UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

IN RE HENRY SCHEIN, INC. SECURITIES LITIGATION	**Master File No. 1:18-cv-01428-MKB-VMS** **CLASS ACTION**

DEFENDANTS' MEMORANDUM OF LAW IN SUPPORT OF MOTION FOR PRELIMINARY APPROVAL OF CLASS-ACTION SETTLEMENT

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INTRODUCTION

This case is a putative securities class action brought on behalf of purchasers of common stock issued by Henry Schein, Inc. ("Schein"), one of the largest distributors of dental supplies and equipment. The suit alleges that Schein "engaged for years in collusive and anticompetitive practices" with its primary competitors in the North American dental distribution market "to maintain Schein's margins, profits, and market share," but defrauded investors by "misleadingly attribut[ing] the strength of [its] dental distribution business to the quality of [its] value-added business model." [Consolidated Complaint ("Complaint" or "Compl.") ¶ 3] Schein's stock price allegedly fell "[w]hen the market learned the truth – that Schein's purported profit margins and market share were unsustainable and had been inflated by collusive conduct" [*id.*]. The Complaint asserts claims under §§ 10(b) and 20(a) of the Securities Exchange Act of 1934.

The defendants moved to dismiss the case, and the Court partially granted the motion. Shortly thereafter, Schein won a complete victory after a lengthy trial before a Federal Trade Commission ("FTC") Administrative Law Judge ("ALJ"), who concluded that Schein had not engaged in the primary anticompetitive conduct underlying the claims in this action.

For the reasons explained below, Lead Plaintiff ("Plaintiff") would face enormous – and probably insurmountable – obstacles if it were to proceed with this case. Schein's victory in the FTC trial destroys Plaintiffs' allegations that Schein made false or misleading statements about the competitive nature of the dental distribution market and otherwise engaged in anticompetitive misconduct. Moreover, a fully briefed motion for reconsideration of a potentially dispositive issue concerning corporate scienter has been filed – a motion that Schein expects to win.

Nevertheless, the parties agreed to explore settlement prospects without further pursuing litigation, and they reached an agreement in principle after a two-day mediation under the

auspices of retired California Superior Court Judge Daniel Weinstein. The parties later entered into a Settlement Agreement, which is being submitted to this Court for preliminary approval.[1]

As Plaintiff's motion papers more comprehensively explain, the proposed settlement is worthy of preliminary approval. Defendants support Plaintiff's motion because they are interested in putting this case behind them to avoid the further distractions and expenses of continued litigation. Defendants submit this separate memorandum to focus on the litigation risks that would confront Plaintiff and the Class if the Court does not approve the settlement.

BACKGROUND AND PROCEDURAL HISTORY

A. Schein's Dental Distribution Business

Schein is a global healthcare distribution business with three primary segments: dental, animal health (until February 2019), and medical. [Compl. ¶ 17] Stanley Bergman is Schein's CEO and Chairman [*id.* ¶ 18]; Steven Paladino is its Chief Financial Officer [*id.* ¶ 19]; and Timothy Sullivan is President of the North American portion of Schein's Global Dental Group [*id.* ¶ 20]. The securities and antitrust matters concern only the U.S. dental distribution business, which provides dental products and services to a wide variety of healthcare providers.

The U.S. dental distribution market has several principal competitors, with Schein, Patterson Companies, Inc., and Benco Dental Supply Company being the three largest. [*Id.* ¶¶ 4, 25] In light of the various types of competition that Schein faces, Schein stated in SEC disclosures, earnings calls, and investor conferences that the dental market is highly competitive. [*E.g.*, *id.* ¶¶ 34-35]

Schein repeatedly expressed its belief that it could maintain its position in a competitive market because of the value it provides to its customers. [*Id.* ¶¶ 36-37] Schein marketed itself as

[1] All capitalized terms not defined in this Memorandum have the meanings given to them in the Settlement Agreement.

a "solutions" company: a one-stop shop for dental needs, with an array of supplemental services such as practice-management software systems, financial services, e-services, practice technology, network and hardware services, and continuing education. Schein stressed that, because of the range of services it provided, it would "'not match [a competitor's] prices'" in some circumstances to avoid "'dilut[ing] the value that is ascribed to our offering.'" [*Id.* ¶ 36]

B. Antitrust Allegations

Starting in 2012, various private antitrust actions and governmental investigations alleged that Schein had engaged in anticompetitive activities with its primary competitors (Patterson and Benco) and others (including certain manufacturers) to fix prices and margins in the dental distribution business and to boycott buying groups.

***Archer and White*.** The first such case was *Archer and White Sales, Inc. v. Henry Schein, Inc.*, No. 2:12-cv-0572 (E.D. Tex.), filed on August 31, 2012. The plaintiff, a regional distributor of dental equipment and supplies, alleged that Schein and another distributor (Burkhart) had conspired to fix prices, refused to compete with each other, forced their supplier to terminate or reduce Archer's and its partner's (Dynamic Dental's) distribution territory, and maintained an illegal boycott that allowed Schein and Burkhart to sustain price-fixing and noncompetition agreements. The case has been on the public docket since 2012 and, as shown below, was discussed extensively in complaints filed in other matters since at least January 2016.

Texas AG Investigation. On July 18, 2014, the Texas Attorney General ("AG") began an investigation of Schein, Patterson, and Benco arising out of their alleged reactions to an online buying platform (called TDA Perks) launched by the Texas Dental Association (the "TDA") and a company called SourceOne Dental, Inc. TDA Perks claims to allow TDA member dentists to buy supplies online at a discount. The Texas AG alleged that Schein, Benco, and Patterson had conspired to boycott the TDA's trade show in an (unsuccessful) attempt to

cause the TDA to shut down TDA Perks. The Texas AG's investigation was mentioned in news articles and in other lawsuits since at least September 2015 (as described below). On August 3, 2017, Schein settled with the Texas AG for mostly limited injunctive relief, and Schein did not admit liability. The settlement was publicized by August 7, 2017.

