CA Nos. 08-16745, 08-16873, 09-15021 (consolidated)
DC No. C 07-01389 JW

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

THE FACEBOOK, INC., ET AL.,

Plaintiffs/Appellees/Cross-Appellants,

v.

CONNECTU, INC.,

Defendant/Appellee,

and

CAMERON WINKLEVOSS, TYLER WINKLEVOSS
and DIVYA NARENDRA,

Defendants/Appellants/Cross-Appellees.

Appeal From Judgment Of The United States District Court
For The Northern District Of California
(Hon. James Ware, Presiding)

APPELLANTS' REPLY BRIEF
[PUBLIC RECORD VERSION]

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I.

THE FOUNDERS HAVE STANDING TO APPEAL.

The motions panel referred Facebook's motion to dismiss the Founders' appeal to the merits panel. The shortest path to resolving that motion lies in the rule that the Founders were permitted to rely on a co-party's (ConnectU's) objection. ConnectU Founders' Opposition to Facebook's February 18, 2009 Motion to Dismiss ("Opp. to Motion") at 16; Appellants'/Cross-Appellees' Opening Brief ("AOB") 26. But even if the *Founders* could be said to have waived their appellate rights below—a view the District Court itself repeatedly rejected (Opp. to Motion 4, 9-10)—*ConnectU* did not. Since the motions panel allowed the Founders to intervene in ConnectU's appeal, the Founders have the same appellate rights as would ConnectU.

Intervenors on appeal have the same full appellate rights as intervenors in the District Court who file a notice of appeal. *See* CHRISTOPHER A. GOELZ & MEREDITH J. WATTS, NINTH CIRCUIT CIVIL APPELLATE PRACTICE ¶2:637 (2010) (an intervenor "has full party status"); *Bates v. Jones*, 127 F.3d 870, 873 (9th Cir. 1997) ("Intervention on appeal is governed by Rule 24 of the Federal Rules of Civil Procedure"); *see also* Confidential Brief of Appellees ("AB") 71-72 (Rule 24 governs "[i]ntervention here").

Hutchinson v. Pfeil, 211 F.3d 515 (10th Cir. 2000), cited by Facebook, is inapposite. There, a proposed intervenor who missed the deadline to appeal an order was not permitted to intervene in another party's appeal. *Id.* at 519.

Here, the Founders filed timely notices of appeal (AOB 11-12) and have been permitted to intervene in ConnectU's appeal. Facebook has not sought reconsideration of the motions panel's decision on that point; it should be treated as settled. *See United States v. Houser*, 804 F.2d 565, 568 (9th Cir. 1986).

II.

THE TERM SHEET SHOULD BE RESCINDED FOR VIOLATION OF THE FEDERAL SECURITIES LAWS.

Facebook asserts:

- An agreement to settle litigation can never be set aside on the ground that it was induced by securities fraud.
- An issuer or seller of stock has no Rule 10b-5 duty to disclose material information unless it has a pre-existing fiduciary relationship with the issuee or purchaser.
- An issuer or seller of stock is relieved of its usual duty to disclose material information if the issuee or purchaser is a "sworn enemy."
- That a company's board has obtained, and acted upon, a valuation of its stock at 25% of a previously disclosed valuation is not "material" information that need be disclosed.
- An issuer or seller of corporate stock is excused from its duty of disclosing material information if that information could be found by scouring the internet.

If Facebook truly believes any of these things—let alone all of them—then it badly needs a crash course in securities law compliance. As we now show, it is wrong in every respect.

A. The Founders Did Not Release Their Securities Law Defense.

Facebook argues that the Founders have conceded that the Term Sheet's provision for a "broad release" was "written broadly and categorically enough to release their fraud claim." AB 39. The Founders have made no such concession, and the District Court made no such ruling. The Term Sheet refers to "releases as broad as possible" of the claims being made in the pending litigation, but says nothing about releasing claims of securities fraud that induced the agreement itself. *See* 4-ER-482-83. Facebook's argument amounts to the untenable claim that standard releases in any settlement agreement would exempt a securities transaction included within that agreement from the 1934 Act.

Facebook's reliance on *Petro-Ventures, Inc. v. Takessian*, 967 F.2d 1337 (9th Cir. 1992) (AB 37), rests on a misdescription of that case, as the opinion and briefs in that case confirm. *See* Motion for Judicial Notice in Support of Appellant's Reply Brief ("MJN") Exs. 1-4. The question in *Petro-Ventures* was whether, after settling a prior case about a securities transaction, the plaintiff could bring a second securities fraud case about the same transaction. MJN Ex. 2 at 1; *id.* Ex. 3 at iv-v. This Court held that Section 29's anti-waiver rule

did not permit the plaintiff to bring a second case based on the same transaction, contrary to the terms of the settlement agreement, merely because the plaintiff subsequently learned new facts. *Petro-Ventures*, 967 F.2d at 1343; MJN Ex. 1 at 5-6, 9. The Court held that the release in the first case barred all claims related to the 1986 transaction even if they had not been asserted in the settled lawsuit. 967 F.2d at 1338, 1342.

This case is different. Here, the securities law violation took place in connection with the settlement agreement itself, not in the underlying transaction that was the subject of the litigation to be settled. Under federal law, a settlement agreement "may be attacked on the grounds that it was procured by fraud, duress or other unlawful means." *First Nat'l Bank of Cincinnati v. Pepper*, 454 F.2d 626, 632 (2d Cir. 1972) (duress); *see also Brown v. County of Genesee*, 872 F.2d 169, 175 (6th Cir. 1989) (fraud or other unethical conduct); *accord*, *Callen v. Pennsylvania R.R.*, 332 U.S. 625, 630 (1948) (upholding settlement because no evidence of fraud or mistake). Facebook ignores those authorities, relying on two inapposite cases. AB 40-41. The first of those cases, *Mergens v. Dreyfoos*, 166 F.3d 1114 (11th Cir. 1999), applied Florida law but, as Facebook itself notes (AB 41 n.4), federal law, not state law, governs the validity of releases of federal statutory causes of action. *Petro-Ventures*, 967 F.2d at 1340. Under the authorities just cited, fraud in the inducement of a settlement *is* a defense to its enforcement.

Facebook's citation to *Harsco Corp. v. Segui*, 91 F.3d 337 (2d Cir. 1996), is even farther afield. There, a stock purchaser agreed to rely *only* on fourteen pages of representations, disclaiming reliance on any others. *Id.* at 342-43. The Term Sheet has no comparable provision. *Harsco* noted that, in "different circumstances (e.g., if there were but one vague seller's representation) a 'no other representations' clause might be toothless and run afoul of § 29(a)." *Id.* at 344. This is such a case. In the Term Sheet, Facebook made only one representation (of the number of total Facebook shares outstanding) (4-ER-483) and, unlike *Harsco*, the Founders did not disclaim reliance on any other representation. Nor is there anything in *Harsco* to support Facebook's contention (AB 40) that *Harsco* implicitly undermines *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1142 (2d Cir. 1970) (settlement stipulation "void" if it violates the securities laws), *overruled on other grounds*, *Bennett v. United States Trust Co. of N.Y.*, 770 F.2d 308, 311-13 (2d Cir. 1985). *See* AOB 45-46.

