Corporate Dualism: Applying a Dual-Standard of Liability Under Section 14(e)'s Tender Offer Antifraud Provisions

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I. INTRODUCTION

The Ninth Circuit Court of Appeals recently diverged from the decisions of five other federal circuit courts in *Varjabedian v. Emulex Corp.*, when the court applied a negligence standard in assessing a claim for material misstatements or omissions in a tender offer under Section 14(e) of the Securities Exchange Act of 1934 (1934 SEA).[1]

1. Varjabedian v. Emulex Corp., 888 F.3d 399, 408 (9th Cir. 2018); *Ninth Circuit Establishes Negligence Standard for Section 14(e) Claims in Circuit-Splitting Decision*, PERKINS COIE (Apr. 27, 2018), https://www.perkinscoie.com/en/news-insights/ninth-circuit-establishes-negligence-standard-for-section-14-

This Note will begin by addressing the purpose of Section 14(e) and by providing a brief overview of the federal circuits' statutory interpretations of the Securities and Exchange Commission (SEC) Rule 10b-5. It will end with a brief discussion of *Varjabedian*, and the Ninth Circuit's rationale for applying a negligence standard.

Part III will discuss the statutes and rules that provide support for the federal circuits' interpretations of Section 14(e) to include, or not include, a scienter requirement. The final portion of Part III will focus on the implications of applying a negligence standard as opposed to a scienter standard.

Finally, Part IV will focus on why the application of a dual-standard of liability is more favorable than a scienter standard. Part IV.A will discuss the policy arguments promoting the interests of shareholders, offerors, and directors, which supports a dual-standard of liability under Section 14(e). Part IV.B will focus on the statutory interpretation of similar language in Rule 10b-5 and Section 17(a) compared to Section 14(e) in support of a dual-liability standard. Part IV will end by briefly discussing the implications of the Supreme Court establishing a dual-standard of liability for Section 14(e) claims in terms of legal precedent.

II. BACKGROUND

This Part provides a general background on tender offers and Section 14(e)'s antifraud provisions, focusing on the ambiguity surrounding the mental state requirement (i.e., standard of liability) for material misstatements or omissions committed in connection with a tender offer. Additionally, this Part summarizes the cases applying a scienter standard to Section 14(e) claims, as well as the Ninth Circuit's decision to apply a negligence standard in *Varjabedian*.

A. Tender Offers and Ambiguity Surrounding Section 14(e)

Tender offers are a form of public offer that corporations or individuals use to acquire a specific amount of corporate security and, with that, a substantial or entire stake in a company.[2] The SEC defines a tender offer as "a broad solicitation by a company or a third party to purchase a substantial percentage of a company's Section 12 registered equity shares or units for a limited period of time."[3] Tender offers are one way a corporation or a third party can obtain corporate securities.[4] Tender offers are regulated by the SEC and are subject to the antifraud provisions set out in Section 14(e) of the 1934 SEA.[5] Section 14(e) states:

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2. Joshua Kennon, *Understanding a Tender Offer's Effect on Investors*, THE BALANCE (July 13, 2018), https://www.thebalance.com/what-is-a-tender-offer-4129430.

3. *Tender Offer*, SEC: FAST ANSWERS, https://www.sec.gov/fast-answers/answerstenderhtm.html (last modified Jan. 16, 2013).

4. Jeffrey J. Giguere, *Negligence vs. Scienter: The Proper Standard of Liability for Violations of the Antifraud Provisions Regulating Tender Offers and Proxy Solicitations Under the Securities Exchange Act of 1934*, 41 WASH. & LEE L. REV. 1045, 1045 (1984).

5. *See Tender Offer*, SEC: INVESTOR.GOV, https://www.investor.gov/additional-resources/general-resources/glossary/tender-offer (last visited Sept. 22, 2018) (noting all tender offers are subject to the SEC rules and regulations' antifraud provisions).

> 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. The 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.[6]

The crux of Section 14(e) focuses on an offeror or director's use of material misstatements or omissions, or fraudulent acts in connection with a tender offer.[7] Though Section 14(e) is comprised of antifraud provisions, it does not assign a specific standard of liability to cases involving Section 14(e) antifraud violations.[8]

Until recently, federal courts have consistently applied a scienter standard of liability to Section 14(e) claims because they have generally applied the same scienter standard to violations of SEC Rule 10b-5.[9] Rule 10b-5 states:

> It 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 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.[10]

Similarly, Rule 10b-5 does not assign a standard of liability for antifraud violations in connection with the purchase or sale of any security.[11] However, the Supreme Court held in *Ernst* & *Ernst v. Hochfelder* that a scienter standard is the proper standard of liability for Rule 10b-5 violations.[12]

B. Cases Applying a Scienter Standard to 14(e) Claims

In *Ernst*, the Supreme Court noted that the scienter requirement is satisfied when an individual, in connection with a tender offer, exhibits the "mental state embracing intent

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6. Williams Act § 14(e), 15 U.S.C. § 78n(e) (2018).
7. Giguere, *supra* note 4, at 1045.
8. *Id.* at 1046–47.
9. *Id.* at 1048.
10. 17 C.F.R. § 240.10b-5 (2019).
11. *See id.* (outlining the antifraud provisions for statements and acts made in connection with the purchase or sale of any security without assigning a standard of liability).
12. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) ("When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.").

