Exhibit A

CA Nos. 08-16745, 08-16849, 08-16873, 09-15021, 09-15133 (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'/CROSS-APPELLEES' OPENING BRIEF [PUBLIC REDACTED VERSION]

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STATEMENT OF JURISDICTION

The District Court had jurisdiction under 28 U.S.C. §§1331 and 1367. This Court has jurisdiction under 28 U.S.C. §1291.[1]

ISSUES PRESENTED

1. Where a corporation offers to issue common stock using a value—confirmed by information the issuer had previously made public—of $35.90 per share:

a. Does Rule 10b-5 require the issuer to disclose that its Board of Directors recently had approved, and taken corporate action in reliance on, an outside expert valuation of $8.88 per share?

b. If Rule 10b-5 required such disclosure and it was not made, is the agreement for the issuance of such stock subject to rescission pursuant to Section 29 of the Securities Exchange Act of 1934?

c. Is the securities transaction exempted from Rule 10b-5 and Section 29 because it was entered into in connection with the settlement of litigation?

2. When a securities transaction is entered into during a private mediation, is evidence supporting a claim of securities fraud in connection

[1]Because five notices of appeal have been consolidated in this proceeding, listing each notice of appeal here would be cumbersome and duplicative of the Statement of the Case. Each notice of appeal and the orders and judgments to which it relates is listed at pp.11-14, 16, *infra*.

with that transaction precluded by either (a) a mediation privilege established in a local rule of court that, by its terms, applies to mediations conducted through the court's mediation program; or (b) a federal common-law mediation privilege?

3. Where parties to litigation purport to settle by signing a 1-1/3 page, handwritten "term sheet" (the "Term Sheet") providing for the payment by one side of [redacted] plus a specified number of shares of that party's stock in exchange for an "acquisition" of an adverse corporate party, but the parties thereafter cannot agree on numerous legal and economic terms embodied in approximately 140 pages of transaction documents drafted by one side, is the 1-1/3 page Term Sheet incomplete and unenforceable because it does not (a) specify the downward adjustments to the price the acquiring party is to pay based on the amount of the acquired company's liabilities; (b) define the representations and warranties to be made by each corporation whose stock is to be exchanged; (c) determine whether the transaction is to be a taxable exchange of stock or a non-taxable merger; (d) resolve whether the shares of the defendant's stock to be issued will be subject to restrictions on transferability and, if so, exactly what those restrictions will be; (e) determine whether the releases will extend to related parties, including parties to the litigation who did not sign the Term Sheet; and (f) determine whether the release will apply to unknown claims?

4. Do Appellants (the Founders) have standing to appeal, and raise on

appeal issues that were vigorously asserted, briefed and argued by a co-party below, where the District Court found that Appellants had appeared through counsel and this Court has permitted Appellants to intervene in an appeal filed by the co-party?

5. If the Term Sheet is rescinded or declared unenforceable, must the order disqualifying the Founders' trial counsel based on a conflict of interest created by enforcement of the Term Sheet be vacated?

INTRODUCTION AND SUMMARY OF ARGUMENT

The law favors settlement of litigation. In appropriate cases, courts enforce agreements to settle where one party refuses to carry out a settlement bargain to which it had agreed. But contracts of settlement are subject to the law of contracts, and settlements that include the sale or exchange of securities are subject to the securities laws. In this unusual case, the District Court misapplied both of those areas of law to enforce a settlement memorialized in a handwritten 1-1/3 page "Term Sheet" that called for a [redacted] securities transaction. Based on those errors of law, the District Court compelled Appellants to transfer their company, ConnectU, Inc. ("ConnectU"), to their litigation adversary, The Facebook, Inc. ("Facebook").

In a ruling contrary to precedent and the broad language of the 1934 Securities Exchange Act, the court held that the antifraud provisions of the securities laws do not apply to settlement agreements calling for the sale or

exchange of securities. On that basis, the court enforced the Term Sheet notwithstanding undisputed evidence that Facebook failed to disclose material facts in connection with trading in its own stock. In addition, the court disregarded Appellants' showing that the Term Sheet was not a valid contract because it failed to address material economic and legal terms—terms that the parties immediately began to negotiate, but could not resolve, in the weeks following the purported settlement. The inadequacy of the Term Sheet as a contract was vividly demonstrated when Facebook moved for enforcement of the purported settlement. In that motion, Facebook provided the District Court with approximately 140 pages of Facebook-drafted, densely-written legal documents. While Facebook claimed that these lengthy documents merely implemented agreements embodied in the Term Sheet, the reality is that those documents addressed numerous material issues nowhere covered in the Term Sheet. There could hardly be more compelling evidence that the Term Sheet failed to resolve material economic and legal issues.

Facebook's Motion To Dismiss The Appeals. Facebook attempts to avoid this appeal altogether by contending, in a motion to dismiss, that the Founders waived their right to appeal by allowing ConnectU to defend against enforcement of the Term Sheet rather than presenting those arguments themselves. This argument lacks merit.

At the time the parties signed the Term Sheet, the Founders had been dismissed from the litigation on the ground that they were not subject to personal jurisdiction in California. However, that circumstance changed when the Founders agreed to the Term Sheet, which specified that any proceeding to enforce it would take place in District Court in California. The District Court ruled that the Founders had actual notice of the settlement enforcement proceedings, that they were present through counsel at the hearing, and that they were (as Facebook contended) bound by the District Court's orders on enforceability. Both sides have accepted these rulings. Facebook's motion to dismiss rests, therefore, on the unexplained premise that an appellant lacks standing to appeal on a legal ground raised by a co-party that the appellant did not itself raise in the proceedings below. That premise is contrary to settled law: the Founders, who are indisputably aggrieved by the judgment, are entitled to raise any legal objection that was preserved by a co-party (in this case, ConnectU). That rule makes perfect sense: were co-parties not entitled to rely on the objections of similarly situated parties, the District Courts would be inundated with pointless "me too" objections. *See* Part I, *infra*.

Violation Of Securities Laws. The securities law violation was blatant. The settlement was originally to be for [redacted] in cash but was modified to be [redacted] in cash, with the balance being delivered in the form of [redacted] in Facebook common stock valued at $35.90 per share—a figure derived from, and consistent with, Facebook's own public statement that

Microsoft was making a $240 million equity investment based on a $15 billion valuation of Facebook. Facebook knew, but did not disclose, that its Board of Directors had recently approved an expert valuation of Facebook's common stock at $8.88 per share. (This valuation was the basis for the exercise price of employee stock options issued by Facebook.) Any reasonable investor contemplating the acquisition of Facebook stock at $35.90 per share would have acted differently had it known of Facebook's own valuation of its stock at $8.88 per share. Facebook's failure to disclose that valuation was a violation of Rule 10b-5; and that violation entitled the Founders to rescind the settlement pursuant to Section 29 of the Securities Exchange Act of 1934.[2]

The District Court rejected the Founders' rescission claim because the parties had cited no case applying the securities laws to an agreement of settlement. That was not correct (*see* p.45, *infra*), but in any event the absence

[2]Facebook's violation of the securities laws was further corroborated by evidence of the communications, through the mediator, that led to Appellants agreeing to take Facebook stock in lieu of [redacted] of cash consideration. *See* pp. 20-21, *supra*. The District Court said that this evidence was precluded by a mediation privilege imposed by a local rule of court. While the securities law defense can be resolved without consideration of this evidence, the District Court's mediation privilege ruling was also error. The local rule the court relied upon applies only to court-conducted mediations, but this was a private mediation. Whether there is any federal common-law mediation privilege is an unresolved question; but if there is, it yields where there is a defense to enforcement of a purported settlement that rests upon what transpired during the mediation. *See* Part II(E), *infra*.

of precedent would mean only that the issue was one of first impression, not that the Founders' securities law claim was without merit. The court pointed to nothing in the language of the securities statutes supporting an implied exemption of settlement agreements from the reach of the federal securities laws. (Nor could it have, as both Rule 10b-5 and Section 29 are broadly worded so as to apply to "all" securities transactions.) Nor did the court suggest any reason in policy or practical terms why a party should have a "safe harbor" in which it would be free to make misrepresentations or fail to make full disclosure about a contemplated sale or exchange of securities in connection with a settlement of litigation. Its ruling was error. *See* Part II, *infra*.

The Term Sheet Was Not An Enforceable Contract. Even if there had been no violation of the securities laws, the Term Sheet should not have been enforced because it did not address numerous issues material to the transaction. While the law encourages settlement of litigation, it does not exempt contracts of settlement from the usual rules of contract formation and validity. At the heart of those rules is the requirement that a contract contain all material terms of the transaction; if it does not, the contract cannot be enforced. Here, the 1-1/3 page Term Sheet failed to address critical issues:

- what the settlement amount would be, net of a credit to Facebook for ConnectU's liabilities;
- whether the parties would make representations and warranties to one another in connection with the exchange of Facebook and

ConnectU securities;

- whether the transaction was to be a non-taxable merger or a taxable sale of stock;
- whether the Facebook stock transferred to the Founders would be subject to material restrictions on transferability; and
- the nature and scope of the releases.

That these were material terms that needed to be in the contract is conclusively demonstrated by the fact that, promptly after the mediation, the parties exchanged drafts of contracts addressing those issues; when they could not resolve them, Facebook drafted approximately 140 pages of densely written transactional documents which it claimed were embodied in the Term Sheet and asked the District Court to require the Founders to sign them. Although this issue was fully briefed below, the District Court's opinion ignores it. *See* Part III, *infra*.

Disqualification Of Counsel. After the District Court transferred control of ConnectU to Facebook, Facebook caused ConnectU to seek disqualification of two law firms that had previously represented ConnectU and its Founders as joint clients. The Founders' appeal from the order granting disqualification of their counsel is easily resolved because reversal of the judgment enforcing the settlement will eliminate the conflict of interest on which the disqualification was based. *See* Part IV, *infra*.

STATEMENT OF THE CASE

A. Overview Of Litigation Between ConnectU, Its Founders And Facebook.

The First Massachusetts Action. On September 2, 2004, ConnectU filed an action in the District of Massachusetts against Facebook, Zuckerberg, and four other individual defendants. *ConnectU LLC v. Zuckerberg et al.*, Case No. 1:04-CV-11923 (DPW) (D. Mass. Sept. 9, 2004); 2-Excerpts of Record ("ER")-148; Request for Judicial Notice in Support of Appellants'/Cross-Appellees' Opening Brief ("RJN") Exs. A, B. The District Court dismissed the case for lack of subject matter jurisdiction, a ruling that the First Circuit reversed in *ConnectU LLC v. Zuckerberg*, 522 F.3d 82 (1st Cir. 2008).

The Second Massachusetts Action. While the First Circuit appeal was pending, ConnectU on March 28, 2007, filed a second action raising substantially similar allegations. *ConnectU LLC v. Zuckerberg, et al.*, No. 1:07-CV-10593 (DPW) (D. Mass.). RJN Ex. C. This second action added additional allegations more clearly establishing federal question jurisdiction.

The California Action. On August 17, 2005, Facebook filed an action in California Superior Court against ConnectU and the Founders. 2-ER-111. On June 2, 2006, the Superior Court dismissed the Founders for lack of personal jurisdiction. 2-ER-227-28. On February 23, 2007, Facebook filed a First Amended Complaint that stated federal claims, and ConnectU removed the action to the Northern District of California. 2-ER-76-78, 230-40.

On March 21, 2007, ConnectU moved to dismiss for failure to state a claim. 2-ER-122. The District Court granted that motion in part, denied it in part and granted Facebook leave to amend. 2-ER-184-93. On May 30, 2007, Facebook filed a Second Amended Complaint that added Zuckerberg as a plaintiff and again named the Founders as defendants. 2-ER-195:1-6, 242:1-7.

On September 5, 2007, the Founders moved the District Court to be dismissed for lack of personal jurisdiction. 2-ER-214. The District Court granted that motion on November 30, 2007, ruling that the prior state court determination on jurisdiction was "conclusive." 1-ER-67.

B. The District Court Enforces A Purported Settlement.

After some discovery was taken, the parties to both the Massachusetts and the California cases attended a private mediation in California before mediator Antonio Piazza on February 22, 2008. About two months later, Facebook and Zuckerberg filed a "Confidential Motion" seeking an order enforcing a settlement that Facebook and Zuckerberg contended had been reached at the mediation. 4-ER-465-66. ConnectU moved for expedited discovery on factual issues related to the putative settlement and also for an evidentiary hearing. 4-ER-637. The District Court denied ConnectU's motion for discovery without explanation. 1-ER-61-62.

Without holding an evidentiary hearing, the District Court granted Facebook's motion to enforce the Term Sheet. 1-ER-48. On July 2, 2008, the court entered a "Judgment Enforcing Settlement Agreement" (the "7/2/08 Judgment"). 1-ER-43. That judgment required not only ConnectU but also its Founders (who previously had been dismissed from the action) to deliver various items of consideration, including all of ConnectU's stock endorsed for transfer and proposed forms of releases, to a special master. ConnectU filed a notice of appeal from that judgment, the order enforcing the settlement and other orders on July 30, 2008. 3-ER-296 (Appeal No. 08-16745).

On July 29, 2008, ConnectU's Founders moved to intervene, stating that the Founders wished to ensure they had the right to appeal enforcement of the settlement. 3-ER-281-87. On August 8, 2008, the court denied the motion to intervene, because the Founders were "already parties to these proceedings to enforce the Settlement Agreement." 1-ER-38:1-2. The court granted the Founders an extension until August 22, 2008, to appeal the 7/2/08 Judgment, pursuant to Rule 4(a)(5) of the Federal Rules of Appellate Procedure. 1-ER-38:3-5, 40:15-16.

On August 11, 2008, the Founders appealed from the 7/2/08 Judgment and related orders. 3-ER-318-19 (Appeal No. 08-16873). On August 13, 2008, Facebook and Zuckerberg cross-appealed the dismissal of the Founders for lack of personal jurisdiction and the denial of a sanctions motion. 3-ER-320-21 (Appeal No. 08-16849). The Founders sought a stay of the

7/2/08 Judgment from the District Court and from this Court, and each court denied a stay pending appeal. 3-ER-293-94; Docket Nos. 8, 11, 14, 51.