Facebook contends that *Harsco* limited Section 29's protection to "unsuspected and unsophisticated consumers who, unaided by counsel, enter into contracts of adhesion" and excludes from its protection "sophisticated business entities negotiating at arm's length." AB 40 (internal quotation marks omitted). There is nothing in *Harsco* that adopted any such exemption. Congress has not enacted a "sophisticated business entities" exception to Section 29's broad sweep, and there is no warrant for a court to declare a statutory exemption that Congress has not seen fit to adopt. *See 62 Cases, More or Less, Each*

Containing Six Jars of Jam v. United States, 340 U.S. 593, 596 (1951); *see also* AOB 47-48.[1]

B. Facebook Breached Its Duty To Disclose Material Facts.

1. Facebook Owed A Duty To Disclose Material Information To The Founders As Purchasers Of Facebook Securities.

Issuers of securities must disclose material information to the counterparty when trading in their own stock. *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 876 (9th Cir. 1994) (corporation buying its own stock had duty to disclose to seller). "When the issuer itself wants to buy or sell its own securities, it has a choice: desist or disclose." VII LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3499 (3d ed. 1991); *see also Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1203-04 (1st Cir. 1996); *Newby v. Lay (In re Enron Corp. Sec. Derivative & ERISA Litig.)*, 258 F. Supp. 2d 576, 589 & n.9 (S.D. Tex. 2003).

Facebook denies it had a duty to disclose because, in *McCormick*, this Court supposedly "took pains to distinguish" a transaction with *potential* shareholders, to whom Facebook claims no duty of disclosure is owed, from transactions with current shareholders, to whom Facebook implicitly concedes disclosure would be required. AB 55. Facebook's characterization of *McCormick* is false.

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[1]In addition, both *Mergens* and *Harsco* hold that the parties who signed releases there could not reasonably rely on the party executing the release. Those holdings are inapplicable here, where reliance is presumed. *See* p.16, *infra*.

The opinion nowhere distinguishes between an issuer's duty to disclose to current versus prospective shareholders; the authorities cited in the preceding paragraph—among many others—confirm that no such distinction exists. *See* p.6, *supra*; *Chiarella v. United States*, 445 U.S. 222, 227 & n.8 (1980) ("'the director or officer assume[s] a fiduciary relation to the buyer by the very sale: for *it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one*'") (citation omitted; emphasis added); *see also SEC v. Murphy*, 626 F.2d 633, 652 n.23 (9th Cir. 1980); *United States v. Chestman*, 947 F.2d 551, 565 n.2 (2d Cir. 1991) ("insider's fiduciary duties . . . run to a buyer (a shareholder-to-be)"); *Starkman v. Warner Commc'ns, Inc.*, 671 F. Supp. 297, 305 (S.D.N.Y. 1987).

Facebook expresses alarm at the notion that "hundreds of private companies that pay their employees in stock options" would be "committing securities fraud every day, because they do not reveal to employees all sorts of material inside information . . . ." AB 50. Facebook's assumption that Rule 10b-5 does not apply to employee stock options is breathtakingly incorrect. *See, e.g.*, *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1127, 1130 (9th Cir. 2002) (allegation that employer "concealed" material information from employees "to make the options more attractive" was "precisely the type of claim that is properly the subject of federal securities law"), *amended on other grounds*, 320 F.3d 905 (9th Cir. 2003); Matthew T. Bodie, *Aligning Incentives With Equity: Employee*

Stock Options and Rule 10b-5, 88 IOWA L.R. 539, 558 (2003) (employees holding stock options can sue under Rule 10b-5 as long as "such options are deemed to be 'securities' for purposes of the Acts. Thus far, courts have held that employee stock options are securities"); *Collins v. Rukin*, 342 F. Supp. 1282 (D. Mass. 1972) (denying motion to dismiss securities fraud claim against employer for failure to disclose material facts to prospective employee).

Facebook also contends that an issuer's duty of disclosure of material information under Rule 10b-5 is limited to those counterparties to whom the issuer already owes a fiduciary duty. AB 51-53. Facebook cites no authority for that astonishing proposition, and there isn't any. Facebook relies on cases that discuss fiduciary duty in an entirely different context: to determine which *outsiders* who possess inside information are deemed to be subject to the same trading limitations as the issuer and its insiders, such as directors and officers. AB 50-53. For instance, *Chiarella* involved an employee of a printing firm who deduced the identities of a company's takeover targets based on confidential documents his employer was printing for the acquiring company. The employee was convicted under Section 10(b) for using that information to trade the takeover targets' stock. The Supreme Court reversed his conviction because he was neither a corporate insider nor a fiduciary to the sellers of the targets' stock. *See also Dirks v. SEC*, 463 U.S. 646 (1983) (outsider who received a "tip" of inside information subject to Rule 10b-5 only if the outsider knew or should have known that the information was disclosed in breach of a fiduciary

duty). These cases about the outer limits of *third party* liability for failure to disclose do not limit the *issuer's* duty to disclose.

Nor does Facebook cite any authority for its extraordinary proposition that the 1934 Act excludes "sworn enemies" or litigation adversaries from the scope of an issuer's duty to disclose. AB 52. There is no such exception in the 1934 Act or Rule 10b-5, and courts do not carve exceptions to those bedrock provisions out of thin air. The cases Facebook cites are inapposite. *See* AB 52-53 (citing *Mid-Island Hosp., Inc. v. Empire Blue Cross & Blue Shield (In re Mid-Island Hosp. Inc.)*, 276 F.3d 123 (2d Cir. 2002) (insurance company not obligated to invest funds as to which a hospital had a claim); *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646 (9th Cir. 1988) (addressing whether professional service firms owe a duty to disclose); *Camp v. Dema*, 948 F.2d 455 (8th Cir. 1991) (corporate director owed no duty of disclosure to another director)). The duty of disclosure imposed by the most fundamental principle of federal securities law is not based on friendship, affection or the lack of animosity.[2]

[2]Facebook spends several pages of its brief discussing disputed facts and legal issues in the underlying case (AB 5-7), with the overall theme that Mark Zuckerberg did not engage in misconduct regarding the founding of Facebook and that the Founders were the real poachers. This is not the place to debate those points; this appeal is not about the merits of the underlying cases but whether a settlement of the litigation should be enforced.

The relevant case directly on point remains *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1142 (2d Cir. 1970), in which the court voided two settlement agreements because they violated securities laws. *See* AOB 36-39. Facebook attempts to distinguish *Pearlstein* on the ground that the violation there involved unlawful extension of a broker's credit, rather than a Rule 10b-5 violation, but that is a distinction without substance. Section 29 voids any contract made in violation of *any* provision of the 1934 Act. 15 U.S.C. §78cc(b) ("Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . shall be void").

2. The Valuation That Facebook Failed To Disclose Was Material.

Facebook argues that because stock valuations are "subjective," the undisclosed $8.88 valuation was immaterial. AB 47. Facebook is incorrect. Information does not have to be "objective" to be "material." Information is material if a reasonable investor would conclude that it "significantly alter[ed] the 'total mix' of information" relevant to the investment decision. *McCormick*, 26 F.3d at 876 (citation and internal quotation marks omitted). Here, Facebook's board received an independent valuation of its stock and, based upon that valuation, determined $8.88 per share to be the fair market value; based on that valuation, the board took action in setting the exercise price of employee stock options. 5-ER-722 ¶3, 702 ¶9; *see* AOB 20. That the independent valuation is "subjective" is of no consequence. What matters is that a reasonable investor

would want to know of the $8.88 valuation, and the fact that the Board approved it and based the stock option exercise price upon that valuation.

Facebook claims that the $8.88 valuation was immaterial because the Founders unreasonably viewed Microsoft's valuation of Facebook shares at $35.90 as "gospel." *See* AB 44. Nonsense. The Founders have never contended that the $35.90 valuation was "gospel." The question, which Facebook dodges, is whether a reasonable investor in the Founders' position would have viewed the $8.88 valuation as altering the mix of information which, "if known, would [have] affect[ed] their investment judgment." *Chiarella*, 445 U.S. at 227 (citation and internal quotation marks omitted). The answer here is yes. *See Gerrard v. A.J. Gerrard & Co.*, 285 F. Supp. 2d 1331, 1352 (S.D. Ga. 2003) (where close corporation bought back stock from shareholders who knew of a prior stock valuation, triable issue of fact existed concerning corporation's failure to disclose a later, higher valuation).