to deceive, manipulate, or defraud."[13] Further, the Supreme Court decided the scienter mental state is required for Rule 10b-5 claims because the Rule incorporates language prohibiting manipulative and deceptive activity.[14] The Court reasoned that the extent to which the SEC can regulate "manipulative or deceptive device[s]" under the rule-making power of Section 10(b) limits Rule 10b-5 to fraudulent acts entailing an intent to defraud.[15]

Since 1973, five federal circuits have held that a Section 14(e) antifraud violation in connection with a tender offer requires proof of scienter, as opposed to mere proof of negligence.[16] In addressing the 14(e) claims, each circuit focused on the similar language in Rule 10b-5 and the Rule's accepted scienter standard.[17]

In 1973, the Second Circuit applied a scienter standard of liability to a Section 14(e) claim in *Chris-Craft Indus. Inc. v. Piper Aircraft Corp*.[18] In *Chris-Craft*, the court determined the liability standard under Section 14(e) for a person or corporate officer soliciting a misleading tender offer is "whether . . . [the] defendant either (1) knew the material facts that were misstated or omitted, or (2) failed or refused to ascertain such facts when they were available to him or could have been discovered by him with reasonable effort."[19] The Second Circuit also noted a negligence standard was not appropriate in claims arising under Sections 17(a) or 10(b) of the 1934 SEA.[20] In making its decision to require scienter, the court focused on Congress' intent in enacting Section 14(e), which was to promote and ensure informed shareholder voting in the case of tender offers.[21]

In that case, in response to Chris-Craft issuing a tender offer to purchase Piper stock, Piper sent a letter to its shareholders discouraging the offer because it was not in the company's best interest.[22] Piper then agreed to an exchange offer with Bangor Punta Corp. before issuing a press release outlining the exchange offer.[23] Accordingly, Chris-Craft brought a private right of action against Piper and Bangor Punta Corp. under Section 14(e) and Rule 10b-5, claiming the letter to Piper stockholders and the press release contained material misstatements.[24] The court held that both Piper and Bangor Punta Corp. violated Section 14(e) because the shareholders were entitled to accurate information adequate to make an informed decision regarding the Piper family's personal recommendations.[25]

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13. *See id.* at 193 n.12 (defining the Court's use of the term "scienter" used throughout the opinion).

14. Giguere, *supra* note 4, at 1048.

15. William Jordan, *Negligence, Rather Than Scienter, Is Standard for Liability Under Section 14(e) of Securities Exchange Act of 1934*, 43 No.6 PROF. LIABILITY REP. NL 31 (2018).

16. *Id.*

17. *Id.*

18. *Id.*

19. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 364 (2d Cir. 1973).

20. *Id.* at 363 ("We have indicated, however, that mere negligent conduct is not sufficient 'to permit plaintiffs to recover damages in a private action under § 17(a) or § 10(b).'").

21. *See id.* at 359 (explaining the goal of 14(e) as facilitating "openness and truthfulness in the solicitation of shares through tender offers and in the opposition to such solicitation").

22. *Id.* at 349–54.

23. *Id.*

24. *Chris-Craft*, 480 F.2d at 349–54.

25. *Id.* at 366.

In the following year, the Fifth Circuit also applied a scienter standard to a Section 14(e) claim in *Smallwood v. Pearl Brewing Co*.[26] In that case, the court stated a degree of culpability that exceeds mere negligence is required in cases alleging violations of Rule 10b-5. The evidence was not sufficient to find that the defendant knew or acted with culpability when they sent a letter to shareholders containing omissions of material facts.[27]

The trend continued in *Adams v. Standard Knitting Mills, Inc.*, where the Sixth Circuit applied a scienter standard of liability for a Section 14(a) claim.[28] In *Adams*, the court found for the defendant proxy statement issuers, stating, "[w]e find nothing in the record indicating an intent to deceive or a motive for deception . . . here we find no evidence of anything other than a negligent error."[29]

Similarly, in *SEC v. Ginsburg*, the Eleventh Circuit relied on similar language in Rule 10b-5 and Section 14(e) to conclude that a Section 14(e) violation requires scienter.[30] In *Ginsburg*, the court found that the defendant, the chairman of the board of a public company involved in a tender offer, violated Section 14(e) because he had material, nonpublic information related to the tender offer that he did not disclose.[31] The Third Circuit followed suit in *In re Digital Island Sec. Litig*.[32] Lastly, in *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*, the Fifth Circuit decided to follow their decision in *Smallwood* and maintain a scienter requirement for Section 14(e) claims.[33]

C. Cases Applying a Negligence Standard to 14(e) Claims

In *Varjabedian v. Emulex Corp.*, the Ninth Circuit split from five other circuits and applied a negligence standard to a Section 14(e) claim.[34] In *Varjabedian*, two corporations, Emulex and Avago, entered into a merger agreement.[35] Subsequently, a subsidiary of Avago, Emerald Merger Sub, Inc., issued a tender offer for Emulex's outstanding stock.[36] Emulex issued a recommendation statement to its shareholders.[37]

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26. *See* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir. 1974) ("suffice it to say that some culpability, beyond mere negligence, is required").

27. *Id.* at 606–07.

28. Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 428 (6th Cir. 1980). Although the Sixth Circuit applied a scienter standard, the Ninth Circuit focused on the fact that the court in *Adams* distinguished between the first clause of Section 14(e), which contains similar language to Rule 10b-5 (i.e., "fraudulent, deceptive, and manipulative"), and the second clause which does not contain similar language. Jordan, *supra* note 15; *see also* Veronica E. Callahan et al., *Arnold & Porter Discusses Ninth Circuit Ruling on Section 14(e) of Exchange Act*, THE CLS BLUE SKY BLOG (May 3, 2018), http://clsbluesky.law.columbia.edu/2018/05/17/arnold-porter-discusses-ninth-circuit-ruling-on-section-14e-of-exchange-act/.