Meanwhile, pursuant to the 7/2/08 Judgment, each side submitted a proposed form of release to the special master, and each side objected to the other side's proposed form of release. 3-ER-261, 269, 273, 278. The special master filed a report in which he inventoried the deposits that the parties had made, summarized various issues for the District Court to decide and made recommendations to the District Court. 3-ER-326-36. After issuing an order to show cause and holding a hearing, the District Court on November 3, 2008, entered an "Order Directing The Special Master To Deliver The Property Being Held In Trust To The Parties In Accordance With The Terms Of Their Settlement Agreement" (the "11/3/08 Order"). 1-ER-26. On that same date, the District Court entered a "Judgment Ordering Specific Performance Of Settlement Agreement and Declaratory Judgment of Release" (the "11/3/08 Judgment"). 3-ER-337.

The 11/3/08 Judgment directed the special master to enforce the settlement agreement by transferring the consideration the parties had deposited and filing motions to dismiss that the District Court had previously compelled the parties to deposit. Instead of ordering the parties to execute releases as had previously been contemplated, the court issued a declaration that Facebook and Zuckerberg, on the one hand, and ConnectU and the

Founders, on the other hand, had "jointly, severally and mutually released each other as broadly as possible from all claims." 3-ER-338.

Facebook sought modification of the District Court's 11/3/08 Order, contending that the order stated incorrectly that ConnectU and the Founders had objected to enforcement of the settlement. 3-ER-340-41. According to Facebook, only ConnectU had opposed enforcement of the settlement. *Id.* The District Court denied Facebook's request, noting that the court had asserted personal jurisdiction over the Founders and that counsel for the Founders was present at the hearing on the motion to enforce the settlement. 3-ER-353-54.

To address another issue Facebook raised, which is not relevant to these appeals, the court vacated the 11/3/08 Judgment and entered an amended judgment on November 21, 2008 (the "11/21/08 Judgment"). 3-ER-353; 1-ER-23. On December 15, 2008, the court dismissed the action. 1-ER-21-22.

On December 19, 2008, the Founders appealed from the 11/3/08 order directing the special master to deliver property, the 11/21/08 Judgment, and the 12/15/08 dismissal order. 3-ER-358-60 (Appeal No. 09-15021).

On January 7, 2009, Facebook and Zuckerberg cross-appealed from the order dismissing the Founders for lack of personal jurisdiction. 3-ER-362-63.[3]

C. Proceedings Before This Court.

Prior to the filing of this brief, there was considerable motion practice in this Court concerning the various appeals described above, all of which have been consolidated. Docket No. 94. This section describes those proceedings in this Court that are either pertinent to the resolution of the appeals by the merits panel or which provide useful background. In the interests of relative brevity, some detail has been omitted, and the Court's orders are grouped by subject matter rather than in chronological order.

Consolidation. All of the notices of appeal described above have been consolidated and are referred to herein as the "Consolidated Appeals." Docket No. 94.

ConnectU's Appeal. By December 22, 2008, Facebook had taken control of ConnectU. On that date, Facebook caused ConnectU to file a motion

[3]In the Massachusetts action, Facebook moved for dismissal after the District Court in this case (the California action) issued its July 2, 2008, order enforcing the settlement. RJN Ex. D. The Massachusetts court has not yet ruled on that motion, pending resolution of these appeals. RJN Ex. F (staying action and terminating all pending motions without prejudice). If this Court affirms the District Court's ruling in this case enforcing the Term Sheet, the District Court in Massachusetts would need to consider whether Facebook's apparent failure to produce certain information should prevent the dismissal of the Massachuetts case. RJN at 3 & Ex. F.

to dismiss ConnectU's own appeal. Docket No. 52. The Founders opposed this motion out of concern that Facebook could later use a dismissal to frustrate appellate review of the order and judgment enforcing the settlement. Docket No. 57 at 2-3. On December 11, 2009, the motions panel ruled on ConnectU's motion as follows:

> The Founders' opposition to ConnectU, Inc.'s motion for voluntary dismissal of appeal No. 08-16745 is construed as a motion to intervene in appeal No. 08-16745. So construed, the motion is granted. ConnectU, Inc.'s motion for voluntary dismissal of appeal No. 08-16745 is construed as a motion to withdraw from that appeal. So construed, the motion is granted. (Docket No. 94)

This ruling reflected a resolution of ConnectU's claim that its rights would be abridged if it were forced to prosecute an appeal against the interests of its parent company, Facebook. *See* Docket No. 52 at 6; Docket No. 88 at 3. By deeming the Founders to have intervened, and ConnectU to have withdrawn, the motions panel placed the Founders in control of ConnectU's appeal.

Facebook's Motion To Dismiss The Founders' Appeals. On February 18, 2009, Facebook moved to dismiss "portions" of the Founders' appeals. Docket No. 69. In this motion, Facebook contended that, in the District Court, the Founders had failed to oppose the motion to enforce the purported settlement and, therefore, waived their right to appeal. On December 11, 2009, the motions panel referred Facebook's motion to the merits panel. Docket No. 94. (That motion to dismiss is addressed in Part I, *infra*.)

ConnectU's Motion To Disqualify Counsel. On January 20, 2009, ConnectU filed a motion to disqualify three firms that had represented ConnectU and the Founders as joint clients: Finnegan, Henderson, Farabow, Garrett & Dunner LLP ("Finnegan"); Boies, Schiller & Flexner LLP ("Boies"); and O'Shea Partners LLP ("O'Shea"). ConnectU asserted that Finnegan, Boies, and O'Shea were disqualified from representing the Founders adverse to ConnectU, which each firm formerly represented. Docket No. 63.

On July 1, 2009, this Court remanded ConnectU's motion to disqualify to the District Court. On September 2, 2009, the District Court granted the motion to disqualify Finnegan and Boies. 1-ER-1. On September 15, 2009, the Founders appealed from the disqualification order. 3-ER-372-73 (Appeal No. 09-17050) (the "Disqualification Appeal").

On October 9, 2009, this Court directed the Founders to dismiss the Disqualification Appeal or demonstrate why the Court had appellate jurisdiction. After considering the parties' submissions, the Court on December 14, 2009, "dismissed as unnecessary" the Disqualification Appeal and deemed the Disqualification Appeal to be an amended notice of appeal in the Consolidated Appeals. Docket No. 117. (The disqualification issue is addressed in Part IV, *infra*.)

Prior Briefing. After the District Court had issued the 7/2/08 Judgment but before the District Court had issued the 11/3/08 judgment and the

12/15/08 dismissal order, ConnectU and the Founders jointly submitted an opening brief on appeal on October 7, 2008. Docket Nos. 33, 79. No further briefs were filed because ConnectU and Facebook subsequently filed motions to dismiss. *See* 9th CIR. L. R. 27-11.

After the Boies and Finnegan firms were disqualified and the Founders retained new counsel, the Founders asked to withdraw their October 7, 2008, brief and sought permission to file a new brief addressing all of the Consolidated Appeals. This Court granted that request and deemed the opening brief submitted on October 7, 2008 (and filed on November 4, 2008), to be withdrawn. The Court also set a new briefing schedule that commenced with the filing of this opening brief. Docket No. 94.

STATEMENT OF FACTS

A. The Underlying Litigation.

In the Massachusetts action, Appellants Cameron Winklevoss, Tyler Winklevoss and Divya Narendra (the "Founders") alleged that, during their junior year at Harvard, they conceived the idea of creating a website that would connect people through networks of friends and common interests. *See* 2-ER-150 ¶12. In November 2003, Zuckerberg—then a fellow Harvard student—agreed to join the Founders to complete the computer programming necessary to establish the website. *Id.* ¶14. The proposed website was initially dubbed "HarvardConnection" and later renamed "ConnectU." RJN Ex. C ¶¶13, 15.

Zuckerberg repeatedly assured the Founders that he would complete the programming in time to launch the website before the end of the 2004 school year. 2-ER-150-51 ¶¶15-16. But just days after reconfirming his intention in writing, Zuckerberg registered the domain name "TheFaceBook.com" and launched his own website, thereby misappropriating the Founders' ideas and intellectual property. 2-ER-151-52 ¶¶19-20. Zuckerberg and Facebook thereafter exploited the advantage they appropriated for great personal gain. Facebook has changed the way people communicate around the world, and the privately held company has been valued in the billions of dollars. 5-ER-729.

In late 2004, ConnectU sued Facebook and its CEO, Zuckerberg, among others, in the District of Massachusetts. In essence, ConnectU alleged that Zuckerberg had misappropriated their intellectual property and used it to found Facebook. The complaint alleged fraud, unjust enrichment, copyright infringement, breach of contract, breach of fiduciary duty, misappropriation of trade secrets, breach of the implied covenant of good faith and fair dealing, and intentional interference with business relations. 2-ER-153-59 ¶¶24-76.

In August 2005, Facebook filed an action in California Superior Court against ConnectU and the Founders, alleging unfair competition and claims under the CAN-SPAM Act, 15 U.S.C. §§7701 *et seq*. 2-ER-111-19. The state court dismissed the Founders for lack of personal jurisdiction. After

Facebook added federal claims, ConnectU removed the action to the Northern District of California. Later, Facebook again tried to name the Founders as defendants. On the Founders' motion, the District Court again dismissed the Founders for lack of personal jurisdiction. *See* Statement of the Case, *supra.*

B. The Mediation And Purported Settlement.

On February 22 and 23, 2008, the parties attended a mediation. 5-ER-800 ¶1. They signed a handwritten 1-1/3 page Term Sheet (the "Term Sheet"), which Facebook had drafted. *Id*. ¶5; 4-ER-482-83; 5-ER-845:13-19. The Term Sheet called for Facebook's acquisition of ConnectU, the release of claims against Facebook, payment by Facebook of [redacted], and the issuance of [redacted] shares of Facebook stock to the Founders. As explained below, that precise number of shares was determined on the basis of a $15 billion valuation of Facebook resulting in a per-share value of approximately $35.90. *See* pp.37-39, *infra*. However, unknown to the Founders at the time they signed the Term Sheet, Facebook's Board of Directors had recently obtained, and thereafter approved, an expert valuation of Facebook's stock at $8.88 per share. 5-ER-801 ¶8; 702 ¶9. (This valuation was a significant event, and its accuracy a matter of great importance, because it was obtained in connection with the issuance of employee stock options; as explained below, if the stock options were issued

below the value of the shares, the tax consequences would be highly adverse for the recipients of the options, and liability would be created for directors and officers. *See* p.38 n.5, *infra.*) Facebook did not disclose the $8.88 per share valuation to the Founders.

The undisclosed $8.88 valuation was markedly different from a valuation Facebook had publicized in a press release five months earlier, in October 2007. In that press release, Facebook announced Microsoft's agreement to "take a $240 million equity stake in Facebook's next round of financing *at a $15 billion valuation.*" 5-ER-729-31 (emphasis added). Based on Facebook's representation in the Term Sheet of the total number of Facebook shares outstanding at the time of the mediation, it was a matter of simple arithmetic to conclude—based on Facebook's own public statement concerning its $15 billion value—that Facebook shares were worth approximately [redacted] per share, more than four times the value Facebook's Board and its outside valuation expert had ascribed to the shares. 5-ER-801 ¶7.

The apparent value of Facebook's stock at $35.90 per share was central to the parties' settlement, as Founder Cameron Winklevoss's declaration explained:

2. [redacted]

3. [redacted]

4. [redacted]

5. [redacted]

* * * *

7. [redacted]

8. [redacted]

Just hours after the Term Sheet was signed, Facebook's counsel called the agreement "tentative" and suggested that the two District Courts be informed the parties were "in the process of preparing a final agreement." 5-ER-807. Counsel also proposed asking the courts to "stay all deadlines and

proceedings while the parties complete the settlement." *Id*. The next week, another Facebook attorney informed the Massachusetts court that "[t]he parties are still *attempting to finalize* a settlement, and it may be a few weeks." 5-ER-810 (emphasis added).

Beginning on February 27, 2008, and continuing through early April 2008, the parties' counsel attempted to complete the deal. Facebook's lawyers prepared the first draft of a non-taxable merger agreement, which would have resulted in an exchange of the Founders' ConnectU stock for Facebook common stock. 5-ER-700 ¶4, 702 ¶9. Lawyers for the parties discussed and reviewed various other documents for the transaction, including a disclosure letter, schedules and a stockholders' agreement. 5-ER-701-02 ¶8; 4-ER-512 ¶5.

At some point during these negotiations, ConnectU's counsel asked Facebook's counsel for Facebook's

> "409(A) valuation," meaning the price that Facebook's Board of Directors had determined to be the fair market value of Facebook's common stock in connection with setting the exercise price of options (also known as the "strike" price) granted to employees and other service providers under Facebook's stock option plan. (5-ER-722 ¶3)

Facebook's counsel responded that Facebook's Board had recently "determined the fair value of the Facebook common stock to be $8.88." 5-ER-702 ¶9. Facebook declined ConnectU's request for a copy of the valuation report. *Id.*

The difference between Facebook's previously undisclosed $8.88 valuation, and the $35.90 per-share value the parties used in negotiating the Term Sheet, became an issue in the parties' discussions. When the parties discussed how to calculate the credit Facebook would receive in the event that ConnectU's liabilities to be assumed by Facebook exceeded a certain level, ConnectU's counsel proposed

> that the maximum amount of liabilities that Facebook and its affiliates would assume in the proposed merger without recourse to the ConnectU stockholders be increased from [redacted] to [redacted] or [redacted], and that the shares of Facebook common stock issued to the ConnectU stockholders in the merger be reduced commensurately at the rate of one . . . less share of Facebook common stock for every [redacted] of increased liabilities assumed by Facebook and its affiliates. . . . [Facebook's lawyer subsequently] stated that Facebook was unwilling to agree to my proposal, indicating that Facebook would not want to establish an explicit value of $35.90446 per share of common stock, in light of the prior determination by Facebook's Board of Directors that the fair market value of the Facebook common stock was $8.88 per share. (5-ER-702 ¶10)

Facebook was willing to agree to ConnectU's proposal only "if the number of shares included in the merger consideration [were] reduced by one share for every $8.88 of liabilities in excess of [redacted] assumed by Facebook and its affiliates." *Id.*

C. The District Court Enforces The Term Sheet.

After negotiations between the parties failed to produce agreement, Facebook moved on April 23, 2008, to enforce what Facebook contended was the parties' agreement. Facebook addressed its notice of motion only to

ConnectU, not to the Founders who—as noted earlier—had been dismissed from the California action. 4-ER-465:2-3.

