Securities Litigation Alert

Akin Gump
STRAUSS HAUER & FELD LLP

Ninth Circuit Rejects Heightened State-of-Mind Pleading Requirement for Section 14(e) Claims

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Key Points

- The 9th Circuit, disagreeing again with the 2nd, 3rd, 5th, 6th, and 11th Circuits, reaffirmed that claims under Section 14(e) of the Exchange Act do not require a showing of scienter.
- In the 9th Circuit's view, because claims under Section 14(e) for misrepresentations in connection with tender offers require mere negligence, they are not subject to the PSLRA's Section 4(b)(2) requiring a "strong inference" of scienter. This is true even if a plaintiff in a particular Section 14(e) case proceeds on the theory that a defendant gave a subjectively false opinion.
- In holding that the plaintiff nonetheless failed to state a claim, the 9th Circuit also reinforced that Rule 8's lower pleading standard is not easily met.

Background

Grier v. Finjan Holdings, Inc. centers around a 2020 transaction in which asset manager Fortress Investment Group LLC acquired all shares of a publicly-traded cybersecurity company, Finjan Holdings, Inc., for a purchase price of $1.55 per share.

Two years before, in March 2018, Finjan's board initiated a "strategic review process," which included exploring opportunities to sell the company. Over the next several months, Finjan and an investment bank it had retained contacted various potential buyers, including Fortress as well as another company (described in the complaint and opinion as "Party B"). While Finjan allegedly initially received offers as high as $5.10 per share, negotiations stalled when Finjan's stock price declined in late 2018. In 2019 through early 2020, Finjan renewed its efforts to reach out to potential buyers, but only Fortress and Party B were interested, with offers in the ballpark of $2.30 to $2.60 per share.

As Finjan's stock price continued to fall during the first months of the COVID-19 pandemic, Party B informed Finjan of its intent to purchase more than 5 percent of Finjan's stock on the open market, and also offered to purchase Finjan's outstanding stock for $1.50 per share. With this offer in hand, Finjan contacted Fortress and

Contact Information:

If you have any questions concerning this alert, please contact:

M. Scott Barnard
Partner
sbarnard@akingump.com
Dallas, TX
+1 214.969.4299

Neal Ross Marder
Partner
nmarder@akingump.com
Los Angeles, CA
+1 310.728.3740

Aileen M. McGrath
Partner
amcgrath@akingump.com
San Francisco, CA
+1 415.765.9553

Michelle A. Reed
Partner
mreed@akingump.com
Dallas, TX
+1 214.969.2713

Josh A. Rubin
Counsel
rubinj@akingump.com
Los Angeles, CA
+1 310.728.3282

Sina S. Safvati
Counsel
ssafvati@akingump.com
Los Angeles, CA
+1 310.229.1064

eventually negotiated a sale of all outstanding stock for $1.55 per share, which was subject to shareholder approval.

Finjan's management issued a statement to its shareholders recommending that they vote in favor of the sale. As part of the statement, Finjan included financial projections that were significantly lower than projections the company had issued several months prior, as well as an analysis based on those projections showing that the $1.55 per share offer was reasonable. Finjan's shareholders voted to approve the transaction.

The plaintiff initiated a lawsuit on behalf of himself and a putative class of Finjan shareholders under Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(e) ("Section 14(e)"), which prohibits false statements or omissions in connection with a tender offer. According to plaintiff, Finjan and its management (together, the "defendants") knew that the projections and share estimates in their statement to shareholders understated Finjan's value and that the defendants intentionally provided these unreasonable estimates to make Fortress's offer appear more attractive.

The District Court's Decision

The district court dismissed the complaint with prejudice on the basis that plaintiff failed to adequately allege a misrepresentation. Recognizing that the financial projections were statements of opinion, the district court reasoned that plaintiff could plead that the projections were false only through allegations that the defendants did not genuinely believe them. Finding plaintiff's allegations insufficient on this front, the district court dismissed the action.

Notably, in so holding, the district court applied three separate heightened pleading standards: (i) Federal Rule of Civil Procedure ("Rule") 9(b), which applies to all "alleg[ations of] fraud"; (ii) a provision in the Private Securities Litigation Reform Act (PSLRA) requiring greater particularity by securities plaintiffs in identifying alleged misstatements and why they are false; and (iii) a provision in the PSLRA requiring a strong inference for state-of-mind, i.e., scienter, allegations.

The 9th Circuit's Opinion

A three-judge 9th Circuit panel unanimously affirmed the district court's decision in an opinion by Judge Carlos T. Bea. While the 9th Circuit affirmed the district court's judgment, it disagreed with a critical part of the district court's analysis.

The district court had applied three different heightened pleading requirements in dismissing plaintiff's complaint. The 9th Circuit approved of the district court's application of the first two heightened pleading standards—Rule 9(b) and the PSLRA's particularity requirement for falsity, 15 U.S.C. § 78u-4(b)(1) ("Section 4(b)(1)"). But the 9th Circuit disapproved of the district's court's application of the third heightened pleading standard—the PSLRA's heightened plausibility standard for pleading scienter. 15 U.S.C. § 78u-4(b)(2)(A) ("Section 4(b)(2)").

