Simpson Thacher

To read the oral argument transcript, please click here.

Report from Washington

Supreme Court Considers Whether Private Securities Plaintiffs Can Bring Suit Under Section 14(e) for Merely Negligent Conduct

April 19, 2019

Introduction

"As you well know, this is a court of review, not of first view. If we're going to take up [the private right of action] question, it shouldn't start here."

— Justice Ginsberg

The Supreme Court heard oral argument in *Emulex Corp. v. Varjabedian*, No. 18-459, on Monday, April 15, 2019, to decide whether Section 14(e) of the Securities Exchange Act of 1934 (Exchange Act) establishes a private right of action based on a negligent misstatement or omission made in connection with a tender offer. Currently, the Second, Third, Fifth, Sixth, and Eleventh Circuits require plaintiffs to plead scienter, knowing or willful conduct, to bring a claim under Section 14(e). The Ninth Circuit recently departed from this prevailing rule, finding that only an allegation of negligence is required. The resolution of this circuit split could have broad implications for private securities plaintiffs, either easing or increasing the pleading standard for merger-related private litigation under Section 14(e).

However, the Court may well not even reach the substantive question of what standard should be applied, depending on whether and how it decides to answer another question raised by Emulex, namely whether private plaintiffs are permitted to bring such claims under Section 14(e) in the first place. The Court appeared to be interested in this issue during oral argument, with the Court divided among conservative justices on the one hand, who suggested that Section 14(e) does not provide a private right of action (notwithstanding that there does not appear to be a single lower court decision in the last half-century that has reached such a conclusion), and liberal justices on the other hand indicating that the Court should not sua sponte decide the issue in this case.

Background

In February 2015, Emulex Corp. (Emulex), an electronic equipment producer, and Avago Technologies Wireless (USA) Manufacturing Inc. (Avago), a designer of analog semi-conductor devices, announced that they had entered into a merger agreement, with Avago

offering to pay $8.00 per share of outstanding Emulex stock—a 26.4% premium on the stock price the day before the merger was announced. Avago initiated its tender offer on April 7, 2015 and, on the same day, Emulex filed a statement with the Securities and Exchange Commission supporting the tender offer and recommending that shareholders tender their shares. The recommendation statement included a five-page "fairness opinion" that Emulex received from its financial advisor, but Emulex declined to include a one-page premium analysis showing that the transaction premium fell within the normal range of transaction premiums but below the average.

In April 2015, Emulex investors brought a class action suit in the Central District of California alleging that the negligent exclusion of the premium analysis was a violation of the first clause of Section 14(e), which makes it 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 . . . not misleading" in the context of a tender offer.[1] In January 2016, the district court dismissed the case on the grounds that "only negligence" will not suffice and plaintiffs must plead that defendants acted with scienter.

On appeal, the Ninth Circuit reversed, finding that negligence is adequate to support a claim under the first clause of Section 14(e) because the text of the clause does not suggest that scienter is required. In doing so, the Ninth Circuit expressly declined to follow the prior consensus of the Second, Third, Fifth, Sixth, and Eleventh Circuits, which have all held that scienter is required to make a claim brought by private plaintiffs under Section 14(e). The Ninth Circuit found that Section 14(e) is fundamentally different from Section 10(b) of the Exchange Act because Section 14(e) prohibits a wider variety of conduct, including acts that are not fraudulent. The Ninth Circuit further reasoned that Section 14(e) contains nearly identical language to Section 17(a)(2) of the Securities Act of 1933, which the Supreme Court has held does not require a showing of scienter in *Aaron v. SEC*.[2]

Emulex appealed to the Supreme Court, which granted certiorari on January 4, 2019. The Court also granted leave for the Office of the U.S. Solicitor General to participate in oral argument in favor of neither party, charting a third course arguing against finding an implied private cause of action and in favor of applying a negligence standard.

[1] 15 U.S.C. § 78n(e) (2016).

[2] 446 U.S. 680 (1980).

Oral Argument Highlights

"[W]e want to know what Congress was intending to do here, but we're not going to throw out the whole statutory interpretation toolbox, except for the text because sometimes context matters a great deal in understanding text."

— Justice Kagan

The Justices focused on two issues: (1) Whether Section 14(e) supports a private cause of action, and (2) whether a cause of action under Section 14(e) requires a showing of only negligence or whether a heightened scienter standard should apply.

Can Section 14(e) be Vindicated by Private Plaintiffs or Only by the SEC?

Emulex argued that a private right of action under Section 14(e) does not exist at all, despite decades of lower court precedent indicating otherwise. Emulex did not dispute the existence of the private right before the Ninth Circuit, and it is unclear whether the Justices will render a decision on this issue. Justice Sotomayor, in particular, appeared to critique Emulex's failure to raise the issue before the Ninth Circuit or to otherwise address it as a separate question in its cert petition, as she questioned why the Court should be "rewarding counsel for changing or moving the ball on cert grounds." Emulex argued that the Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[3] where the Court took it upon itself to decide there was no private cause of action for aiding and abetting under Section 10(b) and Rule 10b-5, provides sufficient basis for the Court to take up the question regarding Section 14(e). Emulex further noted that it did not earlier dispute that Section 14(e) provides for a private right of action due to unfavorable precedent in the lower courts.