Facebook's other cases involve failure to disclose immaterial details about a company. AB 47; *Abromson v. Am. Pac. Corp.*, 114 F.3d 898, 902-03 (9th Cir. 1997) (company's dispute with third party over loan repayment terms immaterial when it was unlikely the dispute would have adverse consequences); *In re Rockefeller Ctr. Props. Sec. Litig.*, 184 F.3d 280, 290 (3d Cir. 1999) (value of development rights immaterial due to "limited prospect they would ever be sold"). The Microsoft valuation and the undisclosed $8.88 valuation—

and the stock option exercise price based thereon—went directly to the value of Facebook's stock, not to some peripheral detail of Facebook's business.

3. In Assessing Materiality Of The $8.88 Valuation, The Court Should Disregard Facebook's Extensive Factual Statements Unsupported By The Record.

Facebook bases the rest of its argument about materiality on supposed facts that are outside the appellate record or stated in briefing and argument below that do not constitute evidence. We have separately filed a Motion To Strike these improper references. Below, we discuss additional reasons why these matters—even if the Court were to consider them—would not assist Facebook.

Facebook's description of the Founders' "sophistication" (*see* Motion to Strike Portions of Brief Unsupported by Record ("Motion To Strike") at 1-2) is legally irrelevant to materiality. Materiality does not vary based on a particular investor's characteristics. "[T]he test of materiality is whether a *reasonable man* would attach importance to the fact misrepresented in determining his course of action. Even sophisticated investors are entitled to the protections of this rule." *Wheat v. Hall*, 535 F.2d 874, 876 (5th Cir. 1976) (citations and internal quotation marks omitted; emphasis added); *see also TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976); *United States v. Reyes*, 577 F.3d 1069, 1075 (9th Cir. 2009).

Facebook asserts that the Founders were "aware of" numerous prior valuations of Facebook [redacted], all but one of which is not in the present appellate record.

See AB 45; Motion To Strike at 3-4. Even if these matters could be considered, these valuations (which predate the Microsoft investment) do not come close to establishing that the undisclosed $8.88 valuation was immaterial. Facebook points out that its own valuation was volatile, and it boasts of being "probably the hottest start-up in the world." AB 5. According to a *Fortune Magazine* article Facebook cites, it was valued at $24 billion as of April 2010. AB 47. With this kind of hype, a reasonable investor in the Founders' position in February 2008 would have wanted to know that, at a recent meeting, the Facebook board had relied on a professional valuation firm to value the company's stock at a mere $8.88 per share. 5-ER-702 ¶9, 722 ¶3. That sobering valuation—whose accuracy was essential to avoid disastrous income tax consequences (*see* AOB 29 n.4)—could suggest that Microsoft's investment reflected undue optimism, and that would surely affect the total mix of information.

Facebook argues that the Founders could not "uncritically" compare the hybrid stock the Term Sheet specified (common stock with anti-dilution protection) with regular common stock, the undisclosed valuation pegged at $8.88 or with the Series D preferred stock Microsoft purchased at a value of $35.90. AB 48. The record lacks any evidence concerning how the hybrid stock the Founders received would differ in value, if at all, from common stock. Accordingly, Facebook's argument that the stock the Founders received was "more valuable" than common stock is unsupported.

In any event, the "hybrid" stock described in the Term Sheet would not have to be identical to common stock for the $8.88 valuation to be material. The common stock's value pertained to the entire company, and affected the mix of information relevant to a reasonable purchaser of this "hybrid" security. The valuation was therefore material.

In yet another foray beyond the record, Facebook refers to a Section 409A valuation that Facebook assertedly obtained in Fall 2007, around the time of the Microsoft transaction, that came in at $6.61. AB 46. This valuation, not raised below or in the record, is also the subject of our Motion to Strike (at pp.3-4).

In any event, Facebook introduced no evidence below that the Founders—or anyone else—knew of this valuation, and even if the $6.61 valuation had been made public, this would be of no moment legally. *See, e.g.*, *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1114 (9th Cir. 1989) ("Ordinarily, omissions by corporate insiders are not rendered immaterial by the fact that the omitted facts are otherwise available to the public"); *see also Miller v. Thane Int'l*, 519 F.3d 879, 887 n.2 (9th Cir. 2008) ("that truthful information is available elsewhere does not relieve a defendant from liability for misrepresentations in a given filing or statement").

C. Facebook Also Engaged In A Device, Scheme Or Artifice To Defraud.

Facebook's arguments against the Founders' alternative theory that Facebook engaged in a bait-and-switch at the mediation are mostly a rehash of

Facebook's arguments as to why it claims it owed no duty to disclose the $8.88 valuation. AB 55-56. This misses the point, because the Founders' alternative Rule 10b-5 argument is that, *regardless* of any duty to disclose, Facebook acted wrongly in agreeing to the Founders' suggestion to substitute approximately [redacted] shares of Facebook stock for [redacted] in cash, and then calculating the number of shares based on a $35.90 price, while failing to disclose the recent $8.88 valuation.

While Facebook implies that its misconduct was mitigated because communications took place through an intermediary (AB 58), Facebook fails to challenge settled law in this Circuit that securities fraud carried on through a third party is just as wrongful as if committed face-to-face. AOB 34 n.6. And Facebook's contention that the Founders waived their "device, scheme or artifice" variation on their securities fraud defense by failing to frame the issue in exactly those terms below is no more persuasive. Having raised the Section 10(b) defense in the first instance, the Founders may present variations of that initial theme that consist of pure legal argument and do not depend on any new facts. *Dream Palace v. County of Maricopa*, 384 F.3d 990, 1005 (9th Cir. 2004).

D. The Founders Did Not Need To Establish Reliance.

1. Reliance On An Omission Is Presumed.

Facebook does not rebut the Founders' argument that reliance is *presumed* in Rule 10b-5 claims based primarily on an omission. AOB 43-44 (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972)).

2. Alternatively, Reliance Need Not Be Shown To Obtain Rescission.

Facebook argues that reliance must be established to obtain rescission under Section 29. AB 60. Not so. The Third Circuit has held that a plaintiff seeking rescission under Section 29(b) does not have to establish reliance. *See* AOB 42-43 (and cases cited).

Facebook points only to an older decision of the Eleventh Circuit in *Rousseff v. E.F. Hutton & Co.*, 843 F.2d 1326 (11th Cir. 1988), which held that all elements of a private Rule 10b-5 action for damages, including reasonable reliance, must be established to obtain rescission. But *Rousseff* did not address Section 29 and, contrary to Facebook's assertion (AB 60 n.8), includes little reasoning. The Third Circuit's decisions, by contrast, demonstrate careful analysis of Section 29 and its relationship to the elements of a private right of action (*e.g.*, *GFL Advantage Fund Ltd. v. Colkitt*, 272 F.3d 189, 206 n.6 (3d Cir. 2001)) and are more persuasive.[3]

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[3]The other cases Facebook cites on this point are irrelevant. *Nat'l Union Fire Ins. Co. v. Turtur*, 892 F.2d 199, 207 (2d Cir. 1989) (no rescission because (continued . . .)

E. Evidence Related To Facebook's Securities Fraud Is Not Precluded By Any Applicable Mediation Privilege.

Facebook's assertion of a mediation privilege is sweeping. If it were correct, then—without fear of consequences—a litigant could induce a settlement by making fraudulent misrepresentations. *See* AB 69-71. Facebook is unable to support its sweeping contention with even a single case applying the federal common law, which governs in this case (*see* Part II(E)(1), *infra*). This Court should not be the first to provide immunity for fraudulent conduct merely because it occurs in the course of a mediation.

