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

Brief of Plaintiff-Appellant Frank Whiting

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JURISDICTIONAL STATEMENT

A. *Statutory Basis of District Court's Subject Matter Jurisdiction:* Plaintiff alleges that Defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a). The District Court had jurisdiction over this claim pursuant to 15 U.S.C. § 78aa and 28 U.S.C. § 1331 (federal question jurisdiction).

B. *Basis for Claiming Judgment Appealed from is Final and Statutory Basis for Jurisdiction of the Court of Appeals:* The District Court granted Defendants' Motion to Dismiss pursuant to Fed. R. Civ. Proc. 12(b)(6), with prejudice. This Court has jurisdiction pursuant to 28 U.S.C. § 1291.

C. *Effective Dates:* Judgment was entered on February 8, 2006; the Notice of Appeal was filed on March 8, 2006. The appeal is timely pursuant to Fed. R. App. Proc. 4(a)(1)(A).

STATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Whether the District Court erred in holding that Defendants' statements concerning the amount of Applied Signal, Inc.'s ("Applied Signal" or "the Company") "backlog" were not materially misleading as a matter of law.

2. Whether the District Court erred in holding that Defendants' statements concerning the amount of the Company's backlog were "forward looking" and non-actionable, as a matter of law, under the "safe-harbor" provisions of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-5.

3. Whether the District Court erred in holding that the facts alleged in the Consolidated Amended Class Action Complaint ("the Complaint," or "Compl.") did not satisfy the scienter pleading standards of the PSLRA.

4. Whether the District Court erred in holding that the Complaint failed to properly allege the "loss causation" element of a Section 10(b) violation.

5. Whether the District Court erred in denying Plaintiff leave to amend his Complaint and dismissing the case with prejudice.

STATEMENT OF THE CASE

Nature of the Case: Lead Plaintiff Frank Whiting ("Whiting" or "Plaintiff"), on behalf of himself and a class of persons similarly situated, alleges that Defendants Applied Signal, CEO Gary Yancey ("Yancey"), and CFO James Doyle ("Doyle") are liable for violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a) as a result of Defendants' issuance of materially misleading statements concerning the business and financial results of the Company. Compl., ¶¶ 1, 2, and 54, Excerpts of Record ("ER") at 3, 22. The proposed class (the "Class") consists of all persons who purchased the Company's common stock from August 24, 2004 through February 22, 2005 (the "Class Period"). Compl., ¶ 14, ER at 6.

Course of the Proceedings: This litigation was initiated on March 11, 2005 by Brent Berson, Class member unrelated to Plaintiff Whiting. *In re Applied Signal Technology, Inc. Sec. Litig.*, Master File No. C 05-1027 SBA, Order Granting Defendants' Motion to Dismiss ("Decision"), at 11 (N.D. Cal. Feb. 8, 2006), ER at 115. On May 10, 2005, Plaintiff Whiting applied for appointment as lead plaintiff pursuant to the PSLRA and for approval of his selection of counsel, which application was granted on July 13, 2005. *Id.*, ER at 116. Following an investigation that included detailed discussions with numerous confidential witnesses, Plaintiff Whiting filed the Complaint on August 12, 2005, in accordance

with the Court's July 13, 2005 Order. Docket Item No. 23, ER at 165.[1] Defendants filed a Motion to Dismiss on September 14, 2005, which was fully briefed by November 14, 2005. Docket Item Nos. 35, 50, and 52, ER at 165-66. The Court twice postponed oral argument on the motion, and on January 30, 2006, (the day before the rescheduled argument was to occur), cancelled oral argument altogether.

Disposition Below: On February 6, 2006, the District Court issued its ruling and order granting Defendants' Motion to Dismiss, with prejudice. Decision, ER at 138. The District Court held that Defendants' statements concerning the amounts of the Company's backlog were not materially misleading as a matter of law, and were inactionable "forward-looking statements." *Id.*, ER at 128-131. Furthermore, the District Court held that the Complaint failed to properly allege that Defendants acted with scienter under the PSLRA, and failed to properly allege "loss causation" as required to establish an actionable violation of Section 10(b) of the Securities Exchange Act of 1934. *Id.*, ER at 131-133.[2]

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[1] The Complaint was the first filed in this litigation by Whiting and Lead Counsel. Neither Plaintiff Whiting nor Lead Counsel were involved, in any way, with the commencement of this litigation or the preparation of the Berson complaint.

