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**SOFTWARE DISCLOSURE AND LIABILITY UNDER THE SECURITIES ACTS****Introduction**

*Can a software company be liable under the securities laws when it sells securities without disclosing that it will not give free updates on current software as new technology makes them obsolete? What exactly must be disclosed and how does one say it without subjecting the company's business practices to close scrutiny? The Eleventh Circuit recently applied the time-honored standard of meaningful cautionary language to software companies in finding that the disclosures of a software company were enough to avoid liability under the securities laws when the company provided meaningful cautionary language in their prospectus.<sup>1</sup>*

**Ehlert v. Singer**

¶ 1 Medical Manager Corporation was one of the leading providers of software to the healthcare industry. Among other things, they provided computer management systems to the health care industry. Most of their sales, and thus most of their revenues, were derived from their product known as Medical Manager, a practice management system. In 1994, Medical Manager Corporation began selling "Version 8" of its Medical Manager software. In February 1997, Medical Manager Corporation made an initial public offering and thus became a publicly traded company subject to the provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934. In 1997 Medical Manager Corporation also released "Version 9" of its Medical Manager software. Version 9 was the first version of Medical Manager Corporation's Medical Manager software that was year 2000 compliant. On April 23, 1998, Medical Manager Corporation conducted a secondary public offering at an offering price of \$30 per share, selling 2.5 million shares. On August 5, 1998, information circulated publicly that a class action lawsuit had been filed against Medical Manager Corporation for its refusal to provide free upgrade service for its Version 8 software in order to make that software year 2000 compliant. News of this lawsuit and Medical Manager Corporation's refusal to provide the software upgrades drove the stock price of Medical Manager Corporation down from \$26.75 per share to \$20.375 per

share.

¶ 2 On August 31, 1998, Medical Manager Corporation issued a statement saying it was "no longer enhancing, updating or maintaining versions prior to Version 9" and that it would make "no representations with respect thereto, including those concerning the current or future ability of Version 8 or prior versions to handle industry and regulatory requirements."<sup>2</sup> A group of shareholders then filed suit for shares they had purchased on or about April 24, 1998, at the offering price of \$30 per share. The Plaintiffs alleged that "[d]efendants' issuance of materially false and misleading statements and omissions in the prospectus and registration statement, issued as part of the secondary public offering, caused the class to purchase the stock at artificially inflated prices."<sup>3</sup> The Plaintiffs' major claim was that the prospectus filed as part of MMC's registration statement was materially false and misleading for failing to state that MMC's Version 8 would no longer be enhanced or upgraded and that Version 9 would essentially render it obsolete.

### **Legal Basis for the Claim**

¶ 3 The Plaintiffs based their claim on Sections 11 and 12(a)(2) of the Securities Act of 1933. Section 11 of the Act allows for a private cause of action where a registration statement either "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."<sup>4</sup> Section 12(a)(2) allows for a private cause of action against those who either offer or sell a security "which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading."<sup>5</sup> Section 12 liability extends to those who transfer title to the security and to those who successfully solicit for profit the purchase of the security.<sup>6</sup> In order for the Plaintiffs to state a cause of action, they had to provide evidence that MMC made a material misstatement or omission in its prospectus that was filed in conjunction with the registration statement. The Plaintiffs pointed to two statements made in the prospectus that they alleged led to the material misstatement. First the Plaintiffs alleged that MMC made a misleading statement by saying, "the Company's future success will depend, in part, upon its ability to enhance its current products, to respond effectively to technological changes, to sell additional products to its existing client base and to introduce new products and technologies that address the increasingly sophisticated needs of its clients."<sup>7</sup> Second, Plaintiffs alleged that MMC's statement that "the Company is devoting significant resources to the development of enhancements to its existing products and the migration of existing products to new software

platforms"<sup>8</sup> was misleading. The Plaintiffs argued that by making these statements without disclosing the company's lack of intent to provide upgrades for Version 8, thereby essentially making it obsolete upon the introduction of Version 9, MMC made materially misleading statements.

