NO. 06-15454

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRENT BERSON,
Individually and on Behalf of All Others Similarly Situated,
Plaintiff,

and

FRANK WHITING,
Plaintiff-Appellant,

v.

APPLIED SIGNAL TECHNOLOGY, INC., GARY YANCEY AND JAMES DOYLE,
Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of California, Oakland Division

Reply Brief of Plaintiff-Appellant Frank Whiting

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INTRODUCTION

Plaintiff's case is simple. Defendants announced impressive backlog numbers without disclosing that they had received stop-work orders affecting their ability to turn that backlog into revenue. When Defendants belatedly disclosed the first stop-work order ("SWO1"), Applied Signal's stock plummeted. When they subsequently disclosed revenue and earnings that were negatively impacted by additional undisclosed stop-work orders, Applied Signal's stock plummeted again. Before the final substantial stock drop, Defendant Yancey sold over 40 percent of his company stock.

Contrary to Defendants' arguments, Defendants had a duty to disclose the stop-work orders because it was materially misleading to report backlog while concealing stop-work orders. The statutory safe-harbor is inapplicable because backlog is not "forward-looking," and Defendants did not provide "meaningful" cautionary language. The Complaint alleges misleading statements with adequate detail, supports a strong inference of scienter, and pleads "loss causation."

ARGUMENT

I. DEFENDANTS HAD A DUTY TO DISCLOSE STOP-WORK ORDERS WHEN THEY REPORTED BACKLOG

A. Defendants' Backlog Announcements Were Materially Misleading

Defendants wrongly claim that Plaintiff's case depends on a duty to disclose stop-work orders "in real time" – as soon as they were received. Brief of

Defendants/Appellees ("DB") at 21, 35 (Aug. 28, 2006). Elsewhere in their brief, however, Defendants acknowledge that Plaintiff never made such a claim. DB at 19-20. They eagerly attack arguments that Plaintiff did not make but cannot refute the argument Plaintiff actually *did* make: that a duty to disclose exists whenever Defendants make statements that mislead by omitting materially adverse facts. See Brief of Plaintiff-Appellant Frank Whiting ("PB") at 24-25 (June 16, 2006). Nor do Defendants dispute that it is improper to grant a motion to dismiss unless no reasonable person could find the challenged statements misleading. *See* PB at 19.

Reasonable minds *could* find that Defendants' failure to disclose existing stop-work orders rendered their reported backlog numbers misleading; indeed, it would be difficult to conclude otherwise. Even Defendants – belatedly – felt compelled to disclose SWO1 and discuss its impact on backlog when they filed their September 9, 2004 10Q Report. Consolidated Amended Class Action Complaint ("Compl."), ¶ 29(a), Excerpts of Record ("ER") at 11. They assuredly would not have done so if they did not believe stop-work orders were material to an understanding of the quality of their backlog. Defendants had a duty to provide this information about each of the stop-work orders when they reported backlog.

B. The Supposedly "Contingent" Nature of Stop-Work Orders Does Not Relieve Defendants of the Duty to Disclose Them

Because Defendants' backlog numbers were misleading without disclosure of existing stop-work orders, they had a duty to disclose. This duty is unaffected

by the supposedly "preliminary" or "contingent" nature of stop-work orders. DB at 39-40. *See, e.g., In re Amylin Pharma. Sec. Litig.*, No. 01 CV 1455BTM (NLS), 2002 WL 31520051 * 5 (S.D. Cal. Oct. 10, 2002) (public statements created duty to disclose FDA concerns, even though FDA's approval process "is highly uncertain and drug companies engage in a 'continuous dialogue' with regulators"); *see also* cases cited in PB at 29 n.5.[1] Moreover, stop-work orders do have immediate impacts which are not contingent – they immediately prevent the Company from generating revenue from the affected portion of the contract. *See* PB at 29-30.

C. Defendants Failed to Disclose Active Stop-Work Orders

Contrary to Defendants' arguments, the four stop-work orders were active when Defendants announced backlog.

[1] The cases cited by Defendants are not to the contrary. *Kalnit v. Eichler*, 264 F.3d 131, 144 (2d Cir. 2001), declined to disturb the District Court's finding that plaintiff sufficiently alleged materially misleading statements. *See Kalnit v. Eichler*, 85 F. Supp. 2d 232, 240 (S.D.N.Y. 1999). *City of Sterling Heights Police & Fire Ret. Sys. v. Abbey Nat'l, PLC*, 423 F. Supp. 2d 348, 360 (S.D.N.Y. 2006), also found a duty to disclose based on materially misleading statements. Other cases turned on factual determinations that concealed information did not render public statements misleading. *See Oxford Asset Management, Ltd. v. Jaharis*, 297 F.3d 1182, 1192 (11th Cir. 2002) (prospectus *predicted* slow sales; failure to disclose confirmatory preliminary data not misleading); *Financial Acquisition Partners, L.P. v. Blackwell*, No. Civ. A.-3:02-CV-1586-K, 2004 WL 2203253 (N.D. Tex. Sept. 29, 2004) (failure to disclose hiring of restructuring specialist did not render statements about company's present financial condition misleading); *In re SeaChange, Int'l, Inc. Sec. Litig.*, No. Civ. A-02-12116-DPW, 2004 WL 240317 (D. Mass. Feb. 6, 2004) (knowledge about merits of patent claim did not render misleading statement that outcome of litigation was uncertain). *In re CDNOW, Inc. Sec. Litig.*, 138 F. Supp. 2d 624, 630 n.5 (E.D. Pa. 2001), the only potentially misleading statement occurred prior to the Class Period and was therefore inactionable.