29. *Adams*, 623 F.2d at 422, 428.

30. SEC v. Ginsburg, 362 F.3d 1292, 1303–04 (11th Cir. 2004).

31. *Id.*

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

33. Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp., 565 F.3d 200, 207 (5th Cir. 2009); Jordan, *supra* note 15.

34. *See* Varjabedian v. Emulex Corp., 888 F.3d 399, 408 (9th Cir. 2018) ("Ultimately, because the text of the first clause of Section of 14(e) is devoid of any suggestion that scienter is required, we conclude that the first clause of Section 14(e) requires a showing of only negligence, not scienter.").

35. *Id.* at 401.

36. *Id.* at 402.

Some of the shareholders believed that Emulex's recommendation was misleading and suggested the merger would be more beneficial than it really was.[38] In response, plaintiffs brought a claim against Emulex, Avago, Merger Sub, and the Emulex Board of Directors for failure to include material information in the recommendation statement.[39] The district court dismissed the plaintiff's Section 14(e) claim for failure to plead scienter.[40] The Ninth Circuit reversed the district court's decision to apply a scienter standard and remanded with instruction to assess the Section 14(e) claim under a negligence standard.[41]

Similar to the five opposing circuits' rationale for applying a scienter standard, the Ninth Circuit's rationale in *Varjabedian* was based on textual similarities between statutes.[42] However, instead of comparing Section 14(e) and Rule 10b-5, the court focused on the "nearly identical wording" in Section 14(e) and Section 17(a)(2).[43] In *Aaron v. SEC*, the Supreme Court decided that a claim under Section 17(a)(2) of the 1933 SEA[44] requires a negligence standard as opposed to scienter.[45] Thus, the Court diverged from its tradition of applying Rule 10b-5 principles to statutes encompassing similar language to Rule 10b-5.[46] The Court explained this divergence in *Aaron* stating:

> The language of § 17(a)(1), which makes it unlawful 'to employ any device, scheme, or artifice to defraud,' plainly evinces an intent on the part of Congress to proscribe only knowing or intentional misconduct. Even if it be assumed that the term 'defraud' is ambiguous, given its varied meanings at law and in equity, the terms 'device,' 'scheme,' and 'artifice' all connote knowing or intentional practices . . . [b]y contrast, 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,' is devoid of any suggestion whatsoever of a scienter requirement.[47]

In distinguishing Section 14(e) from Rule 10b-5, the Ninth Circuit argued the first clause, "making or omitting an untrue statement of material fact," does not necessitate a

37. *Id.*

38. *Id.* at 403.

39. *Varjabedian*, 888 F.3d at 403.

40. *Id.*

41. *Id.* at 409–10.

42. *See* Jordan, *supra* note 15 ("These decisions have rested on the textual similarities between Rule 10b-5 and Section 14(e).").

43. *Varjabedian*, 888 F.3d at 406.

44. For a comparison between Section 17(a) and Section 14(e), see *id.* ("Section 14(e) and Section 17(a) serve similar purposes. Both provisions govern disclosures and statements made in connection with an offer of securities, albeit in different contexts: Section 17(a) applies to initial public offerings while Section 14(e) applies to tender offers."). For a comparison between Section 17(a) and Rule 10b-5, see *Section 17(a) of the Securities Act of 1933: Unanswered Questions*, KEKER, VAN NEST, & PETERS (July 8, 2013), https://www.keker.com/news/news-items/Section-17-a-of-the-Securities-Act-of-1933-Unanswered-Questions- ("Section 17(a) is similar . . . to Rule 10b-5, promulgated pursuant to Section 10(b) of the 1934 Securities Exchange Act, and the two provisions follow roughly the same structure. However, . . . Section 17 is broader than Section 10(b) and Rule 10b-5 claims require proof of scienter. On the other hand, Section 17 is narrower than Rule 10b-5 because it does not allow for private rights of action.").

45. Aaron v. SEC, 446 U.S. 680, 697 (1980).

46. *Id.* at 695–97.

47. *Id.* at 696.

scienter requirement because only the second clause, "engaging in fraudulent, deceptive, or manipulative acts or practices," is similar to the language of Rule 10b-5.[48] The Ninth Circuit argued that Rule 10b-5's scienter requirement stems from the authorizing statute as opposed to the specific wording of the Rule, and thus the court's reading of a scienter requirement in Rule 10b-5 does not necessarily apply to the statute encompassing Section 14(e).[49]

III. ANALYSIS

This Part will discuss the courts' application of Rule 10b-5's scienter interpretation and Section 17(a)(2)'s negligence interpretation to Section 14(e) of the Williams Act. Additionally, this Part will analyze the advantages and disadvantages of the two respective standards of liability—scienter and negligence—and how they affect the information contained in an offeror or director's disclosures in connection with tender offers. This Part is situated in the context of the majority of circuits' application of a Rule 10b-5 interpretation to Section 14(e) requiring scienter, and the recent Ninth Circuit decision applying a negligence standard under a Section 17(a)(2) interpretation of Section 14(e).[50]