1. The California Mediation Privilege Does Not Apply To This Case.

Facebook's assertion that California's mediation privilege applies in this case (*see* AB 63-64)—unsupported by any authority—contradicts Facebook's acknowledgement that "California law is inapplicable to releases of federal statutory causes of action." AB 41 n.4 (internal quotation marks omitted). State privilege law applies where "[s]tate law supplies the rule of decision" (FED. R. EVID. §501), but here, as Facebook concedes, "federal law governs" (AB 41 n.4) the federal securities law issues, which are based on a federal

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(. . . continued)
defendants had no duty to disclose); *Occidental Life Ins. Co. of North Carolina v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1267 n.7 (4th Cir. 1974) (declining to address the elements of a Section 29(b) claim).

statute. *See Agster v. Maricopa County*, 422 F.3d 836, 839-40 (9th Cir. 2005) (federal evidence law applies in federal question cases).[4]

2. Even If A Federal Mediation Privilege Exists It Does Not Bar Evidence That A Mediated Settlement Was Induced By Fraud.

Privileges in federal court are "governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." FED. R. EVID. §501; *see also* AOB 46-50.[5] Facebook cites no federal appellate decision in which a common law mediation privilege has been recognized, and this Court recently declined to address whether such a privilege exists. *See Babasa v. LensCrafters, Inc.*, 498 F.3d 972, 975 (9th Cir. 2007). Indeed, the only federal appellate decision Facebook cites that even mentions a federal mediation privilege expressly declines to adopt one. *See In re Anonymous*, 283 F.3d 627, 639 n.16 (4th Cir. 2002).

Even if a federal mediation privilege were recognized, it would not bar proof of fraudulent inducement of a settlement agreement. The scope of any

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[4]Even if California law were applicable in this proceeding, it would be preempted by Section 29 of the 1934 Act, discussed in Part II(E)(5), *infra*.

[5]Facebook cites *Anand v. California Department of Developmental Services*, 626 F. Supp. 2d 1061 (E.D. Cal. 2009), for the proposition that "federal common law should not displace state law." AB 66 n.9. That case does not involve a claim of privilege at all, but an attorney's authority to settle a claim on his client's behalf. *See* 626 F. Supp. 2d at 1064. Under Rule 501 of the Federal Rules of Evidence, privilege determinations in federal question cases require application of the common law; no analogous rule applies to an attorney's authority to settle a claim.

such privilege, and exceptions thereto, would be informed by the laws of all 50 states. *See* AOB 46-47. Nearly every state that has adopted a mediation privilege has an exception when one party to a mediated settlement seeks to establish contract defenses such as fraud. *See id.* at 47-50.

Facebook's only response is that "no federal court has ever adopted this exception." AB 64. Not quite: *Federal Deposit Insurance Corp. v. White*, No. 3-96-CV-0560-BD, 1999 WL 1201793, at *2 (N.D. Tex. Dec. 14, 1999), found it "unlikely" that Congress intended to create a federal mediation privilege that "would effectively bar a party from raising well-established common law defenses such as fraud, duress, coercion, and mutual mistake . . . under the guise of preserving the integrity of the mediation process." And of course, since no federal appellate court has ever recognized the existence of a federal mediation privilege to begin with, the Circuit Courts of Appeals have had no occasion to explore the scope of, or exceptions to, such a privilege.[6]

3. No Federal Statute Creates A Privilege Against Evidence Of Fraud.

The Alternative Dispute Resolution Act ("ADRA") directs the District Courts to create local rules regarding confidentiality. *See* 28 U.S.C. §652(d).

[6]Facebook portrays the specter of mediators "tormented with depositions" if evidence of fraud in the course of a mediation could be presented. AB 61. The hyperbole is colorful but unhelpful, for neither party attempted to subpoena the mediator here. The only issue here is whether the *parties* are able to testify as to what was—or wasn't—said during the mediation that is relevant to a claim of securities fraud.

The particular local rules adopted pursuant to that statute are entirely up to each District Court; their terms are not specified by the statute. *See Olam v. Congress Mortg. Co.*, 68 F. Supp. 2d 1110, 1123 (N.D. Cal. 1999); *Folb v. Motion Picture Indus. Pension & Health Plans*, 16 F. Supp. 2d 1164, 1176 (C.D. Cal. 1998), *aff'd*, 216 F.3d 1082 (9th Cir. 2000).

Even if the ADRA unequivocally required the *confidentiality* of all mediation communications, that would not create a *privilege*. Facebook conflates "confidentiality" with "privilege" throughout its brief, but the two concepts differ in important ways. *See In re Grand Jury Subpoena Dated Dec. 17, 1996*, 148 F.3d 487, 492 (5th Cir. 1998) ("*In re Grand Jury Subpoena*") (communications made in the course of an agricultural loan mediation in Texas that by statute were "confidential" but not privileged); *Nguyen Da Yen v. Kissinger*, 528 F.2d 1194, 1205 (9th Cir. 1975) ("The records are confidential but not privileged"); *United States v. Phoenix Union High Sch. Dist.*, 681 F.2d 1235, 1237 (9th Cir. 1982) (statute providing that "[m]inutes of executive sessions shall be kept confidential" deemed "generally worded" and "prohibit[ed] voluntary public disclosure" but "not disclosure pursuant to a legitimate legal inquiry") (citation and internal quotation marks omitted).

Moreover, even if the ADRA required District Courts to adopt rules establishing an evidentiary privilege for statements made during a mediation, it would not apply to evidence of fraud during the mediation. As the Fifth Circuit concluded in *In re Grand Jury Subpoena*, "Congress did not intend that [a

statute providing for confidential mediations] be used to shield wrongdoing arising out of the state agricultural loan mediation process." 148 F.3d at 493. Just so here. That is why most jurisdictions recognizing a mediation privilege have an exception for evidence of fraud. *See* pp.18-19, *supra*.

4. The Local ADR Rule Does Not Preclude Evidence Of Fraud In A Private Mediation.

Facebook continues to assert that a local rule created an evidentiary privilege barring evidence of fraud in the course of the mediation. AB 62-63. To begin with, as shown in our opening brief, the local rule did not apply to this case because the parties went to a private mediator—not a mediator from the District Court's panel. *See* AOB 50-51.[7] Facebook argues that the local rule must apply to private mediators because a private mediation fits within the ADRA's definition of "alternative dispute resolution." AB 68 (citing 28 U.S.C. §651(a)). While private mediation undoubtedly is a form of "alternative dispute resolution" (*see* N.D. CAL. ADR R. 8-2), Local Rule 3-4(b) unambiguously provides that "*[p]rivate ADR proceedings . . . are not subject to the enforcement, immunity or other provisions of the ADR Local Rules*." (Emphasis added.)[8]

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[7]Facebook asserts that the Founders waived this argument by not raising it below. *See* AB 67. Facebook is wrong. *Claims* that a party fails to raise below are waived, but new *arguments* are not. *See California Pro-Life Council, Inc. v. Randolph*, 507 F.3d 1172, 1185 n.18 (9th Cir. 2007); *Yee v. City of Escondido*, 503 U.S. 519, 534-35 (1992). The Founders properly asserted their claim that no mediation privilege applies in this case. *See* 5-ER-692-95.

[8]The version of these local rules in force at the time of the mediation (*see* (continued . . .)