1. Stop-Work Order 1 Was "Active" on August 24, 2004

Defendants' claim that the Complaint is "silent" about the status of SWO1 on August 24, 2004, when Defendants announced $111 million in backlog (DB at 38-39, 21, 41) is nonsensical. The Complaint alleges that Defendants received SWO1 in June of 2004 and that it was still in effect on January 14, 2005. Compl., ¶¶ 29 & 34, ER at 10-13. Since SWO1 was issued in June of 2004 and remained in effect in February of 2005, it was "active" on August 24, 2004.

Defendants confuse the issue by arguing that SWO1 was "about to expire" on August 24, 2004, under the terms of the applicable contracting regulations. DB at 21, 38-41. The regulations, however, expressly permit parties to extend stop-work orders beyond 90 days, and also authorize the government to cancel the affected portions of a contract. 48 C.F.R. 52.242-15(a), PB, Statutory/Reglatory Addendum, at ix. Therefore, the only legally relevant question is whether SWO1 *had* expired on August 24, 2004. Since it had not, Defendants had a duty to disclose its present and potential future impact on the affected contract when they reported backlog – even if they sincerely hoped that it *would* expire. *See, e.g.*, *In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 598 (D.N.J. 2001) and cases cited in PB at 29, n.5.[2]

[2] Defendants similarly argue that Stop-Work Order 2 ("SWO2") "probably would have expired" by August 24, 2004. DB at 11-12. This argument improperly requires the Court to resolve factual issues in Defendants' favor on a motion to dismiss. The Court would have to find – with no support in the record – that

2. Stop-Work Order 3 Was "Active" on December 21, 2004

Defendants wrongly argue that Stop-Work Order 3 ("SWO3"), which was received in August or September of 2004, *must* have expired after 90 days, and thus *must* have been a "dead letter" when Defendants announced $143 million in backlog on December 21, 2004. DB at 16, 49. However, the Complaint specifically alleges the following contrary facts:

> CW-3 [Confidential Witness 3] stated that work on this major project was discontinued for about a week after receiving [SWO3]. However, Applied Signal determined that the group should continue to work on the project for the remainder of the calendar year without customer funding. According to CW-3, work on the project continued through the end of the calendar year 2004 and was then abandoned. The MSD group in Sunnyvale that had been working on this project, which had consisted of between 50-75 employees, was a "ghost town" after CW-3 left the Company in January of 2005.

Compl., ¶ 43, ER at 18-19. The clear import of these allegations is that Applied Signal elected to continue work, despite SWO3 and without customer funding, until it abandoned the affected portion of the project in January of 2005. Defendants' contrary argument is impossible to square with any rational reading of this text.[3]

SWO2 was received *prior* to May 26, 2004 (90 days before the August 24, 2004 backlog announcement), when the Complaint alleges that SWO2 was received in "late May or early June." Compl., ¶ 30, ER at 9-10. The Court would then have to find that the government did *not* cancel the portions of the contract covered by SWO2, *and* that the parties did not extend SWO2 beyond 90 days.

[3] If the District Court found this allegation to be unclear, it should have permitted Plaintiff to amend the Complaint to clarify it. *See infra* Section V.

3. Defendants Mischaracterize the Complaint With Respect to Stop-Work Order 4

Defendants claim – without citation – that Stop-Work Order 4 ("SWO4") "may" have been received after the backlog announcements on December 21, 2004 and January 14, 2005, because "[t]he Complaint alleges that SWO4 was received in 'December 2004 or January 2005.'" DB at 49. The absence of a citation is not surprising, because the Complaint expressly alleges that SWO4 was received in *December of 2004*. Compl., 35(c), ER at 14. Defendants' argument is directly contrary to the Complaint.

D. Defendants' Argument that SWOs 1, 3 and 4 Were the Same Is Without Merit

Defendants invite the Court to speculate that SWO3 *and* SWO4 may have been continuations of SWO1, and thus, may have been disclosed on September 9, 2004. *See* DB at 22, 51. The Court should decline the invitation; when deciding a motion to dismiss, the facts alleged in the Complaint should be accepted as true and construed in the light most favorable to the plaintiff. *See, e.g., No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 935 (9th Cir. 2003). The Complaint clearly refers to the receipt of four separate stop-work orders, not to the renewal of a single order.[4]

[4] Defendants' hypothesis is further undermined by the fact that CW-3 is the principal source of information about both SWO3 and SWO4; there is no reason why CW-3 would describe SWO3 and SWO4 as separate orders if they were the same order. *See* Compl., ¶ 35, ER at 14.