The following set of hypothetical facts will be assessed throughout the Analysis section to illustrate the difference between negligence and scienter in the context of tender offers. For example, suppose Company X wants to purchase 51% of T Corporation's (T Corp.) shares.[51] The market value of T Corp.'s stock is ten dollars per share. Company X makes a tender offer to purchase 51% of T Corp.'s stock at a premium price of $15 per share. T Corp. is anxious to execute the deal and quickly gathers the information required for disclosure. Company X makes a disclosure to the SEC, and the board of directors of T Corp. issues a recommendation statement in support of the offer to its shareholders. The recommendation statement did not include a document that was prepared just before T Corp. received the tender offer containing an analysis showing a premium price of $15, which was within range of similar transactions in the current market, but was below the average price. After the deal goes through, a group of shareholders files a class action suit alleging that the defendants (T Corp.'s board of directors) violated Section 14(e) by failing to include the share price analysis. Throughout the following section, the facts in the T Corp. example will be assessed to illustrate the benefits and disadvantages for offerors, directors, and shareholders under both standards of liability in the context of tender offers.

A. Application of Liability Standards to Tender Offer Antifraud Violations

In the context of a tender offer, the general notion of an antifraud violation entails the typical elements of untrue statements or omissions of material fact and the use of "fraudulent, deceptive, or manipulative acts or practices," but "in connection with any

48. William K. Pao et al., *Ninth Circuit Creates Circuit Split for Section 14(e) Claims Regarding Tender Offers*, WESTLAW J. DEL. CORP. (May 21, 2018).

49. *Id.*

50. *Id.*

51. [Hereinafter T Corp. example].

tender offer."[52] The standard of liability for a tender offer antifraud violation pertains to the information that a company, third-party acquirer, or director of the target company discloses, so shareholders can make an informed decision about whether to accept the offer.[53] Thus, the difference between a scienter standard and a negligence standard turns on whether the offeror or director knew or should have known that either the information disclosed was untrue or material information was withheld. In practice, it is the amount of information an offeror or director discloses to shareholders that is likely to vary between the two standards.[54]

B. Benefits and Disadvantages of Applying a Scienter Standard

As stated in Part II, applying a 10b-5 interpretation requiring scienter means the shareholders must show the defendant had some level of knowledge and that, in disclosing information to shareholders, the defendant was committing fraud in connection with the tender offer.[55] If the Supreme Court decides to follow the majority of circuits and apply a 10b-5 interpretation requiring scienter, offerors and directors will likely continue to benefit from the higher burden of proof required for plaintiffs to show intent, while courts may benefit from decreased litigation of antifraud violations in connection with tender offers.

1. Benefits of Applying a Scienter Standard of Liability

First, a scienter standard benefits the offeror of a tender offer, as opposed to the shareholders, because it requires the plaintiff to show the offeror committed fraud with a degree of knowledge beyond mere negligence.[56] With a higher bar required for the plaintiff to show fraudulent intent in connection with a tender offer, it is reasonable to believe offerors may be more forthright in making riskier tender offers that do not necessarily allow for a sufficient amount of time to gather the requisite information to fully insulate directors from a shareholder derivative suit.

Second, courts requiring application of the more limiting scienter standard would satisfy policy concerns calling for more restrictions of Rule 10b-5 to limit the growing number of frivolous securities fraud lawsuits.[57] The purpose of securities regulation is to prevent shareholders from being deceived, which is accomplished by a Rule 10b-5 interpretation requiring scienter.[58]

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52. Williams Act § 14(e), 15 U.S.C. § 78n(e) (2018).

53. Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 23–24 (1977).

54. *See* Callahan et al., *supra* note 28 (noting the probable increase in information included in disclosure statements under a negligence standard).

55. *See supra* Part II (defining scienter requirement in connection with tender offers).

56. William F. Sullivan et al., *Lowering the Bar on Tender Offer Claims: The Ninth Circuit Adopts a Negligence Pleading Standard*, LEXOLOGY (May 1, 2018), https://www.lexology.com/library/detail.aspx?g=45890016-85ff-44eb-b207-422b994ebcec.

57. *See* Brendan J. McCarthy, *"In Connection With": The Need for Limitation to SEC Rule 10b-5 in Dissemination of Misleading Information Cases*, 54 CASE W. RES. L. REV. 1347, 1347 (2004) (discussing the desire to limit excessive lawsuits that currently arise under Rule 10b-5).

58. Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir. 1984).

2. Disadvantages of Applying a Scienter Standard

A scienter standard of liability, as opposed to a negligence standard, naturally puts a larger burden on the plaintiff to show the defendant committed a fraudulent act.[59] Hence, the instances of unintentional misrepresentation or omission may occur more frequently under a scienter standard, resulting in increased harm to shareholders. However, serious acts of intentional fraud and deceit, the kind of fraud the Supreme Court decided was intended to be covered by 10b-5, would still be covered.

3. Application of Scienter Standard to Hypothetical Tender Offer

In the T Corp. example, the shareholders would have to show the defendants (T Corp.'s Board of Directors) intentionally omitted the price analysis, or knew the price analysis should have been included but was not submitted as part of the disclosure statement. The higher bar required to show scienter makes it more difficult for the shareholders to prove the defendants were acting with the requisite fraudulent intent. However, the scienter standard also shields the defendant directors from liability if the omission was a mistake or a reasonable oversight.