Arizona AG Investigation. The Arizona AG began to investigate Schein, Patterson, and Benco on August 6, 2014, focusing on allegations similar to those in the Texas investigation.

***SourceOne*.** On September 21, 2015, SourceOne itself filed a private antitrust action against Schein, Benco, and Patterson, raising the same allegations at issue in the Texas and Arizona AG investigations. *SourceOne Dental, Inc. v. Patterson Cos., Inc.*, No. 2:15-cv-5440 (E.D.N.Y.). The complaint discussed those two AG investigations as well as a pending investigation by the FTC. An article published on September 22, 2015 in *Newsday* described the *SourceOne* case and mentioned the FTC, Texas, and Arizona investigations. Schein disclosed *SourceOne* in its November 4, 2015 financial statement.

Dentists' Class Actions. Starting on January 20, 2016, various dental practices filed class actions against Schein, Benco, Patterson, and Burkhart, alleging (among other things) a conspiracy to fix prices and boycott competing distributors and companies, including Archer/Dynamic and SourceOne. *See, e.g., Comfort Care Family Dental, P.C. v. Patterson Cos., Inc.*, No. 1:16-cv-0282 (E.D.N.Y.). The complaints described the *Archer* litigation as well the Texas, Arizona, and FTC investigations. Those allegations were repeated in a consolidated complaint filed on March 11, 2016. *In re Dental Supplies Antitrust Litig.*, No. 1:16-cv-0696 (E.D.N.Y.). Schein disclosed the class actions in its annual report on February 10, 2016.

***IQ Dental*.** On August 17, 2017, IQ Dental, a distributor of dental supplies and equipment, sued Schein, Benco, and Patterson based on the allegations in the *SourceOne* case.

IQ Dental Supply, Inc. v. Henry Schein, Inc., No. 2:17-cv-4834 (E.D.N.Y.). The complaint discussed in detail the allegations in the *Archer* case and the Texas and Arizona AG investigations. Schein disclosed *IQ Dental* on November 6, 2017.

FTC Investigation. In 2015, the FTC began an investigation of Schein's, Benco's, and Patterson's alleged dealings with buying groups and internet-based retailers. The FTC investigation was mentioned publicly in multiple news articles and lawsuits since at least September 2015 (as shown above). The FTC filed an enforcement action against Schein, Benco, and Patterson on February 12, 2018, and Schein promptly disclosed it on February 13, 2018.

The FTC action was tried before an ALJ over 21 days during a nine-week period between October 16, 2018 and February 15, 2019. The extensive trial record contained testimony from 65 witnesses (live or by deposition) and 5,070 exhibits.

On October 15, 2019, the ALJ published a 245-page decision ruling that Benco and Patterson had violated the FTC Act by conspiring to refuse to offer discounted prices to buying groups or to compete for their business. *In the Matter of Benco Dental Supply Co.*, No. 9379 (Oct. 15, 2019) (the "FTC Decision") [ECF No. 59-1]. But the ALJ held that the FTC Staff had failed to prove any conspiracy involving Schein. The ALJ concluded that "the evidence, viewed as a whole, fails to persuasively demonstrate that Schein conspired with Benco, or with Benco and Patterson, to refuse to discount to or otherwise negotiate with buying groups." [*Id.* at 95]

The ALJ found that Schein had made its own, independent decisions about whether to deal with buying groups based on its assessments of its own interests and had not conspired with its competitors. Such unilateral decisions to deal – or not to deal – with other entities are perfectly legal. *See, e.g.*, *Anderson News, LLC v. Am. Media, Inc.*, 899 F.3d 87, 103 (2d Cir. 2018) ("a business entity has a right to deal, or refuse to deal, with whomever it likes, as long as

it does so independently") (internal quotation omitted), *cert. denied.*, 139 S. Ct. 1375 (2019).

The ALJ concluded:

- "[F]or years prior to 2011, Schein executives . . . were skeptical about the value buying groups could bring to Schein and to the individual dentist members." [FTC Decision at 56] This skepticism arose because "providing discounts for membership in a buying group can negatively impact FSCs [*i.e.*, field service consultants], who are paid a commission based on gross profit from a particular customer. . . . This reduction in commission is a disincentive to FSCs to continue to call on that customer and drive increased business." [*Id.* at 54]

- "Schein also identified certain economic risks and potential economic benefits in partnering with buying groups. One of the most glaring risks for Schein of working with a buying group is the risk of cannibalization. . . . Still, Schein recognizes that some buying groups might be able to present an economic benefit if they are able to bring new customers that could not otherwise be obtained by offering discounts to the individual members." [*Id.* at 55 (citations omitted)]

- "Schein believes that buying groups that can provide a commitment to purchase from a particular distributor, referred to within Schein as 'compliance,' might be able to present an economic benefit to a distributor like Schein, but that without such a commitment, buying group members can 'cherry-pick' and 'basically only pick the items that were cheapest on the formulary' instead of giving Schein 'all their business.' Schein views compliance as one of the fundamental issues with buying groups. Schein also found that it was a challenge for some groups to maintain members, referred to within Schein as 'stickiness,' if the group does not offer any value-added services ('value proposition') for the members in exchange for the membership fee, beyond price discounts, such as camaraderie, education, or other services that help a buying group retain and influence its membership." [*Id.* (citations omitted)]

- "Notwithstanding Schein's skepticism, the company chose to work with buying groups where it made business sense to Schein. . . . Schein looked primarily at whether a buying group could 'enforce a certain amount of compliance and . . . affect and influence behavior of' the members to drive purchases to Schein.'" [*Id.* at 56-57]