Defendants' argument that they could not be liable for making misleading statements if SWO3 and SWO4 were continuations of SWO1 is also incorrect. *See* DB at 51. If all of the facts in the Complaint concerning SWO3 are attributed to SWO1, then Defendants reported the stop-work order on September 9 and December 21, 2004 without informing investors that the Company *did not intend to comply with the Order*. Defendants continued work on affected portion of the contract *without customer funding*, despite the stop-work order, from September through December, 2004, thus materially lowering Applied Signal's earnings for the quarters which ended on October 31, 2004 and January 31, 2005. Compl., ¶ 43, ER at 18-19. The omission of this critical information would have rendered Defendants' disclosure of the stop-work order materially misleading, since any reasonable investor would have assumed that Defendants were complying with the order they disclosed. Whether there was one stop-work order or four, therefore, Defendants committed fraud.

E. Defendants Included Amounts Affected by SWOs 2-4 in Backlog

Defendants' argument that Plaintiff cannot claim they did not reduce the backlog numbers announced in December 2004 and January 2005 to reflect SWOs 2-4 (DB at 8, 12, 44, and 46-47), ignores their own practice. Applied Signal did not reduce its reported backlog when it disclosed SWO1; Defendants did not even "debook" the affected amounts from backlog in December of 2004, when they

described cancellation of the affected portion of the contract as "pretty much a certainty." See Transcript of December 21, 2004 Conference Call, ER at 88; see also id. at 85 ($143 million backlog number "includes the $12 million that has not been debooked" from SWO1 and is "not net of any potential debooking."). Thus, Defendants did not "debook" portions of contracts affected by stop-work orders unless and until the stop-work order resulted in a formal cancellation. Plaintiff's claim that Defendants did not debook backlog affected by SWOs 2-4 is therefore amply supported.[5]

F. The Complaint Pleads Facts With Sufficient Particularity

Defendants incorrectly argue that the amount of evidentiary detail provided in the Complaint is insufficient to show that the backlog statements were materially misleading. DB at 11, 15-17, 22, 35, 48-50. The PSLRA does not require infinite detail, or the precise amounts by which financial data are overstated. *In re Daou Systems, Inc.*, 411 F.3d 1006, 1018 (9th Cir. 2005), *cert. denied*, 126 S. Ct. 1335 (2006), is instructive. The district court dismissed the complaint for failing to quantify the revenue defendants *actually* recognized compared to the amounts they *should have* recognized. This Court reversed,

[5] The Complaint only alleged that Defendants had a duty to disclose stop-work orders when they reported backlog, not that they had an obligation to "debook" stop-work orders from backlog. *See* Comp., ¶¶ 29, 30, 35, ER at 11-14.

holding that the complaint contained adequate information to demonstrate that the accounting violations were large enough to be material. *Id.* at 1020.[6]

Here, as in *Daou*, the allegations in the Complaint demonstrate that Defendants' statements about backlog were materially misleading. Defendants themselves indicated that SWO1 could reduce backlog by between $10-15 million. Compl., ¶ 29(a), ER at 11. Similarly, the Complaint specifically alleges that SWO3 adversely impacted a major project with one of the Company's largest customers, involving 50-75 workers in Sunnyvale, California and additional workers in Utah; and that work was continued despite SWO3, without customer funding, for approximately four months, and was then abandoned, leaving the Sunnyvale facility a "ghost town." Compl., ¶ 43, ER at 18-19. A stop-work order which kept between 10-15 percent of Applied Signal's total workforce (Compl., ¶ 40(a), ER at 17) from working on revenue-producing projects for *four* months clearly was not immaterial.

The Complaint also alleges details which are incompatible with SWO2 and SWO4 being immaterial. SWO2 involved an $8 million project for the U.S. Military referred to as "Cowbird." Compl., ¶ 30, ER at 12. Applied Signal won the contract by promising to complete the job within a year at half the cost of a

[6] *See also Campbell Soup*, 145 F. Supp. 2d at 592 ("While Plaintiffs will need to 'fill in the details' to prove their claims," they sufficiently pled "the who, what, where, when and how of the allegedly fraudulent practice.").

competitor, but proved unable to do so. *Id.* This led to a series of meetings where the Company attempted to renegotiate the contract; the customer, unsatisfied, issued SWO2. *Id.* At the very least, there is a question of fact as to whether SWO2 was immaterial. SWO4, issued in December, was received as the result of Applied Signal's inability to satisfy governmental reporting requirements – a key responsibility for a government contractor. Compl., ¶ 35, ER at 14-15. The cumulative impact of the four stop-work orders was clearly material. *See S.E.C. v. Cohen*, No. 4:05CV371-DJS, 2006 WL 2225410, *2 (E.D. Mo. Aug. 2, 2006) (materiality analysis should address both individual and cumulative impacts).

Defendants also attack the sufficiency of Plaintiff's factual allegations because Plaintiff's confidential witnesses never saw the stop-work orders. DB at 15, 48. The test, however, is whether "a person in the position occupied by the source would possess the information alleged." *Daou*, 411 F.3d at 1015. Unlike an arcane accounting gimmick, the adverse impact of a stop-work order affects everyone who is working on the project, and cannot be hidden. The details provided by the confidential witnesses, who were software engineers and a technical editor, are ones that would have been widely known within the Company: the nature of the affected projects, the customers, what the problems were, when stop-work orders were received, and their general impact on the people working on the projects.

