MORRISON FOERSTER

Unofficial transcript for users of mofo.com

Juan Monteverde (00:01):

Good afternoon. This is Juan Monteverde for the appellant. Would it be now the time that you want me to start, or would you like at the lead to introduce himself first?

Judge 1 (00:10):

It's great. If you go ahead and start. Thank you.

Juan Monteverde (00:13):

Thank you. I'll try to reserve two minutes if I may. May it please the court, this case is pretty straightforward, and it boils down to whether the same projections that a company prepares, approves, and uses during a sales process, and the bidders use to make a bid in a prior company, can be considered immaterial as a matter of law. Plaintiff has identified, there were two sets of projection here not disclosed—the June and August projections—and those same projections were actually used during the sales process—

Judge 2 (00:48):

Let me make sure I understand the facts here. Those projections did not result in the kinds of bids that the company wanted. And after trying with many companies, eventually they were down to two and then they were just down to a one. And so when they issued their final fairness opinion, they gave us a projection, a projection that was lower because it reflected what the marketplace had shown about what the company was worth. What was wrong with that?

Juan Monteverde (01:40):

That's actually inaccurate because the buyer here Mallinckrodt never received the November projections and made offers based on the June and August projections. The fact that they lowered their bid, that's a part of a sales process. It's okay to do that, but management is not supposed to lower projections because of feedback. And the truth of the matter is, the reasons defendants offer are not valid. We have challenged them with specific facts. They had no issues between June and November to lower projections. All the negative issues they had with their product was known to the market in January before they conducted a sales [**inaudible**].

Judge 3 (02:16):

So counsel, your view is that going from 34 potential bidders to two and then one, in large part based upon the results of the phase two, that that's not a reason to lower projections? That you have projections that you think are going to result in huge offers from many people. They end up resulting in

one offer that’s lower than the offer initially made in large part because of the likely need for another phase two. That’s not a legitimate reason to lower projections?

Juan Monteverde (03:02):

That's not what happened. First of all, in a sales process, you always going to end up with one bidder. That's an auction process. Second of all, the issues that their defendants raise, which was safety concerns, as well as mixed views of the market opportunities, that’s not reflected in their 10-Qs. And we were relying on facts that support the opposite view. In fact, in the Q1 for 2017, they said that their primary endpoint reveal patients improve faster. That’s positive. And, the court, what the court did relied on the facts presented by defendants and interpreted in their favor. We had no discovery here. This was a motion to dismiss and the court hang its hat on language from the 10-Q that says, well, the ability to continue as a going concern within 12 months following the date of the filing of this firm’s form 10-Q is an issue. That same language was in all three things Qs. If within 12 months was the issue on Q1 and things are getting worse. You wouldn’t expect the same sentence on Q3. Also, the court took the liberty to interpret these things—

Judge 1 (04:09):

So, are you saying that they did not need investment to be—to continue as a company?

Juan Monteverde (04:16):

Oh, but that’s a normal thing for a pharmaceutical. Yes, they need investments, but doesn’t mean that you lower your projections because the value the bidders are telling you and the court interpret the 10-Q when the, when the 10-Q says will depend heavily on the value investors see. Investors, the court interpreted to mean the bidders. It’s not that; it’s shareholders. We know that because on Q3, they announced the transaction and they have the same boilerplate language. We can lead to the conclusion that they’re talking about shareholders. The problem here—

Judge 1 (04:52):

Well if that’s true, the stock price at the time of the, of the merger was lower than the price they got. So if we’re looking at what shareholders think, how did that help you?

Juan Monteverde (05:00):

Well, a premium doesn’t mean you’re getting fair consideration in the face of facts that we put in our pleading, that they were analysts saying the company was worth double that price at that same time—

Judge 1 (05:11):

But apparently the investors who are the shareholders didn’t agree.

Juan Monteverde:

Why, why you say that?

Judge 1 (05:11)
Well, why was the stock prices what it was?

Juan Monteverde (05:21):

The investors. I don't decide what the stock trades on the open market today. I wish I could. That's not how it works.

Judge 1 (05:29):

Right. Investors do.

