CA No. 15-55173

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

IN RE: QUALITY SYSTEMS, INC. SECURITIES LITIGATION

CITY OF MIAMI FIRE FIGHTERS' AND POLICE OFFICERS' RETIREMENT TRUST, et al.,

Plaintiffs-Appellants,

v.

QUALITY SYSTEMS, INC., et al.,

Defendants-Appellees.

On Appeal from the United States District Court
for the Central District of California, No.-8:13-cv-01818-CJC-JPR

Honorable Cormac J. Carney

BRIEF OF THE WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR REHEARING EN BANC

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1, *Amicus Curiae* Washington Legal Foundation (WLF) states that it is a nonprofit corporation organized under § 501(c)(3) of the Internal Revenue Code. WLF has no parent corporation and issues no stock owned by a publicly held corporation.

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I. STATEMENT OF INTEREST OF *AMICUS CURIAE*

The Washington Legal Foundation ("WLF") is a nonprofit public-interest law and policy center with supporters in all fifty states.* WLF devotes a substantial portion of its resources to defending free enterprise, individual rights, and a limited and accountable government. To that end, WLF has appeared before this and other federal courts in numerous cases related to the proper scope of the federal securities laws. *See, e.g.*, *Cal. Pub. Emps' Ret. Sys. v. ANZ Sec.*, 137 S. Ct. 811 (2017); *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015).

II. SUMMARY OF ARGUMENT

To encourage companies to disclose internal assessments of their future business prospects, Congress created a "Safe Harbor" from securities law liability for forward-looking statements. The Safe Harbor has two prongs: a forward-looking statement is not actionable *either* (1) if it is accompanied by meaningful cautionary statements disclosing important risk factors that could cause the prediction not to be realized, *or* (2) if it is made without actual knowledge of its falsity. 15 U.S.C. § 78u-5(c)(1). As this Court has acknowledged, legislative history shows that Congress intended the first prong to be an *objective* test, without any inquiry into the speaker's state of mind. *See In re Cutera Sec. Litig.*, 610 F.3d 1103, 1112–13 (9th Cir. 2010).

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* Pursuant to Fed. R. App. P. 29(a)(4)(E), no party's counsel authored any part of this brief, and no person other than *amicus curiae* or its counsel made any monetary contribution to the preparation or submission of this brief. Pursuant to 9th Cir. R. 29-2(a), all parties have consented to the filing of this brief.

Unfortunately, like many courts before it, the panel in this case interpreted the Safe Harbor in a way that thwarts the statute's purpose because of its discomfort with the Safe Harbor's apparent "license to defraud." By holding that cautions cannot be "meaningful" unless they also disclose the falsity of related statements of present or past fact, the panel's decision adopts an inflexible rule that effectively nullifies the Safe Harbor's first prong by disregarding all other cautionary disclosures that a company may have made.

This Court should grant rehearing en banc not merely to correct the panel's errors, but to provide guidance for all courts in this circuit on the proper application of the Safe Harbor—a centerpiece of the Reform Act that has generated much confusion, and that courts all too often simply seek to avoid. The Court should reaffirm that the Safe Harbor's first prong is an *objective* standard, and that the "meaningfulness" and "importance" of cautionary statements should be determined through an examination of the content and quality of those statements themselves, viewed in the context of the company's disclosures and other relevant judicially noticeable information—just as the U.S. Supreme Court has directed for judging allegations of falsity and scienter. *See, e.g.*, *Omnicare*, 135 S. Ct. at 1327–30; *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322–23 (2007). That standard will also provide clear guidance for companies to follow.

III. ARGUMENT

A. Congress Enacted the Safe Harbor to Encourage Forward-Looking Statements.

The Safe Harbor was one of several substantial reforms enacted as part of the Private Securities Litigation Reform Act of 1995 (the "Reform Act").

Congress adopted the Safe Harbor because "the investing public and the entire U.S. economy have been injured by the unwillingness * * * of issuers to discuss publicly their future prospects, because of fear of baseless and extortionate securities lawsuits." H.R. Rep. No. 104-369, at 31–32 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 730–31. The Conference Committee noted the testimony of former SEC Chairman Richard Breeden, who explained that the threat of litigation created a "chilling effect" on corporate disclosure that harmed investors because "[u]nderstanding a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm." *Id*. at 42–43. The Committee also cited a study showing that over two-thirds of venture capital firms were reluctant to discuss their performance publicly due to the threat of litigation, and anecdotal evidence that corporate counsel routinely advised companies to say as little as possible, "so as to provide no grist for the litigation mill." *Id*. at 43 (citation omitted).