Facebook's motion did not seek to enforce the short, 1-1/3 page Term Sheet. Facebook instead sought an order compelling ConnectU and the Founders to execute approximately 140 pages of dense transactional documents packed with important terms not discussed in the Term Sheet, including:

- a 6-1/2 page "ConnectU Stockholders Agreement," (4-ER-516-22);
- a 44-page "Stock Purchase Agreement" (4-ER-526-70);
- a form for ConnectU's lenders to complete indicating that all loans to ConnectU have been satisfied (4-ER-577);
- a disclosure letter from ConnectU to Facebook vouching for 26 pages of representations arranged into schedules (4-ER-580-605);
- a "Company Legal Opinion" that would need to be issued by a lawyer representing ConnectU (4-ER-630-31); and
- a 10-page "Confidential Mutual Release of Claims" (4-ER-485-96).

The documents Facebook presented to the District Court were "substantively very different" from those that had previously been exchanged by the parties. 5-ER-701 ¶7. Among other differences, Facebook's new documents contemplated a "direct purchase of ConnectU stock by Facebook or an affiliated entity from the ConnectU Stockholders," a transaction that would be a taxable sale rather than a non-taxable merger. *Id.* In addition to that significant

change, Facebook took it upon itself to resolve how the credit to Facebook for ConnectU's liabilities would be calculated. In an effort to dodge the problems created by Facebook's failure to disclose the $8.88 valuation, Facebook proposed to have excess ConnectU liabilities reduce not only the amount of Facebook stock but also the amount of *cash* Facebook would pay to the Founders. 4-ER-532 (Facebook's proposed agreement defined "Total Cash Consideration" as "[redacted] less the sum of the Company Liabilities Amount as set forth on the Company Expenses Certificate"); 4-ER-531-32 ("Total Share Consideration" reduced by one share for each $8.88 of ConnectU liabilities above [redacted]); 5-ER-713 ¶15.

In light of all this, it was no wonder that, by the time of the hearing, Facebook conceded that "this has become a little . . . complicated" (5-ER-821:25-822:1) and invited the court to "essentially staple [the Term Sheet] on to the judgment." 5-ER-822:25-823:1. On June 25, 2008, the court granted Facebook's motion and enforced the Term Sheet instead of the lengthy documents Facebook had proposed. 1-ER-48. In rejecting the Founders' securities fraud defense, the District Court:

- Concluded that Facebook had not violated Rule 10b-5 by failing to disclose the $8.88 share valuation while trading in its own stock because "insider trading . . . is not an issue in this case." 1-ER-58.
- Applied a "mediation privilege" to bar consideration of evidence of what transpired during the mediation. 1-ER-57 n.11.

- Refused to apply Rule 10b-5 and Section 29 of the Securities Exchange Act of 1934 to void the settlement agreement on the ground that settlement agreements in which shares are exchanged are exempt from Section 29 and Rule 10b-5. 1-ER-58 ("[n]either Plaintiffs nor Defendants have cited authority that an agreement to exchange shares of closely held corporations pursuant to settlement of litigation between companies is voidable by showing securities fraud").
- Ruled that the release in the Term Sheet prohibited any claim under the securities laws that the release itself was fraudulently procured. *Id*.

The court also ruled that the Term Sheet was an enforceable contract. In ruling that the Term Sheet stated all material terms, the court refused to consider any extrinsic evidence, stating that, under California law, it was compelled to look only at the "four corners" of the Term Sheet. 1-ER-53.

STANDARDS OF REVIEW

The District Court's decision to enforce the Term Sheet is reviewed for abuse of discretion. *Callie v. Near*, 829 F.2d 888, 890 (9th Cir. 1987). The District Court abuses its discretion when it makes an error of law. *E.&J. Gallo Winery v. Andina Licores S.A.*, 446 F.3d 984, 989 (9th Cir. 2006). Legal principles underlying the District Court's exercise of discretion are

reviewed *de novo*. *Id.*; *Husain v. Olympic Airways*, 316 F.3d 829, 835 (9th Cir. 2002), *aff'd*, 540 U.S. 644 (2004).

Where there are no disputed material facts, the District Court should treat a motion to enforce a settlement agreement like a summary judgment motion. *City Equities Anaheim v. Lincoln Plaza Dev. Co. (In re City Equities Anaheim, Ltd.)*, 22 F.3d 954, 958-59 (9th Cir. 1994) (citing *Tiernan v. Devoe*, 923 F.2d 1024 (3d Cir. 1991)); *Tiernan*, 923 F.2d at 1031 ("whether there was any disputed issue of material fact as to the validity of the settlement agreements . . . is similar to that which any court must address when ruling on a motion for summary judgment"). In the absence of a disputed issue of material fact, the court can enter summary judgment for the non-moving party. *Cool Fuel, Inc. v. Connett*, 685 F.2d 309, 311 (9th Cir. 1982) ("if one party moves for summary judgment and, at the hearing, it is made to appear . . . that there is no genuine dispute respecting a material fact essential to the proof of movant's case and that the case cannot be proved if a trial should be held, the court may *sua sponte* grant summary judgment to the non-moving party").

A ruling on the scope of an evidentiary privilege involves a mixed question of law and fact, and is reviewed *de novo*, except that review is limited to clear error where the scope of the privilege is clear and the decision is essentially factual. *UMG Recording, Inc. v. Bertelsmann AG (In re Napster, Inc. Copyright Litig.)*, 479 F.3d 1078, 1089-90 (9th Cir. 2007), *overruled on*

other grounds, Mohawk Indus., Inc. v. Carpenter, —U.S.—, 130 S. Ct. 599 (2009).

An order disqualifying counsel is subject to review for abuse of discretion. *Paul E. Iacono Structural Eng'r, Inc. v. Humphrey*, 722 F.2d 435, 438 (9th Cir. 1983). If the District Court "misperceives the relevant rule of law" in granting a motion to disqualify counsel, the order should be reversed. *Id.*

ARGUMENT

I.

THE FOUNDERS DID NOT WAIVE THEIR APPEAL.

As noted earlier, the motions panel referred to the merits panel Facebook's motion to dismiss "portions of" the Founders' appeals. Facebook's motion to dismiss contends that the Founders failed to oppose the motion to enforce settlement, thereby waiving their right to appeal. Docket No. 69. The motion is meritless and should be denied.

A. Relevant Facts.

At the time Facebook filed its motion to enforce the settlement, the Founders had been dismissed from the California action. 1-ER-67. Facebook's notice of motion was not addressed to the Founders but only to ConnectU and certain other defendants besides the Founders. 4-ER-465:2-3. While Facebook omitted the Founders from the notice of motion, its motion

sought relief against them, requesting that the Founders "be ordered to sign the Mutual Release Agreement prepared by Facebook." 4-ER-465:15-16.

Not having been named in the motion, the Founders did not formally appear in response to it. ConnectU, the party to whom the motion was addressed, vigorously opposed the motion, filing over 170 pages of briefs and extensive declarations and supporting evidence. 5-ER-666-98, 699-705, 706-17, 718-20, 721-22, 723-31, 765-810 (to comply with Local Rules 30-1.4 and 30-1.5, only selected portions are included in the ER). The Founders reasonably relied on ConnectU to protect their interests.

In Facebook's reply, it seized on the procedural trap it had laid, arguing that the Founders had "waive[d] any objection to enforcement." 5-ER-671 n.1. Facebook contended that the Founders had notice of the settlement enforcement motion through certain lawyers representing ConnectU in the California action who *also* represented the Founders in the Massachusetts action. 5-ER-882:18-883:15. The District Court agreed. In its June 25, 2008 order granting Facebook's motion to enforce the settlement, the court concluded that it had jurisdiction over the Founders and that they had received notice of the proceedings. 1-ER-52. However, the District Court did not agree with Facebook that the Founders had waived their objection to enforcement of the Term Sheet (1-ER-51-53), and addressed the merits of Facebook's motion to enforce. *Id.*

As further proceedings played out in the District Court, the court repeatedly rejected Facebook's contention that the Founders had waived their right to object. For example, when the court denied the Founders' motion to intervene, the court commented that the Founders "have already been made parties to the action" and participated through counsel in the proceedings concerning enforcement of the settlement. 1-ER-34:4, 37:20-21. The court concluded that its judgment was "binding" on the Founders "and they may appeal that Judgment." 1-ER-37:21-22. At a hearing on August 6, 2008, ConnectU (still controlled by the Founders) alerted the court to the possibility that handing control of ConnectU over to Facebook might cause ConnectU to attempt to dismiss its own appeal, thereby preventing appellate review. The District Court commented that "I won't deny the right to appeal" (3-ER-324:18-19) and that "I have to put the opposing party to my judgment in a position so they can challenge my judgment." 3-ER-324.1:6-8.

In its November 3, 2008 order directing the special master to distribute the property he held in trust so as to enforce the Term Sheet, the District Court stated that it had enforced the Term Sheet "over objections by ConnectU *and the Founders*." 1-ER-26:22-23 (emphasis added). Facebook filed a motion contending that the November 3, 2008 order incorrectly stated that the Founders had objected. 3-ER-340. The court denied Facebook's request, noting that it had asserted personal jurisdiction over the Founders

and that counsel for the Founders was present at the hearing on the motion to enforce the settlement. 3-ER-353-54.

B. The Founders' Right To Appeal Was Preserved.

1. The Founders Were Parties To The Enforcement Proceeding Below.

As just shown, the District Court ruled that the Founders were parties to the enforcement proceeding, and that it had jurisdiction to order them to comply with the Term Sheet. Facebook has not cross-appealed from, and does not challenge, that ruling; it could hardly do so inasmuch as it has benefited from the District Court's ruling ordering the Founders to comply. The Founders have not challenged it either.[4]

[4]While the Founders moved to intervene in an abundance of caution to ensure their appellate rights were preserved, the District Court was correct that the Founders did not need to intervene for that purpose. As set out above, the District Court ruled that the Founders were already parties, rendering intervention unnecessary. Facebook opposed the motion to intervene, contending that the Founders already were parties. 3-ER-316. Any person has standing to appeal if the trial court treats the non-party "as if [it] were a party" and subjects it to an adverse judgment. *SEC v. Wencke*, 783 F.2d 829, 834 (9th Cir. 1986); *see also Hal Roach Studios, Inc. v. Richard Feiner & Co.*, 896 F.2d 1542, 1546-47 (9th Cir. 1989) (non-party against whom judgment was entered had standing to appeal even though it had failed to move to intervene in the proceedings below); *SEC v. Lincoln Thrift Ass'n*, 577 F.2d 600, 602-03 (9th Cir. 1978) (non-party creditors had standing to appeal, because trial court's ruling affected creditors' rights).

2. A Co-Party May Rely On Another Co-Party's Objection.

Facebook does not deny that all of the issues raised by the Founders' appeal were fully and vigorously presented to the District Court in briefs and evidentiary submissions by ConnectU and Facebook. Its motion to dismiss therefore rests on an implicit and unexplained contention that because those objections to enforcement were presented by ConnectU, the Founders cannot assert them on appeal. Facebook's failure to articulate that premise, let alone to support it with authority, is understandable, for it is well established that an appellant's right to appeal an issue is preserved when another party has presented that issue below. *See, e.g.*, *United States v. Hardy*, 289 F.3d 608, 612 n.1 (9th Cir. 2002) (co-defendant's objection "preserved the issue for both defendants"); *United States v. Bagby*, 451 F.2d 920, 927 (9th Cir. 1971) (co-defendants' objection "'called the matter to the judge's attention'") (citation omitted); *Holy Cross Wilderness Fund v. Madigan*, 960 F.2d 1515, 1525 n.14 (10th Cir. 1992) (reaching merits of issue raised by co-party). Facebook's motion would, if accepted, compel co-parties to echo each legal argument or objection made by another party. District Courts would be inundated with pointless "me too" briefs and objections.

The rule that only one of several co-parties must object to preserve an issue reflects the purpose of the waiver rule, which is not to bestow procedural windfalls but to avoid unfair second-guessing or blindsiding of the District Court. *Morrow v. Greyhound Lines, Inc.*, 541 F.2d 713, 724 (8th

Cir. 1976) ("The purpose of the [waiver] rule is to inform promptly the trial judge of possible errors so that he may have an opportunity to reconsider his ruling and make any changes deemed desirable"); *see also Whittaker Corp. v. Execuair Corp.*, 953 F.2d 510, 515 (9th Cir. 1992) ("A workable standard . . . is that the argument must be raised sufficiently for the trial court to rule on it. This principle accords to the district court the opportunity to reconsider its rulings and correct its errors") (citations and internal quotation marks omitted). Here, of course, the District Court knew very well that the issues had been comprehensively briefed and argued, and itself stated repeatedly that the issues have been preserved for appeal.

Facebook likewise was on full notice of the Founders' contentions and cannot claim to have been prejudiced. *See Singleton v. Wulff*, 428 U.S. 106, 120 (1976) (purpose of waiver rule is to prevent litigants from being "surprised on appeal by final decision there of issues upon which they have had no opportunity to introduce evidence") (citation and internal quotation marks omitted); *Dream Palace v. County of Maricopa*, 384 F.3d 990, 1005 (9th Cir. 2004) (waiver rule "prevents parties from sandbagging their opponents with new arguments on appeal").

3. Facebook Is Estopped From Arguing Waiver.

In the proceedings below, Facebook supported its successful contention that the District Court had the power to compel the Founders to perform the

purported settlement by arguing that ConnectU and the Founders were in "privity." 3-ER-314:13; *see also* 5-ER-882:16-17 (Facebook argued that the Founders "are the company [ConnectU] for all intents and purposes"). In fact, Facebook referred to ConnectU as a "representative" of the Founders. 3-ER-314:28-315:1 ("[a] non-party can be bound by the litigation choices made by his virtual representative"). In other words, Facebook sought to bind the Founders to ConnectU's "litigation choices" when it suited Facebook (enforcement of the settlement) but on appeal Facebook seeks to deny the Founders the right to rely on ConnectU's "litigation choices" to preserve the Founders' right to appeal.