Juan Monteverde (05:30):

Right. But you have analysts following it. And if they're saying this has a potential for greater value, that is something we can use to support economic loss. I get this motion to dismiss—

Judge 2 (05:39):

But counsel, you allege that analysts estimated the target price to be between 267 and 450 a share. And there were 35 potential bidders and none bid anywhere close to that as an upfront number, correct?

Juan Monteverde (06:03):

Yes. But there's reasons for that. It's an option—

Judge 2 (06:08):

So explain, explain to me given the facts, which you've just agreed are correct. What was it that caused your clients a loss? What was the loss causation? What's the theory plausibly that they should and would have made more money absent, these what you say are the false or misleading projections. What was the path to your clients doing better economically so that they plausibly suffered a loss here?

Juan Monteverde (06:41):

Right. So, one you have analysts saying it's a higher price—

Judge 2 (06:08):

I understand that.

Juan Monteverde (06:41):

I got that. I got that. Sorry. Two, you had, Mallinckrodt essentially knowing how the process is developing and getting lower projections. Eventually Mallinckrodt figured it out. We're the only game in town and we're going to squeeze. That's what happened. Because you get a sense of what management is doing. And they were lowering projections without a need for it.

Judge 2 (07:06):

What do the projections have to do with what Mallinckrodt offered? If there were like 10 other bidders, but there weren't. So how was it that your, that the projections, which you say are false or misleading, caused the only bidder to offer what you think apparently was a lowball offer? How are those two things plausibly connected? Because presumably they made their offer based on their due diligence, like the other 34. So how did, how does that plausibly suggest that your clients would have done better absent these projections? Even if we were to agree with you that they were improper.

Juan Monteverde (07:51):

So let's assume it’s true. There’s the only one bidder. And that’s what happened. And the company sells just to that one bidder, but perhaps it's not the right time to sell. I mean, that’s also something that we have to recognize. And the issue here is not what would have happened with other bidders, it’s why did Ocera not disclose those projections.

Judge 2 (08:11):

So maybe, maybe you’re right, that this wasn’t the right time to sell. But how does that relate to, in terms of loss causation, how is that loss caused by the projections? How does the projections result in the company selling at a time when it, when it shouldn’t have. You’re saying that even though this was the only bidder that you’ve plausibly suggested that, that if the projections had been higher, that there wouldn't have been enough people to have approved the merger?

Juan Monteverde (08:48):

No, no, no. The issue here is they need to disclose projections that they’re using. That’s our position. And your question is, what is the loss and the loss we have identified. And I think Lane does a good job at 1231, explain that four steps. First, you gotta identify the misrepresentation. We did that. Then we have to allege that based on that misrepresentation, which is not disclosing the higher projections, shareholders thought they were getting a fair price. Third, you have to show there were other appraisals out there. We have identified that in our complaint of higher, higher values and due to the submissions, shareholders were not informed. That’s my job today. And I’ve done that job, and I did it well. And I have the specific facts and we challenged the, the statements to lower projections. The court disregarded it. The court at ER-202, essentially says, “I’m not going to consider plaintiff’s allegations because there were five, these five reasons.” And we only challenged three. Well it doesn’t matter. That’s a credibility issue for trial, not any sort of motion to dismiss. The court took liberties to not view the facts in the light most favorable. And that fact that you only have one bidder at the end, that’s how every auction process is going to work.

Judge 1 (10:01):

So, in some cases, there’s evidence that the board has a conflict of interest or something. Do you have any reason to think that this board had any interest in undervaluing the company?

Juan Monteverde (10:14):

I have litigated both types of cases. I understand Your Honor, but you don't need to have a conflict and you don’t need to have—because there’s no state of mind here. It’s a negligence case. And, whatever the board did during the sales process, it’s irrelevant frankly. All that matters is what they did in relation to the disclosures in the recommendation statement. That’s where you need to view the negligent act and negligence lies when you omit a material fact. And that’s the *Wilson* case from the Second Circuit that said it. We also in our supplemental letter, of March 16th, I think it is. We put forth the *Willis Towers* case. They knew of—

Judge 3 (10:50):

So I have a question about that because I am familiar with Second Circuit precedent in this area. But to be frank, doesn’t that mean that every time there’s a material misstatement, or this case a material omission, is really what you’re claiming, is its strict liability. It’s not negligence. It’s strict liability?