- "[S]ubstantial probative evidence conflicts with the assertion that Schein had a blanket policy to categorically refuse to do business with buying groups during the alleged conspiracy period . . . . Schein did not cease discounting to or negotiating with buying groups in or after 2011 and Schein entered into new buying group relationships during the alleged conspiracy period. Such evidence is contrary to the inference that Schein adopted or maintained a no buying group policy, similar to Benco's, during the alleged conspiracy period." [*Id.* at 63-64]

- "Schein's business dealings with buying groups . . . is inconsistent with a no buying group policy and contrary to a conclusion that Schein had a meeting of the minds with

Benco that Schein would refuse to deal with buying groups, or that Schein had a conscious commitment to refuse to deal with buying groups." [*Id.* at 65]

- "The evidence also proves that Schein was working independently to develop a buying group policy, before and during the alleged conspiracy period, which is also contrary to a conclusion that Schein had a conscious commitment, due to an agreement with Benco, to adopt and maintain a blanket no buying group policy in conformance with Benco's policy." [*Id.* at 66]

- "The evidence demonstrates that Benco made unsolicited contacts to Schein that related to buying groups. Schein rebuffed the outreach, however, and the evidence fails to show that in these contacts, Schein provided Benco with any information concerning Schein's policies or strategies regarding buying groups. Furthermore, the evidence shows that Schein did not alter its conduct in response to Benco's outreach and that Schein engaged in conduct that is contrary to the conclusion that Schein had an agreement with Benco not to do business with buying groups." [*Id*. at 73]

- "[T]he evidence fails to prove that Schein exchanged assurances with Benco or that Schein had a policy during the alleged conspiracy period of categorically refusing to deal with buying groups. The evidence shows that during the alleged conspiracy period, Schein continued discounting to most of its pre-existing buying group partnerships, although it terminated two of them; and Schein accepted some new relationships with buying groups, but rejected some others, all of which is evidence of a selective approach to buying groups that is dissimilar to the conduct of both Benco and Patterson." [*Id.* at 81]

- "[T]he evidence fails to prove [the FTC's] contention that Schein adopted a no buying group policy in late 2011, or abandoned that policy beginning in April 2015. Schein continued discounting to most of its pre-existing buying group customers and entered into new buying group relationships throughout and after the alleged conspiracy period." [*Id*. at 86]

The ALJ's ruling has become final. The FTC staff, Benco, and Patterson did not appeal it, and the Commission did not review the ALJ's findings on its own motion.

C. <u>Securities Class Action</u>

This securities class action was filed less than one month after the FTC commenced its enforcement action on February 12, 2018. Plaintiff alleges that Schein's stock price was artificially inflated from March 7, 2013 through February 12, 2018 (the "Class Period") because Schein had misleadingly portrayed its dental distribution business "as successfully producing excellent profits while operating in a highly competitive environment" even though, "in reality,

[Schein] had engaged for years in collusive and anticompetitive practices in order to maintain Schein's margins, profits, and market share." [Compl. ¶ 3] The contentions about collusive conduct come from the allegations in the antitrust lawsuits and government investigations, which were matters of public record and had been known for years. [*E.g.*, *id.* ¶¶ 38-45]

Plaintiff alleges that Schein's stock price fell starting in August 2017 when Schein announced below-expected financial performance that allegedly "revealed that Schein's poor results were a product of abandoning prior attempts to inflate sales volumes and margins through anticompetitive collusion." [*Id.* ¶ 109] The full "truth" supposedly was revealed with the news of the FTC's suit on February 12, 2018. [*Id.* ¶¶ 115, 117, 119]

Defendants moved to dismiss the case, and the Court granted the motion in part and denied it in part. *In re Henry Schein, Inc. Sec. Litig.*, No. 18-cv-1428 (E.D.N.Y. Sept. 27, 2019) (the "MTD Decision") [ECF No. 54]. The Court dismissed allegations that Schein's historical financial results had been false or misleading. But the Court held that Plaintiff had adequately pled material misrepresentations or omissions concerning Schein's statements about competition in the dental distribution business and about its pricing and value-added services. *Id.* at 18-36.

As to scienter, the Court ruled that Plaintiff had not pled the requisite strong inference that either of the individual defendants in the § 10(b) count (CEO Bergman and CFO Paladino) had known about the allegedly anticompetitive conduct that purportedly had made Schein's statements false or misleading. The Court also rejected allegations that Messrs. Bergman's and Paladino's sales of Schein stock during the Class Period created an inference of scienter. *Id.* at 38-47. But the Court upheld allegations of scienter as to Schein itself based on the purported knowledge of Mr. Sullivan, the head of Schein's North American Dental business. The Court

concluded that Mr. Sullivan was senior enough so that his alleged knowledge of anticompetitive activities could be attributed to the company for scienter purposes. *Id.* at 48-51.

The Court dismissed the plaintiff's loss-causation allegations as to the first of three supposed "corrective disclosures" (August 8, 2017) because that disclosure, "although it revealed disappointing financial results, . . . did not disclose that Defendants were engaging in anticompetitive conduct or any other facts relevant to the purported fraud." *Id.* at 54. The Court also ruled that Plaintiff had not "connect[ed] the disappointing financial results . . . to the materialization of any risk concealed by Defendants' allegedly fraudulent statements . . . ." *Id.* at 55. Although Plaintiff had pled that "several lawsuits caused Defendants to change their anticompetitive behavior, which drove down profits, and subsequently, Schein's stock price," Plaintiff had "not allege[d] or argue[d] that Defendants actually abandoned their anticompetitive conduct prior to the August 8, 2017 disclosure." *Id.*

For the same reasons, the Court also dismissed Plaintiff's loss-causation allegations as to the November 6, 2017 press release to the extent they were "based on the disclosure of disappointing financial results." *Id.* at 56. But the Court sustained the loss-causation allegations as to (*i*) the November 6, 2017 press release's disclosure of the *Archer* and *IQ Dental* lawsuits and (*ii*) the February 12-13, 2018 disclosures of the FTC enforcement action, holding that they had revealed new information. *Id.* at 56-58.