This is just the sort of about-face that the doctrine of judicial estoppel prevents. That doctrine "was developed to prevent litigants from 'playing fast and loose' with the courts by taking one position, gaining advantage from that position, then seeking a second advantage by later taking an incompatible position." *United Nat'l Ins. Co. v. Spectrum Worldwide, Inc.*, 555 F.3d 772, 778 (9th Cir. 2009). Facebook gained an advantage by convincing the District Court that the Founders (despite not being served with notice of the settlement enforcement proceeding) were *de facto* "parties" in privity with ConnectU and subject to the District Court's jurisdiction and judgment. Facebook cannot now reverse position to preclude review of the judgment it obtained by equating ConnectU and the Founders. *See, e.g.*, *Whaley v. Belleque*, 520 F.3d 997, 1002 (9th Cir. 2008) ("judicial estoppel

bars a state from taking different legal positions in state and federal court in order to create a procedural default that would otherwise bar a habeas petition"); *Wagner v. Prof'l Eng'rs in California Gov't*, 354 F.3d 1036, 1044-50 (9th Cir. 2004) (judicial estoppel prevented plaintiffs from taking inconsistent position on state-law liability to preclude state-court review).

4. This Court Has Placed The Founders In Control Of ConnectU's Appeal.

As noted in the Statement of the Case, after extensive motion practice in this Court, the motions panel deemed ConnectU (under Facebook's control) to have withdrawn from its appeal of the order enforcing the settlement. The motions panel also allowed the Founders to intervene in ConnectU's appeal, thus placing that appeal under the Founder's control. Even if the Founders lacked standing to appeal on their own behalf (which is not the case, as explained above), the motions panel, after careful consideration, placed the Founders in ConnectU's shoes for purposes of preserving the Founders' ability to appeal the District Court's decision to enforce the settlement.

II.

THE SECURITIES LAWS BAR ENFORCEMENT OF THE TERM SHEET.

ConnectU opposed enforcement of the Term Sheet on the ground that Facebook violated the duty of full disclosure imposed by Rule 10b-5 and that this violation warranted rescission under Section 29 of the Securities

Exchange Act of 1934. The District Court rejected these contentions on the grounds that (1) the parties had cited no "authority that an agreement to exchange shares of closely held corporations pursuant to settlement of litigation between the companies is voidable by showing securities fraud" (1-ER-58:7-9); and (2) the release of claims in the Term Sheet barred any claim for securities fraud in connection with entering into the Term Sheet. 1-ER-58-59. The District Court erred on both grounds.

A. Facebook Violated The Securities Laws In Two Separate And Independent Ways.

1. Facebook's First Violation Of Securities Laws: Trading In Its Own Stock Without Disclosing Material, Non-Public Information.

Section 10(b) of the 1934 Act and Rule 10b-5 imposed a duty on Facebook, as an issuer trading in its own stock, to disclose all material information in its possession to the Founders. *McCormick v. Fund Am. Cos., Inc.*, 26 F.3d 869, 876 (9th Cir. 1994) ("'When the issuer itself wants to buy or sell its own securities, it has a choice: desist or disclose'") (quoting VII LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1505 (3d ed. 1991)); *see also Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1203-04 (1st Cir. 1996), *superseded on other grounds by* PRIVATE SECURITIES LITIGATION REFORM ACT (PSLRA), 15 U.S.C. §78u-4(b)(1)-(2); *Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & ERISA Litig.)*, 258 F. Supp. 2d 576, 589, 590 n.9 (S.D. Tex. 2003) ("courts have imposed a duty to disclose"

when "a corporate issuer . . . trades in its own securities"); *Simon v. Am. Power Conversion Corp.*, 945 F. Supp. 416, 425 (D.R.I. 1996) (a publicly traded "issuer, in possession of material undisclosed information, may not issue or otherwise trade in its own stock unless it first discloses this information to the market").

To comply with its duty to disclose, Facebook had to "'disclose material facts which are known to [it] by virtue of [its] position but which are not known to persons with whom [it] deal[s] and which, if known, would affect their investment judgment.'" *Chiarella v. United States*, 445 U.S. 222, 227 (1980) (quoting *Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961)). Information is material if a reasonable investor would have viewed the information as "significantly alter[ing] the 'total mix' of information made available." *McCormick*, 26 F.3d at 876 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)); *see also Basic Inc.*, 485 U.S. at 231 ("[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote") (citation and internal quotation marks omitted); *SEC v. Fife*, 311 F.3d 1, 10 (1st Cir. 2002).

Here, the $8.88 per share valuation that the Facebook Board had approved, but which was not disclosed to the Founders, comprised material, non-public information. That valuation was a critical event for Facebook, for the validity for tax purposes of employee stock options was based on it; if the

valuation was not reasonable, the tax consequences would be horrendous.[5] That valuation altered the mix of information available to an investor in the Founders' position. Just months earlier, in the October 2007 press release, Facebook had publicly represented its total valuation at nearly four times the level established by the Facebook Board's $8.88 per share valuation. 4-ER-729. ("Microsoft will take a $240 million equity stake in Facebook's next round of financing *at a $15 billion valuation*") (emphasis added).

Based on Facebook's representation in the Term Sheet that it had [redacted] fully diluted shares outstanding, it was a matter of simple math to conclude that each share of Facebook in February 2008 was worth approximately $35.90, *unless* there had been a material change in Facebook's total value since the October 2007 press release. Facebook submitted no evidence that a reasonable investor in February 2008 would conclude that Facebook's valuation had decreased materially since October 2007, much less by a factor of four.

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[5]The failure to properly calculate the stock price pursuant to Section 409A of the Internal Revenue Code can expose employees, officers, directors and consultants to federal and California state tax rates in excess of 84% when they receive stock options below the properly valued fair market value. *See* VANESSA A. SCOTT, *Fallacies of Presumption: Unpacking The Impact Of The Section 409A Proposed Regulations On Stock Appreciation Rights Issued By Privately-Held Companies*, 59 TAX LAWYER 867, 876-80 (2006); *see also* Victor Fleischer, *Two and Twenty*: *Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 26 (2008) (Section 409A was enacted "in response to deferred compensation abuses associated with the Enron scandals").

Indeed, the Founders had compelling reason to think that Facebook was valuing its shares at $35.90. [redacted] 5-ER-800-01 ¶¶6-7.[6] Simple math shows that this very precise number of shares was obtained by dividing [redacted] by $35.90446 per share and rounding down the number of shares to the nearest whole number.

A reasonable investor in February 2008 would certainly have acted differently had the investor known that Facebook's Board had approved a formal valuation of Facebook that placed a value on the company [redacted] lower than the $15 billion valuation Facebook publicized in October 2007. "[A] misrepresentation or omission is material if there is a substantial likelihood that a reasonable investor would have acted differently if the misrepresentation had not been made or the truth had been disclosed." *Livid*

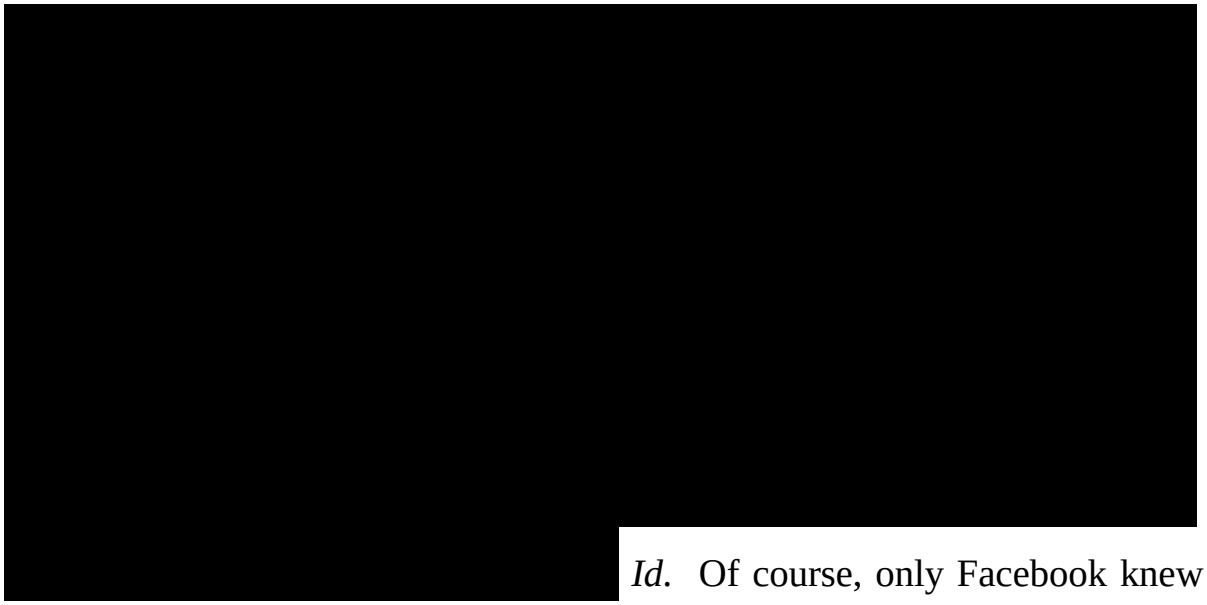
[6]The admissibility of evidence concerning the economic terms agreed to in the mediation is discussed in Part II(F), *infra*.

Holdings Ltd. v. Salomon Smith Barney, Inc., 416 F.3d 940, 946 (9th Cir. 2005); *see also* p.37, *supra*.

In the District Court, Facebook claimed that the Microsoft deal described in the press release involved Series D preferred stock and, as a consequence, the valuation stated in the press release was not material to the stock the Founders received. 5-ER-742. As a result, Facebook argued, it owed no duty to disclose the $8.88 valuation because that valuation related only to common stock, not to Series D preferred stock. *Id.* This argument was illogical and the District Court did not accept it. The significance of the press release was not the value of each Series D share but rather Facebook's statement concerning its total value. A reasonable investor, faced with Facebook's statement of its own value at $15 billion, knowledge of the number of shares outstanding and the fact that Microsoft had agreed to a $240 million investment based on that valuation, would conclude that the value of Facebook's shares was approximately $35.90 per share.

2. Facebook's Second Violation Of Securities Laws: Engaging In A Device, Scheme, Or Artifice Prohibited By The 1934 Act.

As we have seen, the parties first agreed at the mediation that Facebook would transfer total [redacted]



Id. Of course, only Facebook knew about the undisclosed $8.88 valuation, which made the number of shares Facebook proposed to transfer worth only about [redacted], rather than the agreed-upon [redacted]. Facebook's bait-and-switch in preparing the Term Sheet was a "device, scheme, or artifice" that violated the 1934 Act.

However subtle and clever Facebook's scheme may have been, it was prohibited by Rule 10b-5. The catch-all clause of Rule 10b-5—which makes it illegal to "employ any device, scheme, or artifice to defraud"—is intended to forbid not just "garden variety" fraud, but also those involving complex, unusual or unique schemes. Section 10(b) and Rule 10b-5

> prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws. (*Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 n.7 (1971))

See also Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & ERISA Litig.), 235 F. Supp. 2d 549, 574 (S.D. Tex. 2002) (elaborate Ponzi scheme involving numerous corporate entities was an illegal device to defraud under §10 and Rule 10b-5).

[redacted] Courts have found liability under the "device, scheme, or artifice" language for such diverse schemes as:

- "stand[ing] mute" and failing to disclose material information while engaging in self-interested securities transactions with the plaintiffs (*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972));
- selling a client's securities without authorization and personally retaining the proceeds (*SEC v. Zandford*, 535 U.S. 813, 819-24 (2002));
- providing information to third-party analysts in order to inflate the value of defendants' stock (*Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1998)); and
- creating "a pattern of . . . unlawful [entities] and utilizing fraudulent transactions with these entities as contrivances or deceptive devices

> to defraud investors into continuing to pour investment money into Enron securities to keep afloat the Ponzi scheme and thereby enrich themselves in a variety of ways" (*Enron*, 235 F. Supp. 2d at 578 n.15).

[redacted] is a "device, scheme, or artifice" for which Facebook is liable under Section 10(b) and Rule 10b-5. *See Affiliated Ute Citizens*, 406 U.S. at 152-53.[7]

B. Facebook Acted With Scienter In Failing To Disclose Material Facts About Its Own Stock's Value.

In the context of a failure to disclose, scienter is established if the defendant "had actual knowledge of undisclosed material information; knew it was undisclosed, and knew it was material, *i.e.*, that a reasonable investor would consider the information important in making an investment decision." *SEC*

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[7] [redacted]. A securities-fraud defendant who "intentionally used . . . third parties to disseminate false information" to a potential investor "cannot escape liability simply because it carried out its alleged fraud through the . . . statements of third parties." *Cooper*, 137 F.3d at 624 (quoting *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996)); *see also Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1235 (9th Cir. 2004) (when misleading statements in a third-party analyst's report "clearly originated from the defendants, and do not represent a third party's projection, interpretation, or impression, the statements may be held to be actionable even if they are not exact quotations").

v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983); *Aaron v. SEC*, 446 U.S. 680, 696 (1980); *see also Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (scienter can be based on "knowing *or* intentional misconduct") (emphasis added). Here, Facebook had actual knowledge of the $8.88 per share valuation that its own Board of Directors, after retaining an expert valuation firm, had recently approved. 5-ER-702 ¶9.

[redacted] Facebook acted with scienter. *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir. 1978) (per curiam) (evidence that defendants' omissions "were, at the very least, with knowledge" was sufficient to find 10b-5 liability); *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000) ("[S]ecurities fraud claims typically have sufficed to state a claim . . . when they have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements").

C. The Founders Are Entitled To Rescind The Term Sheet Due To Facebook's Violations Of The 1934 Act.

Section 29(b) "provides that any contract made in violation of any provision of the 1934 Act shall be void. An innocent party may sue under §29(b) to rescind a contract." *W. Fed. Corp. v. Erickson*, 739 F.2d 1439, 1443 n.5 (9th Cir. 1984). "Section 29(b) itself does not define a substantive violation of the securities laws; rather, it is the vehicle through which private parties

may rescind contracts that were made or performed in violation of other substantive provisions" of the 1934 Act. *Berckeley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195, 205 (3d Cir. 2006) (citation omitted). Here, ConnectU was entitled to invoke Section 29(b) as a defense to enforcement of the Term Sheet based on Facebook's violation of Section 10(b) and Rule 10b-5. *See, e.g.*, *id.* at 207 n.11 ("[T]he Section 29(b) claim premised on a violation of Section 10(b) is readily apparent").

The District Court gave only two reasons for refusing to void the Term Sheet pursuant to Section 29. Those reasons were unsound.