Even if the Local ADR rule applied, exclusion of evidence that Facebook's securities law violation fraudulently induced a settlement calling for a transaction involving [redacted] of dollars would comfortably qualify as a "manifest injustice" for which "the need for disclosure outweighs the importance of protecting the confidentiality of a mediation." N.D. CAL. ADR R. 6-11, cmt.; *see* AOB 51. Immediately after identifying "manifest injustice" as a circumstance warranting disclosure, the commentary to ADR Rule 6-11 cites Section 6 of the Uniform Mediation Act ("UMA"). That section of the UMA identifies a claim for rescission of a contract arising out of a mediation as a circumstance justifying an exception to the mediation privilege. *See* AOB 49.[9]

5. The Mediator's Confidentiality Agreement Does Not Preclude Proof Of Securities Fraud.

Facebook contends that a Confidentiality Agreement signed by the parties provided that nothing said at the mediation could be used as evidence in any legal proceeding. AB 63. Whether that provision should be read so sweepingly as to preclude evidence of fraud during the mediation raises the same

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(. . . continued)
AOB 50 n.11) is set forth in the Appendix to this brief.

[9]Moreover, even if the local rules' confidentiality provision applied here, it could not override the federal common law's recognition of an exception to any applicable mediation privilege. Rule 501 lists only three things that can trump the federal common law: "the Constitution of the United States," an "Act of Congress," and "rules prescribed by *the Supreme Court* pursuant to statutory authority . . . ." FED. R. EVID. §501 (emphasis added). A local rule is none of these things. *See Lee v. Lampert*, No. 09-35276, 2010 WL 2652505, at *4 (9th Cir. July 6, 2010) ("the express mention of one thing excludes all others").

interpretational question as is presented in cases involving the scope of the mediation privilege in jurisdictions that recognize a privilege. *See* AOB 46-50; pp.18-19, *supra*. But if the Confidentiality Agreement did preclude evidence of fraud in a mediation that results in an agreement for the sale or exchange of securities, then it would be invalidated by Section 29 of the 1934 Act. *See* AOB 51-52.

Facebook responds that "[t]he anti-waiver provision [of the 1934 Act] has nothing to say about how parties may prove securities fraud. That is a matter of evidence law on which §29 is silent." AB 69. Facebook elevates form over substance. If parties could agree that nothing said in their negotiations could ever be evidence of securities fraud, that agreement would in substance be an impermissible advance waiver of any claim of securities fraud to which Section 29 of the 1934 Act would apply. *See Can-Am Petroleum Co. v. Beck*, 331 F.2d 371, 373 (10th Cir. 1964) ("the remedial aspects of [the Securities Act] cannot be waived *either directly or indirectly*") (emphasis added); *McMahan & Co. v. Wherehouse Entm't, Inc.*, 65 F.3d 1044, 1051 (2d Cir. 1995) ("no-action" clause that established conditions to commencing suit violated anti-waiver provision; rejecting argument that the clause merely established "a procedure that must be followed before an action may be brought"); *Kusner v. First Pennsylvania Corp.*, 531 F.2d 1234, 1239 (3d Cir. 1976) (similar); *Special*

Transp. Servs., Inc. v. Balto, 325 F. Supp. 1185, 1187 (D. Minn. 1971) (Section 29 applies to a contract that "waive[s] statutory liabilities . . . by indirection").[10]

F. Facebook's Failure To Submit Evidence To The District Court Does Not Call For Remand.

Facebook and ConnectU argue that if the Court concludes the District Court erred in rejecting the Founders' securities law defense outright, the Court should remand so that Facebook can submit additional evidence challenging the "Founders' account of what transpired" at the mediation. AB 42; *see also* ConnectU's Appellee's Brief ("CUAB") 4. But Facebook was not precluded from presenting evidence below, and could have done so conditionally without waiving its position on the mediation privilege. It is not entitled to prolong this dispute by a remand and another evidentiary submission.

Moreover, evidence of what transpired at the mediation is not necessary to establish that Facebook violated its duty to disclose the $8.88 valuation. AOB 44-46. But even if it were, Facebook's request for remand is unjustified

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[10]Our opening brief also pointed out that Facebook waived any mediation privilege by affirmatively asserting that the Founders have "no . . . evidence" supporting their claim of fraud. *See* AOB 53-54. Facebook's brief misleadingly omits the pertinent part of the sentence in which it asserted that the Founders actually have no evidence of fraud, implying that no such evidence exists. AB 69. While Facebook claims that it has "made no . . . assertion about what occurred at the mediation" (AB 69), in fact, when Facebook was eager to prove that the Term Sheet was heavily negotiated, it disclosed plenty about what occurred at the mediation, including how extensive negotiations were, that "substantial" time passed before a term sheet was finalized, and that there were revisions to the Term Sheet. *See* 4-ER-467.

because it is unaccompanied by any offer of proof as to what evidence Facebook would offer regarding what happened at the mediation. The material facts on which the Founders base their security law defense are

- Facebook did not disclose the $8.88 valuation to the Founders during the mediation. AOB 17, 20, 32.
- The parties agreed in principle to Facebook paying [redacted] in cash to settle the case and acquire ConnectU. AOB 5, 18-19.
- The parties agreed to substitute Facebook stock for [redacted] of the [redacted] cash payment. AOB 5, 18-19, 30-31.

Absent a good faith representation that Facebook could present evidence that contests those facts, a remand is unwarranted.

III.

THE TERM SHEET IS NOT AN ENFORCEABLE CONTRACT.

A. Settlement Agreements Must Meet The Same Standards Applicable To Every Other Contract.

Facebook contends that settlement agreements reached at a mediation must be enforced despite the parties' failure to agree on material terms—which it derisively calls "a laundry list of ancillary terms that are typically addressed" in business agreements covering the same subject (AB 35 (internal quotation marks omitted))—lest the Court "deal a *mortal blow* to mediation." *Id.* (emphasis added). Facebook's argument presupposes that the choice is between

mutually exclusive alternatives: enforce an incomplete Term Sheet or destroy the institution of mediation.

More nonsense. California law has long held that the "principles of contract formation are the same in both the settlement and the nonsettlement context." *Terry v. Conlan*, 131 Cal. App. 4th 1445, 1458 (2005); *Distefano v. Hall*, 263 Cal. App. 2d 380, 385 (1968); AOB 55. As *Terry* demonstrates, that includes the requirement that an agreement must resolve all material terms. *See* AOB 56; pp.35-36, *infra*. Despite this, mediation has thrived. As long as human beings and institutions have disputes, then (like England) there will always be mediation. And in most cases litigants will continue to prefer to take the time and trouble to document sufficiently their settlement agreements over the long, painful and costly march to a final judgment.

In fact, only a very small number of mediated agreements result in disputes over enforceability. James R. Coben & Peter N. Thompson, *Disputing Irony: A Systematic Look at Litigation About Mediation*, 11 HARV. NEGOT. L. REV. 43, 46-49 (Spring 2006) ("Only the rare mediated dispute shows up in a reported opinion"; an average of fewer than 250 mediation disputes per year were litigated nationally from 1999 through 2003). As Facebook comments, "[n]othing about this transaction or the underlying litigation was 'customary,' 'standard,' or 'typical[].'" AB 30. While most cases can be, and are, settled at mediation through a brief handwritten agreement, this settlement took the form of a corporate transaction, including the sale or merger of ConnectU, the payment of [redacted]

[redacted] of cash and the issuance of Facebook's stock (with a combined price tag of [redacted] dollars). Business transactions of this complexity and consequence are not defined on the back of the proverbial envelope. Experienced lawyers who attend mediations know the requirements for drafting enforceable agreements. If those rules mean staying at the mediation a bit later (or, in extremely complex matters, assuming the risk of leaving resolution of material terms to subsequent discussions), lawyers and litigants will do what they need to do to achieve a binding documentation of their mediated agreements.