C. Benefits and Disadvantages of Applying a Negligence Standard

As this Note states in Part II, courts applying a Section 17(a)(2) interpretation, involving a negligence standard of liability, afford a lower bar for the plaintiff to show the defendant should have known that in disclosing information to shareholders, it was committing fraud in connection with the tender offer.[60] Similarly, if the Supreme Court decides to follow the Ninth Circuit and apply a negligence standard, shareholders will benefit in court from the lower bar of a negligence standard which may facilitate director diligence in providing access to more relevant information. However, offerors and directors may experience greater hardships in ascertaining relevant information in a timely manner in order to facilitate tender offers with greater risk of liability.

1. Benefits of Applying a Negligence Standard

Contrary to courts requiring scienter in Section 14(e) claims, a negligence standard benefits the plaintiff and eases the burden of proof required to show the defendant committed fraud in connection with a tender offer.[61] Proponents of a Section 17(a)(2) interpretation of Section 14(e) argue that directors will provide more information to shareholders, which will facilitate informed decision-making and decrease the chance of unintentional omission of material information.[62] Accordingly, "the higher degree of care occasioned by a negligence standard will more surely guarantee greater disclosure and

59. *See* Sullivan et al., *supra* note 56 ("By lowering the bar and recognizing that a claim under Section 14(e) can be based on mere negligence, the Ninth Circuit broke new ground and now stands alone among the circuits in allowing such claims.").

60. *See supra* Part II.C.

61. Christopher Joseph Habenicht, *A Negligence Standard for Material Misstatements and Omissions in Tender Offers Under § 14(e) of the Securities Exchange Act of 1934*, 31 WASH. & LEE L. REV. 733, 736–44 (1974).

62. *Id.* at 743.

thus the achievement" of fair dealing and access to information.[63] Thus, a lower liability standard may facilitate the goals of securities laws and allow shareholders to avoid becoming plaintiffs by protecting the flow of information in the securities market.[64]

2. Disadvantages of Applying a Negligence Standard

Though additional information may seem like a shareholder's delight, it is unclear whether an increase in the amount of information provided in disclosure statements to shareholders will actually provide a "clearer picture of the information that is in fact material to their decision whether or not to tender."[65] The amount of information offerors and directors provide for disclosures under a scienter standard is already burdensome, and additional details that may not be important, but are nonetheless included under a negligence standard to insulate offerors and directors from liability, may end up complicating the shareholders' decision.[66]

A negligence standard of liability enhances the certainty that the number of Section 14(e) claims will increase in the courts, especially in the Ninth Circuit, because the lower burden of proof incentivizes plaintiffs to forum shop.[67] Logically, if directors have a greater work-load because of an increase in the amount of time it takes to prepare a proper disclosure statement under a negligence standard, the number of potential tender offers may decrease because of a lack of time and feasibility.[68] A negligence standard may also reduce the desire for qualified persons to accept directorships because shareholders' incentive to bring Section 14(e) claims is higher than if courts applied a scienter standard of liability.[69]

3. Application of a Negligence Standard to Tender Offer Hypothetical

In the T Corp. example, a negligence standard would ease the burden on the shareholders to show the T Corp. directors violated Section 14(e). T Corp. shareholders would only have to show that a reasonable person in the defendant's position should have known to include the price analysis or should have known the price analysis was not included and needed to be provided in the disclosure statements. Even if the defendants accidentally omitted the price analysis, especially in the haste to finish the deal, the shareholders could easily prevail despite the shareholders receiving a profitable deal.

The T Corp. example sheds light on the complex scenarios tender offers present. Company X's tender offer was within the range of acceptable offers compared to companies like T Corp. If T Corp. received no other offers, and the shareholders sold their shares at a premium, were they actually injured by not having access to the price

63. *Id.*

64. *Id. But see id.* at 743 n.58 (casting doubt on the universal acceptance of the proposition that a negligence standard will increase information included in disclosures).

65. George Casey et al., *Attention Forum Shoppers! Blue Light Special in the Ninth Circuit, M&A Watch Update*, SHEARMAN & STERLING LLP (May 11, 2018), https://www.shearman.com/-/media/Files/Perspectives/2018/05/MAWatchAttentionForumShoppersBlueLightSpecialintheNinthCircuit.pdf.

66. *See* Callahan et al., *supra* note 28 (suggesting that acquirers may have to be more "vigilant" and incorporate extra information in disclosure statements under the more "plaintiff friendly negligence standard").

67. PERKINS COIE, *supra* note 1.

68. *See* Callahan et al., *supra* note 28.

69. Habenicht, *supra* note 61, at 743.

analysis? What if the success of the deal turned out to be dependent on a decision the board made that inadvertently caused the omission of the price analysis in the disclosure statement? If the board had lost the deal because of a decision that caused the price analysis to be disclosed to shareholders, and the shareholders voted in favor of the deal knowing the below average price, would the board be liable yet again for negligence? The T Corp. example shows the competing interests at play and suggests a dual-standard of liability may be the key.