Finally, the Court dismissed the § 20(a) control-person claim against Messrs. Bergman and Paladino, but refused to dismiss it as to Mr. Sullivan. *Id.* at 62-64.

Schein and Mr. Sullivan filed a limited, partial motion for reconsideration based on two critical arguments that the Court's decision had overlooked. [ECF No. 58] First, Schein asserted that, even if Mr. Sullivan had known about allegedly anticompetitive conduct, and even if he was

high enough in the organization so that his purported knowledge could be attributed to the company, corporate scienter still could not exist unless Mr. Sullivan had some connection *to the alleged securities-law violation* – financial reporting and disclosures – but the Complaint did not plead any such connection. Second, Mr. Sullivan contended that, even if he had had the requisite control over the dental distribution business, he could not be held liable as a control person for securities-law purposes under § 20(a) unless his alleged control related to the securities-law violation at issue: financial reporting and disclosures.

After Defendants filed their reconsideration motion, the parties began to discuss the prospect of mediating. The parties finished briefing that motion [ECF Nos. 65, 66] and then asked the Court to adjourn any ruling pending mediation. On November 1, 2019, the Court took the motion off the docket and directed the parties to report back by February 21, 2020. The parties then participated in a two-day mediation and agreed to the proposed settlement terms.

ARGUMENT

A court called upon to preliminarily approve a proposed class-action settlement "must review the proposed terms of settlement and make a preliminary determination on the fairness, reasonableness and adequacy of the settlement terms." *In re Payment Card Interchange Fee & Merch. Disc. Antitrust Litig.*, 330 F.R.D. 11, 27 (E.D.N.Y. 2019) (internal quotations omitted) ("*In re Payment Card*"). In so doing, the court considers the factors outlined in the recently adopted Fed. R. Civ. P. 23(e)(2), which apply to the final-approval stage but also guide the preliminary approval inquiry. *Id*. at 28. The court also considers the factors that the Second Circuit had previously articulated in *City of Detroit v. Grinnell Corp.*, 495 F.2d 448 (2d Cir. 1974), *abrogated on other grounds by Goldberger v. Integrated Res., Inc.*, 209 F.3d 43 (2d Cir. 2000), because "the new Rule 23(e) factors . . . add to, rather than displace, the *Grinnell* factors"

and because "there is significant overlap between the *Grinnell* factors and the Rule 23(e)(2)(C-D) factors . . . ." *In re Payment Card*, 330 F.R.D. at 29.

Plaintiff's motion in support of preliminary approval reviews the various considerations that arise at the preliminary approval stage. Defendants therefore will focus on only one portion of Rule 23(e): Rule 23(e)(2)(C) – the costs, risks, and delay of trial and appeal – which "implicates several *Grinnell* factors, including (i) the complexity, expense and likely duration of the litigation; (ii) the risks of establishing liability; (iii) the risks of establishing damages; and (iv) the risks of maintaining the class through the trial." *In re Payment Card*, 330 F.R.D. at 36. In evaluating those risks, the Court does not need "to adjudicate the disputed issues or decide unsettled questions; rather, the Court need only assess the risks of litigation against the certainty of recovery under the proposed settlement." *Id.* at 36-37 (internal quotations omitted).

I. RISKS OF ESTABLISHING LIABILITY AND DAMAGES

Plaintiff would face significant hurdles in proving its case if the litigation were to proceed. Those hurdles include hotly disputed issue about Plaintiff's ability to prove material misrepresentations or omissions, corporate scienter, and loss causation.

A. No Material Misrepresentations or Omissions

Plaintiff's claims rest on the theory that Schein had engaged in anticompetitive conduct and that its statements about the reasons for its financial performance were false or misleading because they failed to disclose that the alleged misconduct was the "real" reason for Schein's success and high prices. The Court upheld most of those allegations at the pleading stage – but did so *before* the FTC ALJ ruled after a trial, on the basis of an exhaustive evidentiary record, that Schein had not engaged in any such anticompetitive conduct.[2] The ALJ's thorough decision

[2] The Court's decision also predated the Second Circuit's ruling that a securities plaintiff seeking to allege a securities-law violation based on underlying antitrust violations must plead

demonstrates that, if this case were to continue, Plaintiff would not be able to prove (as opposed to merely plead) the allegations underlying its claims.

Plaintiff has raised a number of arguments to try to evade that fundamental problem, but none of them withstands scrutiny.

1. Necessity of Proving an Antitrust Violation

Plaintiff has contended that Schein's statements about competition in the dental distribution market were false and misleading even in the absence of any antitrust violations. This argument would present serious hurdles to Plaintiff for a number of reasons.

First, the allegedly false statements pled in the Complaint refer to Schein's own purported, illegal collusion with horizontal competitors (specifically Benco and Patterson), but the FTC ALJ found, after examining the facts, that Schein had not engaged in any anticompetitive conduct involving those two companies.