1. Securities Transactions That Take Place In Conjunction With Settlement Of Litigation Are Subject To The Securities Laws.

The District Court concluded that there is an implied exemption for securities fraud committed in connection with a settlement agreement. It gave no reason for that ruling other than to observe that the parties had not cited any authority on the issue one way or the other. *See* p.26, *supra*. In fact, ConnectU did cite to a case on point, *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1142 (2d Cir. 1970), *overruled on other grounds*, *Bennett v. U.S. Trust Co. of N.Y.*, 770 F.2d 308, 311-13 (2d Cir. 1985) (*cited at* 5-ER-810.4). In that case, the Second Circuit voided two settlement agreements because they violated the securities laws.

Pearlstein arose from two transactions that a broker had arranged for a customer. In each transaction, the broker failed to comply with

Regulation T, which required the broker to sell the securities if the customer did not pay in full within seven business days. 429 F.2d at 1138. Instead of complying with Regulation T, the broker sued the customer for the balance due concerning one of the transactions, which involved the purchase of Lionel securities. The parties signed a settlement agreement in which the customer agreed to pay the balance due in two installments. *Id.* On the same day that settlement was signed, the parties entered into a separate agreement concerning the other securities the broker had bought for the customer. With regard to those securities in AMF, the broker agreed to seek a bank loan for the customer for part of the amount due, and the customer agreed to pay the remainder in two installments. *Id.* at 1138-39. The Second Circuit held that the settlement agreements were void under Section 29 because they involved "a continuation of credit which was illegal under the Act." *Id*. at 1142.

The District Court attempted to distinguish *Pearlstein* on the ground that it involved "an agreement which violated the margin requirements of Regulation T because the defendant failed to recover capital after the settlement." 1-ER-58:15-16. This was a distinction without a difference, because Section 29(b) of the 1934 Act voids every 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 . . ." (emphasis added)).

Consistent with *Pearlstein*, an exemption from Rule 10b-5 and from Section 29 for settlement agreements would conflict with the plain language of the rule and the statute. Rule 10b-5 prohibits "*any* device, scheme, or artifice to defraud," "*any* untrue statement of a material fact or [failure] 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 "*any* act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" that occurs "*in connection with the purchase or sale of any security*." (Emphases added.) Likewise, Section 29 applies by its own terms to "*[e]very contract* made in violation of any provision of this chapter or of any rule or regulation thereunder." 15 U.S.C. §78cc(b) (emphasis added).

In enacting the 1934 Act to protect investors, Congress did not carve out an exception for investors who take an equity interest in a company as part of a litigation settlement. Courts should not infer an exception to a broadly stated antifraud statute. *See Affiliated Ute Citizens*, 406 U.S. at 151 (the "proscriptions" of Section 10 and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive"); *see also 62 Cases, More or Less, Each Containing Six Jars of Jam v. United States*, 340 U.S. 593, 596 (1951) ("Congress expresses its purpose by words. It is for us to ascertain—neither to add nor to subtract, neither to delete nor to distort"); *Water Quality Ass'n Employees Benefit Corp. v. United States*, 795 F.2d

1303, 1309 (7th Cir. 1986) ("It is a basic principle of statutory construction that courts have no right first to determine the legislative intent of a statute and then, under the guise of its interpretation, proceed to either add words to or eliminate other words from the statute's language"). Exemption of settlement agreements from the reach of Section 29 would be contrary to Congress's intent that "securities legislation enacted for the purpose of avoiding frauds . . .be construed not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens*, 406 U.S. at 151 (citation and internal quotation marks omitted).

2. The Release In The Term Sheet Does Not Bar A Claim That The Term Sheet Was Itself Induced By Securities Fraud.

The District Court's second reason for not voiding the Term Sheet under Section 29 was that "the Ninth Circuit has held that a broad release in a signed settlement agreement operates to prevent a party from collaterally attacking the agreement by alleging it violates the securities laws . . . ." 1-ER-58:18-19. To reach this conclusion, the District Court relied on *Petro-Ventures, Inc. v. Takessian*, 967 F.2d 1337 (9th Cir. 1992). *Petro-Ventures* is inapposite, and the District Court's second rationale was contrary to precedent.

Petro-Ventures unremarkably held that when litigation concerning a securities transaction is settled with broad releases, including an express waiver of unknown claims, the settled litigation cannot be reinstated if the

plaintiff thereafter develops a new theory of recovery or discovers new facts. *See id.* at 1342 (in settling the case, the parties gave up all claims, known and unknown, concerning a May 1986 transaction); *id.* at 1339 (plaintiff sought to rescind settlement based on a claim that defendant failed to disclose "misrepresentations and omissions surrounding the May, 1986 purchase agreement"). The decision therefore stands for nothing more than that a broad release of pre-existing claims releases pre-existing claims. *Petro-Ventures* did *not* hold that a release contained in a settlement agreement (or any other type of contract, for that matter) immunizes the agreement itself from rescission under Section 29. Rather, as *Pearlstein* recognized, a settlement agreement is void under Section 29 if the agreement violates the securities laws.

Numerous principles of law establish that a settlement agreement is subject to rescission on the ground that it was the result of securities fraud, just as is any other contract. *First*, Section 29 itself prohibits advance waiver of any of the 1934 Act's provisions. 15 U.S.C. §78cc(a) (any "condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder . . . shall be void"); *Petro-Ventures*, 967 F.2d at 1340-41 (Section 29 prevents the unknowing release of a federal securities claim). A release purporting to bar a claim that the contract in which the release appears is void under Sec-

tion 29 would be an impermissible advance waiver of a securities fraud claim.

Second, under California contract law, settlement agreements are subject to rescission on the same grounds as any other contract, including fraud. *See, e.g.*, *Callen v. Pennsylvania R.R.*, 332 U.S. 625, 630 (1948) (settlement can be overturned if the contract is tainted by fraud); *First Nat'l Bank of Cincinnati v. Pepper*, 454 F.2d 626, 632 (2d Cir. 1972) ("[A] settlement contract or agreement, like any other, may be attacked on the grounds that it was procured by fraud, duress or other unlawful means"); *Brown v. County of Genesee*, 872 F.2d 169, 174 (6th Cir. 1989) ("[T]he existence of fraud or mutual mistake can justify reopening an otherwise valid settlement agreement"). A provision in the contract purporting to excuse false representations, or to release claims of fraud in connection with the contract, is invalid because the "fraud renders the whole agreement voidable, including the waiver provision." 1 B. WITKIN, SUMMARY OF CALIFORNIA LAW, *Contracts* §304 (10th ed. 2005) (emphasis omitted); *see, e.g.*, *Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Dev. Corp.*, 32 Cal. App. 4th 985, 996 (1995) ("a party to an agreement induced by fraudulent misrepresentations or nondisclosures is entitled to rescind, notwithstanding the existence of purported exculpatory provisions . . . in the agreement") (citation and internal quotation marks omitted). *Manderville v. PCG&S Group, Inc.*, 146 Cal. App. 4th 1486, 1499-1502 (2007); *McClain v. Octagon Plaza, LLC*, 159 Cal.

App. 4th 784, 794 (2008); CAL. CIV. CODE §1668 ("[a]ll contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud . . . or violation of law, whether willful or negligent, are against the policy of the law").

Third, a California statute specifically prevents the release of unknown claims unless the release so states. Under Section 1542 of the California Civil Code, a "general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor." "Civil Code section 1542 was intended by its drafters to preclude the application of a release to unknown claims in the absence of a showing, *apart from the words of the release*, of an intent to include such claims." *Casey v. Proctor*, 59 Cal. 2d 97, 109 (1963) (emphasis added). Since the Term Sheet does not establish an express waiver of unknown claims, the release cannot be read to release any unknown claims, including claims or defenses arising under the securities laws.

D. The Founders Did Not Need To Establish Reliance To Obtain Rescission Of The Term Sheet.

In the District Court, Facebook argued that the Founders could not justifiably rely on the October 2007 press release for various reasons, such as the idea that Facebook's stock was volatile. 5-ER-744:11-745:22. The District Court did not accept those fact-based arguments. In fact, they were legally

irrelevant because, for two distinct reasons, the Founders did not have to establish justifiable reliance.

1. A Party Seeking Rescission Under Section 29 Does Not Need To Establish Justifiable Reliance.

A party seeking rescission under Section 29 does not need to establish reliance and damages. Reliance and damages must only be proven when a private plaintiff seeks money damages. *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 206 n.6 (3d Cir. 2001). When a private party seeks rescission, the

> situation is analogous to a government prosecution under Section 10(b), in which the government is not required to meet the normal standing requirements imposed on those asserting a private remedy, inasmuch as the government need not demonstrate that the defendant's conduct induced reliance by investors or affected the price of the security. (*Id.* (citation omitted))

See also Berckeley, 455 F.3d at 208 ("In the Section 29(b) context, a plaintiff seeking rescission does not have to establish reliance and causation"); *McGowan Investors LP v. Frucher*, 481 F. Supp. 2d 405, 411-12 (E.D. Pa. 2007).

2. Reliance Is Not An Element Of A Section 10(b) Violation That Arises Primarily From A Failure To Disclose.

Where a Rule 10(b) violation involves "primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this

decision." *Affiliated Ute Citizens*, 406 U.S. at 153-54. "In a case of nondisclosure, the task of positively proving reliance may become impossible to perform, and although the courts still refer to the element of causation in fact, the question really becomes one of materiality . . . ." *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 92 n.6 (2d Cir. 1981); *see also Grubb v. FDIC*, 868 F.2d 1151, 1163 (10th Cir. 1989) ("reliance on the omission is presumed when the plaintiff establishes that the defendant withheld material information and that the defendant owed the plaintiff a duty to disclose"). "This presumption recognizes the unique difficulty of proving reliance on a failure to disclose material information of which the plaintiff did not know." *Id.*; *see also Blackie v. Barrack*, 524 F.2d 891, 905, 907 (9th Cir. 1975) (because plaintiffs' claims "either are, or can be, cast in omission or non-disclosure terms," "we eliminate the requirement that plaintiffs prove reliance directly in this context because the requirement imposes an unreasonable and irrelevant evidentiary burden").

E. The District Court Erred By Refusing To Consider Evidence On The Basis Of A Mediation Privilege.

The District Court declined to consider any evidence of what took place during the mediation on the ground that a local rule of court created a mediation privilege precluding consideration of such evidence. 1-ER-57

n.11.[8] This was error. However, the Court need not reach the mediation privilege issue if it finds that Facebook's failure to disclose the $8.88 per share valuation was a violation of Rule 10b-5 regardless of how the number of shares in the Term Sheet was determined. *See* Part (I)(E)(1), *infra*. In any event, the mediation privilege does not preclude evidence of how the number of Facebook shares was determined, and the per-share price on which that determination was based. *See* Part (I)(E)(2), *infra*.

1. ConnectU Did Not Need To Rely On Mediation Evidence To Establish That Facebook Traded In Its Stock Without Disclosing Material Information Or That The Term Sheet Is Not An Enforceable Contract.

In the context of the Founders' securities law claim, the only evidence that could possibly be affected by the claimed mediation privilege is the evidence, described on pp.20-21, *supra*, [redacted] (Both parties agree that

[8]This ruling was addressed to the Founders' claim of common-law fraud, which is not the subject of this appeal. As previously explained, the District Court rejected the securities fraud defense on legal, not factual, grounds. *See* pp.25-26, *supra*. Because the mediation privilege, if applied, would preclude some evidence that reinforces the securities fraud defense asserted here, we discuss the mediation privilege question.

the Term Sheet itself was not protected by any privilege and was properly considered by the District Court.)

The Court can decide the securities law issue without reaching the mediation privilege question if it agrees that the $8.88 valuation was material and that Facebook's failure to disclose that valuation violated the 1934 Act. The October 2007 press release, coupled with the Term Sheet's representation as to the number of Facebook shares outstanding, demonstrates the materiality of the undisclosed $8.88 valuation, as discussed above. There is no dispute that Facebook failed to disclose the $8.88 valuation. Regardless of *how* Facebook came up with the number of shares to be issued to the Founders, that valuation was material to their evaluation of the settlement. That is all that is needed to reverse the judgment without reaching the mediation privilege issue.[9]

2. In Any Event, The Mediation Privilege Does Not Preclude Admission Of Evidence To Establish Defenses—Such As Securities Fraud—To A Settlement Reached During A Mediation.

The evidence to which the claimed mediation privilege relates explains the origin of the [redacted] shares in the Term Sheet. As explained previously, Facebook calculated the number of shares by using a $35.90446 per

[9]The judgment may also be reversed, without reaching the mediation privilege issue, on the ground that the Term Sheet did not address material terms. *See* Part III, *infra*.

share valuation to determine the number of shares that would equal the agreed [redacted]. That calculation was apparent to the Founders, who [redacted] could just as easily do the math. *See* p.38, *supra.* Consequently, this evidence provides powerful confirmation of the *materiality* of the undisclosed $8.88 per share valuation.

a. Federal Common Law Allows Consideration Of Evidence Demonstrating Defenses To A Mediated Settlement Agreement.

Federal evidentiary privileges 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. Pursuant to Rule 501, federal courts apply the common law method of case-by-case determination to decide whether an evidentiary privilege should be recognized and what are its parameters. *Jaffee v. Redmond*, 518 U.S. 1, 12-14 (1996) (looking to law in all 50 states and District of Columbia to hold that federal privilege law recognizes a psychotherapist-patient privilege); *Folb v. Motion Picture Indus. Pension & Health Plans*, 16 F. Supp. 2d 1164, 1170 (C.D. Cal. 1998) (federal mediation privilege should be informed "by the law of the 50 states in the aggregate"), *aff'd*, 216 F.3d 1082 (9th Cir. 2000).

To date, the law on the mediation privilege in federal court is thin. The only federal Court of Appeals to address the question concluded that federal law does not recognize a mediation privilege. *See In re Grand Jury*

Subpoena Dated December 17, 1996, 148 F.3d 487 (5th Cir. 1998). District Court decisions have reached varying results.[10] While the existence of a mediation privilege in federal court may be subject to debate, there is broad consensus among the states, and the few federal cases on point, that any mediation privilege is not absolute. *See, e.g.*, *Sheldone v. Pennsylvania Turnpike Comm'n*, 104 F. Supp. 2d 511, 517 (W.D. Pa. 2000) ("[n]umerous court[s] and legislatures have recognized exceptions and/or limitations to the [mediation] privilege"); *Folb*, 16 F. Supp. 2d at 1180 n.10 (leaving "for another day" the question of which "traditional exceptions such as the crime-fraud exception to the attorney-client privilege are applicable in the context of a mediation privilege").

