

October 2019

Section 14(e)'s Culpability Requirement: *Scienter v. Negligence*

Edward Rivin

University of Cincinnati, rivinei@mail.uc.edu

Follow this and additional works at: <https://scholarship.law.uc.edu/uclr>

Recommended Citation

Edward Rivin, *Section 14(e)'s Culpability Requirement: *Scienter v. Negligence**, 88 U. Cin. L. Rev. 289 (2019)
Available at: <https://scholarship.law.uc.edu/uclr/vol88/iss1/8>

This Student Notes and Comments is brought to you for free and open access by University of Cincinnati College of Law Scholarship and Publications. It has been accepted for inclusion in University of Cincinnati Law Review by an authorized editor of University of Cincinnati College of Law Scholarship and Publications. For more information, please contact ronald.jones@uc.edu.

SECTION 14(E)'S CULPABILITY REQUIREMENT: SCIENTER V. NEGLIGENCE

Edward Rivin

I. INTRODUCTION

A long-standing and important feature of America's free, open and relatively democratic capital markets is the ability of individuals to invest in publicly traded companies. Although a public company's management handles the company's day-to-day operations and the board of directors makes the company's major strategic decisions, the shareholders of a public company, as a group, are the real owners of the entity and its ultimate decision-makers. That being said, being a shareholder comes with certain rights and obligations that create a special relationship between public companies and their shareholder-investors.

Arguably the most fundamental power that shareholders have is the ability to sell their shares; knowing when to do so has tremendous effect on whether a shareholder's investment is profitable or not. Usually, shareholders' best opportunity to sell their shares for a high price is in a change of control transaction.¹ One common way a potential offeror can present a change of control transaction directly to a target company's shareholders is through a tender offer.² In this situation, it is a shareholder's decision whether to sell his or her shares for the offered price. Needless to say, having all of the material information³ when making the decision whether to accept a tender offer is critical to a shareholder's decision to accept or reject the offer.

The Securities Exchange Act of 1934 ("The Exchange Act") and the Securities and Exchange Commission ("SEC") more generally are the main federal sources of authority and regulation when it comes to

1. See the SEC's "Change in Control Agreement" for a full definition of a "change of control transaction." SEC. AND EXCH. COMM'N., CHANGE IN CONTROL AGREEMENT, <https://www.sec.gov/Archives/edgar/data/1283699/000119312510182910/dex102.htm> (last visited Mar. 8, 2019) (A "change of control transaction" is generally defined by the SEC to mean one of the following: "(i) A "change in the ownership of the Company" . . . (ii) A "merger of the Company" . . . (iii) A "change in the effective control of the Company" . . . or (iv) A "change in the ownership of a substantial portion of the Company's assets" . . .").

2. *Id.*

3. See *Tsc Indus. v. Northway*, 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available").

protecting the rights of shareholders during a tender offer process.⁴ Section 14(e) of the Exchange Act (“Section 14(e)”) was promulgated to ensure that shareholders have all of the necessary information to make the decision of whether to sell their shares for the offered price in the tender offer.⁵ Specifically, Section 14(e) protects shareholders from being materially misled when making said decision.⁶

When a shareholder feels that she was materially misled by the offeror in such a way that she was deceived into selling her shares for an insufficient price, that shareholder has a private right of action under Section 14(e) of the Exchange Act against either (1) the offeror or (2) corporation who issued a 14D-9 recommendation (hereafter collectively referred to as the “offeror”).⁷

While much of Section 14(e)’s statutory language has been litigated and settled, as is discussed in Part II of this Note, some of Section 14(e)’s requirements are not harmonized across the United States Circuits. Within Section 14(e)-based litigation, the Circuit Courts of Appeal are divided as to whether Section 14(e) requires the plaintiff shareholder class to prove that the offeror acted with scienter⁸ in materially misleading the shareholders or whether the shareholder class needs only to prove that the offeror acted negligently in misstating or omitting material information. As will be discussed in Part III, the standard a federal circuit chooses to apply will have a profound effect of Section 14(e)-based litigation within that jurisdiction.

This Note reviews the two possible burdens⁹ and why various circuits have opted to implement the burdens that they have chosen. Part II outlines Section 14(e) and explains its history and underlying purpose. In addition, Part II examines the previous rulings of various federal Circuit

4. See Legal Information Institute, *Securities Exchange Act of 1934* (last visited Sep. 19, 2019), https://www.law.cornell.edu/wex/securities_exchange_act_of_1934#targetText=General,on%20which%20securities%20are%20sold (“To protect investors, Congress crafted a mandatory disclosure process designed to force companies to disclose information that investors would find pertinent to making investment decisions. In addition, the Exchange Act regulates the exchanges on which securities are sold.”); See also SEC. AND EXCH. COMM’N, *What We Do* (last visited Sep. 19, 2019), <https://www.sec.gov/Article/whatwedo.html> (“The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”).

5. See *infra* Section II(A)-(B).

6. *Id.*

7. See *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (holding that private rights of action are a “necessary supplement” to the Exchange Act and that “the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement” of the Exchange Act).

8. In its opinion in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, n. 12 (1976), the United States Supreme Court used the term scienter to refer to “a mental state embracing intent to deceive, manipulate, or defraud.” Hence, it can be argued that the term “scienter” means something “more than simple negligence.”

9. The two possible burdens being scienter and negligence.

Courts on this issue as well as the progression of the Section 14(e) analysis over the span of the previous fifty years. Part II also discusses relevant United States Supreme Court cases and dissects the most recent decision in this area of law: the Ninth Circuit's decision in *Varjabedian v. Emulex Corporation*.¹⁰ Part III compares the scienter and negligence standards and discusses the practical implications of each standard, respectively. Part IV dissects Section 14(e) using various regulatory interpretation mechanisms. Then, Part V explains why the Second, Third, Fifth, Sixth, and Eleventh Circuits' imposition of a scienter requirement is correct and should have been adopted by the United States Supreme Court in *Varjabedian v. Emulex Corporation*. Finally, Part V explains why all public companies in America should hope that the Court grants another petition for certiorari on this issue and rules that the scienter requirement is the appropriate standard within Section 14(e)-based litigation.

II. BACKGROUND

This Part provides an introduction to Section 14(e) and its purpose within the Exchange Act. This Part then provides a short description of the progression of how Section 14(e) has been treated by the United States courts by discussing relevant precedents from both Circuit Courts and the United States Supreme Court.

A. Section 14(e) Generally

The Securities Act of 1933 and the Exchange Act¹¹ are the two federal securities laws that have the most influence on communication between public companies and their shareholders. The Acts were promulgated for the purposes of governing securities transactions and ensuring transparency and accuracy in the financial markets.¹² 15 U.S.C.S. § 78n(e), commonly referred to as Section 14(e) of the Exchange Act, was added to the Exchange Act by Congress “for the purpose of regulating the conduct of a broad range of players who could influence the outcome of a tender offer.”¹³

10. *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018).