The crux of Emulex's argument was that only Congress has the power to determine whether a statute includes a private right of action. Emulex relied heavily on the Court's recent trend of refusing to infer new private causes of action or expand previously recognized causes of action. In distinguishing Section 14(a), for which the Court *has* recognized a private right of action, Emulex emphasized that Section 14(a) specifically discusses protection of investors, whereas Section 14(e) is silent on that point.

"The whole thing is kind of a time travel argument, oh, Congress would have thought in 1968 that courts create implied causes of action."

— Justice Kavanaugh

The U.S. Solicitor General agreed with Emulex on the private right of action point, emphasizing that the SEC is the sole proper enforcer of Section 14(e). Justice Gorsuch indicated he might agree and suggested that courts have only adopted a scienter standard for the securities laws to prevent frivolous lawsuits where the court has implied a private right of action.

However, as counsel for Varjabedian noted, the Court previously held in *J.I. Case Co. v. Borak*[4] that there is an implied private right of action under Section 14(a) of the Exchange

[3] 511 U.S. 164 (1994).

[4] 377 U.S. 426, 430-433 (1964).

Act, which governs proxy statements, even though there was no express indication of a private remedy. Justice Ginsberg agreed and questioned the rationality of distinguishing Section 14(a) from 14(e), which would require different treatment of proxy statements and tender offers—both common merger mechanisms.

Negligence or More?

Emulex also argued that, even if Section 14(e) does support a private right of action, the Ninth Circuit nonetheless erred in applying only a negligence standard. Emulex's time on this point was cut short during oral argument due to the Court's interest in the gating issue, but in its brief Emulex contends that the words "fraudulent," "deceptive," and "manipulative"—all of which appear in the text of Section 14(e)—are terms that the Court has previously associated with a scienter standard.

"[S]ince 14(e) borrows the language of 10b-5, and we have all along interpreted 10b-5 to require scienter, why shouldn't we require the same standard here."

— Justice Sotomayor

The U.S. Solicitor General and Varjabedian disagreed, highlighting the Court's decision in *Ernst & Ernst v. Hochfelder*,[5] which noted the language of Rule 10b-5 itself would be appropriate for a negligence standard, but that separate language in Section 10(b) demanded a scienter standard. They argued that absent such additional constraining language in Section 14(e), the better comparison is to Section 17(a), which the Court considered in *Aaron* and imposed a negligence standard.

Implications

Given its apparent interest in the private right of action question, the Court may well not even reach the substantive question of what standard—negligence or scienter—should be applied. It seems likely that the Court's more conservative members, particularly Chief Justice Roberts and Justice Kavanaugh, could be enticed by the opportunity to further limit implied rights of action. However, other members of the Court criticized Emulex for not raising the issue below or previewing it fully in its petition for certiorari, and they dismissed Emulex's efforts to invoke *Central Bank* as grounds to raise the issue sua sponte. With no disagreement among the lower courts, the liberal Justices appeared unwilling to disrupt decades of lower court consensus. If the Court were to determine that a private right of action under Section 14(e) did not exist, the SEC would have exclusive authority to bring such claims. As the U.S. Solicitor General indicated, this could help prevent excessive litigation.

"Just to state the obvious, there's no private right of action in the text."

— Justice Kavanaugh

If the Justices do address the underlying substantive question and determine that pleading a violation of Section 14(e) requires a showing of negligence instead of a knowing or willful

[5] 425 U.S. 185 (1976).

violation of the securities laws, private lawsuits under Section 14(e) would certainly increase. Further, the increased litigation risk and costs of tender offer transactions would potentially make other types of merger transactions (where scienter is required) more appealing.

For further information, please contact one of the following members of the Firm's Litigation Department.

WASHINGTON, D.C.

Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

Cheryl J. Scarboro
+1-202-636-5529
cscarboro@stblaw.com

PALO ALTO

Stephen P. Blake
+1-650-251-5153
sblake@stblaw.com

Alexis S. Coll-Very
+1-650-251-5201
acoll-very@stblaw.com

James G. Kreissman
+1-650-251-5080
jkreissman@stblaw.com

LOS ANGELES

Chet A. Kronenberg
+1-310-407-7557
ckronenberg@stblaw.com

NEW YORK CITY

Brooke E. Cucinella
+1-212-455-3070
brooke.cucinella@stblaw.com

Paul C. Curnin
+1-212-455-2519
pcurnin@stblaw.com

Stephen M. Cutler
+1-212-455-2773
stephen.cutler@stblaw.com

Susannah S. Geltman
+1-212-455-2762
sgeltman@stblaw.com

NEW YORK CITY

Paul C. Gluckow
+1-212-455-2653
pgluckow@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Peter E. Kazanoff
+1-212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Joseph M. McLaughlin
+1-212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
+1-212-455-2696
lneuner@stblaw.com

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Mark J. Stein
+1-212-455-2310
mstein@stblaw.com

Craig S. Waldman
+1-212-455-2881
cwaldman@stblaw.com

George S. Wang
+1-212-455-2228
gwang@stblaw.com

Jonathan K. Youngwood
+1-212-455-3539
jyoungwood@stblaw.com

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower A
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000