In nearly every state that has adopted a mediation privilege, exceptions apply when one party to a mediated settlement seeks to establish contract defenses such as fraud. James R. Coben & Peter N. Thompson, *Disputing*

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[10] *Compare In re March, 1994 Special Grand Jury*, 897 F. Supp. 1170, 1172 (S.D. Ind. 1995) ("federal law does not recognize a mediator's privilege"); *Datatel Corp. v. Picturetel Corp.*, No. 3:93-CV-2381D, 1998 WL 25536, at *2-3 (N.D. Tex. Jan. 14, 1998) (no federal mediation privilege despite local ADR rules making mediation communications confidential); *Fields-D'Arpino v. Rest. Assocs., Inc.*, 39 F. Supp. 2d 412, 418 (S.D.N.Y. 1999) (no mediation privilege); *FDIC v. White*, No. 3-96-CV-0560, 1999 WL 1201793, at *2 (N.D. Tex. Dec. 14, 1999) (same) *with Folb*, 16 F. Supp. 2d at 1176-79 (applying a federal mediation privilege); *Sheldone v. Pennsylvania Turnpike Comm'n*, 104 F. Supp. 2d 511, 513-17 (W.D. Pa. 2000) (following *Folb*); *Hays v. Equitex, Inc. (In re RDM Sports Group, Inc.)*, 277 B.R. 415, 427-30 (Bankr. N.D. Ga. 2002) (following *Folb* and *Sheldone*).

Irony: A Systematic Look At Litigation About Mediation, 11 HARV. NEGOT. L. REV. 43, 69-72 (Spring 2006) ("Coben") (in most states, "relevant mediation communications appear to be used regularly in court to establish or refute contractual defenses such as fraud, mistake, or duress"). Only "California, and perhaps Texas," decline to allow admission of mediation communications to establish defenses to enforcement of a settlement agreement. *Id.* (footnote omitted).[11]

The Uniform Mediation Act, approved by the American Bar Association, likewise provides that there "is no [mediation] privilege" in "a proceeding to prove a claim to rescind or reform or a defense to avoid liability on a contract arising out of the mediation." UNIFORM MEDIATION ACT §6(b)(2) (2003).[12] The Act's drafters concluded that, as "with other privileges, the mediation privilege must have limits, and nearly all existing state mediation statutes provide them." *Id.* Prefatory Note, §1. They reasoned that such an exception was necessary "to preserve traditional contract defenses" (*id.* §6(b)(2), cmt. at 32) and should be applied in those situations in which "the evidence is not

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[11]In California, the mediation privilege is a creature of statute that provides for very limited exceptions, thereby precluding common law development and accommodation. *See Fair v. Bakhtiari*, 40 Cal. 4th 189, 194 (2006) (California mediation privilege statute "unqualifiedly bars disclosure of communications made during mediation absent an express statutory exception") (citation and internal quotation marks omitted).

[12]The Uniform Mediation Act is available online at *http://www.law.upenn.edu////mediat/2003finaldraft.pdf*.

otherwise available" and "there is a need for the evidence that substantially outweighs the interest in protecting confidentiality." *Id.* §6(b)(2).

State and federal courts presented with contract defenses to mediated settlements generally consider the evidence freely, without pausing to apply the balancing test recommended by the Uniform Mediation Act. *See* Coben at 48 (cases demonstrate a "rather cavalier approach to disclosure of mediation information"); *id.* at 70 ("An allegation of fraud successfully lifted the veil of confidentiality in most of the cases where the defense was raised"); *see also, e.g.*, *Wilson v. Wilson*, 653 S.E.2d 702, 706 (Ga. 2007) (recognizing exception to mediation privilege when party to settlement agreement "contends . . .that he or she was not competent"); *Few v. Hammack Enters., Inc.*, 511 S.E.2d 665 (N.C. Ct. App. 1999) (under North Carolina mediation statutes, a mediator can be called to testify as to whether the parties reached an agreement and whether sanctions are appropriate).[13]

b. The District Court Erred In Applying Its Local Rule To Preclude Consideration Of Evidence.

The District Court based its application of a mediation privilege on a local rule of court. 1-ER-57 n.11 (citing N.D. CAL. ADR R. 6-11).[14] But that

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[13]State statutory enactments of privilege are entitled to equal weight as court rulings in determining the existence and scope of privileges in federal court. *Jaffee*, 518 U.S. at 13.

[14]The District Court has revised its ADR Local Rules since it issued its order enforcing the Term Sheet. The relevant ADR Local Rules in effect at (continued . . .)

local rule did not and could not negate the exceptions to the mediation privilege recognized by federal law.

To begin with, 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* N.D. CAL. ADR R. 6-3(a) (discussing appointment "*from the Court's panel* [of] a mediator" after "entry of an order referring a case to mediation") (emphasis added).[15] In this case, the District Court and the parties discussed whether to use the court's mediator or a private mediator. 3-ER-366:11-18; 367:22-368:1; 369:5-370:12. The parties chose private mediation, with the District Court's consent. 3-ER-369:14-370:19; 4-ER-663-65 (mediation agreement with private mediation firm).

(. . . continued)
the time of the order on review are included in the Appendix to this brief. (They may also be found online using the following steps: (1) go to *http://www.cand.uscourts.gov*; (2) click on "Local Rules" on the left hand side, below the purple buttons; (3) select "ADR Local Rules"; and (4) open the PDF entitled "ADR12-05.PDF".)

[15]The ADR Local Rules were adopted "to make available to litigants a broad range *of court-sponsored ADR processes* . . . ." N.D. CAL. ADR R. 1-2(a) (emphasis added). They provide for "a panel of neutrals serving in the Court's ADR programs." N.D. CAL. ADR R. 2-5(a). Mediation is governed by Rule 6-3. Mediations governed by Rule 6-3 are, as noted above, conducted by a mediator selected "from the Court's panel . . . ." N.D. CAL. ADR R. 6-3(a). Such mediators volunteer for the first four hours and are compensated as prescribed by Rule 6-3(b). Various procedural details are prescribed by Rule 6. Confidentiality is one of them. *See* N.D. CAL. ADR R. 6-11. Nothing in the text of Rule 6 indicates that the procedural rules prescribed therein, or the rules specifying the compensation (and donated time) of the mediator, were intended to govern mediations conducted at JAMS, the AAA or a private mediator's office.

Moreover, even if the local rule applied, the commentary to ADR Local Rule 6-11 expressly notes that

> 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. (N.D. CAL. ADR L.R. 6-11, cmt.)

The appropriate legal tests are set forth above, beginning with Rule 501 and the cases discussed at pp.56-59, *supra*.

For both of these reasons, the District Court erred in failing to apply the well-established exception to mediation privilege that comes into play when a party asserts defenses to enforcement of a mediated settlement agreement.

c. In Addition, The 1934 Act's Anti-Waiver Rule Prohibits Application Of A Mediation Privilege To Prevent Proof Of Facebook's Securities Law Violations.

The court erred in applying a mediation privilege for the separate and independent reason that the anti-waiver provision of the 1934 Act overrides application of any such privilege. Section 29 of the 1934 Act states that any "condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder . . . shall be void." 15 U.S.C. §78cc(a); *Petro-Ventures, Inc. v. Takessian*, 967 F.2d 1337, 1340-41 (9th Cir. 1992) (anti-waiver rule prevents the unknowing release of a federal securities claim).

Here, application of the mediation privilege would mean that, by agreeing to participate in a mediation, the Founders gave up their right to protection against securities fraud conferred by the 1934 Act. Such an unknowing, advance waiver of the Act's protection is exactly what the anti-waiver rule prohibits. *See Pearlstein*, 429 F.2d at 1143 (it would "contravene public policy" to enforce a stipulation waiving a party's compliance with the 1934 Act); *see also Fox v. Kane-Miller Corp.*, 398 F. Supp. 609, 624 (D. Md. 1975) (viewing waiver of securities claims with "very strong disfavor" in light of the "very specific" anti-waiver provisions in the 1933 and 1934 Acts), *aff'd*, 542 F.2d 915 (4th Cir. 1976). As one court explained:

> Judicial hostility toward waivers generally requires that the right of private suit for alleged violations be scrupulously preserved against unintentional or involuntary relinquishment. Otherwise, recognition of settlements would indeed undermine, rather than abet, the cause of effective enforcement of the interest which the community as a whole, as well as the aggrieved individual, has in regulation of securities markets. (*Cohen v. Tenney Corp.*, 318 F. Supp. 280, 284 (S.D.N.Y. 1970))

Here, the Founders never agreed to forfeit the protection and right to full disclosure the 1934 Act provides. The mediation privilege cannot be used to achieve indirectly what could not have been achieved directly by an express waiver.[16]

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[16]Section 29 of the 1934 Act likewise overrides any application of the District Court's ADR Local Rule 6-11, because local rules "must be consistent with . . . federal statutes." FED. R. CIV. P. 83(a)(1). A local rule cannot strip a party who attends a mediation of the protection conferred by (continued . . .)

d. Facebook Also Waived Any Mediation Privilege By Asserting That No Fraud Occurred At The Mediation.

Even if the mediation privilege would otherwise have applied, Facebook waived it by representing to the District Court that [redacted] 5-ER-746:7-8 (emphasis added). It is well established that placing facts at issue in this manner waives the attorney-client privilege, and the rule should be the same with regard to mediation privilege.

In *Bittaker v. Woodford*, 331 F.3d 715 (9th Cir. 2003), this Court held that

> privilege may be . . . waived by implication when a party takes a position in litigation that makes it unfair to protect that party's attorney-client communications. . . . In practical terms, this means that parties in litigation may not abuse the privilege by asserting claims the opposing party cannot adequately dispute unless it has access to the privileged materials. The party asserting the claim is said to have implicitly waived the privilege. (*Id.* at 719 (citation and internal quotation marks omitted))

See also United States v. Amlani, 169 F.3d 1189, 1195 (9th Cir. 1999) (when a party "puts the privileged information at issue," the privilege is waived); *Granite Partners, L.P. v. Bear, Stearns & Co.*, 184 F.R.D. 49, 55 (S.D.N.Y. 1999) ("A privilege may be impliedly waived where a party makes assertions

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(. . . continued)
the 1934 Act from securities fraud committed at the mediation.

in the litigation or asserts a claim that in fairness requires examination of protected communications") (citation and internal quotation marks omitted).

Since Facebook placed mediation evidence directly at issue by claiming that [redacted] supporting their claim of securities fraud, fairness required that the Founders be allowed to respond. Consequently, Facebook waived the mediation privilege. *See Bittaker*, 331 F.3d at 719 ("'The privilege . . . may not be used both as a sword and a shield'") (quoting *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156, 1162 (9th Cir. 1992)).

III.

THE TERM SHEET WAS NOT A BINDING CONTRACT.

Many significant contracts have their origin in negotiations conducted under great pressure, not infrequently concluded in the wee hours. Because that is often true of settlement agreements, experienced lawyers know that, at the end of a successful settlement conference or mediation, it is essential that they document all of the material terms of the agreement if they wish the parties to be bound. Often, counsel will have done some preliminary drafting and will bring a laptop to the mediation, with a draft of a possible settlement agreement, for use if the mediation is successful.

In this case, however, the parties agreed on *some* terms of a complex business transaction—a settlement of litigation to be effected by a [redacted] cash payment *and* the issuance of [redacted] Facebook stock in return for [redacted] stock in ConnectU and a release of claims—without

discussing and agreeing upon many critical economic and legal terms of the transaction. The parties signed a 1-1/3 page "Term Sheet" whose incompleteness was vividly demonstrated by Facebook's subsequent preparation of approximately 140 pages of densely worded, single spaced corporate transaction documents replete with material terms that had nowhere been addressed in the Term Sheet. *See* pp.23-25, *supra*. And therein lies the problem.

A. A Settlement Agreement That Does Not Contain All Material Terms Is Not An Enforceable Contract.

"If no meeting of the minds has occurred on the material terms of a contract, basic contract law provides that no contract formation has occurred." *Weddington Prods., Inc. v. Flick*, 60 Cal. App. 4th 793, 797 (1998); *see also* 1 B. WITKIN, SUMMARY OF CALIFORNIA LAW, *Contracts* §§117, 125, 137-139 (10th ed. 2005) ("WITKIN"). This fundamental rule applies to contracts for the settlement of litigation just as it does to all contracts. *Terry v. Conlan*, 131 Cal. App. 4th 1445, 1458 (2005) ("The principles of contract formation are the same in both the settlement and nonsettlement context"); *Weddington*, 60 Cal. App. 4th at 815 ("Contracts are formed in the same way in both the settlement and the nonsettlement context"); *Callie v. Near*, 829 F.2d 888, 891 (9th Cir. 1987). It is not enough that the parties subjectively intended to be bound by the contract, or even that the contract recites that the parties intend to be bound; to be enforceable, a settlement agreement must

specify all material terms, just as any other contract must. *Callie*, 829 F.2d at 891 ("In addition to the intent of the parties to bind themselves, the formation of a settlement contract requires agreement on its material terms") (emphasis omitted).

In *Terry*, a decedent's wife and his children agreed to settle a probate dispute at a judicially supervised settlement conference. 131 Cal. App. 4th at 1450-52. The wife contended that the agreement memorialized on the court's record was fatally uncertain and incomplete, based on (among other things) the agreement's lack of clarity concerning whether a trust created by the settlement had to be structured so as to be eligible for certain tax benefits. *Id.* at 1455. She also argued that, while the parties had agreed that a ranch would be held in trust during her lifetime, the parties failed to agree on the material issue of whether the ranch would be managed by one of the children acting as a trustee or by an independent manager. *Id.* at 1456. The court held that these unsettled issues indicated that "although the parties agreed to the goals of the settlement, they clearly did not agree to the means of achieving the goals." *Id.* at 1459. Since the "means of achieving the goals" would have a "significant fiscal impact on the parties," the agreement's failure to specify the means rendered the settlement agreement unenforceable.

B. The District Court Erred In Refusing To Consider Extrinsic Evidence On The Issue Of Whether The Term Sheet Was An Enforceable Settlement Agreement.