11. Codified at 15 U.S.C.S. §§ 78a-78qq.

12. See generally *The Laws That Govern the Securities Industry*, Securities Exchange Commission, (last visited Sep. 19, 2019), <https://www.sec.gov/answers/about-lawsshtml.html>.

13. *Varjabedian v. Emulex Corp.*, 888 F.3d 399 at 404.

B. Section 14(e)'s Purpose

A tender offer is a high profile transaction that has been deemed necessary for regulation because it is one of two common ways of effectuating a change of control transaction.¹⁴ The second common way of effectuating a change of control transaction is through a merger that that shareholders approve. However, that merger is governed by the Exchange Act's proxy rules and therefore beyond the scope of this Article.

There are two common ways that an offeror solicits the company's shareholders. The first route is through having the company file a Schedule 14D-9 recommendation with the SEC.¹⁵ The Schedule 14D-9 recommendation is the step that wraps up the negotiations between the company and the third party seeking to acquire the company's shares.¹⁶ Once the company is satisfied with the negotiated price per share, it will issue a Schedule 14D-9 recommendation statement with the SEC that supports the tender offer and recommends that its shareholders sell their shares for the offered price, which is usually at a premium. The second, more hostile, route of effectuating a tender offer is through a so called "hostile" or "unsolicited" offer.¹⁷ This route is chosen by a third party offeror when it either does not succeed in negotiations with the board or chooses not to negotiate with the board and elects to appeal directly to the shareholders.¹⁸

Regardless of which route an offeror elects to take, the shareholders being solicited are entitled to all material information needed to make a decision to sell their interest.¹⁹ Section 14(e) serves to protect shareholders in tender offers. Specifically, Section 14(e) requires that offerors make their offerings and supporting documents not materially

14. *Supra* note 1.

15. *See generally* SEC. AND EXCH. COMM'N, § 240.14d-9, *Authenticated U.S. Government Information*, GPO (last visited Nov. 14, 2018), <https://www.gpo.gov/fdsys/pkg/CFR-2016-title17-vol14/pdf/CFR-2016-title17-vol14-sec240-14d-9.pdf>.

16. *Schedule 14D-9*, INVESTOPEDIA (last visited Nov. 14, 2018), <https://www.investopedia.com/terms/s/schedule14d-9.asp#ixzz5PrZrwBgr> (stating that "a tender offer is a public offer to buy some or all of the shares in a corporation from the existing shareholders. The SEC's definition: 'a broad solicitation by a company or third party to purchase a substantial percentage of a company's Section 12 registered equity shares or units for a limited period of time. The offer is at a fixed price, usually at a premium over the current market price, and is customarily contingent on shareholders tendering a fixed number of shares or units'").

17. *See generally Hostile Takeover*, INVESTOPEDIA (last visited Mar. 8, 2019), <https://www.investopedia.com/terms/h/hostiletakeover.asp> (stating that a hostile offer "occurs when an entity attempts to take control of a firm without the consent or cooperation of the target company's board of directors. In lieu of the target company's board approval, the would-be acquirer may then issue a tender offer," or use other means to take control of the majority of the company's shares).

18. *Id.*

19. *See Tsc Indus. v. Northway*, 426 U.S. 438, 449 (1976).

misleading in light of the circumstances under which they are made.²⁰ Hence, Section 14(e) imposes an obligation on an offeror to provide all material information necessary to ensure the shareholders presented with the offer have all of the material information to make a fully informed decision.²¹

C. The Text of Section 14(e)

While many of the SEC's rules and regulations have clarity, others are subject to various interpretations and have been long debated. Section 14(e) is one such rule. In relevant part, Section 14(e) states:

Untrue statement of material fact or omission of fact with respect to tender offer. It shall be unlawful for any person [1] 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 or [2] to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation²²

Although various uncertainties of Section 14(e) have been debated and resolved,²³ one unsettled debate concerns the culpability requirement under the Section. Specifically, the question is: under Section 14(e), must the plaintiff shareholder class prove that the alleged violation was done with scienter²⁴ or whether the class merely has to prove negligence on the part of the corporation. As will be discussed in Part III, the practical implications of these standards are massive.

D. Approaches Adopted by the United States Circuits

There is a split among the United States federal courts as to which culpability standard is appropriate under Section 14(e). Currently, the

20. 15 U.S.C. § 78n(e).

21. *Id.*

22. *Id.* (emphasis added).

23. *See generally* Commonwealth Oil Ref. Co. v. Tesoro Petroleum Corp., 394 F. Supp. 267, 274 (S.D.N.Y. 1975). Whether the incorrect or omitted facts in a tender offer need to be material in order to sustain a Section 14(e) claim has been debated and resolved. The court in *Commonwealth* held that the omission of information in a tender offer does not in itself violate Section 14(e); rather, the misstated or omitted facts must also be material which depends upon whether reasonable investor might have considered them important in deciding whether to accept tender offer. *Id.*

24. *See generally* *Scienter*, The Free Dictionary (last visited Nov. 14, 2018), <https://legal-dictionary.thefreedictionary.com/scienter> (defining scienter as a state of mind often required to hold a person legally accountable for her acts).

Second,²⁵ Third,²⁶ Fifth,²⁷ Sixth,²⁸ and Eleventh²⁹ Circuits all hold that, although not explicitly stated, a scienter requirement is present within Section 14(e). On the other hand, a recent 2018 opinion from the Ninth Circuit expressly parted from this interpretation and held that negligence, not scienter, is the appropriate culpability requirement in Section 14(e)-based litigation.³⁰ As will be described in the following subsections, the reasoning behind each side of the circuit split is founded on Section 14(e)'s legislative history, analogies to other similarly written rules such as Rule 10b-5, and the United States Supreme Court's interpretations of similar rules and legislations.

1. The 1970s

The 1970s brought the first major cases to developed Section 14(e) jurisprudence. *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*³¹ has been cited as the seminal case in Section 14(e) jurisprudence. In *Chris-Craft*, the Second Circuit analogized the language in Section 14(e) to the virtually identical language of Rule 10b-5.³² Rule 10b-5 reads as follows:

[i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.³³

The court noted that because of the parallel language and legislative

25. See *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973).

26. See *In re Dig. Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004).

27. See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 605 (5th Cir. 1974); see also *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*, 565 F.3d 200, 207 (5th Cir. 2009).

28. See *Adams v. Standard Knitting Mills*, 623 F.2d 422, 430 (6th Cir. 1980).

29. See *U.S. SEC v. Ginsburg*, 362 F.3d 1292, 1297 (11th Cir. 2004).

30. See *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018); see also *Negligence*. Law.com (last visited Nov. 14, 2018), <https://dictionary.law.com/Default.aspx?selected=1314> (defining negligence as the failure to exercise the care toward others which a reasonable or prudent person or company would do in the circumstances).