B. The Term Sheet Omitted Material Terms.

Facebook cannot dispute that settled contract law principles deny enforcement of contracts in which the parties have failed to resolve material issues. AOB 55-56. But it begins its discussion of the enforceability issue with an irrelevant argument of the undisputed proposition that the parties subjectively *intended* the Term Sheet to be binding. AB 21-22. That misses the point: the issue is whether the Term Sheet is sufficiently definitive to be enforceable. Facebook then spends two more pages enumerating the provisions of the agreement that *are* sufficiently definitive, such as the number of shares Facebook would issue and the cash consideration it would pay. AB 23-24. That also misses the point: the issue is whether there are *other* material issues that the Term Sheet does *not* address and resolve. There are—several of them.

1. Whether Omitted Contract Terms Are Material Is A Question Of Law, Judged On An Objective Basis, After Considering All Relevant Extrinsic Evidence.

Where there are no disputed material facts, the question of whether an agreement is unenforceable for lack of material terms is a question of law. *Ersa Grae Corp. v. Fluor Corp*., 1 Cal. App. 4th 613, 623 (1991). The materiality of an omitted term is an objective question, based on the *expressed* intent of the parties and on relevant extrinsic evidence. *Weddington Prods., Inc. v. Flick*, 60 Cal. App. 4th 793, 808, 811 (1998).

Initially, Facebook recognized that the Term Sheet did not resolve a number of issues that it regarded as critical. As a consequence, it drafted, and asked the District Court to order enforcement of, 140 pages of transactional documents that, according to Facebook, were consistent with the Term Sheet and—to the extent they embellished the Term Sheet—reflected customary practices in corporate acquisitions. 4-ER-471, 479, 512; 5-ER-737, 739-40.[11] Eventually, Facebook evidently recognized that although corporate acquisition transactions customarily include contract terms addressing those omitted issues, *how* they were resolved is a matter for negotiation and agreement—and that there was no agreement on many critical issues here. Facebook then withdrew its 140 pages

[11]When the Founders objected to Facebook's documents, Facebook presented expert opinion testimony that the contract documents were "consistent with" the Term Sheet (5-ER-756) and "typically included in formal merger documents" are "'such items as (1) the purchase price, (2) when the merger will occur, (3) how the merger price will be paid, (4) representations and warranties by both the buyer and the seller . . . ." 5-ER-757.

documentation and urged the District Court to issue a simple order enforcing the Term Sheet. *See* AOB 23.

This sequence of events revealed material gaps in the Term Sheet. Facebook now contends that none of this evidence can be considered. Its contention that the Court must limit its analysis to the face of the Term Sheet violates the rule that post-contracting conduct is probative of the contract's meaning. AOB 57. Moreover, as Facebook points out, this case involves a question of contract *formation*, not contract *interpretation*. *See* AB 27-28. "A written contract must be in force as a binding obligation to make it subject to" the rule prohibiting a court from considering parol evidence. *Harper v. French*, 29 Cal. App. 2d 214, 216 (1938) (citation and internal quotation marks omitted); *Mitchell v. Leslie*, 39 Cal. App. 4th Supp. 7, 12 (1995) (extrinsic evidence should be considered where contract validity at issue); *see also* CAL. CODE CIV. PROC. §1856(f).[12]

Facebook cites several cases in which courts upheld contracts against claims of invalidity by implying customary terms (AB 25-26, 32-34),[13] but that

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[12]ConnectU's request for a remand for the District Court to consider the extrinsic evidence it declined to consider should also be rejected. *See* AOB 7 n.2. On this record, the significance of the extrinsic evidence is a pure question of law. *See City of Hope Nat'l Med. Ctr. v. Genentech*, 43 Cal. 4th 375, 395 (2008).

[13]*Hutton v. Gliksberg*, 128 Cal. App. 3d 240, 245 (1982) (agreement was enforceable because specified adjustments to price were "routine" and could be resolved by looking to "custom"); *Patel v. Liebermensch*, 45 Cal. 4th 344, 350 (2008) (length of escrow period in a real property sale is "determinable by (continued . . .)

is not our case. Here, neither custom and practice, nor any other objective criteria, could be used to resolve the issues the Term Sheet left unaddressed. *See* pp.30-38, *infra.*

2. The Parties Did Not Agree That The Omitted Terms Were Immaterial.

Facebook asserts that parties can agree that a given issue is not material and need not be addressed in their agreement. AB 24-26. It cites no case so holding, but we have no occasion here to debate that point, because the Term Sheet contains no provision stipulating that the omitted issues we contend were material are unimportant and that the parties have elected not to address and resolve them. For all that the Term Sheet (and this record) reveals, the omission of these important terms was the result of inadvertence or a deliberate decision to reserve them for subsequent negotiations. There is no logical justification for a presumption that the parties *agreed* that all such omitted terms were immaterial and did not need to be addressed. Any such presumption would nullify the established rule that contracts failing to address material issues are unenforceable.

(. . . continued)
implication"); *Elite Show Servs., Inc. v. Staffpro, Inc.*, 119 Cal. App. 4th 263, 268-69 (2004) (statutory offer to settle not uncertain because prevailing party clauses are customary and courts commonly determine reasonableness of claimed attorneys' fees); *Ersa Grae Corp.*, 1 Cal. App. 4th at 623-24 (contract contemplating lease of real property "at market rates" enforceable because market rate could be objectively determined and other lease terms could be supplied by custom).

3. The Omitted Terms Were Material.

Facebook argues that the omitted terms were not material, which could only be true if the order enforcing the Term Sheet disposed of all material legal and economic issues that a settlement agreement calling for the acquisition of a corporation in return for payment [redacted] dollars and issuance of stock would ordinarily be expected to have. Of course that is not the case here.

Facebook cites *Core-Vent Corp. v. Implant Innovations, Inc.*, 53 F.3d 1252 (Fed. Cir. 1995), as an exemplar case demonstrating judicial reluctance to invalidate settlement agreements on the ground of incompleteness. AB 33. The distinction between that case and this one is instructive. In *Core-Vent*, the parties had placed on the record a settlement of a patent infringement case. On the record, they agreed (1) to a declaration of patent validity; (2) that the defendant's products infringed; (3) the payment of $450,000 for past infringement; (4) a royalty at a specified rate on a specified royalty base; (5) minimum royalties; (6) discontinuance of minimum royalties on certain terms; (7) certain agreed credits against royalties; and (8) in return for the royalty payments, a non-exclusive worldwide license. The defendant attempted to avoid the agreement on the ground that the last item—the worldwide license—had to be reduced to a separate written document. The District Court rejected this contention, holding that the essential terms of the license were spelled out on the record and were enforceable whether or not they were reduced to writing. The Court of Appeals affirmed, finding that the foregoing terms covered the

essential elements of the settlement, including the worldwide license, and that it was enforceable whether or not the parties reduced the terms of the license to writing. 53 F.3d at 1256. There was no claim of omitted terms remotely comparable to those that were left unaddressed by the Term Sheet in this case, to which we now turn.

a. The Formula For A Price Adjustment Reflecting Liabilities Facebook Assumed Was Material.

The Term Sheet is silent as to whether Facebook would receive any credit for ConnectU's liabilities. AOB 62-63. The parties' post-mediation conduct, including Facebook's motion to enforce the settlement, shows that the parties agreed Facebook would be entitled to some kind of credit, but that the calculation and amount of the credit had not been determined when they signed the Term Sheet. Facebook asked the District Court to impose a term providing for and defining the credit it would receive. 4-ER-479, 484-510, 515-636.