Given its brevity, the Term Sheet did not contain an integration clause specifying that this was the entire agreement of the parties. After it was signed, the parties exchanged drafts of detailed, lengthy transaction documents purporting to implement what had been agreed upon. *See* pp.23-25, *supra*. Sharp disagreements quickly arose. As detailed below, the drafts proposed by the parties contained provisions on issues that are nowhere addressed in the Term Sheet. By the time Facebook filed its motion, the "settlement" documents it had drafted purportedly in conformity with the Term Sheet had ballooned to about 140 pages. *Id*.

Just as a party's post-contracting conduct may shed light on the contract's meaning (*see, e.g.*, *City of Hope Nat'l Med. Ctr. v. Genentech, Inc.*, 43 Cal. 4th 375, 393 (2008); 1 WITKIN, §749),[17] these post-settlement negotiations over definitive documents purporting to implement the Term Sheet shed light over what was—and what was not—agreed to in the settlement, and whether terms *not* expressly included in the Term Sheet but subsequently demanded were material, omitted terms. *See, e.g.*, *Terry*, 131 Cal. App. 4th

[17]Post-contracting conduct of the parties is particularly probative evidence of the contract's meaning "for they are probably least likely to be mistaken as to the intent." 1 WITKIN §749. "When parties to a contract perform under it and demonstrate by their conduct that they knew what they were talking about the courts should enforce that intent." *Crestview Cemetery Ass'n v. Nieder*, 54 Cal. 2d 744, 754 (1960).

at 1459; *Weddington Prods.*, 60 Cal. App. 4th at 815-18. Vigorous post-contracting negotiation over numerous legal and economic issues not resolved in the Term Sheet is compelling proof that material terms had been omitted.

Surprisingly, the District Court concluded that, in considering whether the Term Sheet constituted an enforceable contract, the court was required to determine the parties' intent from the "four corners" of the Term Sheet, not from the extrinsic evidence. 1-ER-53. That conclusion stood California law on its head.[18]

The California Supreme Court has long held that, when interpreting a writing, extrinsic evidence must be considered if it "is relevant to prove a meaning to which the language of the instrument is reasonably susceptible." *Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 37 (1968):

> [T]he meaning of a writing can only be found by interpretation in the light of all the circumstances that reveal the sense in which the writer used the words. The exclusion of parol evidence regarding such circumstances merely because the words do not appear ambiguous to the reader can easily lead to the attribution to a written instrument of a meaning that was never intended. (*Id.* at 38-39 (citation and internal quotation marks omitted))

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[18]The parties agreed that California law governed the question of whether the Term Sheet was an enforceable contract. 4-ER-469:19-21; *see also Perfumebay.com Inc. v. eBay, Inc.*, 506 F.3d 1165, 1178 (9th Cir. 2007) (applying California contract law to determine whether settlement agreement was a valid contract).

See S. Pac. Transp. Co. v. Santa Fe Pipelines, Inc., 74 Cal. App. 4th 1232, 1246 (1999) ("It is reversible error to refuse to consider extrinsic evidence upon concluding that an agreement is clear on its face"); 2 B. WITKIN, CALIFORNIA EVIDENCE, *Documentary Evidence* §§74-85 (4th ed. 2000), and numerous cases cited.[19]

The District Court cited *Brinton v. Bankers Pension Services, Inc.*, 76 Cal. App. 4th 550 (1999), and Section 1639 of the California Civil Code for the proposition that the court was bound to consider "'the writing alone, if possible.'" 1-ER-53 (quoting *Brinton*, 76 Cal. App. 4th at 559). That preference yields whenever a contract may be susceptible to more than one reading, as *PG&E* and its progeny vividly develop. Neither *Brinton* nor Section 1639 countenances the refusal to consider probative extrinsic

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[19] *See also Wolf v. Superior Court*, 114 Cal. App. 4th 1343, 1356 (2004) (California courts consider "extrinsic evidence of such objective matters as the surrounding circumstances under which the parties negotiated or entered into the contract; the object, nature and subject matter of the contract; and the subsequent conduct of the parties"); *Lopez v. Charles Schwab & Co.*, 118 Cal. App. 4th 1224, 1230 (2004) ("'The determination of whether a particular communication constitutes an operative offer, rather than an inoperative step in the preliminary negotiation of a contract, depends upon all the surrounding circumstances'") (citation omitted); *Moss Dev. Co. v. Geary*, 41 Cal. App. 3d 1, 9 (1974) (meaning of contract "must be ascertained from the words used, after taking into consideration the entire contract and the circumstances under which it was made"); *City of Stockton v. Stockton Plaza Corp.*, 261 Cal. App. 2d 639, 644 (1968) ("'Both prior negotiations and prior conversations may be construed as well as the subsequent acts of the parties in ascertaining the true intention of the parties to the contract'") (quoting *Anchor Cas. Co. v. Sur. Bond Sav. & Loan Ass'n*, 204 Cal. App. 2d 175, 183 (1962)).

evidence of the meaning of a contract whose words are capable of being interpreted in more than one way, and scores of California cases—including the California Supreme Court's decision in *PG&E*—repudiate that notion. Section 1639's preference for considering "the writing alone, if possible" has never been thought to apply where an agreement's language is capable of more than one meaning, in which event relevant parol evidence *must* be received. *See* pp.68-69 & n.19, *supra*. Indeed, Section 1639 goes on to say that the preference for interpreting a contract from its words is "subject . . . to the other provisions of this Title." Those provisions include Civil Code Section 1647, which provides that a "contract may be explained by reference to the circumstances under which it was made, and the matter to which it relates." *See also id.* §1648 (contract "extends only to those things concerning which it appears the parties intended to contract"); *id.* §1657 (implication of reasonable time for performance). The California Supreme Court's decision in *PG&E* relied on Section 1647 to conclude that contract "interpretation requires at least a preliminary consideration of all credible evidence offered to prove the intention of the parties." 69 Cal. 2d at 39-40.

Brinton, of course, must yield to California Supreme Court precedent. But in addition, *Brinton's* actual holding was much narrower than the District Court's quotation implied. The only extrinsic evidence at issue was a declaration setting forth the alleged subjective and unexpressed intent of one party to a contract. *Brinton*, 76 Cal. App. 4th at 560. Such evidence was

inadmissible under the basic principle that only objective manifestations of intent can be considered "regardless of what may have been the person's real but unexpressed state of mind on the subject." *Id.*

As succeeding sections will demonstrate, the post-settlement conduct of the parties, in which they negotiated and disagreed about numerous important terms of the settlement, and the [redacted] that it called for, shows that the Term Sheet was incomplete and omitted material economic and substantive terms about which the parties subsequently attempted unsuccessfully to reach agreement.

C. The Undisputed Evidence Shows That The Term Sheet Lacks Material Terms As To Both The Nature Of The Settlement And The Corporate Acquisition And Issuance Of Securities It Called For.

The settlement described in the Term Sheet included some broadly stated terms for a corporate acquisition and issuance of securities: Facebook would acquire ConnectU in what was ambiguously described as a "stock and cash for stock *acquisition*" (emphasis added): [redacted] in cash and [redacted] shares of Facebook common stock. 4-ER-482-83. The Term Sheet fell far short of demonstrating agreement on all material terms of a settlement and corporate acquisition. As a leading treatise on mergers and acquisitions explains,

> [T]here is virtually no legal transaction that can be quite so complex and multi-disciplined as a business combination. And the point at which it all comes together (or falls apart) is in structuring the transaction. By structuring, I mean selecting the optimum form and

> substance for the transaction to take, so as to accomplish the goals of the parties . . . . (JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 75 (2004 ed.) ("FREUND"))

The absence of agreement on any one of numerous material terms—some (but not all) of which are discussed below—renders the Term Sheet unenforceable as a contract.[20] Collectively, they show that the parties had a great deal of heavy lifting to do before they would have agreement on all of the material terms for the type of settlement and corporate transaction they were attempting. They never got there.

1. Facebook's Expectation That The Price Was Subject To Downward Adjustment In Ways Not Specified In The Term Sheet Demonstrates Lack Of Agreement On Material Terms.

Not until after the parties signed the Term Sheet did they address the issue of a credit that Facebook should receive for those ConnectU liabilities that Facebook would assume. 5-ER-702 ¶10. ConnectU did not dispute that Facebook should receive a credit for liabilities assumed against the price Facebook would pay, but the Term Sheet did not address the amount of the credit or a formula for determining it. *Id.*

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[20]We have identified in this brief five economic and legal issues that the Term Sheet failed to resolve. There are many others that the parties subsequently addressed but could not resolve. To pick just one example, Facebook subsequently drafted a detailed contract document specifying the subjects on which California counsel for ConnectU would be required to opine as part of the closing documentation. *See* 4-ER-630-31. The Founders never agreed to this.

When the parties could not agree, Facebook asked the District Court to craft this material term out of thin air including a dollar-for-dollar credit in its favor for ConnectU's liabilities plus a reduction in the Facebook stock to be delivered. 4-ER-532 (agreement Facebook presented to the District Court defined "Total Cash Consideration" as "[redacted] less the sum of the Company Liabilities Amount as set forth on the Company Expenses Certificate."); 4-ER-531-32 ("Total Share Consideration" reduced by one share for each $8.88 of ConnectU liabilities above [redacted]). The parties' shared understanding that Facebook was entitled to a credit of unspecified amount, and their failure to agree in the Term Sheet on the amount, or the formula for determining it, demonstrates the absence of agreement on the net price Facebook would pay to acquire ConnectU. *See Forde v. Vernbro Corp.*, 218 Cal. App. 2d 405, 407-08 (1963) (quoting *California Lettuce Growers, Inc. v. Union Sugar Co.*, 45 Cal. 2d 474, 482 (1955)) (price is a material term that may be omitted from a contract only "'if it can be objectively determined'"); *Peterson Dev. Co. v. Torrey Pines Bank*, 233 Cal. App. 3d 103, 812-13 (1998) (loan commitment letter unenforceable because it lacked material terms, including amount of the loan).

2. The Term Sheet Does Not Address The Issue Of Representations And Warranties, Or The Related Issue Of Indemnity.

With the single exception of Facebook's representation of the total number of Facebook shares outstanding, the Term Sheet did not address the issue

of representations and warranties. The expert declarations submitted by both sides agreed that representations and warranties are customary in an acquisition like Facebook's acquisition of ConnectU.

Facebook's expert, Dr. Sarin, explained that representations and warranties are elemental in corporate acquisition agreements. According to Dr. Sarin, such representations and warranties establish what liability each party may have for '"problems relating to the target that are discovered after the closing."' 5-ER-762 ¶34 (citation omitted). Dr. Sarin opined, "It is standard practice in the realm of mergers and acquisitions to include in formal documents not only a thorough description of both the buyer and seller's representations and warranties and covenants, but also a detailed section in the formal documents devoted to specifying the indemnification rights of each party . . . ." *Id.*; *see also* STANLEY FOSTER REED, ET AL., THE ART OF M&A 468 (4th ed. 2007) ("REED") (representations and warranties are "[v]ery important" topics about which "a great deal of the negotiation" takes place); FREUND at 148, 240-41 (parties omit detailed representations only "for a transaction between two public companies").

Dr. Sarin went on to identify highly material subjects that should be, and typically are, addressed in an acquisition agreement, such as (1) indemnification provisions, which "can be structured to run in both directions: the buyer indemnifies the seller in certain circumstances, and *vice versa*"; and (2) the length of the "survival period" for indemnity claims, the

expiration of which terminates the right to assert a claim. Dr. Sarin admitted that the structure of indemnity rights, and the length of time they could be asserted, varies by agreement of the parties. 5-ER-762-63 ¶34. ConnectU's expert explained that indemnification provisions are among "the most intensely negotiated provisions" of private company transactions, for which there is no "market standard." 5-ER-795 ¶17.

As with the credit for ConnectU's liabilities, Facebook attempted to fill the void by presenting a proposed Stock Purchase Agreement that contained indemnification provisions and extensive representations about ConnectU and Facebook. 5-ER-714-15 ¶17; 4-ER-535-59, 562-63. In the end, the District Court declined to adopt Facebook's lengthy proposed transactional documents, including the indemnification provisions, seemingly heeding the lesson of *Weddington*. In *Weddington*, the California Court of Appeal ruled that things had gone "seriously awry" when the trial court entered a "thirty-five page judgment containing numerous material terms to which appellant had never agreed" based on a one-page memorandum signed at a mediation. *Weddington*, 60 Cal. App. 4th at 796.

But enforcing the 1-1/3 page Term Sheet without representations and warranties did not solve the problem of omitted material terms. The Term Sheet's failure to address these issues is a material omission that renders the Term Sheet unenforceable.

3. The Term Sheet Also Failed To Resolve The Material Question Of Whether The Transaction Involved A Non-Taxable Merger.

Another fundamental problem with the Term Sheet is its overall silence on the structure and mechanics of the transaction. It specifies only a "stock and cash for stock acquisition." 4-ER-483. But the term "acquisition" is nothing more than a "generic term used to describe a transfer of ownership." *See* REED at 4. It does not indicate whether or not the acquisition would involve a merger. A merger "occurs when one corporation is combined with and disappears into another corporation" and it "may or may not follow an acquisition." REED at 3, 4.

After the mediation, Facebook's counsel prepared the initial draft of proposed contracts that would have effectuated a merger between ConnectU and a subsidiary of Facebook. 5-ER-700 ¶4. This was of great significance because structuring the transaction as a merger would provide tax benefits to the ConnectU founders. 5-ER-701 ¶7 ("the direct stock purchase . . . would be a taxable sale of stock by the ConnectU [Founders] to Facebook, whereas the mergers contemplated by [the documents prepared by the ConnectU Founders] were intended to be consistent with a tax-deferred exchange of ConnectU stock for Facebook common stock"). All drafts exchanged by the parties reflected a merger structure. *Id.* ¶¶6-7.

When the parties were unable to complete their negotiations and sign binding documents, Facebook asked the District Court to impose documents

that did not include a merger. 4-ER-525-74; *see also* 5-ER-719 ¶4. While the court did not impose Facebook's documents on the Founders directly, the end result of its rulings was to compel a taxable direct stock purchase, and not a merger.