31. See *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973).

32. *Id.* at 362.

33. 17 C.F.R. § 240.10b-5.

intent behind Rule 10b-5 and 14(e), when determining whether there has been a violation of Section 14(e), the court will “follow the principles developed under Rule 10b-5 regarding the elements of such violations” to adjudicate Section 14(e) claims.³⁴ The court further examined that the only notable difference between the text of Section 14(e) and Rule 10b-5 is that Rule 10b-5 applies only to the purchase or sale of a security while Section 14(e) is also applicable to tender offers.³⁵ Because of the virtually indistinguishable language of the two sections, the Second Circuit concluded that scienter is the culpability required under Section 14(e) just like it is required by Rule 10b-5.³⁶ In essence, the Second Circuit used a purely textual approach to conclude that Section 14(e) requires a showing of scienter.

In its decision, the Second Circuit made strong reference to Senate Report No. 510 that accompanied Section 14 when it was originally proposed.³⁷ In regard to subsection (e) of Section 14, the Senate Report stated that:

[p]roposed subsection (e) would prohibit any misstatement or omission of a material fact, or any fraudulent or manipulative acts or practices, in connection with any tender offer, whether for cash, securities or other consideration, or in connection with any solicitation of security holders in opposition to or in favor of any tender offer. This provision would affirm the fact that persons engaged in making or opposing tender offers or otherwise seeking to influence the decision of investors or the outcome of the tender offer are under an obligation to make full disclosure of material information to those with whom they deal.³⁸

Based on this Senate Report, the Second Circuit reasoned that the legislative intent behind the addition of Section 14(e) to the Exchange Act was to make applicable to a tender offer the antifraud proscriptions of the federal securities laws.³⁹ Following that reasoning, Section 14(e) must include a scienter component. In 1974, the Fifth Circuit endorsed the Second Circuit's view that Section 14(e) was substantially identical, both in language and in legislative history, to Rule 10b-5 and therefore also

34. *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 at 362.

35. *Id.*

36. *Id.* (the Court concluded that “[i]n determining whether § 14(e) violations were committed ... we shall follow the principles developed under Rule 10b-5 regarding the elements of such violations. In short, we hold that a violation of § 14(e) is shown when there has been a *material misstatement or omission concerned with a tender offer* and when such misstatement or omission was *sufficiently culpable* to justify granting relief to the injured party. The key concepts in this formulation are materiality and culpability.”) (emphasis added).

37. *Id.* at 358 (citing S. Rep. No. 510, 90th Cong., 2d Sess. (1968)).

38. *Id.*

39. *Id.* Rule 10b-5 is a powerful antifraud provision.

required scienter.⁴⁰ Since the 1970s, the Third, Sixth, and Eleventh Circuits have all adopted a scienter requirement for the same reasons.⁴¹

2. The United States Supreme Court Interprets Similar SEC Rules

While the United States Supreme Court has not yet directly ruled on a case involving Section 14(e)'s culpability requirement, the Court has issued opinions on cases involving similar SEC Rules that are useful to consider. The Court heard *Ernst & Ernst v. Hochfelder*⁴² and *Aaron v. SEC*⁴³ in 1976 and 1980, respectively. The central issues in those cases were whether two SEC provisions, Rule 10b-5 and § 17, required a showing of scienter. Both of these Rules contain substantially similar language to Section 14(e) and are therefore useful in Section 14(e)'s culpability analysis.

In *Ernst & Ernst*, the Supreme Court agreed that Rule 10b-5 required proof of scienter. The Court approached the Rule from a strictly textualist analysis. It noted that "the words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10b was intended to proscribe knowing or intentional misconduct."⁴⁴ In rejecting the SEC's argument that mere negligence was the burden of proof placed upon a plaintiff shareholder class, the Supreme Court stated that

[this] argument simply ignores the use of the words "manipulative," "device," and "contrivance" - terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.⁴⁵

Throughout its purely textual analysis of Rule 10b-5, the Court did not expressly reject the possibility of using Rule 10b-5's legislative history as another supportive factor in reaching the conclusion that Rule 10b-5 required scienter.⁴⁶ Hence, the Court's approach does not reject the

40. See *Smallwood v. Pearl Brewing Co.*, 489 F.2d at 605 (stating "[the Fifth Circuit is] in accord with the Second Circuit that the same elements must be proved to establish a violation of either [Rule 10b-5 or Section 14(e)] . . . Congress adopted in Section 14(e) the substantive language of the second paragraph of Rule 10b-5 and in so doing accepted the precedential baggage those words have carried over the years").

41. See e.g. *In re Dig. Island Sec. Litig.*, 357 F.3d at 328; *Adams v. Standard Knitting Mills*, 623 F.2d at 430; *U.S. SEC v. Ginsburg*, 362 F.3d at 1297.

42. 425 U.S. 185 (1976).

43. 446 U.S. 680 (1980).

44. *Ernst & Ernst*, 425 U.S. 185 at 197.

45. *Id.* at 199.

46. See generally *id.* at 185.

approach taken by the Second Circuit's in analyzing Section 14(e)'s culpability requirement in *Chris-Craft Industries*. In fact, in *Ernst*, Rule 10b-5's legislative history impacted the court's textual analysis. In addition to the reasoning above, in rejecting the SEC's argument that Rule 10b-5 requires only a showing of negligence, the Court stated that while a textual analysis that isolated subsections (b) and (c) may only require a showing of negligence, "such a reading cannot be harmonized with the administrative history of the Rule, a history making clear that when the Commission adopted the Rule it was intended to apply only to activities that involved scienter."⁴⁷ This led to the Court reading the statute as a whole and not as disjunctive parts; consequently, the entire Rule was deemed to require scienter culpability. Hence, while the Supreme Court adjudicated *Ernst & Ernst* mostly on textualist grounds, it is clear that the Court also considered the legislative history of Rule 10b-5.

In *Aaron v. SEC*,⁴⁸ the United States Supreme Court analyzed SEC Rule 10b-5 as well as § 17 (a) of the Securities Act of 1933.⁴⁹ Using a similar textual and legislative analysis as the Court did in *Ernst & Ernst*,⁵⁰ the Court once again concluded that Rule 10b-5 required a showing of scienter.⁵¹ In *Aaron*, the Court took a novel, disjunctive textual approach in analyzing § 17(a) of the Securities Act of 1933.⁵² After a short analysis of the text of § 17 (a)(1), the Court concluded that the section clearly required scienter because the language "to employ any device, scheme, or artifice to defraud," plainly evidences an intent on the part of Congress to proscribe only knowing or intentional misconduct."⁵³ In contrast, when read in isolation, the language of § 17(a)(2), which prohibits any person from obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact"⁵⁴ is "devoid of any

47. *Id.* at 212.