Second, if Plaintiff means that it could prosecute its claims by showing that Schein had engaged in "anticompetitive" conduct that did *not* violate the antitrust laws, Plaintiff has never explained how such conduct would have been in any way improper. But even if Schein had engaged in "anticompetitive" conduct that did not violate the antitrust laws (whatever that means), Plaintiff has not explained why Schein would have needed to stop that *legal* conduct in response to antitrust claims asserted against it. Plaintiff's thesis is that Schein's performance deteriorated when the company was "forced" to "abandon" its anticompetitive conduct because of suits filed by the FTC, the State AGs, and private plaintiffs. [Compl. ¶¶ 13, 109-10, 113-14, 118] But those litigants and governmental authorities were asserting *antitrust* claims, not vague claims about nonactionable "anticompetitiveness." If Schein's conduct was not illegal under the

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and prove the alleged antitrust misconduct with the particularity required by the securities laws. *Gamm v. Sanderson Farms, Inc.*, 944 F.3d 455 (2d Cir. 2019).

antitrust laws, Schein would not have been "forced" to "abandon" its *legal* conduct because of suits alleging different, *illegal* antitrust violations.

Third, if Plaintiff means that Schein's statements about market competition were false or misleading because *other* market participants (such as Patterson or Benco) had violated the antitrust laws even if Schein had not done so (but had known about Patterson's and/or Benco's allegedly illegal conduct), it is difficult to see how any such statements were material or could have caused any loss. If Schein itself was not engaging in anticompetitive conduct, its financial performance was not inflated by allegedly improper sales practices regardless of whether Patterson's or Benco's might have been. And Schein would not have needed to change its own, legal conduct regardless of what Patterson or Benco might have been doing.

2. No Proof of Alleged Misconduct *Not* Covered by ALJ's Decision

Plaintiff also would have trouble showing that Schein engaged in anticompetitive conduct *not* covered by the ALJ's ruling. The FTC did not look solely at issues involving buying groups. And Plaintiff will not be able to establish any other type of improper anticompetitive conduct.

Quashing online competition. The Complaint spends eight pages [¶¶ 69-83] on allegations that Schein, Benco, and Patterson colluded to injure SourceOne, which was working with State Dental Associations to launch online distribution platforms. But the FTC ALJ addressed the FTC Staff's allegations that Schein had colluded to boycott the 2014 TDA meeting in order to get the TDA to shut down SourceOne. [FTC Decision at 92-95, 227-30] The ALJ's decision quotes internal Schein documents expressly *rejecting* Benco's efforts to coordinate with Schein [*id.* at 93]; it also notes that Schein did *not* coordinate with Patterson about whether to attend the TDA meeting [*id.* at 94]. In addition, the ALJ found that Schein had proposed that it "and the TDA 'work together instead of against each other' and requested that the TDA switch partners from SourceOne to Schein." [*Id.* at 93] Schein reasonably had no interest in assisting

the TDA if the TDA continued to use its brand to promote SourceOne, a competitor of Schein, instead of serving as a neutral platform for the whole industry.

Pressuring manufacturers to boycott competitors. The Complaint alleges in various places that Schein colluded with Benco and Patterson to pressure manufacturers to cut off or restrict lower-price competitors. [*E.g.*, Compl. ¶¶87-91, 94, 102-05] The evidence will show, however, that Schein's complaints were unilateral and thus do not give rise to any antitrust violation. Schein views its relationships with its suppliers as a form of partnership, in which Schein's Field Sales Consultants actively promote and market the suppliers' products and provide technical and educational support. Low-cost distributors that sell primarily on price, but do not provide this level of support, can free-ride on those costly efforts, undermining Schein's investments in its relationships. Schein therefore has an interest in the number and types of authorized distributors. Antitrust law does not prohibit authorized distributors from discussing manufacturers' distribution networks – or from encouraging manufacturers to terminate discounting distributors. *See, e.g.*, *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 763 (1984) ("complaints about price-cutters are natural – and from the manufacturer's perspective, unavoidable – reactions by distributors to the activities of their rivals") (internal quotation omitted). The law prohibits only "group boycotts," in which *competing distributors* conspire with each other to force manufacturers to boycott a third distributor.

Price/margin-fixing. Plaintiff also will not be able to produce any evidence of price- or margin-fixing collusion between Schein and its principal competitors. There is also no evidence that Schein charged the same prices or maintained the same margins as did Benco and Patterson. In fact, Schein's Field Sales Consultants and Equipment Sales Specialists, who were paid based

on their sales, had individual discretion to discount the retail price by reducing their own profit to encourage customers' purchases.

3. Market's Awareness of the Antitrust Allegations

Plaintiff also will be unable to prove a material misrepresentation or omission because the allegations about Schein's anticompetitive conduct had been public knowledge since at least 2012, and the FTC and State AG investigations had been known since at least 2015. The Court has already recognized that "[t]he 'truth-on-the-market' defense provides that a misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market." MTD Decision at 59-60 (internal quotation omitted). But the Court declined to apply the truth-on-the-market defense *at the pleading stage* because of factual issues. *Id.* at 60.

If the case does not settle, however, Plaintiff will face an uphill battle in showing that the market was not sufficiently aware of the antitrust allegations and the governmental investigations since at least 2015 or 2016 – well before the allegedly "corrective" disclosures emerged in 2017 and 2018. And to the extent Plaintiff's claim depends on the disclosure of the FTC enforcement action, that suit could not have been disclosed any earlier than it was – because it was not filed until the last day of the Class Period.

B. No Corporate Scienter

The Court's ruling on corporate scienter hung solely on the allegations as to Mr. Sullivan; the Court dismissed the scienter allegations as to Messrs. Bergman and Paladino, the only two individual defendants named in the § 10(b) count. Defendants will not argue about those conclusions here (although they certainly would do so at trial, based on the facts). However, even if Mr. Sullivan had known of allegedly anticompetitive conduct, and even if one accepts the Court's conclusion that Mr. Sullivan was senior enough for his alleged knowledge to be

attributed to Schein, attribution to the corporation *for securities-law purposes* is improper unless Mr. Sullivan was alleged to have had some connection to, and perhaps even oversight of, the purported *securities-law violations*: financial reporting and disclosures. The Complaint contains no such allegations, so Schein is likely to prevail on its dispositive reconsideration motion.