D. Application of a Negligence Standard in Varjabedian

In *Varjabedian*, the court applied a Section 17(a)(2) interpretation to the first clause of Section 14(e) based on the Supreme Court's rationale in *Aaron* and *Ernst*.[70] Further, the *Varjabedian* court's rationale for a negligence standard is based on both the rule-making power of Section 10(b) and the Supreme Court's acknowledgment of a plausible interpretation of the first clause of Section 14(e) as allowing a negligence standard.[71]

1. Rule-Making Power of Section 10(b) and Section 14(e)

The court in *Varjabedian* argues against applying a 10b-5 interpretation of Section 14(e) by pointing to the limitations of Rule 10b-5 set forth in Section 10(b) of the 1934 SEA.[72] The court interprets the SEC's rule making power under Section 14(e) by acknowledging that the rules must be limited to "means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."[73] The Court's rationale in *Ernst*—as applied to the power granted under Section 10(b) by its terms relating to "manipulation and deception"—does not apply to the terms fraudulent, deceptive, or manipulative in Section 14(e).[74] In *Varjabedian*, the court used this argument to prove that a negligence standard of liability under a Section 17(a)(2) interpretation should prevail, and it is clear from the language of Section 14(e)'s rule-making power that the Supreme Court, following its rationale in *Ernst* and *Schreiber*, could find that both clauses of Section 14(e) do not require scienter because Section 10(b) limits Rule 10b-5 to scienter, whereas Section 14(e) is not so limited.[75]

2. Possible Interpretation of Section 14(e) to Allow a Negligence Standard

The court in *Varjabedian* relied heavily on the Supreme Court's statements in *Ernst* concerning the similar language in Rule 10b-5 and Section 14(e).[76] The Ninth Circuit noted that the Court in *Ernst* stated one could "reasonably" read the language in Rule

70. *See generally* Aaron v. SEC, 446 U.S. 680 (1980) (ruling that liability under Section 17(a)(2) of the Securities Act requires negligence instead of scienter); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (stating Rule 10b-5 requires scienter because rule-making power under 10(b) is limited to intentional acts of fraud); Varjabedian v. Emulex Corp. 888 F.3d 399, 406 (9th Cir. 2018).

71. *Varjabedian*, 888 F.3d at 406–07.

72. *Id.*

73. Williams Act § 14(e), 15 U.S.C. § 78n(e) (2018).

74. *Ernst*, 425 U.S. at 185–86.

75. Schreiber v. Burlington N., Inc., 472 U.S. 1, 10–12 (1985); *Ernst*, 425 U.S. at 185–86.

76. *Varjabedian*, 888 F.3d at 405–07.

10b-5(b)[77] to include negligent or intentional acts of fraud.[78] Thus, the similar language in Section 14(e)[79] could plausibly entail a negligence standard, especially because it is not limited by Section 10(b) of the 1933 SEA.[80] The Ninth Circuit determined that this opens the door for application of Section 17(a)(2), which requires mere negligence.[81] However, the Court in *Ernst* also stated the additional language in Rule 10b-5[82] that is present in Section 14(e) is open to interpretation of negligence or scienter.[83] Thus, the Ninth Circuit's exclusive use of Section 17(a)(2) to make a definitive standard of liability determination based on identical language in Section 14(e) is not conclusive.

The court could just as easily rely on Rule 10b-5 or Section 17(a)(2) to define the appropriate standard of liability in Section 14(e). Given the majority of the circuit courts' application of Rule 10b-5, a strictly scienter standard may appear to prevail. However, the rationale for applying a Section 17(a)(2) interpretation to the first clause of Section 14(e) should ultimately persuade the Supreme Court to adopt a dual-standard of liability because the Supreme Court would be acting contrary to its own interpretations of Section 14(e)'s language if it decides to solely apply a negligence or scienter standard across both clauses of Section 14(e).

IV. RECOMMENDATION

The courts should apply a negligence standard to the first clause of Section 14(e), while a scienter standard, consistent with current precedent,[84] should be applied to the second clause. Thus, Section 14(e) claims should encompass a dual-standard of liability. The Ninth Circuit's statutory language argument—that the negligence standard required in Section 17(a)(2) should apply to Section 14(e) because the language in the first clause of Sections 14(e) and 17(a)(2) is identical[85]—cannot prevail over the argument for a 10b-5 interpretation based on similar language in Section 14(e) since that same language is present in both the SEC Rule and the Public Offering statute.[86] Thus, the real decision the Supreme Court must make, if it decides to grant certiorari, is whether to rely on the

77. 17 C.F.R. § 240.10b-5 (2019) ("[t]o 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 . . . .").

78. *Varjabedian*, 888 F.3d at 405.

79. *See* 15 U.S.C. § 78n(e) (2018) (mirroring the language of 10b-5(b)).

80. *Varjabedian*, 888 F.3d at 405–07.

81. *Id.*

82. 17 C.F.R. § 240.10b-5 (2019) ("It shall be unlawful for any person . . . 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.").

83. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976).

84. *See generally* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973) (applying the standard); Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974) (the same); Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (6th Cir. 1980) (the same); SEC v. Ginsburg, 362 F.3d 1292 (11th Cir. 2004) (the same); *In re* Dig. Island Sec. Litig., 357 F.3d 322 (3d Cir. 2004) (the same); Flaherty & Crumrine Preferred Income Fund Inc. v. TXU Corp., 565 F.3d 200 (5th Cir. 2009) (the same).

85. *Varjabedian*, 888 F.3d at 404–09.

86. *See* 17 C.F.R. § 240.10b-5 (2019); 15 U.S.C. § 78n(e) (1965); 15 U.S.C. § 77q(a)(2) (1976) ("any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made").

standard applied by the accompanying determinations of Rule 10b-5[87] or Section 17(a).[88]

A. Public Policy Favors a Dual-Standard of Liability

Setting aside the statutory language comparison between Rule 10b-5, Section 17(a)(2), and Section 14(e), policy arguments for courts adopting a single standard to apply to both clauses in Section 14(e) tend to favor directors or shareholders but not both.[89] Corporate deals involve large amounts of money, a short amount of time, are in the board's control, and are for the benefit of the shareholders. With such critical deals occurring within these constraints, antifraud provisions become necessary to police corporate deals to protect the shareholders in charge of deciding whether to accept these types of deals. Such antifraud provisions would also keep directors, who are in positions of power and have privileged knowledge, acting in the best interest of the shareholders.