48. 446 U.S. 680 (1980).

49. § 17 is codified at 15 U.S.C.S. § 77q(a).

50. 425 U.S. 185 (1976).

51. 446 U.S. 680 (1980).

52. *Id.* at 695 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 at 214, for the proposition that "if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary 'to examine the additional considerations of "policy" . . . that may have influenced the lawmakers in their formulation of the statute'").

53. *Id.* at 696; *see also* § 17(a)(1) which reads, in its entirety, as follows:

It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud

(2) . . .

54. § 17(a)(2) which reads, in its entirety, as follows:

suggestion whatsoever of a scienter requirement.”⁵⁵ Despite arguments from the parties that urged the Court to adopt a uniform culpability requirement for the totality of § 17(a), the Court concluded that § 17(a) requires scienter under § 17(a)(1) but not under § 17(a)(2) due to the material differences between the language used in the subparagraph.⁵⁶

3. The Effect of the Supreme Court’s Decisions

In the wake of *Ernst & Ernst*⁵⁷ and *Aaron*,⁵⁸ the majority of Circuit Courts, relying on their respective case law, continued to hold that Section 14(e) requires a showing of scienter.⁵⁹ Ultimately, these Circuit Courts interpreted *Ernst & Ernst* and *Aaron* as confirming their approaches to read Section 14(e) to require proof of scienter because neither *Ernst & Ernst* nor *Aaron* rejected their approach to analyzing the text of Section 14(e).

Most recently, however, the Ninth Circuit expressly parted from this view and held instead that the Supreme Court’s decisions in *Ernst & Ernst* and *Aaron* support the opposite conclusion—that the culpability requirement encompassed within Section 14(e) is merely negligence, not scienter.⁶⁰ The foundation for this conclusion was the Supreme Court’s holding in *Aaron* that recognized that, where an SEC Rule is clearly

It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

(1) . . .

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading

(3) . . .

55. See *Aaron v. SEC*, 446 U.S. 680 at 696.

56. See *id.* at 697 (stating “[i]t is our view, in sum, that the language of § 17 (a) requires scienter under § 17 (a)(1), but not under § 17 (a)(2) or § 17 (a)(3). Although the parties have urged the Court to adopt a uniform culpability requirement for the three subparagraphs of § 17 (a), the language of the section is simply not amenable to such an interpretation.”).

57. 425 U.S. 185 (1976).

58. 446 U.S. 680 (1980).

59. See *Conn. Nat’l Bank v. Fluor Corp.*, 808 F.2d 957, 961 (2d Cir. 1987) (citing *Chris-Craft Industries* for the proposition that “[i]t is well settled in this Circuit that scienter is a necessary element of a claim for damages under § 14(e) of the Williams Act”); see also *In re Dig. Island Sec. Litig.*, 357 F.3d 322 at 328 (citing *Conn. Nat’l Bank* and *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 605 (5th Cir. 1974) to hold “[w]e . . . join those circuits that hold that scienter is an element of a Section 14(e) claim”); see also *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*, 565 F.3d 200 at 207 (citing *Smallwood v. Pearl Brewing Co.* for the conclude that “[t]he elements of a claim under Section 14(e) . . . are identical to the Rule 10b-5 elements.”).

60. *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018).

disjunctive,⁶¹ it is possible for one of its subparts to require a showing of mere negligence even though other subparts of the same Rule may require scienter.⁶² Using this disjunctive analysis, the Ninth Circuit split the first sentence of Section 14(e) into its two natural parts.⁶³ As a result, the first subpart read:

[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 . . .⁶⁴

The second subpart read:

[It shall be unlawful for any person] to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . .⁶⁵

After splitting Section 14(e) into these parts, the Ninth Circuit noted that “*Ernst & Ernst* explains that where Congress prohibited ‘fraudulent’ or ‘deceptive’ practices—as in the second subpart of Section 14(e)—a heightened showing of culpability is required.”⁶⁶ The Court proceeded to explain that, by the same token, *Ernst & Ernst* stands for the proposition that “[w]here Congress used language banning untrue statements of material fact (or the omission of a material fact necessary to make a statement not misleading), a lesser showing of culpability will suffice.”⁶⁷ Relying on *Aaron*’s disjunctive analysis, the Ninth Circuit concluded that “[o]nly the second clause of § 14(e) contemplates a scienter requirement [because] Congress did not use the words signaling a heightened standard of culpability in the first clause of the statute.”⁶⁸ Consequently, the Ninth Circuit concluded that a suit filed under Section 14(e)’s first subpart requires a showing of mere negligence and not scienter whereas a suit brought under the second subpart of Section 14(e) does require a showing

61. *Id.* (Christen, J., concurring) at 412 (stating that an SEC Rule that is disjunctive—as shown through the use of distinct clauses separated by a disjunctive “or”—can encompass more than one culpability standard).

62. *Id.* (the Ninth Circuit cites to *Aaron* and states: “The similarities between the statute discussed in *Aaron*, § 17(a), and the statute at issue [in *Varjabedian*], § 14(e), are striking: both statutes include distinct clauses separated by a disjunctive ‘or,’ with one clause containing terms that plainly proscribe more culpable conduct by using terms like ‘fraudulent,’ ‘deceptive,’ ‘device,’ or ‘artifice.’ And both statutes have a separate clause more expansively prohibiting ‘untrue statement[s] of a material fact.’ See 15 U.S.C. §§ 77q(a), 78n(e). Because *Aaron* held that § 17(a)’s two clauses require different degrees of culpability, it strongly suggests the same is true of the two very different clauses in § 14(e).”).

63. *Id.* at 404.

64. *Id.*

65. *Id.*

66. *Id.* at 411.

67. *Id.*

68. *Id.* at 411-412.

of scienter.⁶⁹

III. WHY DOES IT MATTER?

Forum shopping is a common strategy in litigation because it allows the plaintiff to pick a court where the law is most favorable to its case. The venue rules within the Exchange Act are relaxed, which consequently means that forum shopping is an ever-present reality in federal securities litigation.⁷⁰ What exactly do attorneys seek in the perfect forum? Many factors weigh on an attorney's decision of where to file suit.

A partial list of reasons that could affect where an attorney elects to file suit includes: (1) a favorable jury pool, (2) a pool of judges that have been favorable to the party's position in previous cases, or (3) ease of access to crucial evidence or witnesses.⁷¹ On the other hand, there are often factors that are consistent throughout all jurisdictions and therefore are not considerations in the forum-shopping analysis. For example, within the arena of Section 14(e)-based litigation, regardless of where suit is brought, the plaintiff shareholder class will always be required to at least (1) meet the Rule 23 criteria⁷² in certifying its class of plaintiffs and (2) prove that the misstated or omitted facts in question were indeed material to the plaintiffs' decisions to sell their shares.⁷³ The listed factors are merely a few of the possible considerations in a plaintiff attorney forum shopping analysis.