Juan Monteverde (11:23):

No, you need, you need economic loss. So you need to also have other ways to show that there was higher value. And also every case you could argue strict liability if you meet the elements of that case, whether it's civil or criminal. Here, you must have an omission, it must be material, and you must be able to claim damages. And when you don't disclose higher projections, I think it's easy to do that. And there's ample authority of that. *Azar*, which is from a sister state, but also within the Ninth Circuit, had the same facts as this case; identical almost. In there, there were three sets of projections, and they didn't disclose the first one. And here, we pled facts. This is not conclusory allegations. We said why we didn't think those reasons made sense. They talk for example, about the PKD PD study. That concluded in March 2017; you're doing projections in June 2017.

Juan Monteverde (12:20):

How can you go back to use that as a reason? The idea, again, that you're lowering projections, because what other people tell you outside your company makes no sense. Then why do shareholders pay millions of dollars in compensation to management to run a company? That is not what they're supposed to do. And by the way, why not disclose the information? We're not fighting about anything other, they should have shown that information to shareholders. There's no argument that these was immaterial as a matter of law. When you plead facts, doesn't mean every time you need to disclose every iteration of projections. And there is no forward-looking defense here for defendants because it's a tender offer. So they don't even get to say that *Oracle*, and they rely heavily on *Oracle*, that has no basis in this case. I know I'm coming to my two minute mark. So unless there's any other questions, I would reserve my remaining time.

Judge 1 (13:15):

Thank you. We can hear from the other side. Thank you.

Brian Matsui (13:25):

May it please the court, Brian Matsui for defendants. Plaintiff's complaint lacks the essential requirements of a section 14(e) claim and multiple independent grounds support the district court's decision. First, there's no materially misleading misstatement or omission. Second, plaintiff does not plausibly allege any facts to show that the individual defendant acted negligently when making the challenge statement. He instead relies on mere conclusory allegations that the individual defendants as a group are quote "negligent." And third, plaintiff seeks to hold defendant liable without pleading loss causation. Economic loss requires a plausible explanation of how he could have gotten more money for his shares, which he simply can't do. Any one of these grounds, each thoroughly grasped by the district court, can and should lead this court to affirm. Now I'd like to start with plaintiff's omissions claim, that the omission of the June and August projections made the November projections materially misleading.

Brian Matsui (14:26):

Plaintiff's not claiming that the November projections are materially false or true. He abandoned that in his blue brief on pages 10 and 11. So, to state an omissions claim, he has to show that the omitted projections were both material and that they made the November projections misleading. And I think the easiest place to start here is with the misleading requirement because my friend focuses a lot on these projections being material, but materiality isn't enough. He also has to show that the omission of those projections made the November projection misleading. And that's a difficult task. As this court's *Brody* decision said, the omission must affirmatively create an impression of the state of affairs that

differs in a material way from one that actually exists. And in the Oracle case, this court noted that companies generate numerous estimates internally, and they may reveal the projection they think best, while withholding others, as long as the projection revealed had a reasonable basis.

Brian Matsui (15:28):

And for an omission, you would need facts tending to seriously undermine its accuracy. And what that gets to is there's no completeness requirement in this circuit or in the Supreme Court's *Omnicare* case. Just because something might be material, and we don't think it is here, doesn't mean that the projection has to be disclosed. The critical question is whether or not it makes the November projection misleading. And there simply are no facts alleged anywhere in the complaint that would indicate that the November projection is misleading by the omission of the June and August projections. The existence of those projections was disclosed. Plaintiff's complaint alleges that, and it's alleged and it's shown in the recommendation statement, that the June projection, at least, was reduced based upon feedback from other—from potential partners. And that's significant here, when you're talking about a company like Ocera that has no product; that has only one product in development in clinical trials that just failed; needs to go through regulatory approval; and never has had any sort of profit.

Brian Matsui (16:40):

Given that that type of projection, which is an opinion statement, you really would need to show that there's no reasonable basis for it in order to show that it's misleading. Now, the plaintiff's other argument with respect to the supplemental disclosure that also fails for very similar reasons. Where he's trying to say that three of the five reasons in the supplemental disclosure were untrue, you need to actually look at what the supplemental disclosure says. And it makes clear that the challenge statement there was an expansion on the feedback that potential partners provided. And there's nothing untrue about that statement. The complaint itself alleges that Ocera received this feedback from potential partners. That's at ER-235 paragraph seven, and at ER-248 paragraph 63. So there's nothing there that would suggest that that's an untrue statement given the fact that plaintiff himself alleges that.