II. DEFENDANTS' BACKLOG STATEMENTS ARE NOT PROTECTED "FORWARD LOOKING" STATEMENTS

A. Backlog Is Not "Forward-Looking"

Defendants defined backlog as "anticipated revenues from the uncompleted portions of existing contracts." *See, e.g.*, ER at 34. To reasonable investors, Defendants' assertion that they had $111 million of backlog meant that they had existing contractual rights to receive $111 million in exchange for performing work. Thus, Defendants' backlog numbers – by their own definition – simply aggregate revenue to be earned under the terms of presently existing contracts, and such information is not "forward-looking."[7] *See, e.g., Griffin v. GK Intelligent Systems, Inc.*, 87 F. Supp. 2d 684, 686 & 689 (S.D. Tex. 1999) (safe harbor did not apply to statement of "existing fact" that company had entered into a three-year agreement from which it expected to realize $12 million), *cited with approval*, *Plotkin v. IP Axess, Inc.*, 407 F.3d 690, 699 (5th Cir. 2005).[8]

Defendants are also incorrect that "the truth or falsity of reported backlog can be determined only by reference to future events: specifically, how much work is performed in subsequent periods." DB at 25, *citing Harris v. Ivax Corp.*,

[7] Defendants' claim that Plaintiff substituted his own definition of backlog for the Company's "forward-looking" definition (DB at 26) is nonsense. Plaintiffs' relies solely on the definition of backlog contained in Applied Signal's SEC filings.

[8] Defendants incorrectly argue that *Plotkin* did not consider the applicability of the safe-harbor. DB at 27-28. The *Plotkin* defendants conceded that facts concerning their existing contracts were not forward-looking, and the Court affirmed that proposition with citations to *Griffin* and the statutory text. 407 F.3d at 699 & n.6.

182 F.3d 799, 805 (11th Cir. 1999).[9] Applied Signal's backlog numbers were misleading because they failed to reveal *existing* facts – stop-work orders – that undermined the quality of contracts included in the backlog. Even if the government subsequently cancelled every one of the stop-work orders, the backlog announcements were misleading *when made*.[10]

Defendants erroneously argue that Plaintiff's position would eliminate the safe-harbor, since "*[e]very* forward-looking statement," such as an earnings forecast, "is issued on a particular date, and is an assessment and snapshot based on information as of that date." DB at 27. Predictions may be based on present facts, just as skyscrapers may be built on foundations – but that doesn't mean that present facts *are* predictions, any more than foundations are skyscrapers.[11]

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[9] If Defendants were correct, accounts receivable would be considered "forward-looking" on the grounds that their truth or falsity could not be determined until customers either paid or defaulted. Rather than challenge the numerous cases which hold that accounts receivable are not "forward-looking" (*see* PB at 33-34), Defendants claim that accounts receivable are the "exact opposite" of backlog because the former has been earned while the latter has not. DB at 24-25. However, both are statements of existing legal entitlement: backlog represents contractual entitlements to perform work and get paid for it; accounts receivable represents contractual entitlements to be paid for work that has been performed.

[10] Defendants again mischaracterize the Complaint, arguing that Plaintiff alleges "the backlog statements were proven false in the quarters *after* they were issued, when Applied Signal did not meet Wall Street analysts' forecasts." DB, at 26, n.11. To the contrary, the Complaint expressly alleges that each of the backlog statements was false or misleading *when made* because Defendants failed to disclose the existence of stop-work orders. Compl., ¶¶ 29, 30 & 35, ER at 12-14.

[11] The cases cited by Defendants (DB at 27) are not to the contrary. *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 242 (3d Cir. 2004), simply affirmed that a prediction about the likelihood of collecting on claims was "forward looking." *Yellen v. Hake*, 437 F. Supp. 2d 941 (S.D. Iowa 2006), involved a challenge to the company's reaffirmation of its earnings forecast; even if the forecast was based on present-tense factors, it remained forward-looking. *Miller v. Champion Enters., Inc.*, 346 F.3d 660, 677 (6th Cir. 2003), involved earnings projections and related

Moreover, representations of past or present fact are not covered by the safe-harbor even when connected to "forward-looking" statements. *America West*, 320 F.3d at 937.[12]

Contrary to Defendants' alternative argument (DB at 26-27), present facts are also not "assumptions underlying or relating to" predictions. *See, e.g., Harris*, 182 F.3d at 806 ("observed facts" are not "assumptions," since an assumption is "the act of taking for granted or supposing that a thing is true.") (quoting Webster's Third New International Dictionary 133 (1981)); *see also In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160, 1169 (W.D. Wash. 1998) (same). Moreover, the safe harbor does not apply to assumptions unless they "underlie" or "relate to" a forward-looking statement. 15 U.S.C. § 78u-5(i)(1)(D). Defendants do not identify any such forward-looking statement that the backlog numbers supposedly relate to.

B. Defendants Did Not Provide "Meaningful Cautionary Language"

Even if Defendants' statements could be construed as forward-looking – and they manifestly cannot – Defendants' argument that they provided "meaningful cautionary language" (DB at 30-33) is without merit.