To encourage companies to be more forthcoming about their future prospects, Congress adopted the two-pronged Safe Harbor. Under the first prong, designated forward-looking statements accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially" are not actionable. *Id*. Congress intended this prong to set an *objective* standard: "Courts should not examine the state of mind of the person making the statement" but rather should "examine only the cautionary statement accompanying the forward-looking statement." *Id*. at 44.

But as the Conference Committee emphasized, the "meaningful" and "important factors" prong has real teeth—"boilerplate warnings will not suffice"; nor will a "cautionary statement that misstates historical facts." *Id*. at 43–44. Rather, "[t]he cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuer's business." *Id*. Moreover, such cautionary statements "must be relevant to the projection and must be of a nature that the factor or factors could actually affect whether the forward-looking statement is realized." *Id*. at 43–44.

At the same time, Congress recognized that companies cannot predict the future with perfect accuracy. So the Committee stressed that "important factors" does *not* mean "all factors." *Id*. at 44. In particular, "[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor." *Id*. The Committee stated that the Safe Harbor was not intended "to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made." *Id*.

The Safe Harbor's second prong—protecting forward-looking statements made without "actual knowledge" that they were false or misleading—was intended as an "alternative analysis." *Id*. Unlike the first prong, it "focuses on the state of mind of the person making the forward-looking statement." *Id*. The Senate bill preceding the Conference Committee's final version of the Reform Act contained a *conjunctive* scienter requirement—to fall within the Safe Harbor, a forward-looking statement had to *both* (1) be accompanied by meaningful cautionary statements *and* (2) be made without a purpose and actual intent to mislead. *See* S. 240, 104th Cong. § 105 (1995) (as passed by the Senate June 28, 1995), *reprinted in* 141 Cong. Rec. 17,444, 17,447–48. Congress's decision to make the meaningful-cautions and actual-knowledge requirements *disjunctive* in the final bill manifests Congress's clear intent to make the first prong an unambiguous, independent, and objective standard that companies could rely upon in making their business forecasts public.

B. Courts Have Shown Discomfort in Applying the Safe Harbor.

Yet courts have struggled with the apparent implication of the Safe Harbor's disjunctive structure: that a company may *intentionally* make false or misleading forward-looking statements so long as they are accompanied by "meaningful" cautionary statements identifying "important" risk factors. That implication led the First Circuit to describe the Safe Harbor as a "curious statute, which grants (within limits) a license to defraud." *In re Stone & Webster, Inc. Sec. Litig.*, 414 F.3d 187, 212 (1st Cir. 2005). Judicial discomfort with this seeming "license to defraud" has led many courts to interpret the Safe Harbor in a manner inconsistent with Congress's intent.

For example, in *Asher v. Baxter Int'l, Inc.*, 377 F.3d 727, 734 (7th Cir. 2004), even Judge Easterbrook—hardly a jurist inclined to depart from the statutory text—read into the Safe Harbor the word "the" before "important" in the phrase "identifying important factors[.]" Judge Easterbook held plaintiffs were entitled to discovery into whether "the items mentioned in Baxter's cautionary language were those that at the time were the (or any of the) ‘important’ sources of variance.” *Id*. He noted that Baxter’s “cautionary language remained fixed even as the risks changed,” so it was unclear without discovery whether “Baxter omitted important variables from the cautionary language.” *Id*. Judge Easterbrook’s insertion of “the” before “important” is contrary to Congress’s clear intent that “not all factors” must be identified, and that the “important” requirement was never intended to open the door to discovery. *See* H.R. Conf. Rep. No. 104-369, at 44.

Another way courts have misinterpreted the Safe Harbor is to read a scienter requirement into the first prong—that is, to convert the “or” to an “and.” Despite concerns about a “license to defraud,” every Circuit to consider the issue (including this one) has correctly interpreted the plain text of the Safe Harbor as setting forth disjunctive requirements—that is, “or” means “or.” *See OFI Asset Mgmt. v. Cooper Tire & Rubber*, 834 F.3d 481, 502 (3d Cir. 2016); *IBEW Local 98 Pension Fund v. Best Buy Co., Inc.*, 818 F.3d 775, 778 n.2 (8th Cir. 2016); *Cutera.*, 610 F.3d at 1111–12; *Slayton v. Am. Express Co.*, 604 F.3d 758, 766 (2d Cir. 2010); *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 794–95 (11th Cir. 2010); *Stone & Webster*, 414 F.3d at 195; *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 371 (5th Cir. 2004); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 548 (6th Cir. 2001) (en banc), *overruling on other grounds recognized by Ricker v. Zoo Entm’t, Inc.*, 534 Fed. App’x 495 (6th Cir. 2013). Nevertheless, several district courts have interpreted the “meaningful” requirement in a manner that effectively turns “or” into “and” by holding that actual knowledge that the forward-looking statement is false means the cautionary language can never be meaningful. *See, e.g.*, *In re Genworth Fin. Inc. Sec. Litig.*, 103 F. Supp. 3d 759, 790 (E.D. Va. 2016); *City of Ann Arbor Emps' Ret. Sys. v. Sonoco Prods. Co.*, 827 F. Supp. 2d 559, 576 (D.S.C. 2011); *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 193–94 (S.D.N.Y. 2010); *In re SeeBeyond Techs. Corp. Sec. Litig*., 266 F. Supp. 2d 1150, 1163–67 (C.D. Cal. 2003).