Judge 1 (17:43):

So that's the first argument that you're making about the lack of any misleading omission or any misleading statements. Does that argument really rise and fall with your loss causation argument? Or is there a way—I know you only need to win on one issue. Is there a way for one of those to succeed and the other to fail? Are they really, are they really sort of boiling down to the same thing?

Brian Matsui (18:07):

These are all independent grounds because for the loss causation argument, there's just simply no economic loss that a plaintiff has alleged at all. All he has is a legal conclusion that Ocera's true value was greater than the merger consideration. And regardless of whether or not you would look at a particularity requirement or [**inaudible**], that's just not enough. It's just a legal conclusion because plaintiff would need to plead actual facts, demonstrating economic loss that he could have actually gotten more for his shares. And I think that when you look at this transaction, there's just no plausible way in which plaintiff could have gotten more for this transaction, given the fact that there were 34 companies interested in January that went down to 15, then to seven, then to two, then to one. It wasn't a situation where it was an auction and there was just one bidder left. It was a situation where various companies conducted due diligence. And during the course of that due diligence, as is stated in

the recommendation statement and as alleged in the complaint, these companies dropped out because of concern they had with the clinical data that they were reviewing. And so—

Judge 1 (17:43):

If I understand the thrust of his argument just a moment ago, it was, it seemed like he was saying that the shareholders should have just not approved the merger and just held on as an independent company, which really had a higher value. And I guess that's why I was asking whether they collapsed the same thing because the materiality would relate to whether there really was a higher value that had been more accurately estimated earlier. And the loss causation, I guess, would be, was it really a company that had higher values as an independent concern on its own.

Brian Matsui (19:52):

[**Inaudible**], two points there. The first is that even if the June and August projections were material, they still would only support a cause of action if they made the November projection itself misleading, and he doesn't have any allegations to support that. But even if the June and August projections were material that would just mean that that's information that would change the total mix of information or the shareholders might find it useful. But that doesn't mean that there would be loss causation by the—or any economic loss suffered by the plaintiff here. I think that the Supreme Court's *Dura* case is instructive because in, in that case, the Supreme Court held that you don't have loss causation because you alleged that you paid too much for a stock, that there's an inflated stock of value. And that's sort of similar here where plaintiff is effectively saying that the stock price was deflated.

Brian Matsui (20:47):

And in both situations, it's too speculative. And that's part of the thrust of *Dura* that you, unless you can show that there actually was a way to have traded the stock and lost money, then you don't have loss causation. And the same thing is true here, unless you can actually show that there wasn't another transaction that could have been entered into, he can't show lost causation. Now the *Brody* case, for example, is an example of how you potentially could have loss causation or an investor sold the shares before tender offer, before the tender offer price, and then said, had the company not omitted information, they would have known there was going to be a tender offer and they wouldn't have sold the shares. And that's a situation where there's the potential for a loss causation, or if you had a situation where there was a company where people were truly interested in it.

Brian Matsui (21:35):

And there were two offers at the end and management chose one offer over the other, and it turns out the other offer was actually better. You know, you could see that situation where there might be conflicted director—insiders, that there might be financial benefits and in that type of situation there could be loss causation if you said the other transaction was better. But I think that if we listened to my friend's argument, a lot of what he's doing is criticizing the business judgment of the company and the executives in the company. That they should've just held onto the company. They should have accepted a better price. That they shouldn't have lowered projections based upon feedback. That's not a section 14(e) claim. That's just a challenge to the business judgment of the company itself. And that's not something that the securities laws are designed to provide a remedy for.

Judge 2 (22:30):

Let me, let me interrupt to ask you. You've covered, if you will, the first and the third of the three points you mentioned. The second of your points was that there was a failure to allege, adequately allege, negligence, but what about those cases that say in this context, it's enough to allege a material misstatement and negligence follows automatically?