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assumptions. Here, in contrast, the challenged statement is itself a statement of present fact and was not tied to any prediction about future earnings.

[12] Defendants inconsistently argue that America West "did not predict, warn about, or provide future guidance," while acknowledging that the relevant company statement was "that the regulatory matter was closed *and there would be no future effect from it*." DB at 28 (emphasis added). The statement at issue in *America West* was closer to a projection than Defendants' statements here.

Defendants argue that Plaintiff "cannot complain he was misled about stop-work orders when he was warned to watch out for them", based on the statement in their post-September 2004 SEC filings that "there can be no assurance that stop-work orders will not be received in future periods." DB at 31. Of course, Defendants *failed* to provide this warning on or before August 24, 2004, when they touted their backlog of $111 million while concealing SWO1.

Defendants' supposedly "cautionary language" is not meaningful in any event. *In re Compuware Sec. Litig.*, 301 F. Supp. 2d 672, 685 (E.D. Mich. 2004) found that functionally identical "warnings" ("'there can be no assurance that IBM will not choose to offer significant competing products in the future'") were not meaningful because they "implied that IBM's development of competing software was a possibility as opposed to an actuality . . . ." *Id.; see also Amylin*, 2002 WL 31520051 at *9 (when FDA raised specific concerns about defendants' drug testing, general warning that FDA approval is not guaranteed is not meaningful); *Collmer v. U.S. Liquids, Inc.*, 268 F. Supp. 2d 718, 745 (S.D. Tex. 2003) (even particularized disclosures are insufficient if they fail to reveal "known, material adverse facts") (quoting *Rubenstein v. Collins*, 20 F.3d 160, 171 (5th Cir. 1994)); *In re Nortel Networks Corp. Sec. Litig.*, 238 F. Supp. 2d 613, 628-29 (S.D.N.Y. 2003) (same); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 599 (7th

Cir. 2006) (warning about *potential* risks not meaningful in light of *existing* problems).

Defendants' allegedly "cautionary" statements were fraudulent. Beginning with the September 9, 2004 10-Q Report, Defendants first disclosed that they had received *one* stop-work order (SWO1), and *then* gave "no assurance" that they would not receive other stop-work orders *in the future*. ER at 70. The purported warnings falsely implied that SWO1 was the only stop-work order Defendants had received.[13]

III. DEFENDANTS' ARGUMENTS CONCERNING SCIENTER LACK MERIT

A. The Complaint Adequately Pleads Scienter For SWO1

Public statements by defendants who are aware of facts suggesting the statements are "misleadingly incomplete" provide "classic evidence of scienter." PB at 35 (quoting *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d 983, 1022 (S.D. Cal. 2005) and *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83 (1st Cir. 2002).

[13] The cases cited by Defendants (DB at 31-32) are inapposite. In *Plevy v. Haggerty*, 38 F. Supp. 2d 816, 832-33 (C.D. Cal. 1998), defendants' warning that they might not successfully transition to a new technology was adequate because they never implied that they would make the transition successfully. *Benzon v. Morgan Stanley Distributors, Inc.*, 420 F.3d 598, 612 (6th Cir. 2005), found that a warning that brokers might receive differential fees was adequate, even though the brokers *already* earned differential fees. *Benzon* would be more analogous to the present case – and likely would have been decided differently – if defendants informed investors that brokers got a higher fee for *one* fund, and offered "no assurance" that they might not make similar arrangements with other funds *in the future*. In any event, at least one court in this circuit has disagreed with *Benzon*. *Siemers v. Wells Fargo & Co.*, No. C 05-04518 WHA, 2006 WL 2355411, * 7 (N.D. Cal. Aug. 14, 2006) (Alsop, J.) (misleading to state that "a fund may award future business on the basis of sales" when the fund "*already has* fixed payback arrangements in place.")

Plaintiff's allegations support a strong inference that Defendants announced their backlog numbers on August 24, 2004, knowing a fact – that the government had issued SWO1 three months earlier – that rendered those backlog numbers "misleadingly incomplete."

Defendants effectively concede that they knew about SWO1 on August 24, 2004, but they argue – without citation to any authority – that they cannot be liable unless they "knew or recklessly disregarded that SWO1 materially *would* reduce Applied Signal's backlog, its future revenues." DB at 42 (emphasis added). However, Defendants were aware that reasonable investors would find information about the *potential* impact of SWO1 material to their assessment of Defendants' backlog number, because SWO1 increased the risk that Defendants would not be able to recognize revenue from a portion of that backlog. [14] Nothing more is required to establish scienter.