Both offerors and shareholders require some protection from the severe consequences that can result from an unintentional omission or false statement pertaining to a tender offer, but the majority of circuit courts seem to favor the policy advocating for increased disclosures. However, courts expanding the realm of conduct that could result in harsh consequences for offerors could have a negative impact on the practice of tender offers if directors and third-party offerors become reluctant to make disclosures.[90] Accordingly, such reluctance could hurt shareholders—the people the statutes were intended to protect by mandating disclosure—by decreasing the availability of information and, in turn, the opportunity for corporate deals.[91] Furthermore, there is a risk that directorships will be harder for companies to fill, which could also end up hurting shareholders if qualified people are not filling open positions.[92]

The argument for courts applying the stricter standard of scienter to all claims arising under Section 14(e) may seem compelling on the side of the directors, while the same can be said for a negligence standard on behalf of the shareholders. Yet, the goal of Rule 10b-5, Section 14(e), and Section 17(a) is to facilitate disclosure and the exchange of information so corporate deals grow out of fully informed decision-making, benefiting the shareholders, acquirers, directors, and the market alike.[93] Ultimately, disclosure,

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87. *See* Aaron v. SEC, 446 U.S. 680, 691 (1980) ("In our view, the rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b–5 . . . .").

88. *See id.* at 697 ("It is our view, in sum, that the language of § 17(a) requires scienter under § 17(a)(1), but not under § 17(a)(2) . . . .").

89. *See, e.g.*, Habenicht, *supra* note 61, at 736–44 (discussing courts' general preference to protect shareholders).

90. *See* Alan J. Ross & James F. Sealler, *Scienter and Rule 10b-5: Development of a New Standard . . .* , 23 CLEV. ST. L. REV. 493, 517 (1974) ("[A]ccess to information by these same investors might very well be severely curtailed. Since a duty to disclose does not exist under all conditions and at every moment in time, and often only where special relationships exist, the end result might be that, in the absence of insider trading, a corporation would avoid as much as possible the disclosure of any information not absolutely necessary of disclosure to avoid incurring liability . . . [T]he potential damages would be so great that corporations might choose 'to remain silent and let false rumors do their work.' The attendant result would be the direct antithesis of the underlying intent of all securities legislation—i.e., encouraging the free flow and mutual access of all material securities information to investors as well as corporate insiders.").

91. *Id.*

92. Habenicht, *supra* note 61, at 743.

93. *Id.*; *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 357 (2d Cir. 1973) (explaining

intended to help shareholders and directors throughout the corporate decision-making process, benefits both parties. A standard of liability only succeeds in achieving that goal if the right kind of injuries are being prevented, and the right kind of acts are being punished.

In terms of public policy, the correct standard is one that "adapt[s] to fluctuating individual factual circumstances."[94] Thus, Section 14(e) claims should encompass a dual-standard of liability to allow for a standard that reflects the complexities that exist in the context of tender offers and provides a combination of standards that encompass a reasonable continuum that aids offerors, directors, and shareholders given any set of circumstances.[95]

B. Statutory Interpretation Favors a Dual-Standard of Liability

On the surface, it seems like a Supreme Court decision to apply either standard would be at odds with a prior decision establishing the differing standards between both Rule 10b-5 and Section 17(a), and the similar language that exists between these provisions and Section 14(e). Yet, the Ninth Circuit is correct in recognizing that the established precedent regarding the scienter standard in Rule 10b-5 is effectively limited to the following language: "to employ any device, scheme, or artifice to defraud" and "act[s] . . . which operates or would operate as a fraud or deceit."[96] Additionally, the established precedent for Section 17(a)(2) is limited to "any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made."[97] Thus, in terms of legal precedent, the logical conclusion is for courts to apply a dual-standard to the two parts of Section 14(e), which would effectively align with both the decisions pertaining to Rule 10b-5's scienter standard and Section 17(a)(2)'s negligence standard.

It would make little sense for courts to apply Rule 10b-5's scienter standard to the language in Section 14(e) that is identical to the language in Section 17(a)(2), when the Supreme Court has already concluded the language does not suggest a scienter standard.[98] Additionally, the Court's decision to consistently apply Rule 10b-5's scienter standard to the identical language in Section 17(a)(1) further supports this pattern of interpretation.[99] Thus, the most consistent decision is for the Supreme Court to continue the pattern of statutory interpretation and apply a negligence standard, which has been established for Section 17(a)(2), to the first clause of Section 14(e).[100]

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the importance of regulating disclosures to protect the integrity of the market).

94. Ross & Sealler, *supra* note 90, at 518.

95. *Id.* at 517–22.

96. 17 C.F.R. § 240.10b-5 (2019); *see* Varjabedian v. Emulex Corp., 888 F.3d 399, 407 (9th Cir. 2018) (discussing the specific wording in 10b-5 the court relies on in *Ernst* and *Aaron* to determine standard of liability).

97. 15 U.S.C. § 77q(a)(2) (1976).

98. *See* Aaron v. SEC, 446 U.S. 680, 696 (1980) (noting that the language of 17(a)(2) "is devoid of any suggestion whatsoever of a scienter requirement").

99. *See id.* at 697 ("It is our view, in sum, that the language of § 17(a) requires scienter under § 17(a)(1), but not under § 17(a)(2) . . . .").