With all of this complexity, one important question remains: is there one consideration that significantly outweighs the rest and would essentially force a plaintiffs' attorney representing a class of shareholders to strategically file a case in one Federal District instead of another? That consideration is favorable case law.

Prior to the Ninth Circuit's decision in *Varjabedian*,⁷⁴ the case law

69. *Id.*

70. 15 U.S.C.S. § 78aa (“... Any suit or action to enforce any liability or duty created by this title [15 USCS §§ 78a et seq.] or rules and regulations thereunder, or to enjoin any violation of such title [15 USCS §§ 78a et seq.] or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.”).

71. *Forum Shopping*, USLegal (last visited Nov. 14, 2018), <https://civilprocedure.uslegal.com/jurisdiction/forum-non-conveniens-and-forum-shopping/forum-shopping/>.

72. *See* FED.R.CIV.P. 23 (Rule 23 provides the criteria that a class of litigants must meet in order to be certified as a class. The criteria is widely known as imposing a rigorous burden upon the class. Rule 23 requires that the class meet all requirements of Rule 23(a) and at least one of the requirements within 23(b)).

73. *See* Commonwealth Oil Ref. Co. v. Tesoro Petroleum Corp., 394 F. Supp. 267, 274 (S.D.N.Y. 1975).

74. *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018).

relating to Section 14(e)'s culpability requirement was similar across the United States Circuits. Due to the consistent application of the scienter requirement across the nation, the existence of a favorable case law in one particular Federal Circuit had no bearing on plaintiffs' attorneys' forum-shopping analysis within Section 14(e)-based litigation. But now, the Ninth Circuit has added an overpowering consideration into the forum shopping analysis that has essentially created a de facto national standard, causing the Ninth Circuit to serve as a magnet for Section 14(e)-based federal securities litigation.⁷⁵ As with any action grounded on the Exchange Act, the plaintiff shareholder class bears the burden of proving each element of Section 14(e). By not reading a scienter requirement into the first clause of Section 14(e), the Ninth Circuit significantly lightened the burden to be carried by plaintiff classes in future securities litigation founded on Section 14(e).

But how has the burden been lightened? Comparing the two eligible standards makes this patently clear. The first option: the burden of proving that the offeror acted with scienter.⁷⁶ This burden requires a plaintiff class of shareholders to prove beyond a preponderance of the evidence that the offeror, at the time of issuing its recommendation to tender, intentionally or knowingly issued said recommendation with material falsities or omissions.⁷⁷ The second option: the burden of proving that the offeror acted negligently.⁷⁸ To prove negligence, all that is required is to prove that the offeror should have known that its statements were false or misleading.⁷⁹

In essence, the Ninth Circuit's parting decision has provided a tremendous incentive to file Section 14(e)-based litigation in the Ninth Circuit. This decision along with the relaxed venue rules involved in federal securities litigation combines all of the questions and strategies involved in forum shopping into one simple question: how in the world

75. *Emulex Corp. v. Varjabedian*, No. 18-459, 2018 U.S. S. Ct. Briefs LEXIS 3733, at *10 (Oct. 5, 2018) (Petition for Writ of Certiorari) (discussing how the Ninth Circuit's decision created a de facto national standard because all strategic plaintiffs' attorneys will see that Circuit as a "magnet" for Section 14(e)-based litigation because of the lessened requirements).

76. *Scienter*, Legal Dictionary (last visited Nov. 14, 2018), <https://legaldictionary.net/scienter/> (describing scienter as "[referring] to a [offeror's] mental state at the time [it] allegedly committed a crime"); see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 at 534-536 ("Scienter is a confusing word because its most natural meaning—and the one often associated with it—is knowledge. But the term is used, at least in the area of securities fraud, to mean simply level of fault. A statement like "scienter is required for liability" often is meant to do no more than rule out strict liability. In this form, scienter stands for a full menu of choices on the matter of awareness: knowledge, knowledge plus willful blindness, recklessness, gross negligence, or negligence.").

77. *Id.*

78. *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018).

79. See *The SEC's Negligence Standard: What Is It, and What Does It Mean?* (last visited February 23, 2019), <https://www.lexology.com/library/detail.aspx?g=0d636648-8867-44b8-b21f-78b7748d28b4> (citing *SEC v. Steffelin*, No. 11-cv-4204 (S.D.N.Y.) (Doc. No. 1)).

do we file in the Ninth Circuit?

Under the Exchange Act's venue rules, the answer to this question is most usually met by finding any connection to the Ninth Circuit (i.e. California). The enormous amount of business activity in California makes this connection relatively easy to find. In turn, just about every plaintiff shareholder class in a Section 14(e)-based litigation would be able to satisfy the venue requirements in the Ninth Circuit and could therefore file in the Circuit with ease—a forum shopper's dream!

IV. DID THE NINTH CIRCUIT GET IT RIGHT?

This Part analyzes Section 14(e) pursuant to the various accepted methods of interpreting statutes in order to answer which side of the circuit split has interpreted the Section correctly. These methods of approaching statutory analysis have been fundamental to courts' analyses in hundreds of cases involving ambiguous statutes and regulations. The major methodologies that will be considered are: (1) the plain meaning rule; (2) investigating the Congressional intent of the Section; and (3) analogizing the text of Section 14(e) to the language of other similar regulations.

A. The Plain Meaning Rule

A purely textual analysis of a regulation's text has been declared a starting point to regulatory interpretation by most courts.⁸⁰ The final sentence of Section 14(e) reads as follows: “[t]he Commission shall . . . prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.”⁸¹ A plain reading of this sentence makes it clear that the Section delegates the power to prevent the acts outlined in Section 14(e) to the SEC. Paying attention to the end of the sentence allows one to see that Congress explicitly granted the described authority to the SEC in the limited situations where the acts of the offeror are fraudulent, deceptive, or manipulative. Each of these adjectives is a way to establish scienter.⁸² Additionally, the use of a period

80. See *United States v. Johnson*, 680 F.3d 1140, 1144 (9th Cir. 2012) (quoting *United States v. Flores Rosales*, 516 F.3d 749, 758 (9th Cir. 2008) for the proposition that statutory interpretation begins with the plain language of the statute. If the plain meaning of the statute is unambiguous, that meaning is controlling); see also e.g. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 at 197 (The United States Supreme Court performed a textualist analysis of Rule 10b-5 to interpret its ambiguities), *Aaron v. SEC*, 446 U.S. 680 at 695-697 (The United States Supreme Court performed a textualist analysis of Rules 10b-5 and 17(a) to interpret their ambiguities).