Amylin is instructive. The *Amylin* defendants assured investors that they had completed testing on the drug "Symlin," and were ready to apply for FDA approval. 2002 WL 31520051 at *2. The *Amylin* defendants specifically informed investors that there were no assurances the FDA would ultimately approve the

[14] Defendants demonstrated their awareness that reasonable investors would consider SWO1 material to backlog when they disclosed it in the September 9, 2004 10-Q Report. The status of SWO1 was the same on August 24 as it was on September 9: it was active, and it had not yet led to a contract cancellation. Since Defendants understood on September 9, 2004 that an active stop-work order would be material to investors' understanding of backlog, there is no reason to believe they were unaware of this elementary fact two weeks earlier.

drug, but they withheld facts suggesting an *increased risk* of disapproval – specifically, that the FDA had expressed concerns about their testing methods. *Id.* at *8. The court rejected defendants' claim that the facts supported an inference that they "reasonably believed that Symlin's Phase III trials were sufficient":

> Amylin clearly *hoped* that its Phase III trials were sufficient to obtain FDA approval and undoubtedly spent significant amounts of money pursuing the trials to that end. However, Amylin's decision to forge ahead with the Phase III trials does not negate the reasonable inference that Amylin knew that the FDA had serious concerns about its study designs which ***could*** prevent the approval of Symlin.
>
> Based on the facts alleged by Plaintiffs, the most plausible inference to be drawn is that Amylin knew that there ***may*** be a problem with the methodology used in conjunction with the Phase III trials but took the calculated risk of continuing the trials and application process as originally planned. There is nothing unlawful about taking a calculated risk. However, if, as Plaintiffs allege, Defendants misled Plaintiffs about such risk by making assurances regarding the completeness of the data and the likelihood of FDA approval, Defendants may be held liable.

Id. at *4-5 (emphasis added). Here, similarly, Defendants assured investors that their backlog numbers were "firm," subject only to actions which the government might take in the future. *See, e.g.*, ER at 34. While they told investors that the government had the *right* to delay or cancel work included in backlog, they concealed the fact that the government had *already* issued an order which stopped work on a portion of work included in the backlog, thus increasing the risk that Applied Signal would not be able to recognize revenue from the affected contract.

Even if Defendants sincerely believed that they could avoid the worst consequences of SWO1, they knew or recklessly disregarded that their statements

materially misled investors concerning risks affecting when and if the backlog could be turned into revenue. That is sufficient for liability. *See also Campbell Soup*, 145 F. Supp. 2d at 598 (defendants liable for withholding information about adverse impacts on demand attributable to channel stuffing even if they believed the losses would be offset by gains in other areas); *Fugman v. Aprogenex, Inc.*, 961 F. Supp. 1190, 1196 (N.D. Ill. 1997) (same).

Defendants erroneously argue that their "prompt disclosure" of SWO1 on September 9, 2004 "undermines" scienter. DB at 43. Their disclosure can scarcely be described as "prompt" when they knew about the stop-work order for three months, *and* their disclosure came two weeks too late to help the investors who purchased stock following their announcement of misleadingly incomplete backlog numbers on August 24, 2004. Defendants likewise argue that their lack of stock sales between August 24 and September 9, 2004, undermines scienter (DB at 53), ignoring this Court's determination that the absence of stock sales does not negate scienter. *America West*, 329 F.3d at 944. Plaintiff need not speculate about Defendants' motives for withholding information on August 24; Plaintiff's allegations that defendants were aware of facts suggesting that their backlog

statements were "misleadingly incomplete" are "classic evidence of scienter," and thus sufficient. PB at 35.[15]

B. Scienter Is Properly Alleged For SWOs 2-4

Plaintiffs' allegations raise a strong inference that Defendants knew about SWOs 2-4 before they announced their backlog in December of 2004 and January of 2005. *See* PB at 37-42. As demonstrated by their disclosure of SWO1, Defendants also were aware that stop-work orders had the potential to impact backlog, increasing the risk that they would not be able to recognize revenue from the affected portions of the backlog. *See supra* n.14.[16] Any doubt Defendants *might* have entertained concerning whether investors would view stop-work orders as being material to backlog would have been dispelled by the dramatic decline in Applied Signal's stock price following disclosure of SWO1 in September of 2004. Compl., ¶ 31, ER at 13. These allegations establish that Defendants announced backlog numbers with knowledge of facts which rendered those numbers misleadingly incomplete. This is sufficient to establish scienter.

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[15] Defendants also argue that their disclosure that backlog is not a prediction of earnings is inconsistent with scienter. DB at 53. However, Defendants did not mislead investors about the *nature* of their backlog, but about its *quality* – about existing constraints on the Company's ability to turn that backlog into revenue.

[16] Defendants' argument that their (belated) disclosure of SWO1 compels an inference that they would have revealed other stop-work orders "if they existed and would have had a material impact" (DB at 53), is inconsistent with the Complaint's specific allegations that Defendants received SWOs 2-4 and did *not* disclose them. It is reasonable to infer that Defendants concealed SWOs 2-4 to avoid the stock drop which followed their disclosure of SWO1.

Defendants wrongly characterize Plaintiff's argument as dependent upon a presumption that executives know all facts critical to a business' "core operations," and argue that such a presumption was rejected by this Court. DB at 52-53, citing *In re Read-Rite Corp. Sec. Litig.*, 335 F.3d 843 (9th Cir. 2003). While the importance of government contracts to Applied Signal contributes to an inference of scienter (which is expressly permitted by *Read-Rite*, 335 F.3d at 848-49), Defendants' own statements, the testimony of confidential witnesses, and CEO Yancey's stock sales also combine to create a strong inference of scienter.

