointly announced the merger on February 25, 2015. Under the terms of the deal $8 would be offered for each outstanding share of Emlex stock, a 26.4% premium to the stock closing price the day before the announcement.

The deal papers included the standard recommendations from the firm and a fairness opinion. A table compiled by Goldman Sachs, adviser to Emulex, was known as the Premium Analysis. According to Petitioner, that Table showed that "the 26.4% premium on the share price. . . was within the range of transaction premiums identified in these unrelated semiconductor transactions . . ." Respondents state that the "analysis revealed Emulex's premium was decidedly below average . . ." Shareholders narrowly approved the transaction. This suit followed.

The district court dismissed the amended complaint with prejudice. The court rejected plaintiff's claim that a negligence standard applied. The Ninth Circuit Court reversed. After noting that five circuit courts had adopted a scienter-based standard for section 14(e) private suits, the Court remanded the action to the district court for further consideration.

Petitioners

Petitioners' (Defendants below) argument is built on three basic points: First, the Circuit Court's decision contradicts the uniform judgment of every circuit which has considered the question. Second, the Circuit Court's decision is wrong as a matter of law. Finally, the question presented here is of "exceptional importance."

First, each Circuit Court which has considered the question agrees that section 14(e), like section 10(b), requires proof of scienter, not negligence. The first was the Second Circuit in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F. 2d 341 (2nd Cir. 1973). There the Court noted the similarity of language between the two Exchange Act sections and concluded that negligence is not sufficient to contravene the provision. Subsequently, the Fifth, Sixth, Eight and Eleventh Circuit reached similar conclusions. *Smallwood v. Pearl Brewing Co.*, 489 F. 2d 579, 606 (5th Circ. 1974); *Adams v. Standard Knitting Mills, Inc.*, 623 F. 2d 422 431 (6th Cir. 1980); *In re Digital Island Securities Litigation*, 357 F. 3d 322 (3rd Cir. 2004); *SEC v. Ginsburg*, 362 F. 3d 1292, 1297 (11th Cir. 2002). While the Ninth Circuit recognized this fact, the Court concluded that the analysis of each Circuit was incorrect and not in accord with that of the Supreme Court's decisions in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) and *Aaron v. SEC*, 446 U.S. 680 (1980).

Second, the decision of the lower court is incorrect because it "upsets" the statutory scheme enacted by Congress. The 1933 and 1934 Acts "constitute interrelated components of the federal regulatory scheme governing transactions in securities," according to Petitioner. When Congress created express causes of action imposing civil liability it added significant procedural restrictions such as a short statute of limitations and a bonding requirement for defendant's costs and attorney's fees.

The same should be true here if there was a negligence-based claim which there is not. When the Supreme Court acquiesced and accepted the implied cause of action under section 10(b), it focused on the overall thrust of the statute and statutory words such as "fraudulent," "deceptive, and "manipulative" which connote scienter, not negligence. The Court also noted that where Congress enacted civil remedies based on negligence there were significant procedural restrictions. Here the statutory language suggests scienter and the procedural restrictions necessary for negligence are absent.

Finally, the question presented in this case is "undeniably important and one that warrants this Court's review," Petitioner told the High Court. The proper administration of the federal securities laws is critical to the effective functioning of the capital markets. Even before the decision in this case the Ninth Circuit was a "magnet" for securities litigation. That highlights the important of employing the correct standard in securities litigation. Indeed, Judge Friendly observed in *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2nd Cir. 1968) that the consequences of implying a cause of action based on negligent misstatements or omission in a securities filing are "frightening." The decision to adopt such a standard in this case is thus seriously misguided and should be rejected.

Respondents

Respondents brief is the reverse mirror image of Petitioners'. It is built on three key points: First, there is no circuit split. Second, the decision below is correct. Third the petition does not warrant consideration by the Court.

First, there is no circuit split on the on the standard of conduct required to violate the first clause of section 14(e): "Contrary to petitioners' contention, the Ninth Circuit did not create a genuine circuit conflict. Petitioners cannot identify a single circuit actually deciding the issue after analyzing Section 14(e)'s *first* clause, especially in a case post-dating this Court's authoritative decisions." (emphasis original). Respondents then dissect each case cited by Petitioners in an effort to demonstrate that none properly considered the language in the first part of the statute in view of *Hochfelder and Aaron*:

- Second Circuit in *Chris-Craft Industries*: The case predates the Supreme Court's decisions in *Hochfelder and Aaron*;
- Fifth Circuit in *Smallwood*: This case also predates the key Supreme Court cases;
- Sixth Circuit in *Standard Knitting Mills*: This decision is based on sections 10(b) and 14(a) but not 14(e).
- Third Circuit in *In re Digital Island*: In this case the issue regarding the applicable standard for section 14(e) was conceded by both parties – not decided by the court; and
- Eleventh Circuit in *SEC v. Ginsburg*: This is an insider trading case – the critical issue is not presented here.

Second, the question regarding the applicable standard should be governed by the plain language of the first clause in the section. Virtually the identical language regarding misstatements and omissions was considered by the Court in *Hochfelder and Aaron*. In each case the Court concluded that the plain text of the provision – either rule 10b-5 or Securities Act sections 17(a)(2) and (3) reflected a negligence standard. For section 10(b) the words of the statute however controlled the broader language of rule 10b-5, mandating a scienter standard. That was not true in the case of Securities Act section 17(a). Here the same should be true – the plain text of the statute should govern. That mandates a negligence standard for the first clause.

The claim by Petitioner that the statute must be read in its totality, rather than evaluated clause by clause should be rejected. There is simply no reason to ignore the first clause of the section.

Finally, the question presented here is clearly not of import. Not only is there no Circuit split, in view of the Court's prior cases there is more than adequate guidance for the lower courts. This counsels permitting the issue to be considered and developed by those courts.

The effort by Petitioners to "obliquely suggest the Court should grant review on a question the Ninth Circuit did *not* decide: whether Section 14(e) provides a private right of action at all should be rejected." (emphasis original). That issue was not presented or considered by the lower courts. It has not been presented here.

Comment

In granting *certiorari* in *Emulex* the Supreme Court has set the stage significantly impacting SEC enforcement and securities litigation. The issues presented by *Lorenzo* and *Emulex* each turn on a question of statutory interpretation – the scope of primary liability for the former and the state of mind requirement for the latter. The question in each case centers on an issue that will impact the scope of a cause of action in an SEC enforcement action and a private damage action.

Nevertheless, the collective impact of these cases may be negligible. At oral argument the High Court showed little appetite for rewriting the scope of primary liability under section 10(b). To the contrary, the Court seemed much more inclined to reaffirm its earlier decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) which held that the text of the statute governs the scope of a cause of action under the section. Such a holding could give the SEC its first supreme court win in some time and permit the agency to continue using the approach to section 10(b) it has employed for years.

Finally, *Emulex* could be resolved by finding that there is no implied cause of action under section 14(e). While this issue has not been specifically presented by either party, it is in fact subsumed within the claim both parties agree has been properly presented. Such a ruling would not only be consistent with the Court's apparent disdain for implied causes of action but its growing conservative tilt. The end result of *Lorenzo* and *Emulex*, viewed in this context, may well be the status quo.