Once again, *Terry* demonstrates why the failure of the parties to resolve the form of the transaction—and with it the tax consequences—means that the Term Sheet was incomplete and therefore unenforceable. In *Terry*, the parties had agreed on the record that the ranch would be held by one of the children (a litigation adversary) as trustee and "would be run for seven years by an independent trustee or labeled a manager[,] whatever labeling is appropriate." 131 Cal. App. 4th at 1451. Subsequently the parties exchanged iterations of settlement agreements that reflected their lack of agreement on whether the manager would act independently or under the trustee's control, serving at her pleasure. *Id.* at 1456. In addition, the parties' oral settlement contemplated that the settlement would be tax advantaged, and that the trust to be formed would therefore qualify as what is known as a "QTIP" trust for tax purposes. The parties subsequently disagreed as to whether the trust would comply with, or abrogate, the provisions of the California Uniform Principal and Income Act ("UPAIA"). *Id.* at 1457. The trial court included in its decree terms that abrogated the UPAIA, which meant that it would no longer qualify as a QTIP for federal tax purposes,

resulting in substantial tax liability to Conlan, the party challenging the settlement. *Id.* at 1459.

The court concluded that in light of these unresolved issues, the parties had assented to the "goals of the settlement, without agreeing to the means that were material to the settlement." *Id.* ("no meeting of the minds" on the material terms). With "regard to the management of the Castroville Ranch, although the parties clearly agreed to the goal that there would be independent management of the ranch, they did not agree on the means of achieving that goal, specifically, whether there would be an independent trustee or a manager . . . ." *Id.* Likewise, "there was no meeting of the minds on . . . whether the trust should be qualified as a QTIP Trust." *Id.*[21]

Here, the parties' conduct indicates that they regarded the issue of whether the transaction would be structured as a merger was material;

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[21]The present case is a much easier case than *Terry*. In that case, a plausible argument could have been made that the parties *had* agreed on these points, and that the dispute was merely a matter of interpretation rather than contract completeness and validity. After all, the settlement did call for the ranch to be managed by "an independent trustee or labeled a manager." 131 Cal. App. 4th at 1451. Likewise, it was to be "structured so [as] to take advantage of taxes" and "structured as a [QTIP] pursuant to IRS codes." *Id.* That arguably would have permitted the Court of Appeal to salvage the settlement by interpreting the agreement in favor of the objecting party on those points. Here, no such interpretation is possible because the words of the Term Sheet do not resolve the material issues discussed here. As a result, the District Court engaged in no interpretation whatever on any of these material issues; the court merely ordered performance according to a term sheet that did not address them.

indeed, for a time both sides agreed that it should be a merger (*see* pp.22-23, *supra*), but ultimately could not agree on all the terms. The merger issue was especially material in light of tax ramifications, just as the QTIP Trust issue was material in *Terry*. *See* FREUND at 80-81 (describing the importance of resolving tax issues before entering into a transaction); J. FRED WESTON & SAMUEL C. WEAVER, MERGERS & ACQUISITIONS 67-72 (2001) (form of transaction determines whether transaction is a taxable event); *Louis Lesser Enters., Ltd. v. Roeder*, 209 Cal. App. 2d 401, 408 (1962) ("The form of entity the proposed venture is to take *is* material; important to the parties are the advantages and disadvantages of the various types of mutual association mentioned in the letter-rights and liabilities, credit rating, formality of creation, tax consequences, et cetera") (emphasis in original); 5-ER-711-12 ¶12 ("the structure of the transaction is of primary importance to the seller for a variety of reasons, including but not limited to, tax planning . . .").

4. The Term Sheet Was Silent On The Issue Of Stock Transfer Restrictions.

The Term Sheet also left unaddressed what restrictions, if any, would be placed on the transfer of the Facebook stock acquired by the Founders. The issue of stock transfer restrictions was so important to Facebook that the Stockholders Agreement Facebook ultimately proposed to the District Court included restrictions on alienability that, *inter alia*, (1) gave Facebook a right of first refusal on any proposed transfer; and (2) provided for a market lock-

up or standoff prohibiting transfer in certain circumstances. 5-ER-713-14 ¶16; 4-ER-518-19 ¶¶4-5. Facebook's expert contended that such trading restrictions are to be expected in a transaction of this type. 5-ER-760-61 ¶¶30-32. However, the parties never agreed in the Term Sheet that such restrictions would be imposed, let alone what form they would take. 5-ER-719 ¶15; 713-14 ¶16 (citing 4-ER-518-19 ¶¶4-5). And in fact, the particular terms of restrictions such as a right of first refusal "are negotiated and vary based on the facts and circumstances of the individual transaction." 5-ER-793-94 ¶15. The failure of the Term Sheet to include provisions resolving issues that Facebook's expert claimed are "typically" addressed in "formal acquisition documents and private placement transactions" (5-ER-760 ¶30) demonstrates the absence of yet another material term in the Term Sheet.

5. Uncertainty Of Release.

Yet another material unresolved question relates to the releases. The Term Sheet provides that "[a]ll parties get mutual releases as broad as possible . . . ." 1-ER-50:3-4. This terse statement failed to address two important questions: (1) whether the Term Sheet would release persons who were not signatories to the settlement; and (2) whether the release would apply to unknown claims. *See United States v. Orr Constr. Co.*, 560 F.2d 765 (7th Cir. 1977) (term "proper legal releases" too uncertain to enforce).

Emblematic of the release provision's uncertainty is the parties' post-Term Sheet dispute over *which* parties were intended to be released by this incompletely drafted language. 3-ER-274:7-16. This dispute arose from the fact that the Term Sheet is internally inconsistent on the topic of which parties would be released. One paragraph of the Term Sheet states that "[a]ll *parties* get mutual releases" while another paragraph states that the Term Sheet resolved "all disputes between "ConnectU *and its related parties*, on the one hand[,] and Facebook *and its related parties*, on the other hand." 4-ER-482 ¶¶1-2 (emphases added). The Term Sheet is therefore uncertain as to who exactly would be released. The District Court's judgment omitted from the release several co-defendants who were named along with ConnectU in the California action but who were not signatories to the Term Sheet. *See* 1-ER-24 ¶1; 2-ER-241 (complaint listing co-defendants Pacific Northwest Software, Inc., Winston Williams, Wayne Chang and David Gucwa).

The Term Sheet's release language also leaves uncertain whether unknown claims are covered. Section 1542 of the California Civil Code forbids an *implied* waiver of unknown claims. The language the parties agreed to in the Term Sheet does not address whether unknown claims are released. 3-ER-274 ¶2 (ConnectU's objection pursuant to California Civil Code §1542). Yet Facebook considered this a significant provision and proposed a waiver of Section 1542 *after* the parties signed the Term Sheet. 4-ER-490-

91 ¶2.15. The parties' failure to agree in the Term Sheet on whether unknown claims would be released demonstrates yet another material uncertainty in the Term Sheet.

D. The Court Should Vacate The Order Granting Facebook's Motion To Enforce The Settlement, And Both Ensuing Judgments, And Direct The District Court To Deny The Motion.

For all of the reasons set forth above, the undisputed evidence demonstrated that the Term Sheet was not an enforceable contract but was, at most, an "agreement to agree." *See Bustamante v. Intuit, Inc.*, 141 Cal. App. 4th 199, 213 (2006) ("Because essential terms were only sketched out, with their final form to be agreed upon in the future (and contingent upon third-party approval), the parties had at best an 'agreement to agree,' which is unenforceable under California law"); *Beck v. Am. Health Group Int'l, Inc.*, 211 Cal. App. 3d 1555, 1563 (1989) ("the letter did not constitute a binding contract, but was merely 'an agreement to agree' which cannot be made the basis of a cause of action"); 1 JOSEPH M. PERILLO, CORBIN ON CONTRACTS §2.8, at 134 (rev. ed. 1993) ("If the document or contract that the parties agree to make [in the future] is to contain any material term that is not already agreed on, no contract has yet been made").

Because there was no genuine dispute of fact concerning whether the Term Sheet was unenforceable, the District Court should have denied Facebook's motion. *See City Equities Anaheim v. Lincoln Plaza Dev. Co.*

(In re City Equities Anaheim, Ltd.), 22 F.3d 954, 958-59 (9th Cir. 1994) (citing *Tiernan v. Devoe*, 923 F.2d 1024 (3d Cir. 1991)) (where there are no disputed material facts, the court may treat a motion to enforce a settlement agreement like a summary judgment motion); *Tiernan*, 923 F.2d at 1031 (The question of "whether there was any disputed issue of material fact as to the validity of the settlement agreements [. . .] is similar to that which any court must address when ruling on a motion for summary judgment"). This Court should therefore reverse the District Court's rulings and direct the District Court to enter an order denying Facebook's motion, along with other relief specified in the Conclusion section below.[22]

IV.

THE DISTRICT COURT ERRED IN DISQUALIFYING TWO LAW FIRMS FROM REPRESENTING THE FOUNDERS.

A. Relevant Facts.

Almost immediately after Facebook took control of ConnectU through enforcement of the Term Sheet, Facebook caused ConnectU to retain new counsel. Through that new counsel, ConnectU instructed three law firms that

[22]In the District Court, Facebook took the position that "[n]o evidentiary hearing is scheduled or necessary." 5-ER-727. Because Facebook did not request an evidentiary hearing on its motion to enforce the Term Sheet, it waived the right to present such evidence. *See Calcor Space Facility, Inc. v. McDonnell Douglas Corp.*, 5 Fed. App'x 787, 789 (9th Cir. 2001) (no evidentiary hearing required in absence of motion requesting a hearing).

had formerly represented ConnectU that they "no longer have authority to take any legal action on behalf of ConnectU, Inc. in any forum." Docket No. 63 (Declaration of James E. Towery in Support of Appellant ConnectU, Inc.'s Motion to Disqualify Counsel, Exs. A-C). Four days later, ConnectU moved in this Court to disqualify the three firms from continuing to represent the Founders in the pending appeals. Docket No. 63. In that same motion, ConnectU requested an order compelling the three law firms to turn over all of their files related to ConnectU.

This Court remanded the motion to the District Court, which disqualified two of the three firms (Finnegan and Boies) and did not disqualify the third firm (O'Shea). The District Court ordered Finnegan and Boies to turn over to ConnectU documents "pertaining to ConnectU's general business, including but not limited to documents relating to ConnectU's financials, assets, and liabilities." 1-ER-18:1-2. The District Court denied ConnectU's request to obtain "files pertaining to ConnectU's litigation against Facebook." 1-ER-18:12-13.

The Founders have appealed the disqualification order. As explained in the Statement of the Case above, that appeal has been deemed part of the Founders' appeal from the orders and judgments enforcing the Term Sheet. *See* p.16, *supra.*

B. If The Term Sheet Is Unenforceable, Then The Disqualification Order Would Necessarily Be Reversed.

If, as this brief urges, the Court reverses the District Court's orders and judgments enforcing the Term Sheet on the ground that the Term Sheet was unenforceable as a matter of law, then control of ConnectU would be returned to the Founders. As a consequence, the factual basis for the disqualification order would be eliminated, as the District Court itself implicitly recognized. 1-ER-19:3-4 ("This Order does not address the circumstances on appeal or afterward should the interests of ConnectU and the Founders merge"). In that event, the disqualification order would necessarily be reversed because the factual basis for the order would no longer exist.

CONCLUSION

For the foregoing reasons, Appellants respectfully request that the Court:

- Reverse the District Court's orders and judgments enforcing the Term Sheet;
- Direct the District Court to enter a new order denying Facebook's motion to enforce the settlement;
- Reverse the District Court's order dismissing the California action;

- Direct the District Court to enter such orders as are necessary to restore the parties to their status existing prior to enforcement of the Term Sheet; and
- Reverse the order disqualifying the Finnegan and Boies firms.

DATED: February 12, 2010.

Respectfully,

JEROME B. FALK, JR.
SEAN M. SELEGUE
JOHN P. DUCHEMIN
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A Professional Corporation

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

Attorneys for Appellants and Cross-Appellees Cameron Winklevoss, Tyler Winklevoss and Divya Narendra

CONTAINS SEALED MATERIAL

STATEMENT OF RELATED CASES

On September 25, 2008, non-party CNET Network, Inc. ("CNET") filed a petition for a writ of mandamus and a motion to intervene, which were docketed as No. 08-74104, and argued that the record in this litigation should not be sealed. The Court denied CNET's petition and motion on November 4, 2008.

DATED: February 12, 2010.

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

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' Opening Brief is proportionally spaced, in a typeface of 14 points or more and contains 20,609 words, exclusive of those materials not required to be counted under Rule 32(a)(7)(B)(iii).

DATED: February 12, 2010.

/s/ Sean M. SeLegue
SEAN M. SELEGUE

ADDENDUM

ADDENDUM
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Section 10(b) of the Securities Exchange Act of 1934
15 U.S.C. §78j

Manipulative and deceptive devices.

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)

(1) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(2) Paragraph (1) of this subsection shall not apply to security futures products.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 29 of the Securities Exchange Act of 1934
15 U.S.C. §78cc

Validity of contracts.

(a) Waiver provisions

Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

(b) Contract provisions in violation of chapter

Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void

(1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and

(2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: Provided,

(A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (3) of subsection (c) of section 78o of this title, and

(B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) or (2) of subsection (c) of section 78o of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation. The Commission may, in a rule or regulation prescribed pursuant to such paragraph (2) of such section 78o(c) of this title, designate such rule or regulation, or portion thereof, as a rule or regulation, or portion thereof, a contract in violation of which shall not be void by reason of this subsection.

Securities and Exchange Commission Rule 10b-5
17 C.F.R. §240.10b-5

Employment of manipulative and deceptive devices

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

(c) 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.

California Civil Code §1542

Certain claims not affected by general release.

A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor.

California Civil Code §1668

Contracts contrary to policy of law.

All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law.

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 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).

CERTIFICATE OF SERVICE

I hereby certify that on March 11, 2010, I electronically filed the foregoing **LETTER RE: APPELLANTS'/CROSS-APPELLEE'S OPENING BRIEF [PUBLIC REDACTED VERSION]** by using the appellate CM/ECF system.

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

I further certify that some of the participants in the case are not registered CM/ECF users. On March 11, 2010, I caused the foregoing document described as **LETTER RE: APPELLANTS'/CROSS-APPELLEE'S OPENING BRIEF [PUBLIC REDACTED VERSION]** to be dispatched 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, for deposit in the United States Postal Service to the following non-CM/ECF participants:

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/s/ *John P. Duchemin*
John P. Duchemin