As the reconsideration motion explains, Second Circuit precedent permits a finding of corporate scienter in a securities-fraud case *only* where a sufficiently high-ranking employee who allegedly had the requisite knowledge of the underlying misconduct *also* had some connection to the securities-law violation. *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 197 (2d Cir. 2008) (vacating denial of motion to dismiss § 10(b) claims as to company because no strong inference that "*someone* whose scienter is imputable to the corporate defendants **and** who was responsible for the statements made was at least reckless toward the alleged falsity of those statements") (bold emphasis added). Defendants' original motion papers and reconsideration motion cited precedent in this Circuit applying *Dynex*, including *Silvercreek Management, Inc. v. Citigroup, Inc.*, 248 F. Supp. 3d 428 (S.D.N.Y. 2017), and *Barrett v. PJT Partners, Inc.*, 2017 WL 3995606 (S.D.N.Y. Sept. 8, 2017).

Silvercreek held that, "under Second Circuit precedent, it is not enough to *separately* allege misstatements by some individuals and knowledge belonging to some others where there is no strong inference that, in fact, there was a connection between the two." 248 F. Supp. 3d at 440. Rather, there must be "*some connection* at the corporation *between a misstatement and the requisite quantum of knowledge of its falsity* ([for example,] by requiring someone with the required knowledge to approve the misstatement)." *Id*. (emphasis added). Similarly, *Barrett* held that "[t]he determinative question" for scienter-attribution purposes is whether the employee

"was involved [in the company's public statements], not whether he was involved in" the underlying conduct that allegedly made those statements false. 2017 WL 3995606, at *8.

Plaintiff's opposition brief cited *Rex & Roberta Ling Living Trust u/a Dec. 6, 1990 v. B Communications Ltd.*, 346 F. Supp. 3d 389 (S.D.N.Y. 2018), which the Court also cited (albeit for a different point). But *Ling* itself quoted *Silvercreek* and articulated the same standard: to impute scienter to a corporation, a complaint must allege that an "employee with knowledge of the facts that make a corporate statement misleading occupies a position likely to enjoy some *oversight over the company's public-facing representations*." *Id.* at 409-10 (emphasis added). The Complaint did not (and could not) allege that Mr. Sullivan had any such oversight.

Defendants' reconsideration motion discussed every case cited in the MTD Decision and showed that *none* of them had found corporate scienter in a situation such as this one. In *all* of those cases, the person whose scienter was attributed to the corporation had had some connection to *the relevant securities-law violation* (here, financial reporting and disclosures), not just to the underlying business operations that allegedly had made the financial reports and disclosures false or misleading. Plaintiff's opposition brief said nothing at all about Defendants' explanations of those cases, and Plaintiff has never cited a single case in which corporate scienter was based on the purported knowledge of an official who was *not* alleged to have had some connection to the securities-law violation. Thus, if this case does not settle, Defendants are likely to prevail on their reconsideration motion, and the Court would need to dismiss the remainder of this action.

C. No Loss Causation

In addition to being unable to prove misstatements and scienter, Plaintiff would face great difficulty in proving loss causation for at least three reasons: (*i*) Plaintiff's loss-causation theory makes no sense and has been disproven; (*ii*) the November 2017 disclosure of two individual antitrust actions could not have caused any loss; and (*iii*) the FTC's announcement of an

enforcement action in February 2018 cannot legally establish loss causation – but even if it could do so, it was not responsible for all of the price drop on that date.

This case thus is about – at most – some undefinable portion of the February 13, 2018 price drop. Plaintiff will not be able to prevail on the surviving allegations about the November 2017 drop, and the Court has dismissed the allegations about the August 2017 drop.

1. Plaintiff's Flawed Theory of Loss Causation

Plaintiff's loss-causation theory is that the governmental investigations and private litigation "forced" Schein to "abandon" its alleged anticompetitive conduct and that the stock price started falling when the market realized that Schein could no longer continue to achieve its prices and margins through anticompetitive collusion. [Compl. ¶¶ 109-10, 113-14, 118] But as the FTC decision shows, Schein did *not* engage in anticompetitive conduct, and it did *not* change its conduct at any point during the Class Period. Schein dealt or refused to deal with buying groups based on its own assessments of its best interests – an entirely legal course of conduct.

The financial performance reported in November (and August) 2017 therefore was not affected by any purported change in Schein's dealings with customers and competitors. Plaintiff will not be able to prove that the innocent explanations that Schein gave for its November (and August) financial results were *not* the reasons for the stock price's decline. *See* Compl. ¶¶ 107, 111 (reciting Schein's explanations of financial results).

2. No Loss Causation from November 2017 Disclosures

The Court has already dismissed Plaintiff's allegations of loss causation for the November 6, 2017 disclosures to the extent they related to Schein's financial performance. The Court held that those disclosures – like the dismissed August 8, 2017 disclosures – revealed only "disappointing financial results," but "did not disclose that Defendants were engaging in anticompetitive conduct or any other facts relevant to the purported fraud." [MTD Decision at

56, 54] But although the Court sustained the November 2017 loss-causation allegations at the pleading stage to the extent they involved the disclosure of the *Archer* and *IQ Dental* cases [*id.* at 56-58], Plaintiff will not be able to *prove* that those disclosures caused any loss at all.

First, the allegations of anticompetitive conduct raised in those two cases had been known to the market since 2012 (when the *Archer* case was filed) and 2015-2016 (when the private civil actions were filed and disclosed, and when the AG and FTC investigations were also reported). [Ex. A][3] Moreover, the *Archer* and *IQ Dental* cases themselves had been known to the market well before November 6, 2017.