As set forth more fully in PB at 37-39, additional facts supporting scienter include the following: (1) Defendants assured investors that management regularly reviewed contract performance, costs incurred, and estimated completion costs, which review would necessarily uncover any extant stop-work order (PB at 40);[17] (2) stop-work orders issued by the government would have been directed to senior management (PB at 41-42);[18] and (3) after stopping work as ordered by SWO3 for a week, Applied Signal elected to resume work and keep 50-75 employees *at its corporate headquarters* working on the affected portions of the project for four months, at which point they abandoned the work and the

[17] *In Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1234 (9th Cir. 2004), this Court found statements that defendants monitored portions of a sales database sufficient to infer that they would have been aware of significant revenue recognition issues.

[18] *See In re Lockheed Martin Corp. Sec. Litig.*, 272 F. Supp. 2d 944, 957 n.6 (C.D. Cal. 2003) (noting that "bad news" from a source from *outside* a company, such as a government agency, is likely communicated directly to senior management).

Sunnyvale headquarters became a ghost town (PB at 38).[19] Such things do not occur in a company the size of Applied Signal without senior management's direction – let alone without their knowledge. The contrary inference is the sort which this Court labeled "patently absurd" in *America West*. See PB 39-41.[20]

Yancey's stock sales also contribute to a strong inference of scienter. Defendants make much of the fact that Doyle, rather than Yancey, announced the backlog numbers during the August 24 and December 21, 2004 conference calls, and signed the September 9, 2004 10-Q Report (DB at 54). However, "[s]cienter can be established even if the officers who made the misleading statements did not sell stock during the class period." *America West*, 320 F.3d at 944. Defendants also fail to mention that Yancey was present and actively involved in both conference calls, signed the Company's 2004 10-K Report, and signed Sarbanes-Oxley compliance certifications for the September 9, 2004 10-Q Report and the 2004 10-K Report. Compl., ¶¶ 28, 30(c), 33 and 34, ER at 10-13.[21]

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[19] These facts also refute Defendants' argument that scienter is lacking because the Complaint fails to plead that SWOs 2-4 were significant. DB at 53. As discussed above, there is every reason to believe that the stop-work orders were material. *See supra* Section I-F.

[20] Defendants imply that *Read-Rite* superseded *America West*, when *Read-Rite* cites *America West* with approval, noting only that the facts in the earlier case – like the facts here – were more compelling. *Read-Rite*, 335 F.3d at 848 n.1.

[21] The two cases cited by Defendants (DB at 54) mention the lack of stock sales by other insiders as a factor in assessing the importance of stock sales, but in each case the court also determined that the insider trading which did occur was insignificant. *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1037 (9th Cir. 2002) (insider sold only 1.4 percent of holdings); *In re Business Objects S.A. Sec. Litig.*, No. C-04-2401-MJJ, 2005 WL 1787860, *8 (N.D. Cal. July 27, 2005) (insider sold less than 10 percent of his shares). Here, in contrast, Yancey sold over 40 percent

Defendants also erroneously argue that the timing of Yancey's sales was not suspicious because he did not hit the high point of the market, did not sell immediately before the end of the class period, and sold after the results of the fourth quarter, 2004 were announced (DB at 55-57). Stock sales that miss market highs can still be suspicious. *See, e.g., Daou*, 411 F.3d at 1024 (sales at $22.86 for one defendant significantly missed market high of $34.375). Moreover, the timing of Yancey's sales is suspicious because he sold over 40 percent of his stock (after selling no stock for a year) immediately after shutting down the portion of the Excelsior project affected by SWO3. Compl., ¶¶ 43, 48, and 49, ER at 18-21. [22]

Defendants cite *Gompper v. VISX, Inc.*, 298 F.3d 893 (9th Cir. 2002), for the proposition that all "anti-scienter" inferences must be drawn against the plaintiff. *See, e.g.*, DB at 21, 41, 43, 44, and 54. *Gompper* did not suggest, much less hold, that courts must draw all inferences against the plaintiff, or reject a strong inference of scienter if there is any conceivable way to construe allegations in the complaint in defendants' favor. In *Gompper*, plaintiff argued that defendants' fierce litigation over the validity of their patents showed that they knew the patents

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of his shares. While Defendants argue that Yancey "retained more stock than he sold," (DB at 56), that is not the standard for significance. *See, e.g., In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1095 (9th Cir. 2002) (sales of 32 percent of stock were "sufficiently substantial," but other factors militated against finding that the sale contributed to inference of scienter).

[22] The time frame in question is similar to *Oracle*, where defendant Ellison sold his stock four to five weeks before releasing a poor earnings report. 380 F.3d at 1232. Defendants attempt to distinguish *Oracle* on the grounds that Ellison's stock sales generated more money (DB at 57), but the Court specifically held that both the amount *and* the timing of Ellison's sales were suspicious. 380 F.3d at 1232.

were invalid; the Court, however, found that the contrary inference – that defendants litigated the patents because they believed that they *were* valid – was "equally if not more plausible." 298 F.3d at 897. Holding that this failed to create a strong inference of scienter, the Court considered "*all* reasonable inference to be drawn from the allegations, including inferences unfavorable to the plaintiffs." *Id.* at 897. Since the Complaint in this case raises a strong inference that Defendants knew or recklessly disregarded that they were misleading investors about the quality of their backlog, the requirements of the PSLRA are satisfied; *Gompper* does not suggest a different result.