Here, the panel's apparent discomfort with the Safe Harbor has likewise led it to interpret the statute in a manner inconsistent with congressional intent. The panel announced a new, bright-line rule for "mixed" statements—that is, "[w]here a forward-looking statement is accompanied by a non-forward-looking factual statement that supports [it]"—that would essentially eviscerate the first prong of the Safe Harbor in most cases. *See* Slip Op. at 30. According to the panel, "[i]f the non-forward-looking statement is materially false or misleading, it is likely that no cautionary language—short of an outright admission of the false or misleading nature of the non-forward-looking statement—would be 'sufficiently meaningful' to qualify the statement for the safe harbor." *Id*. The panel held that for "mixed" statements, whether "the non-forward-looking statements are, or may be, untrue is clearly an 'important factor' of which investors should be made aware." *Id*. at 33.

The panel's analysis conflicts with Congress's intent in two distinctly misguided ways. First, like *Baxter*, the panel focuses on the absence of cautionary language regarding a *particular* "important factor," which essentially reads "the" into the statute before the words "important factors." But not *all* important factors must be disclosed; even the failure to disclose the actual factor that causes the projections to be inaccurate is not necessarily fatal. *See* H.R. Conf. Rep. No. 104-369, at 44.

Second, the panel's categorical rule provides that cautionary language cannot be "meaningful" absent an admission that related statements of present or past fact are false or misleading—even if the company did not *know* that the related statements were false or misleading. That is even worse than the cases that impermissibly turn "or" into "and." Of course, any importation of a scienter requirement into the Safe Harbor's first prong would be contrary to this Court's precedent. *See Cutera*, 610 F.3d at 1111–12. But by not even requiring scienter in making cautionary statements, the panel's rule would effectively create strict liability for companies who inadvertently misstate present or historical facts in connection with a forward-looking statement. Such a result is plainly contrary to Congress' intent to *encourage* companies to make forward-looking disclosures.

The panel's rule would nearly swallow the first prong of the Safe Harbor whole. Companies routinely provide earnings guidance on quarterly analyst calls, during which they also discuss past results and current facts about the business, often in response to direct questions from analysts. Under the panel's rule, those projections might be considered "mixed" statements, and therefore any misstatement regarding the present or past state of the business would nullify the first prong of the Safe Harbor for the projections. The practical result will likely be the very problem Congress sought to address: companies will cease disclosing earnings projections and other information about future business prospects.

C. The Court Should Adopt an Objective Standard for "Meaningful" Cautionary Statements Identifying "Important" Risk Factors.

The panel's bright-line rule is also inconsistent with recent Supreme Court securities-law precedent, which requires courts to examine the defendants' statements in their full judicially noticeable context. The Court should rehear this case en banc and adopt an independent and objective standard for the "meaningful cautionary statements" prong of the Safe Harbor that is consistent with the Supreme Court's directives and provides companies with clear and coherent guidance that will give them confidence when making forward-looking statements.

1. To determine whether cautionary statements are "meaningful" and disclose "important factors," courts should examine the content and quality of the statements themselves.

In *In re Harman Int'l Indus., Inc. Sec. Litig.*, 791 F.3d 90 (D.C. Cir. 2015), *cert. denied*, 136 S. Ct. 1167 (2016), the District of Columbia Circuit turned to a tried and true source—the dictionary—to support an objective standard under the Safe Harbor's first prong. The court observed that "meaningful" means "significant" or of "useful quality or purpose," and that "important" likewise means something "of great significance or value." *Id*. at 101 (citations omitted). Building on those definitions, the court ruled that the first prong of the Safe Harbor required cautionary language "that is tailored to a particular company's status at a particular time" as well as to "the [particular] forward-looking statement that it accompanies." *Id*. at 101–02. "[M]ere boilerplate" and "generalized warnings" that actual results may vary would not suffice, for such language "is not specific regarding the business at issue." *Id*. at 102. Likewise, cautionary language that misstates historical facts is not "significant" or "useful," and so would not invoke

Safe Harbor protection. *Id*. at 102–03. Cautionary language can, however, be "meaningful" even if it does not disclose *all* of the "important" factors—including the one that ultimately renders the forward-looking statement inaccurate. *Id*. at 103. *Harman*'s focus on the objective *content* and *quality* of the cautionary language—rather than the state of mind of the person providing it—coheres with congressional intent. *See* H.R. Conf. Rep. No. 104-369, at 43–44.

