Ninth Circuit Analyzes Mens Rea Requirement in M&A Disclosure Litigation

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In January 2016, the Delaware Chancery Court issued its decision in *In re Trulia, Inc. Stockholders Litigation*, which announced that the court would approve "disclosure only" settlements that had become commonplace in M&A transactions only if the supplemental disclosures provided to a company's stockholders in connection with those settlements were "plainly material." Since that decision, the federal courts have seen a dramatic increase in the number of lawsuits challenging the disclosures made in connection with M&A transactions. Cornerstone reported that there were 198 M&A-related lawsuits filed in federal court in 2017, more than double the number that had been filed in 2016. The lawsuits are very similar to those that used to be filed in Delaware Chancery Court prior to *Trulia*. The complaints assert claims under Section 14 and 20 of the Exchange Act and allege that the disclosure documents filed in connection with M&A transactions are false and misleading because they fail to disclose various pieces of information, typically information about the issuer's financial projections, analysis performed by the issuer's financial advisor, and conflicts of interest. Issuers often provide supplemental disclosures to moot the claims, and plaintiffs file notices of voluntary dismissal and seek to negotiate a fee award for causing the supplemental disclosures. These types of federal disclosure lawsuits rarely lead to judicial decisions.

On April 20, 2018, the Ninth Circuit issued an opinion in ***Varjabedian v. Emulex Corp.*, No. 16-55088 (9th Cir. Apr. 20, 2018)**, holding that Section 14(e) of the Securities Exchange Act of 1934 requires a showing of negligence rather than scienter. The opinion departs from authorities in the Second, Third, Fifth, Sixth, and Eleventh Circuits, all of which have required a plaintiff to plead scienter to assert a Section 14(e) claim.

The lawsuit arose from the 2015 merger between Avago Technologies and Emulex Corporation. In February 2015, Avago and Emulex announced that they had entered into a merger agreement. Avago thereafter initiated a tender offer, which offered Emulex shareholders a premium of 26.4% above Emulex's closing price before the deal was announced.

Prior to entering into the merger agreement, Emulex's board of directors received a fairness opinion from a financial advisor. The financial advisor performed a number of traditional analyses including a discounted cash flow and an examination of historical stock price. The financial advisor also examined premiums paid in connection with a selection of seventeen other semiconductor transactions (the "Premium Analysis"). This analysis, which was ultimately reflected in a one page chart that apparently was provided to Emulex's directors, indicated that the 26.4% premium offered to Emulex's shareholders fell within normal range premiums paid in other transactions, but was below average.

Pursuant to 17 C.F.R. § 240.14d-101 Scheduled 14D-9, Emulex prepared a Recommendation Statement encouraging shareholders to tender their shares. The Recommendation Statement referred to the fairness opinion and four of the financial advisor's analyses: historical stock trading, selected companies, present value of future share price, and discounted cash flow. The 14D-9 did not refer to the Premium Analysis.

Following the tender offer and the consummation of the merger, shareholders filed a class action alleging that Emulex and other defendants violated Section 14(e) of the Exchange Act by failing to disclose the Premium Analysis. Op. at 8. The district court dismissed the suit, relying on out-of-circuit precedent that Section 14(e) required a showing of scienter, which Plaintiffs did not plead. The Ninth Circuit reversed, holding that Section 14(e) requires only negligence.

Section 14(e) regulates the conduct of people who can influence the outcome of a tender offer. Section 14(e) provides that "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 . . . ." 15 U.S.C. § 78n(e). The language tracks in substantial part the language of SEC Rule 10b-5. Accordingly, in a string of decisions over more than three decades, other Courts of Appeals have imposed the same scienter requirement on Section 14(e) actions as employed in the Rule 10b-5's context. Op. at 11.

The Ninth Circuit rejected that approach. The panel's decision focused on two Supreme Court decisions. First, the panel considered *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which analyzed Rule 10b-5 and found that claims brought under the Rule are subject to a scienter requirement. The Ninth Circuit concluded that *Ernst* did not impose a scienter requirement based on the text of Rule 10b-5, but rather because the underlying *statute* (15 U.S.C. § 78j(b)) spoke clearly of manipulation, deception and contrivances. Op. at 13. Section 14(e) does not contain similar language.

Second, the panel looked to *Aaron v. SEC*, 446 U.S. 680 (1980), which analyzed Section 17(a)(2) of the Securities Act of 1933. Both that provision and Section 14(e) prohibit "any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made . . . not misleading." *Compare* 15 U.S.C. § 77q(a)(2), *with* 15 U.S.C. § 78n(e). In *Aaron*, the Supreme Court held that Section 17(a)(2) does not require a showing of scienter. The Ninth Circuit indicated that both statutes serve a similar purpose and that it was therefore appropriate to read Section 14(e) similarly.

The Ninth Circuit read those decisions, taken together, to mean that Section 14(e) does not impose any scienter requirement and that a plaintiff can succeed on a claim under the statute by pleading that the defendants' conduct was negligent. The court noted that the first in the line of Court of Appeals decisions holding otherwise predated *Ernst* and suggested that more recent decisions from other Circuits did not address aspects of *Ernst*, or its interplay with *Aaron*.

While the Ninth Circuit reversed the district court's decision dismissing the Section 14(e) claim, the case is far from over. The panel noted that neither it nor the district court had considered the question whether omitting the Premium Analysis "constitutes omission of a material fact in the context of the entire transaction." Op. at 18. However, the court went on to state that "it is difficult to show that this omitted information was indeed material," citing authority for the proposition that the plaintiffs would need to be able to demonstrate that the omission was highly unreasonable and constituted an extreme departure from the standard of ordinary care. Id. (citing *Zucco Partners, LLC v. Digimarc Corp*., 552 F.3d 981, 991 (9th Cir. 2009).)

It is difficult to see how plaintiffs could meet this burden post-remand. The 14D-9 included extensive analysis of the transaction and Emulex's valuation. The transaction involved a 26.4% premium, and a conclusion from a financial advisor that the premium was *within* the range of those offered in similar transactions. Moreover, while the premium here apparently was below average (within a data set of transactions selected by Emulex's financial advisor), as a matter of simple math that ordinarily would be true in approximately half of the deals examined. Against this backdrop, it seems likely that the district court will conclude—even on a motion to dismiss—that the Premium Analysis would not have materially altered the mix of information available to Emulex's shareholders.

The motion to dismiss briefing and the district court's decision all occurred prior to *Trulia*. Various federal courts have since raised the same objections to disclosure-only settlements as those that led to the *Trulia* decision. For example, the Seventh Circuit in *In re Walgreens Stockholder Litigation* called the typical disclosure only settlement a "racket" and adopted Delaware's "plainly material" standard. Defendants who litigate these disclosure claims in motions to dismiss now direct federal judges to *Trulia* and its federal counterparts, and make the point that the same M&A lawsuits that plagued the Delaware courts pre-*Trulia* have now become the federal courts' problem. Given the Ninth Circuit's commentary on the materiality of the omitted disclosure, and the focus on materiality in the original motion to dismiss briefing, it seems likely that the district court will not have a difficult time concluding that the one-page Premium Analysis was not material.

The majority opinion was written by Circuit Judge Mary Murguia and was joined by Circuit Judge Susan Graber. Circuit Judge Morgan Christen fully concurred in the panel's decision, but wrote separately to explain why the *Ernst* and *Aaron* holdings persuaded her to disagree with several other Circuits.

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