81. 15 U.S.C. § 78n(e).

82. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, footnote 12 (1976) (the Court noted that the term scienter is used to refer to “a mental state embracing intent to deceive, manipulate, or defraud.”).

after the first sentence of Section 14(e)—which outlines the prohibited practices—shows a clear separation between the prohibited practices and the SEC's power to prescribe means to punish those practices. The separation suggests that the second sentence is applicable to each of the clauses in the first sentence. Hence, the plain language of the Section supports the conclusion that where an offeror acts without scienter, the SEC does not have authority to allow a private right of action to shareholders. This suggests that a negligent act is not grounds for a shareholder to bring a private right of action using Section 14(e).

One fault with the Ninth Circuit's analysis in *Varjabedian*⁸³ is its failure to consider this final sentence of Section 14(e). Both Rule 10b-5 and Rule 17(a) have similar language to the first clause within Section 14(e), and therefore the Ninth Circuit's references to said Rules were relevant. However, while the comparisons and references were strong, one crucial difference was overlooked by the Ninth Circuit: neither Rule 10b-5 nor Rule 17(a)⁸⁴ contains any sentence, clause, or subparagraph that explicitly states what exact practices the SEC has the power to stop. Therefore, Rule 10b-5 and Rule 17(a) are arguably more ambiguous than Section 14(e) which expressly limits the SEC's power to prescribing means—in our case, a private right of action—to prohibit only those acts that are done fraudulently, deceptively, or manipulatively—all adjectives that impose a requirement of scienter. This major difference between the Rules and Section 14(e) was not addressed by the Ninth Circuit. Based on the plain meaning of the words and sentence structure used in Section 14(e), the Ninth Circuit's analysis was incomplete and consequently incorrect.

Another error within the Ninth Circuit's analysis is its misuse of the disjunctive approach. The Ninth Circuit's decision relied on the Supreme Court's disjunctive approach in *Aaron*, which allowed the Ninth Circuit to split Section 14(e) into two separate, isolated clauses and attribute different culpability requirements to each clause.⁸⁵ There are distinctions between Section 14(e) and Rule 17(a), however, that make this application of the disjunctive approach inaccurate.⁸⁶ First, unlike Section 14(e) which is one comprehensive paragraph, Rule 17(a) contains three distinct subparagraphs. Therefore, the Court's disjunctive approach in *Aaron* was more appropriate than the disjunctive approach used by the Ninth Circuit because it is clear that Congress intended for Rule 17(a) to

83. *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018).

84. Another difference between Section 14(e) and Rule 17(a) is that there is no private right of action under Rule 17(a). *See Touche Ross & Co. v. Redington*, 442 U.S. 560, 569 (1979) (stating that “§ 17 (a) neither confers rights on private parties nor proscribes any conduct as unlawful.”).

85. *Varjabedian v. Emulex Corp.*, 888 F.3d at 406.

86. Rule 17(a) was the Rule at issue in *Aaron*.

be read semi-disjunctively because of the format in which the Rule was written, whereas that same intent can be said to be lacking within Section 14(e) due to the structure of the text. Because the disjunctive approach cannot be said to apply to Section 14(e), all three sentences of the Section would consequently have to be read in uniformity and a requirement of scienter would have to be read into both clauses of the first sentence of Section 14(e).

B. Congressional Intent Behind Section 14(e)

Section 14(e) was introduced as part of the 1968 Williams Act amendments to the Exchange Act. To accurately understand the legislative intent behind Section 14(e), comprehension of the legislative intent behind the Exchange Act, the Williams Act, and the Private Securities Litigation Reform Act (“PSLRA”) is necessary.

The Securities Exchange Act of 1934⁸⁷ is one of the most influential authorities that governs public entities. The Exchange Act created the SEC and vested in it the power to identify and prohibit certain types of conduct in America’s financial markets as well as various disciplinary powers to enforce the Exchange Act’s Rules.⁸⁸ Pursuant to the disciplinary powers afforded to the SEC, the clear underlying Congressional intent of the Exchange Act was to protect the integrity of America’s financial markets in order to protect the public and ensure that citizens who elect to participate in the public market are protected.

Although the Securities Act and the Exchange Act began stabilizing the reliability of the financial markets in the mid-1900s, the early 1960s were plagued with abusive tender offers and “hostile coercive takeover attempts.”⁸⁹ During this time period, “the vast majority of shares were owned by individual shareholders, a fragmented and ill-informed group unprepared to exert their rights as shareholders.”⁹⁰ Gaps in federal and state law lead to these shareholders lacking protection from the hostile takeovers of companies in which they held shares. The 1968 Williams Act’s amendments to the Exchange Act were Congress’ direct response to this flood of abusive tender offers and takeover attempts.⁹¹ The Williams Act amendments were meant to address gaps in corporate law

87. Codified at 15 U.S.C.S. §§ 78a-78qq.

88. *The Laws That Govern the Securities Industry*. U.S. Securities and Exchange Commission (last visited Nov. 14, 2018), <https://www.sec.gov/answers/about-lawsshtml.html#secexact1934>.

89. *The Williams Act: A Truly “Modern” Assessment*, <https://corpgov.law.harvard.edu/wp-content/uploads/2011/10/The-Williams-Act-A-Truly-Modern-Assessment.pdf>.

90. *Id.*

91. *Id.*

regarding cash tender offers between publicly traded companies.⁹² By prescribing broad anti-fraud powers for the regulation of tender offers to the SEC through these amendments,⁹³ it is clear that Congress intended to heavily regulate public tender offers due to the high risk position held by shareholders in relation to the sophisticated offerors involved. Section 14 of the Exchange Act was amended by the Williams Act specifically to ensure that public shareholders do not have to respond to tender-offer proposals without all material information in hand. This amendment is found in Section 14(e)'s broad anti-fraud remedy.⁹⁴

After the amendments to the Exchange Act, the volume of federal securities litigation increased drastically because shareholders had more abilities to file suit. To protect public entities, in 1995, Congress enacted the PSLRA as a check against abusive litigation in private securities fraud actions.⁹⁵ Congress' explicit intention in implementing the PSLRA was to promote uniformity among pleading standards across the nation's circuit courts and to "strengthen existing pleading requirements."⁹⁶ The Act "unequivocally raised the bar for pleading scienter"⁹⁷ during the pleading stages by requiring the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."⁹⁸ In essence, the PSLRA requires plaintiffs to plead with "particularity both the facts constituting the alleged violation, and the facts evidencing scienter, i.e., the defendant's intention 'to deceive, manipulate, or defraud.'"⁹⁹

In relation to Section 14(e), Congress' intent has been controversial. The majority of courts agree that Section 14(e) was designed to provide shareholders who have been presented with a tender offer a right to receive sufficient information about the details of said offer such that the shareholder has all of the material information he or she needs to make an informed decision.¹⁰⁰ The legislative history of the Williams Act amendments, as described above, supports this conclusion. Senate Report No. 510,¹⁰¹ which accompanied the Section 14 amendments, also supports this conclusion. The report implies that Congress intended Section 14(e)

92. Mark J. Loewenstein, Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons, 71 *Geo. L.J.* 1311 (1983), <https://scholar.law.colorado.edu/cgi/viewcontent.cgi?article=2075&context=articles>.