In its brief, Facebook reverses field and contends that the price adjustment/credit was not actually part of the original settlement agreement at all. AB 28-29. If that were so, then how could Facebook have asked the District Court to order the Founders to proceed on the basis of the specific credit adjustment formula that it submitted?

Having agreed that Facebook should receive a credit, but not on the amount or a formula for determining it, the parties had nothing more than an unenforceable agreement to agree on this essential term, which affected the price. *See*

Bustamante v. Intuit, Inc., 141 Cal. App. 4th 199, 213 (2006) ("an 'agreement to agree' . . . is unenforceable under California law"); *Forde v. Vernbro Corp.*, 218 Cal. App. 2d 405, 407-08 (1963) (price is a material term that may be omitted from a contract only "if it can be objectively determined"). The existence of this gap in the agreement, its importance to the parties and their inability to agree on how to fill this gap is undisputed in the record. 5-ER-702 ¶10. No evidence suggests that the term could be filled in by the Court in any objective manner, such as by reference to custom and practice.

b. The Representations And Warranties, And An Indemnity Provision, Were Material.

Detailed representations and warranties are fundamental to, and customary in, a transaction like Facebook's acquisition of ConnectU. AOB 63-65. Such representations and warranties cannot be determined by custom or practice; rather, they are deal-specific terms about which "a great deal of the negotiation" takes place. STANLEY FOSTER REED ET AL., THE ART OF M&A 472 (4th ed. 2007) ("REED"). Facebook's own expert on corporate transactions testified that "formal documents for the acquisition of a business nearly always contain extensive representations and warranties, indemnification and termination sections" and that these terms vary depending on the parties involved and their respective interests. 5-ER-762-63 ¶34. The Founders' expert agreed, testifying that there is no "market standard" for indemnity provisions, which are "intensely negotiated." 5-ER-795 ¶17. The Term Sheet failed to define the

representations and warranties, and indemnification obligations that would govern this corporate acquisition, and a court would have no objective basis on which to imply terms to rectify the omission.

The parties' post-mediation conduct, including Facebook's motion to enforce the settlement, shows that the parties agreed that some representations and warranties, and an indemnity provision, had to be included in the settlement agreement. After the back-and-forth exchange of post-mediation settlement proposals, Facebook asked the District Court to *impose* representations, warranties and indemnity provisions that *it* unilaterally had drafted. 4-ER-535-559, 562-66. Facebook cannot credibly claim here that such provisions were immaterial.

c. The Form Of The Transaction Was Material.

The Term Sheet did not address a critical business, legal and economic question: Would the corporate acquisition take the form of a non-taxable merger or a taxable sale of stock? AOB 65. The materiality of this omission is demonstrated by Facebook's initial preparation of documents that would have included a non-taxable merger, followed by Facebook's presentation to the District Court of documents that would have implemented a taxable stock sale. 5-ER-701-02 ¶¶6-8. Either one of the structures Facebook proposed would have complied with the Term Sheet's proviso that the form of the acquisition be "consistent" with a stock for cash-and-stock transaction. *See* REED at 4 (the

term "acquisition" is a "generic term used to describe a transfer of ownership"); AOB 65. Yet the selection of which structure to employ would have substantial tax consequences for the Founders and, for that reason, was material.

Facebook now contends that the failure of the Term Sheet to address the issue is not material. AB 32 (citing *Sheng v. Starkey Labs., Inc.*, 117 F.3d 1081, 1083 (8th Cir. 1997) ("*Sheng II*")). *Sheng II* does not support Facebook's counterintuitive proposition. In that case, *after* the parties agreed to settle an employment case, the employee proposed that the employer either not report the settlement payment to the IRS, or indemnify her against any tax liability. *Sheng v. Starkey Labs., Inc.*, 53 F.3d 192, 193 (8th Cir. 1995) ("*Sheng I*"). The *post*-contracting dispute over whether the employee would have to pay her own taxes did not make the agreement unenforceable. *Sheng II*, 117 F.3d at 1083; *see also Quint v. A.E. Staley Mfg. Co.*, 246 F.3d 11, 13, 15 (1st Cir. 2001) (oral settlement agreement was enforceable where, after deal made, one party sought agreement regarding how to characterize settlement payments for tax purposes). Here, by contrast, the Term Sheet expressly defers the question of what form the acquisition was to take, which means a material term was missing and no contract was formed.

This case is most like *Terry v. Conlan*, 131 Cal. App. 4th 1445, 1455-59 (2005), in which the parties' failure to agree on the structure of the agreement created uncertainty due to tax consequences. Facebook claims that *Terry* is distinguishable because, in that case, the "trial court imposed on the parties its

own Solomonic arrangement that no one had agreed to." AB 34. What the District Court did here was worse, because the court picked one of two inconsistent structures after the parties failed to agree on the form of transaction. Rather than executing a Solomonic solution, the court selected the one most unfavorable to the Founders. That was error because the parties never agreed on what structure the transaction should take.

Facebook seeks a different result based on the Term Sheet's grant of discretion to Facebook to determine "the form & documentation of the acquisition," which it claims gave Facebook unbridled power to select between a nontaxable merger and a taxable stock sale. Facebook cites no authority for this position, which is contrary to law. *See* RESTATEMENT (SECOND) CONTRACTS §34 cmt. a (1981) (an agreement leaving terms to the choice of one party is enforceable only if "the agreement is *otherwise* sufficiently definite to be a contract") (emphasis added); *id.* §34 cmt. b ("If one party to an agreement is given an unlimited choice . . . the contract may fail"). This point was illustrated in *Rivadell, Inc. v. Razo*, 215 Cal. App. 2d 614 (1963), in which an agreement to purchase real property identified the buyer as Firestone Corp. "or nominee." The court rejected the contract as uncertain because it let Firestone designate the buyer unilaterally. "What it says is, in effect, that Firestone or someone else designated by Firestone will buy the property." *Id.* at 625. The court described the term "or nominee" as an "escape hatch," allowing Firestone to get out of the agreement. *Id.* This was particularly problematic because the "credit of the

buyer" was an "important . . . factor" in the transaction. *Id.*; *see also Etheridge v. Ramzy*, 276 So. 2d 451, 452 n.1, 456 (Miss. 1973) (agreement "too indefinite and uncertain" where buyer of interest in a corporation was permitted to impose "covenants that an adequate ratio of total net worth of the companies to . . . indebtedness . . . will be maintained").

d. Stock Transfer Restrictions And The Scope Of The Releases In The Term Sheet Were Material.

Facebook's brief is silent on the question of whether the omission of stock transfer restrictions was material. As with the omitted provisions previously discussed, this provision was material to Facebook when it attempted to convince the District Court to impose stock transfer restrictions to which the Founders never agreed. The settlement agreement that Facebook proposed to the District Court gave Facebook the right of first refusal on any proposed stock transfer by the Founders and prohibited transfer outright in certain circumstances. 5-ER-713-14 ¶16; 4-ER-518-19 ¶¶4-5. But the Term Sheet included no such terms.

Similarly, Facebook does not address the uncertainties in the Term Sheet's provision for a release of related parties. *See* AOB 69-70. The Term Sheet's confusing and internally inconsistent release terms represent another material failure of mutual agreement.

DATED: August 5, 2010.

Respectfully,

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W03 091010-180060001/U12/1626882/F

CERTIFICATE OF COMPLIANCE PURSUANT TO FED. R. APP. P. 32(a)(7)(C) AND CIRCUIT RULE 32-1 FOR CASE NUMBER C 07-01389.

Pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C) and Ninth Circuit Rule 32-1, I certify that the attached Appellants' Reply Brief is proportionally spaced, in a typeface of 14 points or more and contains 9,325 words, exclusive of those materials not required to be counted under Rule 32(a)(7)(B)(iii).