Section 4(b)(2) provides that "in any private action arising under [the Exchange Act] in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind," the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Concluding that Section 14(e) was not a cause of action "in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state

of mind," the 9th Circuit held that Section 4(b)(2)'s heightened standard was not implicated.

In reaching this conclusion, the 9th Circuit first observed that, under its prior decision in *Varjabedian v. Emulex Corp.,* 888 F.3d 399 (9th Cir. 2018), a Section 14(e) plaintiff need not show that a defendant intentionally made any misrepresentations, but only that the defendant acted negligently.[1] But here, the plaintiff's theory was that Finjan's projections were false *because* the defendants did not truly believe them. This concept of "subjective falsity" set forth a theory of liability very close to scienter, as it requires allegations of defendants' specific state of mind. The district court had held that Section 4(b)(2) applied for that reason.

The 9th Circuit disagreed. Relying on a textual reading of Section 4(b)(2), the 9th Circuit interpreted that statute as applying—or not applying—to particular *causes of action*, rather than to the facts alleged or theories advanced in a particular case. According to the 9th Circuit, Section 4(b)(2) applies only to those causes of action that necessarily require proof of scienter. If a cause of action does not necessarily require proof of scienter, then Section 4(b)(2) does not apply, even if a plaintiff is proceeding under a legal theory that a defendant made an intentional misrepresentation. Because Section 14(e) does not require "proof that the defendant acted with a particular state of mind" in the 9th Circuit, the 9th Circuit held that the district court's application of Section 4(b)(2) was erroneous.[2]

Although the district court applied the wrong standard, the 9th Circuit determined it reached the correct conclusion. Applying the correct, non-heightened plausibility standard, the 9th Circuit determined that plaintiff had failed to plausibly allege that defendants did not subjectively believe their projections. The plaintiff had identified 10 different facts that he alleged demonstrated subjective falsity, and the 9th Circuit rejected them all, both individually and collectively. Notably, the 9th Circuit rejected the implication that defendants' much higher forecast in December 2019 showed that the more pessimistic projections in 2020 were knowingly false, holding that the intervening impact of the COVID-19 pandemic made that implication implausible.

Takeaways

There are several key takeaways from the *Finjan* opinion.

First, the opinion reaffirms the 9th Circuit's 2018 *Varjabedian* decision holding that Section 14(e) requires only negligence, rather than allegations of a defendant's state of mind. The *Varjabedian* decision created a circuit split, and the *Finjan* decision sheds light on the continued implications of that split in the context of statements of opinion.

Second, the opinion reveals that the PSLRA's heightened requirement for pleading scienter does not apply broadly to all allegations of intentional conduct in a securities fraud case. Instead, courts in the 9th Circuit must now determine whether a particular cause of action *requires* allegations of scienter, and apply Section 4(b)(2) only if the answer is yes.[3]

Third, the opinion suggests that, although a Section 14(e) claim premised on opinions is not subject to Section 4(b)(2), all is not lost for defendants. Indeed, the 9th Circuit, on its own, applied the lower plausibility standard of Rule 8 and nonetheless held that plaintiff had failed to state a claim. In doing so, the 9th Circuit rigorously scrutinized plaintiff's allegations supporting his theory that the projections were knowingly false

and, finding that some were implausible and some merely "inconclusive," held that plaintiff had not satisfied his burden. The ultimate holding of the case gives the defense bar some comfort that, though it may have lost the battle of Section 4(b)(2)'s application in the 9th Circuit, it may have won the war with a ruling that will require district courts to scrutinize closely allegations of knowledge and intent.

[1] The *Varjabedian* decision created a circuit split, as every other Circuit to decide the issue has held that Section 14(e) requires proof of the defendant's scienter. In January 2019, the U.S. Supreme Court granted a petition for a writ of certiorari likely to resolve this split, but shortly after oral argument, the Court dismissed the writ as improvidently granted. *Emulex Corp. v. Varjabedian*, 139 S. Ct. 1407 (2019) (Mem.) (dismissing cert. petition as improvidently granted).

[2] The 9th Circuit gave an example of a situation where a Section 14(e) defendant might give an opinion he or she did not truly believe (thereby satisfying the "subjective falsity" requirement) while not acting with scienter: a corporate executive who believes that a corporation will have revenue of $400 million but, through a negligent scrivener's error, incorrectly states his or her prediction as revenue of $40 million.

[3] As just one type of securities claim where a strong inference of scienter is required, the 9th Circuit identified Section 10(b), highlighting the "significant differences between Section 14(e) and Section 10(b)—the securities fraud provision most commonly addressed in our jurisprudence that deals generally with falsities in the purchase and sale of securities."

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