IV. DEFENDANTS' LOSS CAUSATION ARGUMENTS ARE INCONSISTENT WITH THE FACTS AND THE LAW

Defendants' argument that the Complaint fails to properly allege "loss causation" with respect to SWOs 2-4 is without merit. Defendants repeatedly, and wrongly, assert that the Complaint alleges "only one reason" for plaintiff's losses: because Applied Signal "missed analysts' revenue and earnings forecasts for the Fourth Quarter 2004 and revenue forecasts for the First Quarter 2005." DB at 58; *see also* DB at 12, 17, 23, 60, and 62. However, the Complaint only mentions analysts' forecasts in connection with the December 21, 2004 earnings announcement, and only to demonstrate that the three percent increase in the Company's revenue for the fourth quarter of FY 2004 was poor by historical standards, "as Applied Signal typically experienced a significant increase in

revenues from the third quarter of the fiscal year to the fourth quarter." Compl., ¶ 42, ER at 18. Analysts' forecasts are not mentioned with respect to February 22, 2005 earnings announcement; no historical perspective is needed to appreciate that a twenty-five percent decline in revenue is catastrophic. Compl., ¶ 44.

The Complaint is perfectly clear on the question of causation: By failing to disclose the existence and potential impact of SWOs 2-4, Defendants "masked growing problems with the Company that impacted its revenues in the fourth quarter of [FY] 2004 and caused a substantial loss of revenue in the first quarter of [FY] 2005" (Compl., ¶ 41, ER at 18). When Defendants disclosed the poor results, the stock dropped (Compl., ¶¶ 42 and 44, ER at 18-19). These allegations are more than sufficient to "provide a defendant with some indication of the loss and the causal connection he has in mind." *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 347 (2005).

Defendants' other loss causation arguments fare no better. Defendants' argument that loss causation is only properly alleged when there is "a disclosure to the market that reveals the falsity of the misrepresentations and causes a stock price decline" (DB at 57), ignores the many contrary decisions cited by Plaintiff (PB at 48-49 n.16), most particularly *Daou*, 411 F.3d at 1026 (reversing District Court and holding that plaintiff need not allege "negative public statements, announcements or disclosures" of improprieties to show loss causation).

Defendants next argue that the Complaint does not allege that SWOs 2-4 affected revenue (DB at 59-60), ignoring the paragraphs of the Complaint that allege exactly that. See Compl., ¶¶ 41-47 and 61, ER at 18-20 and 24. Defendants argue that SWO3 *must have* expired by December 21, 2004, but ignore allegations that SWO3 continued until the end of December, 2004 (Compl., ¶ 43). Finally, Defendants argue that there can be no "proximate" causation because backlog is not a projection of revenue, and thus Plaintiff "could not have inferred anything about how Applied Signal would perform from the backlog statements." DB at 64-65. However, investors *would* have inferred from Defendants' backlog announcements that there was no *present* legal or contractual impediment to the Company performing work and recognizing revenue on the contracts in its backlog. Because Defendants failed to disclose that stop-work orders had created such an impediment, Applied Signal's stock was artificially inflated; when the revenue impaired by the concealed stop-work orders was reported, the stock declined. No more is needed to properly allege loss causation under *Dura* and *Daou*.

V. DISMISSAL WITH PREJUDICE WAS IMPROPER

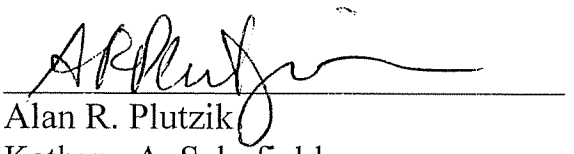
Defendants argue that any amendment to Plaintiff's complaint would be futile, and thus it was proper to dismiss with prejudice. DB at 65-67. For the reasons set forth above, Plaintiff's theory of fraud is *not* flawed, and thus it was

improper to dismiss on that ground. Defendants' alternative arguments ignore this Court's clear directive that dismissal without leave to amend "is improper unless it is clear that the complaint could not be saved by amendment." *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 946 (9th Cir. 2005).[23]

CONCLUSION

For the reasons set forth above, and in the Plaintiff's principal brief, Plaintiff Whiting respectfully requests that the District Court's judgment be reversed and the case remanded with direction that the Motion to Dismiss be denied.

BRAMSON, PLUTZIK, MAHLER & BIRKHAEUSER, LLP



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[23] Defendants argue that an amendment would cause them prejudice because they would be forced to respond to a *new theory of fraud*. DB at 67-68. Defendants ignore the possibility that Plaintiff could be permitted to correct any insufficiency the Court might find in the factual allegations supporting what Defendants describe as the "backlog/stop-work orders" theory of fraud. DB at 66. *See, e.g.*, n.3, *supra*.

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CERTIFICATE OF COMPLIANCE PURSUANT TO FED. R. APP. P. 32(a)(7)(C) AND CIRCUIT RULE 32-1 FOR CASE NUMBER 06-15454

I certify that **(check appropriate option(s))**:

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Marianne Fogle

Marianne Fogle