DATED: August 5, 2010.

/s/ Sean M. SeLegue
SEAN M. SELEGUE

ADDENDUM

ADDENDUM
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United States District Court for the Northern District of California

Local Rules for Alternative Dispute Resolution

(Published December 2005 and Effective Through Dec. 31, 2008)

ADR 1-2. Purpose and Scope.

(a) Purpose. The Court recognizes that full, formal litigation of claims can impose large economic burdens on parties and can delay resolution of disputes for considerable periods. The Court also recognizes that sometimes an alternative dispute resolution procedure can improve the quality of justice by improving the parties' clarity of understanding of their case, their access to evidence, and their satisfaction with the process and result. The Court adopts these ADR Local Rules to make available to litigants a broad range of court-sponsored ADR processes to provide quicker, less expensive and potentially more satisfying alternatives to continuing litigation without impairing the quality of justice or the right to trial. The Court offers diverse ADR services to enable parties to use the ADR process that promises to deliver the greatest benefits to their particular case. In administering these Local Rules and the ADR program, the Court will take appropriate steps to assure that no referral to ADR results in imposing on any party an unfair or unreasonable economic burden.

ADR 2-5. Neutrals.

(a) Panel. The ADR Unit shall maintain a panel of neutrals serving in the Court's ADR programs. Neutrals will be selected from time to time by the Court from applications submitted by lawyers willing to serve or by other persons as set forth in section (b)(3) below. The legal staff of the ADR Unit may serve as neutrals.

ADR 3-4. ADR Options

(a) Court-Sponsored ADR Processes. The Court-sponsored ADR options for cases assigned to the ADR Multi-Option Program include:

(1) Non-binding Arbitration;

(2) Early Neutral Evaluation (ENE); and

(3) Mediation.

(b) Private ADR. A private ADR procedure may be substituted for a Court program if the parties so stipulate and the assigned Judge approves. Private ADR proceedings, however, are not subject to the enforcement, immunity or other provisions of the ADR Local Rules.

ADR 6-3. Mediators.

(a) Appointment. After entry of an order referring a case to mediation, the ADR Unit will appoint from the Court's panel a mediator who is available during the appropriate period and has no apparent conflict of interest. The Court will notify the parties of the appointment. The rules governing conflicts of interest and the procedure for objecting to a mediator on that basis are set forth in ADR L.R. 2-5(d).

(b) Compensation. Mediators shall volunteer their preparation time and the first four hours in a mediation. After four hours of mediation, the mediator may either (1) continue to volunteer his or her time or (2) give the parties the option of concluding the procedure or paying the mediator for additional time at an hourly rate of $200. The procedure will continue only if all parties and the mediator agree. After eight hours in one or more mediation sessions, if all parties agree, the mediator may charge his or her hourly rate or such other rate that all parties agree to pay. In special circumstances for complex cases requiring substantial preparation time, the parties and the mediator may make other arrangement with the approval of the ADR legal staff. No party may offer or give the mediator any gift.

ADR 6-11. Confidentiality

(a) Confidential Treatment. Except as provided in subdivision (b) of this local rule, this court, the mediator, all counsel and parties, and any other persons attending the mediation shall treat as "confidential

information" the contents of the written Mediation Statements, anything that happened or was said, any position taken, and any view of the merits of the case formed by any participant in connection with any mediation. "Confidential information" shall not be:

(1) disclosed to anyone not involved in the litigation;

(2) disclosed to the assigned judge; or

(3) used for any purpose, including impeachment, in any pending or future proceeding in this court.

(b) Limited Exceptions to Confidentiality. This rule does not prohibit:

(1) disclosures as may be stipulated by all parties and the mediator;

(2) a report to or an inquiry by the ADR Magistrate Judge pursuant to ADR L.R. 2-4(a) regarding a possible violation of the ADR Local Rules;

(3) the mediator from discussing the mediation with the court's ADR staff, who shall maintain the confidentiality of the mediation;

(4) any participant or the mediator from responding to an appropriate request for information duly made by persons authorized by the court to monitor or evaluate the court's ADR program in accordance with ADR L.R. 2-6; or

(5) disclosures as are otherwise required by law.

(c) Confidentiality Agreement. The mediator may ask the parties and all persons attending the mediation to sign a confidentiality agreement on a form provided by the court.

Commentary

Ordinarily, anything that happened or was said in connection with a mediation is confidential. *See, e.g.*, Fed. R. Evid. 408; Cal. Evid. Code Sections 703.5 and 1115-1128. The law may provide some limited circumstances in which the need for disclosure outweighs the importance of protecting the confidentiality of a mediation. *E.g.*, threats of death or substantial bodily injury (*see* Or. Rev. Stat. Section 36.220(6)); use of mediation to commit a felony (*see* Colo. Rev. Stat. Section 13-22-307); right to effective cross examination in a quasi-criminal proceeding (*see Rinaker v. Superior Court*, 62

Cal. App. 4th 155 (3d Dist. 1998); lawyer duty to report misconduct (*see In re Waller*, 573 A.2d 780 (D.C. App. 1990); need to prevent manifest injustice (*see* Ohio Rev. Code Section 2317.023(c)(4)). Accordingly, after application of legal tests which are appropriately sensitive to the policies supporting the confidentiality of mediation proceedings, the court may consider whether the interest in mediation confidentiality outweighs the asserted need for disclosure. *See* amended opinion in *Olam v. Congress Mortgage Company*, 68 F. Supp. 2d 1110 (N.D. Cal. 1999).

ADR 8-2. Private ADR

There are numerous private sector providers of ADR services including arbitration, mediation, fact-finding, neutral evaluation and private judging. Private providers may be lawyers, law professors, retired Judges or other professionals with expertise in dispute resolution techniques. Virtually all private sector providers charge fees for their services. The Court does not ordinarily refer cases to private providers except on the stipulation of the parties. The assigned Judge will take appropriate steps to assure that a referral to a private ADR does not result in an imposition on any part of an unfair or unreasonable economic burden.

Commentary

Private ADR proceedings are not subject to the enforcement, immunity, or other provisions of the ADR Local Rules. See ADR L.R. 3-4(b).

PROOF OF SERVICE BY MAIL

I am employed in the City and County of San Francisco, State of California. I am over the age of eighteen (18) years and not a party to the within action; my business address is Three Embarcadero Center, Seventh Floor, San Francisco, California 94111-4024.

I am readily familiar with the practice for collection and processing of documents for mailing with the United States Postal Service of Howard Rice Nemerovski Canady Falk & Rabkin, A Professional Corporation, and that practice is that the documents are deposited with the United States Postal Service with postage fully prepaid the same day as the day of collection in the ordinary course of business.

On September 10, 2010, I served the following document(s) described as **APPELLANTS' REPLY BRIEF [PUBLIC REDACTED VERSION]** on the persons listed below by placing the document(s) for deposit in the United States Postal Service through the regular mail collection process at the law offices of Howard Rice Nemerovski Canady Falk & Rabkin, A Professional Corporation, located at Three Embarcadero Center, Seventh Floor, San Francisco, California, to be served by mail addressed as follows:

Mark A. Byrne
Byrne & Nixon LLP
800 W. Sixth Street, Suite 430
Los Angeles, CA 90017

Jonathan M. Shaw
Bois, Schiller & Flexner, LLP
5301 Wisconsin Avenue NW
Washington, DC 20015

Steven C. Holtzman
Bois, Schiller & Flexner, LLP
1999 Harrison Street, Suite 900
Oakland, CA 94612

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct. Executed at San Francisco, California on September 10, 2010.

/s/ Jerome B. Falk, Jr.
JEROME B. FALK, JR.