Such a standard is also workable from the perspective of company management in providing guidance to investors—the Safe Harbor's animating purpose. The *Harman* standard would require a company to disclose what are essentially "the real risks." *See* Douglas Clark, "Client Alert: How Safe is the Safe Harbor?," June 2005, at 3, *available at* https://www.wsgr.com/publications/pdfsearch/clientalert_safeharbor.pdf. While the "real risks" cannot be identified in the abstract, they have objective characteristics consistent with the *Harman* standard: (1) "they change all the time, so if the safe harbor risks don't change over time, they are not real risks"; (2) they are specific to the particular forward-looking statement to which they apply; *i.e.*, "the same risks that apply to a statement concerning financial projections don't apply to a statement concerning the release of a new product"; and (3) they "are rarely, if ever, vague." *Id*. And, most importantly, "[a]ll companies face real risks," and the company itself is in the best position to identify and disclose them. *Id*. Tailored, detailed risk factors demonstrate an effort on the part of the company to identify the "real risks." But that is *not* to say that courts should inquire into company management's state of mind—no company is perfectly prescient, and a company's failure to identify the risk that ultimately manifested does not mean that its other detailed disclosures of risk factors were not "meaningful" or "important."

2. Using context, courts can evaluate cautionary statements objectively.

But how can we know if a company has actually identified the "real risks" without a subjective inquiry? That is the question posed (but not satisfactorily answered) by the Second Circuit in *Slayton*, 604 F.3d 758. *Slayton* correctly observed that "the Conference Report makes quite plain that it does not want courts to inquire into a defendant's state of mind." *Id*. at 771. Yet the court lamented that it could not assess whether the cautionary language identified "important" factors without "some reference by which to judge what the realistic factors were at the time the statement was made." *Id*. The court reasoned that the most "sensible reference" required "an inquiry into what the defendants knew" at the time the statements were made. *Id*. The court implored Congress to provide "further direction on how to resolve this tension," asking, "May an issuer be protected by the meaningful cautionary language prong of the safe harbor even where his cautionary statement omitted a major risk that he knew about at the time he made the statement?" *Id*. at 772.

But the Second Circuit's assumption that identifying the "real risks" requires a subjective inquiry is mistaken. Courts regularly use the overall context of a statement to make complex assessments of its import—even on motions to dismiss. For example, in *Omnicare*, 135 S. Ct. 1318, the Supreme Court considered when a statement of opinion can be actionable as a false or misleading statement. The Court explained that whether a statement of opinion is "false" turns on whether the speaker actually holds the opinion—a subjective inquiry. *Id*. at 1326. But in most cases—including *Omnicare*—investors also allege that statements were "misleading" because they omitted facts that undermine them. *See id*. at 1327. That, the Court held, is an "objective" inquiry that "depends on the perspective of a reasonable investor." *Id*. And importantly, "whether an omission makes an expression of opinion misleading always depends on context." *Id*. at 1330. The Court observed that investors review a company's statement, "whether of fact or of opinion, in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information," and "tak[ing] into account the customs and practices of the relevant industry." *Id*. A plaintiff must show that a statement is objectively misleading in light of this "full context." *Id*.

Even in an area as explicitly subjective as the scienter analysis, courts rely on objective cues to make judgments at the pleading stage in the absence of direct evidence of a defendant's state of mind. In *Tellabs*, 551 U.S. at 322, the Supreme Court held that, to determine whether a securities fraud plaintiff has alleged facts giving rise to a "strong inference" of scienter as required by the Reform Act, "courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice." "The inquiry * * * is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id*. at 322–23 (emphasis in original). But "the court must [also] take into account plausible opposing inferences." *Id*. at 323. "The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts?" *Id*.