93. *Id.*

94. *SEC v. Mayhew*, 121 F.3d 44, 53 (2d Cir. 1997).

95. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, syllabus (2007).

96. *Id.*

97. *Id.* at 321.

98. *Id.* at syllabus (citing 15 U.S.C. § 78u-4(b)(2)(A)).

99. *Id.* (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 at 194).

100. *See generally supra* Part II.

101. S. Rep. No. 510, 90th Cong., 2d Sess. (1968).

to serve as a medium through which it could provide shareholders a private right of action against the offering party. This is seen where the Committee notes that the amendments to Section 14(e) were meant to impose a high burden on the offerors involved in tender offers in order to provide as much protection as possible for the affected shareholders.¹⁰² The imposition of such a high duty clearly suggests that plaintiff shareholders should have a relatively easy burden to carry; this suggests that the appropriate culpability requirement would be negligence and not scienter in a private action.

However, as discussed in Part IV(A), the last sentence of Section 14(e) appears to expressly contradict the intent implied in the cited Senate Report. The last sentence imposes a possible limitation on this protection to shareholders because it limits a shareholder's power to bring suit only for those actions that are "fraudulent, deceptive, or manipulative."¹⁰³ Due to this evident contradiction, the intent extracted from the Senate Report is not dispositive.

Because the legislative evidence accompanying Section 14(e) is not by itself sufficient to conclude what Congress' true intent was in writing the Section, considering the legislative intent of similar security regulations is necessary. When analyzing the Exchange Act, it is critical to understand that Congress enacted the PSLRA specifically to heighten pleading requirements within securities litigation. That considered, it is evident that where there is uncertainty as to the pleading requirements that a certain rule or section within the Exchange Act requires, Congress desires that the default requirement be a higher standard (i.e. scienter).

C. Public Policy Considerations

In determining whether the scienter or negligence standard is better from a public policy perspective, the practical implications of both standards must be considered. In order to protect the rights of shareholders, Section 14(e) provides shareholders a private right of action.¹⁰⁴ However, there have been many obstacles imposed upon this

102. *Id.* (stating that Section 14(e) "would affirm the fact that persons engaged in making or opposing tender offers or otherwise seeking to influence the decision of investors or the outcome of the tender offer **are under an obligation** to make full disclosure of material information to those with whom they deal.") (emphasis added).

103. *See* 15 U.S.C. § 78n(e) (The last sentence of Section 14(e) states "[t]he Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.").

104. *See* *Wulc v. Gulf & W. Indus.*, 400 F. Supp. 99, 104 (E.D. Pa. 1975) (citing *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973) for the proposition that a private right of action exists under Section 14(e)); *see also* *In re Commonwealth Oil/Tesoro Petroleum Corp. Sec. Litig.*, 467 F. Supp. 227, 243 (W.D. Tex. 1979) (reasoning that a private right to damages under Section 14(e) is a reasonably necessary means of effectuating purposes of the Exchange Act).

private right of action. A few of these obstacles include a burden on the plaintiff shareholder class to prove that the misstated or omitted facts within the tender offer are material,¹⁰⁵ a requirement to prove that the shareholders actually relied on the misleading information,¹⁰⁶ and a burden of proving causation.¹⁰⁷ By imposing a scienter requirement, the courts are making it even harder for a shareholder to establish a cause of action. This directly conflicts with Congress' implied intent within Senate Report No. 510¹⁰⁸ because imposing a burden to prove scienter will decrease an individual shareholder's ability to plead the cause of action under Section 14(e) simply due to the lack of resources at his or her disposal to investigate the case to the extent necessary to prove scienter.¹⁰⁹ As a result, the only way to realistically seek remedy under Section 14(e) is through a class action.

On the other hand, the listed judicially imposed obstacles align with the purpose of the PSLRA. Similarly, the imposition of a scienter requirement also achieves the goals of the PSLRA. By imposing a heightened pleading requirement, the scienter requirement increases the percentage of cases dismissed and therefore protects public companies against abusive federal securities litigation by shareholders. This heightened requirement allows public companies to conduct business, including conducting mergers and acquisitions, without a constant fear of being held liable for negligence. It further allows public companies to admit that they made a mistake in the tender offer process without always being sued for negligence; consequently, this standard leads to a higher chance of transparency between a public company's board of directors and the company's shareholders.

Contrary to this result, the negligence standard increases both the ease of filing suit and the likelihood of said lawsuits moving past the pleading stages which consequently imposes a large burden on the company to

105. *See* Commonwealth Oil Ref. Co. v. Tesoro Petroleum Corp., 394 F. Supp. 267, 274 (S.D.N.Y. 1975).

106. *See* Caleb & Co. v. E. I. du Pont de Nemours & Co., 599 F. Supp. 1468, 1474 (S.D.N.Y. 1984) (citing *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973) reasoning that to properly state a cause of action under Section 14(e), a shareholder must allege (1) that there are misrepresented or omitted facts, (2) that the shareholder relied on those facts, and (3) that the misstatements or omissions were made with the requisite intent).

107. *See* Bertozzi v. King Louie Int'l, Inc., 420 F. Supp. 1166, 1176 (D.R.I. 1976) (citing *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 385 (1970) for the proposition that upon a showing of the materiality of omission within tender offer materials, a shareholder has made sufficient showing of a causal relationship between the violation and the injury for which the shareholder seeks redress).

108. S. Rep. No. 510, 90th Cong., 2d Sess. (1968).

109. While this argument appears to be strong, it alone has not been enough to sway a court, including the United States Supreme Court, to conclude that a scienter requirement within other SEC Rules violates public policy. *See e.g.* *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Aaron v. SEC*, 446 U.S. 680 (1980).

defend these lawsuits. To avoid these burdens, companies are much more likely to hide their mistakes which means that the shareholders are even worse off than before. Alternatively, to protect against claims of under-disclosure, public companies will provide shareholders with so much material that the shareholders will have no idea how to sift through the provided material; as a result, shareholders will have a much harder time making a decision because they will struggle to find the material facts. Moreover, the negligence standard is also harmful to the public as a whole because it distracts public companies from pursuing their ultimate goals: creating wealth for their shareholders.