¶ 4 The Private Securities Litigation Reform Act of 1995 (PSLRA) provides a "Safe Harbor" to companies for certain forward-looking statements.<sup>9</sup> Since MMC's statements fall into the PSLRA's definition of forward-looking statements they will fall into this safe harbor so long as they are surrounded by meaningful cautionary language. In its prospectus, MMC informed investors "the market for the Company's products is characterized by rapid change and technological advances requiring ongoing expenditures for research and development and the timely introduction of new products and enhancements of existing products."<sup>10</sup> MMC also warned investors that "there can be no assurance that the Company will successfully complete the development of new products or that the Company's current or future products will satisfy the needs of the market for practice management systems."<sup>11</sup> MMC also provided the following cautionary language.

"Any failure of the Company's products to provide accurate, confidential and timely information, including failures which may be traceable to the Year 2000 issue, could result in product liability or breach of contract claims against the Company by its clients, their patients or others . . . There can be no assurance that the Company will not be subject to product liability or breach of contract claims . . . the Year 2000 issue relates to whether computer systems will properly recognize and process information relating to dates in and after the year 2000. These systems could fail or produce erroneous results if they cannot adequately process dates beyond the year 1999 and are not corrected. Significant uncertainty exists in the software industry concerning the potential consequences that may result from failure of software to adequately address the Year 2000 issue. The Year 2000 issue also creates risk for the Company from problems that may be experienced by customers of its software. While the Company believes that Version 9 of The Medical Manager practice management system, which was commercially released in November 1997, is Year 2000 compliant, prior versions of the system are not. The Company has encouraged users of pre-Version 9 versions of the Medical Manager software to upgrade to Version 9 in order to become Year 2000 compliant. If these or other customers experience significant difficulties as a result of the Year 2000 issue, or if the Company encounters difficulties in responding in a timely manner to customer requests to upgrade to Version 9, there could be a material adverse

impact on the Company's results of operations, financial condition or business."<sup>12</sup>

¶ 5 Because the Court found the preceding language to be meaningful cautionary language within the meaning of the PSLRA, MMC's statements fell in the safe harbor and were not materially false or misleading. In making this decision the Court stated that, in order to qualify for the safe harbor provided by the PSLRA, the cautionary language must only mention "important factors that could cause actual results to differ materially from those in the forward-looking statement."<sup>13</sup> There is no requirement that the prospectus list every factor that may influence the company's financial future.<sup>14</sup> The meaningful cautionary language need not explicitly mention the factor that eventually causes the company's loss. The company must only list dangers generally similar to the one the company eventually faces. "When an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward."<sup>15</sup>

### **Conclusion**

¶ 6 As technology continues to grow at a rapid pace, businesses must be alert to the need for meaningful cautionary language in their prospectuses concerning the possibility of their current products becoming obsolete. Although meaningful cautionary language may not protect a company from a lawsuit, if the language is adequate it will protect them from liability under the securities laws by preventing their prospectuses from containing materially false and misleading statements.

*Written By:  
Carl C. Carl*

### **Footnotes**

<sup>1.</sup> See *Ehlert v. Singer*, 2001 U.S. App. LEXIS 5290 (11th Cir, 2001).

<sup>2.</sup> *Id.* at 2.

<sup>3.</sup> *Id.* at 3.

<sup>4.</sup> 15 U.S.C. §77(k).

[5.](#) 15 U.S.C. §77(l)(a)(2).

[6.](#) *See Pinter v. Dahl*, 486 U.S. 622, 642-46, 108 S. Ct. 2063, 2075-78, 100 L. Ed. 2d 658 (1988).

[7.](#) *Id.* at 6.

[8.](#) *Id.* at 6.

[9.](#) *See* 15 U.S.C. §77(z)(2).

10.*Id.* at 13.

11.*Id.* at 8-9

12.*Id.* at 14-16.

13.*Id.* at 17.

14.*See Harris v. Ivax Corp.*, 82 F.3d 799, at 807.

15.*Ehlert*, at 17-18.