Courts can likewise look to the objective context of cautionary statements to determine whether they are "meaningful" and disclose "important" risk factors. How closely tailored are the risk factors to the forward-looking statements they support? Are they particular to this company, or could they apply to anyone? Have the risk factors applied to forward-looking statements evolved over time as the overall risk factors facing the business—as disclosed in the company's annual and quarterly reports, press releases, and other public information incorporated into the complaint or subject to judicial notice—have changed? Do the risk factors address additional historical facts that have recently been disclosed in public filings? In short, does it appear that the company has made a genuine effort to identify the "real risks," as opposed to simply issuing boilerplate cautions? Those questions can be answered without inquiring into company management's state of mind. Context provides an objective basis to evaluate cautionary language on a motion to dismiss.

Here, the panel's bright-line rule permits no such nuanced contextual analysis, and is therefore inconsistent not only with congressional intent, but with the Supreme Court's context-based standards in other areas of securities law.

3. An objective analysis does not amount to a "license to defraud."

But, the Court may ask, doesn't an objective standard for "meaningful cautionary statements" give companies a "license to defraud"? It is possible that a company could technically escape liability for knowingly false earnings forecasts if it accompanies them with robust and detailed cautionary language. As a practical matter, however, the risk of such conduct is small and—in the judgment of Congress—outweighed by the salutary effects of encouraging companies to disclose their future prospects without fear of liability.

Quite apart from the threat of liability, "market discipline" provides a strong disincentive for companies to provide knowingly inaccurate projections. *See* S. Rep. No. 104-98, at 18 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 697. Unlike other aspects of its business that a company might seek to mislead investors about, the "truth" about the company's earnings cannot be hidden in the long term—it is *certain* to come out when the company has to make its next earnings report. And it is equally certain that the market will swiftly punish a company that misses its projections. That fact is unlikely to be lost on company management, whose job security and future earnings (both in salary and long-term incentives) are typically closely tied to the company's stock performance. Any short-term gain from overly rosy projections is likely to be erased—and then some—by disappointing actual results, as investors lose confidence in management's credibility and effectiveness. And common sense suggests that a company that is willing to lie about its earnings forecasts and other future business prospects despite the obvious consequences probably has also made false or misleading statements that are not protected by the Safe Harbor.

In any event, the meaningful cautions themselves will ameliorate any risk that investors will unduly rely on a company's predictions. The Safe Harbor's first prong was largely a codification of the judicially-created "bespeaks caution" doctrine, and particularly the Third Circuit's explication of it in *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993). *See* Richard F. Conklin, *Why "Or" Really Means "Or": In Defense of the Plain Meaning of the Private Securities Litigation Reform Act's Safe Harbor Provision*, 51 B.C.L. Rev. 1209, 1225–26 (2010). The Third Circuit's articulation of the "bespeaks caution" doctrine is rooted in a *materiality* analysis—that is, whether a forward-looking statement is "material" depends on "the complete context" in which the statement is conveyed, including the "meaningful cautionary statements" that accompany it. 7 F.3d at 364, 369, 371–73. The Safe Harbor's first prong thus embodies Congress's judgment that forward-looking statements accompanied by "meaningful cautionary statements" are rendered immaterial as a matter of law—thereby making the speaker's state of mind irrelevant.

Judicial discomfort with the Safe Harbor is understandable. Courts exist to do justice, and no court wants to let companies get away with deliberately misleading investors. But even with the protections afforded by a proper interpretation of the Safe Harbor, the risk that a company will escape liability under it is small, and any potential harm is mitigated by the meaningful cautionary statements themselves. Plaintiffs typically challenge a wide range of statements, including some that are not covered by the Safe Harbor. If any of those survives a motion to dismiss, the case will move forward, regardless of the Safe Harbor protection of other statements. Most importantly, in enacting the Reform Act, Congress made a determination that incentivizing companies to provide forward-looking information—qualified by meaningful cautions—outweighed any risk that companies would commit deliberate fraud in doing so. Courts must respect Congress's judgment, and not supplant it with their own.

IV. CONCLUSION

The Court should grant the petition for rehearing en banc so that it may adopt an unambiguous, objective, and workable standard for applying the Safe Harbor that is consistent with the congressional intent behind it.

Dated: September 15, 2017

Respectfully submitted,

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CERTIFICATION OF COMPLIANCE

1. This brief complies with the type-volume limitation of 9th Cir. R. 29-2(c)(2) and Fed. R. App. P. 32(a)(7)(B) because this brief contains 4,191 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii) & 32(f).

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2010 14 point Times New Roman font.

Dated: September 15, 2017

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CERTIFICATE OF FILING AND SERVICE

I hereby certify that I filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on September 15, 2017.

I certify that all parties in the case are registered CM/ECF users and that service will be accomplished by the CM/ECF system. Dated: September 15, 2017

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