Within federal securities litigation, the term scienter has been interpreted broadly to encompass any level of fault that is not negligent.¹¹⁰ Therefore, the imposition of a broad scienter requirement strikes the right balance between protecting shareholders by allowing them to bring suit while also protecting publicly traded companies from abusive suits. It is also beneficial to note that the imposition of a scienter requirement has not been deemed to violate public policy when it has been required for suits based on other SEC Rules such as 10b-5.¹¹¹

For these reasons, the United States Supreme Court will likely conclude that public policy supports the imposition of a scienter requirement in Section 14(e)-based litigation.

D. Balancing the Evidence

There is strong, credible evidence that supports both interpretations presented by the circuit split. The plain language of Section 14(e) suggests that the approach adopted by the Second, Third, Fifth, Sixth, and Eleventh Circuits' is correct. However, both the legislative intent discussed in this Article and the various policy considerations discussed herein can be interpreted to support either side of the split.

Based on the fact that five circuits have considered all of the arguments set forth above and felt that the textual interpretation of Section 14(e) is the strongest influence as to whether a scienter requirement exists, it is likely that the textual approach will be eventually adopted by the Supreme Court. Additionally, the legislative intent and public policy considerations previously mentioned will also likely sway the Court to support the scienter requirement.

110. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 534-36 (1976).

111. See *e.g. Ernst & Ernst*, 425 U.S. at 185; *Aaron v. SEC*, 446 U.S. 680 (1980).

V. WHAT'S NEXT?

As of September 2018, the Ninth Circuit granted Emulex Corporation's motion for a stay of proceedings pending Emulex's filing of a Petition for Writ of Certiorari to the United States Supreme Court.¹¹² The United States Supreme Court granted certiorari on January 4, 2019¹¹³ and oral arguments occurred on April 15, 2019.¹¹⁴

In its Petition for Writ of Certiorari, Emulex puts forth various arguments that are worth examining.¹¹⁵ Emulex begins by pointing out that the United States Supreme Court has "frequently intervened to resolve conflicts over the meaning of the federal securities laws, in part because the flexible venue rules applicable to such suits mean that the outlier position of one circuit can become a de facto national standard simply through forum shopping."¹¹⁶ Emulex argues that "[a]n acknowledged circuit conflict on a matter of such undeniable importance is a sufficient reason by itself to grant certiorari."¹¹⁷ Emulex further states that if this interpretation of Section 14(e) is not addressed and reversed by the United States Supreme Court, *Varjabedian v. Emulex Corp.* will only make the Ninth Circuit "more of a magnet for [Section 14(e)] actions."¹¹⁸

This assertion is correct. Forum shopping is a massive portion of plaintiff classes' litigation strategy and favorable case law is a very persuading factor in deciding which federal circuit to file suit in. Emulex continues:

[t]he Ninth Circuit, and northern California in particular, is home to one of the Nation's hotbeds of corporate startups that present attractive acquisition targets. And even if they are not based in the Ninth Circuit, most publicly traded companies at the very least transact business there. Accordingly, almost every merger that is subject to the securities laws can be challenged in the Ninth Circuit. And now that the Ninth Circuit has embraced a negligence standard for damages claims that the Second and Third Circuits (and every other circuit to have weighed in) has rejected, there is every reason to believe that they *will* be challenged there.¹¹⁹

These facts, in combination with the relatively simple venue

112. *Varjabedian v. Emulex Corp.*, No. 16-55088, 2018 U.S. App. LEXIS 26170 (9th Cir. Sep. 14, 2018).

113. *Emulex Corp. v. Varjabedian*, 202 L.Ed.2d 511 (U.S. 2019).

114. The United States Supreme Court heard oral arguments on April 15, 2019.

115. *Emulex Corp. v. Varjabedian*, No. 18-459, 2018 U.S. S. Ct. Briefs LEXIS 3733, at *1 (Oct. 5, 2018) (Petition for Writ of Certiorari).

116. *Id.* at *3.

117. *Id.*; see also *Varjabedian v. Emulex Corp.*, 888 F.3d 399 at 409 (the Ninth Circuit expressly acknowledged that its decision was "part[ing] ways from . . . five other circuits").

118. *Emulex Corp.*, 2018 U.S. S. Ct. Briefs LEXIS 3733 at *3.

119. *Id.* at *23 (emphasis added).

requirements imposed by the Exchange Act, lead to the conclusion that every remotely strategic plaintiff's attorney will seek a way—and will almost certainly find a way—to file in the Ninth Circuit in order to take advantage of the easier negligence standard. Hence, Emulex is absolutely correct in concluding that the Ninth Circuit in effect has created a new “de facto national standard” of mere negligence for Section 14(e)-based litigation.¹²⁰

Additionally, Emulex correctly asserts that the public policy implications of the Ninth Circuit's adoption of the negligence standard make it necessary for the United States Supreme Court to intervene. Emulex argues that public policy rationale is supportive of a scienter standard, not a negligence standard. It states that under the Ninth Circuit's negligence standard,

[c]ompanies and their directors will now be exposed to a much greater threat of abusive litigation and will have to grapple with whether any corrective disclosures will be read as admissions of negligence that subject them to backward-looking liability--likely restricting the flow of information into the market. That is precisely the opposite of what Section 14(e) was intended to accomplish.¹²¹

Again, this point is clearly correct and in line with the legislative history and purpose of Section 14(e). Emulex also correctly points out that the negligence standard will be more harmful than helpful to both businesses and shareholders because the threat of expensive and drawn out litigation will put significant pressure on companies to either (1) cover up their mistakes, (2) settle potentially weak lawsuits,¹²² or (3) disclose so much material that shareholders are flooded with information and are unable to make an informed decision because of the over-disclosure.

Emulex makes extremely strong points in its Petition for Writ of Certiorari to the United States Supreme Court. However, to the dismay of both Emulex and businesses across the country, the Supreme Court, in a per curiam opinion dated April 23, 2019, dismissed the writ of certiorari as improvidently granted.¹²³ After the issuance of this slip opinion, the circuit split will remain in place until the Court grants certiorari in another case. Consequently, there will certainly be a surge of Section 14(e) based class actions filed in the Ninth Circuit.

All businesses should be hopeful that the Court agrees to grant certiorari in another case addressing this issue and settles the circuit split in favor of the scienter standard; otherwise, offerors from around the

120. *Id.* at *3.

121. *Id.* at *24.

122. *Id.*

123. *Emulex Corp. v. Varjabedian*, 587 U. S. ____ (2019).

country will continue to be dragged into the Ninth Circuit to defend lawsuits that, before *Emulex*, had never before passed the pleading stages. It is now left to the defense attorneys to discern why the Court dismissed Emulex's petition for certiorari and find a model case that will force the Court to shed light on what the right balance within Section 14(e) is: a requirement of scienter or negligence. For all of the reasons discussed in this Article, when that case comes, the Court should find that scienter, not negligence, is the appropriate culpability standard within Section 14(e)-based litigation.