[2] The District Court also dismissed Plaintiff's claim under Section 20(a) of the Exchange Act for failure to allege a "primary violation" of Section 10(b) or Rule 10b-5. *Id.*, ER at 136. Finally, the court dismissed as moot Plaintiff's motion for class certification, which was fully briefed and ready for argument. *Id.*, ER at 138.

STATEMENT OF FACTS

The central facts of this case are simply stated: During the Class Period, Applied Signal provided intelligence-related products and services, effectively to only one client – the U.S. Government – and had a relatively small number of contracts. Compl., ¶¶ 23-24, ER at 9. Defendants told investors that the Company had "backlog" – the revenue Applied Signal was entitled to generate from the uncompleted portions of its existing government contracts – of $111 million at the end of the third quarter of the Company's 2004 fiscal year (which ended July 31, 2004), and $143 million at the end of the fourth quarter of the Company's 2004 fiscal year (which ended October 31, 2004). ER at 104-07.[3] However, when Defendants reported those backlog amounts, they concealed the fact that the U.S. government had instructed the Company to cease performing work (through the government's issuance of "stop-work orders") on portions of several of the contracts included in the backlog. *Id.*, ¶¶ 29, 30 and 35, ER at 10-14.

[3] Specifically, Defendants announced $111 million in backlog during a conference call with investors on August 24, 2004, and in a quarterly report filed with the Securities and Exchange Commission ("SEC") on form 10-Q on September 9, 2004 (the "September 9, 2004 10-Q Report"). Compl, ¶¶ 28-29, ER at 10-11. Defendants announced backlog of $143 million in a conference call with investors on December 21, 2004, and in an annual report filed with the SEC on Form 10-K on January 14, 2005 (the "2005 10-K Report"). Compl., ¶¶ 33-34, ER at 13.

When Defendants belatedly disclosed, in September of 2004, that they had received one stop-work order, the price of the Company's stock dropped dramatically. *Id.* at ¶ 31, ER at 13. However, Defendants never disclosed three other stop-work orders that reduced the Company's revenue during the fourth quarter of FY 2004 (which ended October 31, 2004), and even more dramatically reduced revenue in the first quarter of the Company's 2005 fiscal year (which ended on January 31, 2005). *Id.* at ¶¶ 42-47, ER at 18-20. Instead, Defendants reported misleading backlog amounts and concealed the stop-work orders in December 2004, permitting the CEO to sell large portions of his holdings in Company stock at artificially inflated prices in January of 2005. *Id.* at ¶¶ 33, 34, and 48, ER at 13, 20. Shortly thereafter, when the Company announced the poor performance for the first quarter of FY 2005, the stock price dropped over 15 percent (by $4.28 per share). *Id.* at ¶ 44, ER at 20.

Stop-work orders issued by the government can – and, as alleged in the Complaint, did in fact – disrupt the Company's ability to perform work and recognize revenue on contracts included in Applied Signal's reported backlog. *Id.* at ¶¶ 42-47, ER at 18-20. Most of Applied Signal's contracts with the government were "cost-reimbursement contracts," under which the Company was entitled to bill the government (and recognize revenue) as it performed work under the contracts. 2004 10-K Report, ER at 96. Thus, the amount of revenue that Applied

Signal was entitled to recognize and publicly report was entirely dependent upon the amount of work Applied Signal performed; anything that disrupted the Company's right to perform work on contracts would adversely impact the amount of revenue that the Company would be able to recognize. Stop-work orders had exactly that effect.