Brian Matsui (23:01):

So I don't think that that's right, because that would impose strict liability upon the defendants and this court's *Varjabedian's* decision indicates that negligence is required. And so plaintiff's argument would effectively overrule *Varjabedian*—the court's *Varjabedian* opinion, and the securities laws do have strict liability statutes. Section 11, for example, is a strict liability statute, and the Supreme Court in *Omnicare* reiterated that, that all it requires is a violation. As long as the plaintiff alleges that there has been a material misstatement or omission in a registration statement, then that violation is enough. It doesn't matter that the speaker might have been—innocently made a mistake. There is no negligence requirement there—

Judge 1 (23:54):

But negligence can be shown with duty and breach, right? And damages. So I'm just wondering what kind of evidence you think would show negligence? I know you don't think there is evidence of negligence in this case, but just so I can understand the difference between the circuits that have said you need more evidence or more allegations of negligence and the ones that don't, what do you think it would look like to have more allegations of neglect?

Brian Matsui (24:18):

Well, I think the district court really hit the nail on the head here and that's at ER-27. When the court said there are no facts alleging defendants failed to review certain materials or neglecting the responsibilities or designed and oversaw a flaw review—flawed review process. Those are the types of allegations that would—that could plausibly show negligence on the part of defendants. And, that's what is entirely missing here because we just have a legal conclusion at ER-260 that the individual defendants were negligent in carrying out their duty. And plaintiff had the opportunity to amend his complaint here and he didn't take the court—district court up on that offer. So there just are no allegations that the plaintiff has to show any sort of negligence in this case. I think it's important. We cited the U.S. government brief and the *Emulex* case, and the U.S. government has taken the position on section 14(e) that negligence is required and has compared that to section 11 and strict liability statutes and says that you need some sort of culpability on the behalf of the defendant in section 14(e) because section 14 is broader than section 11. That it covers a broader range of statements.

Brian Matsui (25:38):

And for that reason, that's why you need a negligence requirement in section 14. That's why this court should not overrule of *Varjabedian* and, and go do something less than the negligence. If there are no further questions, then we would ask this court to affirm.

Judge 1 (25:59):

Thank you, counsel. And there are two minutes left on the clock for rebuttal.

Juan Monteverde (26:04):

Sure. So when we're saying that the board should have disclosed the projections. We're not challenging their conduct. We're not challenging their judgment. That's irrelevant. There is a case on economic law that comes to mind, which is *Virginia Bankshares*. And in *Virginia Bankshares* at trial, the way they prove damages, what were the shares worth at the time the deal closed? It's not what they could have got; it's what they are worth. And we would have used the projections that they even disclosed. And to give an example of other ways to seek damages, which we alleged in our complaint in ER-251, Ocera rejected an offer from party A in the October timeframe, a month before entering into the deal with Mallinckrodt to do a licensing agreement that could also lead to more money. We don't know that, but we've alleged it, that they rejected that.

Juan Monteverde (26:53):

And we've alleged in 243 through 248 why we think the idea that you change projections based on feedback makes no sense. And that's what this case is about, about alleging facts that contradict the story defendants are trying to tell, and we have facto specificity to do so. And the two cases that come to mind with regards to the projections issue, we talked about *Oracle* and *KCG*. *Oracle*, all it says is internal forecasts. Here, they're not internal. They were used; approved by the board. Same with KCG. We are saying, shareholders should have seen those projections. And they didn't. And it was individual defendant's failure to disclose that information. And as a board, as they are a group, they all have the same obligation to review the recommendations statement. And of course they did, that's required by law. And they say in their recommendation statements, these are the reasons why the board approves this transaction. So of course we have pled that there was a duty and a violation of that duty. We believe this case should be reversed and remanded to the lower court. Thank you.

Judge 1 (28:00):

Thank you both sides for the very helpful arguments. The case is submitted and we are adjourned for the week.

Juan Monteverde (28:07):

Thank you a good weekend, everyone.

Judge 1 (28:09):

You too. Thank you so much for appearing by telephone. We really appreciate it.

Juan Monteverde (28:14):

No problem.

Brian Matsui (28:15):

Thank you.

Judge 1 (28:17)

And be well and stay safe.

Brian Matsui (28:19):
Thank you. Thank you.