- *Archer* had been filed in 2012 and was available on the public docket since then. As shown above, *Archer* was also discussed in complaints filed in other cases starting in January 2016 and was mentioned in news articles. In fact, on October 20, 2017, Height Securities LLC devoted a research report to the *Archer* case and noted that "Archer states in its amended complaint [filed in August 2017] that its factual theory is *the same as the one alleged in the Class Action lawsuit*," which had been filed in 2016 and was itself the subject of various news articles.

- *IQ Dental* was filed on August 17, 2017, was also available on the public docket since then, and was also reported in the media, including in Height Securities' October 20, 2017 research report. And the allegations in *IQ Dental* involved the issues raised in the *SourceOne* case, which had been a matter of public record since 2015.

The November 2017 disclosure of *Archer* and *IQ Dental* thus was not new news, did not reveal new allegations of anticompetitive conduct, and did not add anything to the mix of information that had long been available to the market.

Second, *Archer* and *IQ Dental* were not class actions; they were filed by individual plaintiffs and thus did not likely pose any threat of significant *additional* liability to Schein in their own right.

Third, none of the analysts that reported on the November 2017 disclosures attributed the stock-price drop in whole or even in part to the reports about *Archer* and *IQ Dental*. To the

[3] "Ex." refers to the exhibits to the accompanying Declaration of Jonathan E. Richman.

contrary, Piper Jaffray – the only analyst that mentioned the antitrust litigation in reporting on Schein's November 6, 2017 financial disclosures – said on November 6 that "[w]e do not believe collusion suits will significantly impact HSIC's operations" (referring to "20+ ongoing lawsuits"). The analysts focused only on the earnings news, which the court has already held does *not* establish loss causation.

The analysts' lack of interest in *Archer* and *IQ Dental* is not surprising. Schein's stock price did not show statistically significant declines after disclosures of *SourceOne*, the dentists' class actions, or the AG and FTC investigations, so there is no reason to believe that the disclosure of the old news about *Archer* and *IQ Dental* should have caused a price decline, either. (In fact, Schein's stock price *rose* on the dates those two cases were filed on the public docket. [Ex. A])

The Complaint asserts that "the market for Schein stock promptly digested current information regarding Schein *from all publicly available sources* and reflected such information in Schein's stock price." [*Id.* ¶ 169 (emphasis added)] Plaintiff thus necessarily agrees that Schein's stock price reflected information about *all* of the publicly available lawsuits – including *Archer* and *IQ Dental* – and the news reports about them. Indeed, if Plaintiff thought otherwise, it could not obtain certification of the putative class, because it would not be able to invoke the presumption of reliance on which the Complaint depends [*id.* ¶¶ 168-69]. *See, e.g., Basic Inc. v. Levinson*, 485 U.S. 224, 242 (1988) ("Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented [plaintiffs] from proceeding with a class action, since individual issues then would have overwhelmed the common ones.").

Fourth, the actual sequence of market events on November 7 shows that the price drop had nothing to do with the disclosure of *Archer* and *IQ Dental*. Schein issued its third-quarter earnings release at 7:00 a.m., before the market opened. The earnings release did *not* mention either *Archer* or *IQ Dental*. Nevertheless, Schein's stock price promptly fell before the market opened [Ex. B], so the drop could not possibly have had anything to do with (nonexistent) news about those two cases; it obviously related only to the earnings report, which the Court has held is not actionable. Not until 2:10 p.m. did Schein issue its third-quarter Form 10-Q, which disclosed *Archer* and *IQ Dental*. The stock price then *rose* from $70.01 to close at $70.35 – thereby proving that the disclosure of those two cases did not cause any loss. [*Id.*]

Plaintiff therefore will not be able to assign *any* of the November 6 price decline to the disclosure of *Archer* and *IQ Dental*. The market clearly reacted to the disappointing earnings news, not to the disclosure of the two lawsuits that had been known to the market for years and simply recycled previously pled allegations. Thus, the only stock drop that could conceivably be relevant is the February 13, 2018 drop following the disclosure of the FTC enforcement action.

3. No Loss Causation from February 2018 Disclosures

The Court sustained Plaintiff's loss-causation allegations relating to the February 12, 2018 disclosure of the FTC's enforcement action. [MTD Decision at 58] But even if the FTC's decision to *sue* was a new development, Plaintiff will have difficulties in proving loss causation.

First, the market had been aware since at least 2015 that the FTC was investigating Schein, but Schein's stock price had not reacted to that news. Schein could not have disclosed the *results* of the FTC investigation (the FTC's decision to sue) any sooner than it did, and Plaintiff does not contend otherwise. Thus, the only "new" information that entered the market in February 2018 was the materialization of a *known* risk (the risk of an enforcement action) that could not have been disclosed earlier. But "materialization of a *known* risk, rather than the

disclosure of a *concealed* one, is not a plausible theory of loss causation." *In re New Energy Sys. Sec. Litig.*, 66 F. Supp. 3d 401, 406 n.33 (S.D.N.Y. 2014) (emphasis added; internal quotation omitted). The February 13, 2018 price decline thus cannot be a legal cause of Plaintiff's loss.

Second, the Court's denial of Schein's motion to dismiss as to the February 2018 news was predicated on the Court's acceptance of Plaintiff's allegation that the FTC lawsuit "revealed 'detail[ed] communications' between executives of Schein and Benco evidencing an anticompetitive agreement, attempts to monitor and ensure compliance with the agreement, and details concerning [Tim] Sullivan's role in the alleged agreement." [MTD Decision at 58 (quoting Complaint)] But, contrary to Plaintiff's allegation, no "new information" was revealed on February 12. On that day, the FTC issued nothing but a bare press release announcing the enforcement action; it did not publish its Complaint until three days later, on February 15.[4] Thus, *none* of the supposedly "detailed," "new" information in the FTC's Complaint entered the market on February 12 or 13, and it therefore could not have caused the price decline.

