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Supreme Court to Address Questions Surrounding Implied Private Right of Action Under Exchange Act of 1934

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Does an implied private right of action exist under Section 14(e) of the Exchange Act of 1934, an anti-fraud provision governing tender offers? And, if so, does it require scienter — i.e., a knowing or reckless violation — or mere negligence? Circuit courts have considered these questions for nearly 50 years, most recently in *Varjabedian v. Emulex Corp.*,[1] an outlier decision by the Ninth Circuit last April. Now the Supreme Court will weigh in.

Emulex involves a merger of two technology companies: Emulex and Avago. The parties agreed that the merger was to be accomplished by an Avago subsidiary making a tender offer for all the outstanding stock of Emulex. Emulex filed a Schedule 14D-9 Recommendation Statement with the SEC recommending that its stockholders accept the offer. As is all too typical, a stockholder sued, claiming that the Recommendation Statement contained material misstatements of fact. Following a recent trend, the plaintiff filed suit in federal court (the U.S. District Court for the Central District of California) rather than the Delaware Court of Chancery.

The plaintiff lost his bid to enjoin the merger, but did uncover a chart prepared by Goldman Sachs — which was **not** included in Emulex's Recommendation Statement — listing the premiums received in similar transactions. Emulex's below-average 26.4 percent premium nonetheless fell within the normal range of merger premiums. After the merger closed, the plaintiff amended his complaint to allege that, by failing to include the premium analysis in its Recommendation Statement, Emulex violated Section 14(e). The plaintiff did not, however, allege that Emulex acted with scienter. The district court dismissed the complaint with prejudice, concluding that Section 14(e) requires a showing of scienter.

The Ninth Circuit reversed, recognizing that the district court's holding was in line with case law in the Second, Third, Fifth, Sixth and Eleventh Circuit Courts of Appeals.[2] In a line of decisions beginning with *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), these courts have consistently held that Section 14(e), like the similarly worded Rule 10b-5, requires a showing of scienter. But the Ninth Circuit "part[ed] ways from [its] colleagues in [those] five other circuits" and held that Section 14(e) requires a showing of "only negligence, not scienter."

According to the Ninth Circuit, these other circuits had missed a crucial distinction between Rule 10b-5 and Section 14(e). Rule 10b-5 is promulgated under Section 10(b), which allows the SEC to regulate only "manipulative or deceptive device[s]." In *Ernst & Ernst v. Hochfelder*,[3] the Supreme Court held that the Rule exceeds the anti-fraud power granted to the SEC by Congress under Section 10(b), unless any violation requires proof of scienter. Section 14(e) — a statute, not an SEC Rule — is not so constrained.

The Ninth Circuit reasoned that, on its own merits, Section 14(e) reaches beyond fraud. The statute contains two disjunctive clauses:[4] The first prohibits making an "untrue statement of a material fact or omit[ting] to state any material fact necessary in order to make such statements, in the light of the circumstances under which they are made, not misleading"; the second proscribes engaging in "fraudulent, deceptive, or manipulative acts or practices." Relying upon the Supreme Court's interpretation of "nearly identical" language in Section 17(a)(2) of the Securities Act of 1933 in *Aaron v. SEC*,[5] the Ninth Circuit concluded that liability under the first clause requires only negligence. The court "question[ed] the continuing viability of the foundation for *Chris-Craft* and the cases that followed it," and was "persuaded that [its] decision . . . is most consistent with the Supreme Court's decisions in *Ernst & Ernst* and *Aaron*."[6]

We will soon know whether the Supreme Court agrees with that assessment. On January 4, 2019, the Court granted Emulex's petition for writ of certiorari. The petition asked the Court to reverse the Ninth Circuit's holding that an implied private right of action under Section 14(e) requires a showing of only negligence, or in the alternative to reexamine whether a private right of action can be inferred at all under Section 14(e). While the Court could decide the case on the narrow scienter ground, the implied right of action is now in play, which could lead to a much broader and more consequential ruling. A decision is expected by June 2019.

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1. 888 F.3d 399 (9th Cir. 2018). ↩

2. *See Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973); *Conn. Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 961 (2d Cir. 1987); *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*, 565 F.3d 200, 207 (5th Cir. 2009); *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 431 (6th Cir. 1980); *SEC v. Ginsburg*, 362 F.3d 1292, 1297 (11th Cir. 2004). ↩

3. 25 U.S. 185, 212-14 (1976). ↩

4. "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, or 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 invitation." 15 U.S.C. § 78n(e). ↩

5. 446 U.S. 680 (1980). ↩

6. The Ninth Circuit did not consider materiality, because "[t]he district court did not reach the question whether omitting the Premium Analysis — a one-page chart containing seventeen transactions involving semiconductor companies — from the Recommendation Statement constitutes omission of a material fact in the context of the entire transaction." *Varjabedian*, 888 F.3d at 408. "Although it is difficult to show that this omitted information was indeed material," the Ninth Circuit noted, "we remand for the district court to consider the question in the first instance." *Id*. ↩

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