100. Additionally, the Supreme Court stated in *Ernst*, "[v]iewed in isolation the language of subsection (b)," to make any untrue statement of a material fact or to omit to state a material fact, "could be read as proscribing, respectively, any type of material misstatement or omission . . . whether the wrongdoing was

Lastly, the difference in the rule-making constraints of Section 10(b) and Section 14(e) suggests that the court's interpretation of Rule 10b-5 requiring a scienter standard, as a whole, should not extend to the similar language in Section 14(e).[101] The rule-making power of Section 14(e) allows for preventative rules that extend beyond antifraud provisions, as opposed to the constraints of Section 10(b) which limit the Rules to fraud.[102] In terms of the standards that have been applied to Rule 10b-5, Section 17(a), and Section 14(e), it is favorable that courts apply a negligence standard to a claim brought under the first clause of Section 14(e) based on the Supreme Court's interpretation of Section 17(a)(2) in *Aaron*.[103]

C. Implications of a Dual-Standard Approach to Section 14(e)

The first clause of Section 14(e) subject to a Section 17(a)(2) interpretation states, "to make any untrue statement of a material fact or omit to state any material fact necessary to make the statements made."[104] The second clause of Section 14(e) subject to a Rule 10b-5 interpretation states, "to engage in any fraudulent, deceptive, or manipulative acts or practices."[105] Two implications result from courts applying a dual-standard of liability across Section 14(e) in this way. First, to avoid surplusage, the two clauses of Section 14(e) must be interpreted to encompass different kinds of conduct. Second, a dual-standard of liability aligns with current precedent for interpreting both Rule 10b-5 and Section 17(a).

First, interpreting the first and second clauses in a way that avoids surplusage requires an interpretation that encompasses different conduct.[106] If claims under Section 14(e) encompass different conduct, then a dual-standard of liability makes the most sense.[107] If Rule 10b-5's scienter standard is limited to fraudulent acts, then acts that are covered under Section 14(e) that are not fraudulent should be considered under a different standard. Courts applying a negligence standard to both clauses would fail to encompass the necessary mental state for fraud, while courts applying a scienter standard to both clauses would impute a mental state for acts that are not considered deceptive. A dual-standard of liability is the only logical way to effectively delineate between the

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intentional or not." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976). Thus, the pattern could theoretically have also extended to the similar language in 10b-5 if the rule-making constraints of Section 10(b) hadn't limited Rule 10b-5 to "deceptive devices." *Id.* at 195.

101. *See* Varjabedian v. Emulex Corp., 888 F.3d 399, 407 (9th Cir. 2018) (arguing that the rule-making authority of 14(e) differs from the rule-making authority under Section 10(b) and thus 14(e) should not be limited to a 10b-5 interpretation). The court states: "If the SEC can prohibit 'acts themselves not fraudulent' under Section 14(e), then it would be somewhat inconsistent to conclude that Section 14(e) itself reaches only fraudulent conduct requiring scienter." *Id.*

102. *Id.*

103. *See Aaron*, 446 U.S. at 697.

104. 15 U.S.C. § 78n(e) (2012).

105. *Id.*

106. *See* Habenicht, *supra* note 61, at 737 ("[M]aterial misrepresentations or omissions under the first clause of § 14(e) could be interpreted to constitute deceptive acts or practices under the second clause, thereby refuting the proposition that the clauses are separable. However, unless the first clause is read to encompass activity other than deceptive or manipulative practices, it is rendered mere surplusage.").

107. *Id.*

types of conduct proscribed under Section 14(e).[108]

Second, the Supreme Court has already decided the language in the second clause of Section 14(e) requires scienter under a Rule 10b-5 interpretation.[109] Additionally, the Supreme Court has already decided that the language in Section 17(a)(2), which is also present in the first clause of Section 14(e), requires a negligence standard.[110] The Supreme Court would be acting contrary to its own interpretations of Section 14(e)'s language if it decides to solely apply a negligence or scienter standard across both clauses of Section 14(e). Only a dual-standard of liability is consistent with current precedent and Supreme Court rationale. Thus, a dual-standard of liability under Section 14(e) claims is the only standard that makes logical and textual sense given the current caselaw and goals of securities regulation.

V. CONCLUSION

The issue of whether courts should apply a negligence or scienter standard to a Section 14(e) antifraud violation seems to favor a scienter standard based on the current five to one split among the federal circuits. However, the Supreme Court's established precedent and pattern of statutory interpretation of Rule 10b-5 and Section 17(a), along with the favorable policy implications of courts encouraging a balanced approach to redressing conflicts between directors, offerors, and shareholders, suggest that a dual-standard of liability is indeed the superior choice. As opposed to courts applying a single scienter or negligence standard to all claims brought under Section 14(e), a dual-standard of liability should be applied across both clauses of Section 14(e). Specifically, courts should apply a negligence standard to the first clause of Section 14(e), consistent with the court's interpretation of Section 17(a)(2), and a scienter standard to the second part of Section 14(e), consistent with the court's interpretation of Rule 10b-5. This dual-standard of liability accords with current precedent and fully encompasses conduct covered under Section 14(e).

108. *See id*. ("Congress surely did not intend the detailed language of the first clause of § 14(e) to be subsumed within the second clause; a more logical conclusion is that the two clauses were designed to proscribe different types of conduct.") (citation omitted).

109. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212–14 (1976).

110. Aaron v. SEC, 446 U.S. 680, 697 (1980).