Moreover, Schein's stock price lost only 5 cents on February 15, the day the market first saw the contents of the FTC's Complaint. This decline from $68.43 to $68.38 – only 0.07% – was not statistically significant. The disclosure of the FTC's enforcement action thus does not adequately establish loss causation.

Third, if the stock drop on February 13 resulted from the announcement of the FTC's enforcement action (as Plaintiff contends), the fact remains that Schein *won* the enforcement

[4] Although the FTC's February 12 press release mentioned the existence of *unspecified* communications between Schein and Benco without describing what they were, the market had known from prior lawsuits and news articles that certain communications had occurred (many of which the FTC ALJ ultimately found did *not* evidence Schein's participation in any conspiracy). For example, Baird Equity Research's February 21, 2018 report on Schein discussed the FTC's Complaint and observed that, "[a]s we've discussed previously, discovery in past state cases uncovered emails between [Schein] and other dealers" about pricing. Baird thus did not view the FTC Complaint as alleging anything new.

action – it proved that the complaint that supposedly caused the stock drop was false. A corporation cannot be held liable for a stock drop based on the filing of a false complaint.

Fourth, even if Plaintiff could prove that disclosure of the FTC suit had some legally cognizable impact on Schein's stock price, it will not be able to prove that the *entire* impact resulted from the FTC news, and it will have difficulty disaggregating that portion of the price drop from the portion attributable to other factors – in particular, the market's concerns about impending competition from Amazon.

The FTC's enforcement action hit the press after the market had closed on February 12. On February 13, hours before the market opened, *The Wall Street Journal Online* reported that "Amazon has invited hospital executives to Seattle in recent months to sound out ideas for expanding the retailer's medical-supply business, and sent employees to a large Midwestern hospital to pilot its effort."[5] Market participants promptly attributed Schein's stock-price decline on February 13 at least in part to the news about a potential threat from Amazon. For example:

- On February 13, at 7:43 a.m., Seeking Alpha reported that "Med supply stocks drop as Amazon preps an entry." The article cited pre-opening price drops for Schein (5.5%), Owens & Minor ("Owens") (4.5%), and McKesson (4%), among others. The report did not mention the FTC's enforcement action, which had been disclosed the previous day.

- Leerink also published a report on February 13 observing that Schein, Owens, and Cardinal Health were "the most exposed" to Amazon's move into the medical-supply business. The report did not mention the FTC's suit. Owen's and Cardinal's closing stock prices were down 4.8% and 3.4%, respectively, on February 13, while Schein's was down 6.6%. The net-of-market returns were statistically significant for all three stocks.

- On February 14, Gabelli published a report titled "Double Whammy – Buy," attributing Schein's stock-price decline to both the FTC suit "and a WSJ article highlighting Amazon's push into healthcare distribution."

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[5] *Amazon's Latest Ambition: To Be a Major Hospital Supplier*, The Wall Street Journal Online, Feb. 13, 2018, 5:30 a.m.; *Amazon Targets a New Health-Care Customer: Hospitals*, Dow Jones Institutional News, Feb. 13, 2018, 5:30 a.m.

The market's concerns about Amazon in February 2018 were not surprising; they also had surfaced on prior occasions when news reports suggested that Amazon was moving into areas that could affect Schein's and similar companies' business models.

Thus, even if the news of the FTC suit affected Schein's stock price on February 13, 2018, and even if that impact could constitute legally cognizable loss causation although the risk of an enforcement action had been known for years, Plaintiff would still need to separate the portion of the price drop attributable to the FTC suit from the portion attributable to the market's renewed concerns about the potential threat from Amazon. That task would require a massive effort and a battle of experts.

II. RISKS OF OBTAINING AND MAINTAINING CLASS CERTIFICATION

Although Defendants have framed the above discussion in terms of lack of loss causation, they also will be able to use those points at the class-certification stage to defeat Plaintiff's invocation of a presumption of reliance, without which the putative class cannot be certified.

The Supreme Court held in *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258, 282 (2014), that, because an alleged misrepresentation's impact on stock price is "an essential precondition for any Rule 10b-5 class action," a court should not ignore "a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption [of reliance] does not apply." Thus, "defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock." *Id.* at 284; *see, e.g.*, *Ark. Teachers Ret. Sys. v. Goldman Sachs Grp.*, 879 F.3d 474, 485-86 (2d Cir. 2018) (vacating grant of class certification because lower court had erred in precluding defendants from showing that previous disclosures of news similar to that revealed in alleged "corrective disclosures" had not had any impact on stock price).

As shown above, the market received many disclosures starting in 2012 about the filing of and allegations in the private lawsuits and the AG and FTC investigations [Ex. A], but *none* of those disclosures was followed by a statistically significant (or, in some cases, any) drop in Schein's stock price. Thus, there is no reason to believe that the price drop following Schein's November 6, 2017 press release was caused by the mention of two lawsuits that had been pending on the public docket and had been disclosed in other publicly available materials. (And the chronology described above shows that any such causal linkage was impossible) Similarly, the prior news about the FTC investigation undermines the Court's conclusion at the pleading stage that the February 12, 2018 disclosure of the FTC's bare press release announcing the enforcement action – without any of the allegations in the FTC's Complaint – caused all or perhaps even most of the stock drop on February 13, 2018. Schein will be entitled to present that evidence at the class-certification stage to rebut the presumption of reliance.

CONCLUSION

The Court therefore should grant preliminary approval of the proposed settlement.

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Respectfully submitted,

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