The applicable regulations state that the government can issue such an order at any time. 48 C.F.R. § 52.242-15. Upon receipt of such an order, the contractor must *immediately* comply with its terms – that is, must *stop work* – and must "take all reasonable steps to minimize the incurrence of costs allocable to the work covered by the order during the period of work stoppage." *Id.* The government can stop work on a contract for ninety days without notice or negotiation, and can continue stop-work orders for longer periods under certain circumstances. *Id.* At the end of the period covered by the stop-work order, the government may elect to cancel the work covered by the order. *Id.* As a result, companies receiving a stop-work order on an ongoing project cannot bill the government for any "stopped" work. For companies like Applied Signal, working on "cost-reimbursement contracts" that only allow payment when work is actually performed, the stop-work order will therefore likely impact current earnings and may impact long-term earnings.

As set forth in the Complaint, Applied Signal received *four* stop-work orders during the Class Period. The Company received the first stop-work order ("SWO1") in June of 2004. SWO1 related to a $10-15 million portion of the Company's largest contract. Compl., ¶ 29, ER at 10-11. Although Defendants reported $111 million in backlog during the Company's August 24, 2004 conference call, they did not disclose SWO1 until two weeks later when they filed the Company's September 9, 2004 10-Q Report. *Id.* While Applied Signal's stock rose in the two weeks following the August 24, 2004 conference call, when analysts discovered the information about SWO1 in the 10-Q Report and broadcast it to the market on September 13, 2004, Applied Signal's stock immediately dropped from $37.64 at the opening of the market to $34.31 by the market's close on September 13, 2004. Compl., ¶ 31, ER at 13. Thus, within two days of the market learning of SWO1, Applied Signal's stock had dropped below the price it commanded prior to the August 24, 2004 conference call. ER at 103.

The Complaint further alleges that the Company received three other stop-work orders, but those orders were concealed by the Defendants throughout the Class Period. Compl., ¶ 47, ER at 20. The Company received the second stop-work order ("SWO2") in May or June of 2004, at about the same time the Company received SWO1. Compl. ¶ 30, ER at 11-12. SWO2 related to a project for the U.S. military referred to as "Cowbird," and was issued in response to

problems that the government discovered concerning the Company's ongoing work on the Cowbird project. *Id.*

The Company received the third stop-work order ("SWO3") in August/September of 2004 on a project referred to as "Excelsior." Compl., ¶¶ 35 , ER at 14. After its receipt of SWO3, the Company decided to continue work on the project *without customer funding* until the end of calendar year 2004, including work by 50-75 employees at the Sunnyvale, California facility where Applied Signal had its headquarters. *Id.* at ¶ 43, ER at 18-19. After the work on the project was abandoned at end of 2004, the Sunnyvale headquarters became a "ghost town." *Id.* In consequence, the Company made a decision to incur the expense of continuing the project – most notably, the expense of paying a significant percentage of its workforce – knowing that it would not be able to bill the government for the work or recognize the revenue in the fourth quarter of FY 2004 or the first quarter of FY 2005.

The last stop-work order ("SWO4") was received in December of 2004. Compl., ¶ 35, ER at 14-15. SWO4 was issued because the Company was unable to comply with reporting requirements for an ongoing project; the Applied Signal employee in charge of the project was then demoted. *Id.*

The receipt of these concealed stop-work orders adversely affected the Company's reported revenue and earnings. Specifically, the Company's revenue

and earnings for the fourth quarter of FY 2004 (ending October 31, 2004) were below analysts' expectations, and caused the stock to drop from $37.22 on December 21, 2004 to $35.74 at the close of the market on December 22, 2004. Compl., ¶ 42, ER at 18. Results for the following quarter were even worse, including a revenue decline of almost 25 percent, which caused the price of the Company's stock to decline further, from $27.52 on February 22, 2005 to $23.24 at the close of the market the next day. Compl., ¶ 44, ER at 19. While Defendants did not admit that these poor results were attributable to the adverse effect of SWOs 2-4 – indeed, Defendants never disclosed the existence of these stop-work orders – the Complaint specifically alleges that the Company's poor financial results were caused, in whole or in part, by the Company's inability to generate the revenues covered by SWOs 3-4. *Id.* at ¶ 61, ER at 24.

Incredibly, in January of 2005 – just a few weeks before reporting the disastrous results caused by these stop-work orders – Defendant Yancey sold over 43 percent of his shares of stock in the Company. *Id.*, ¶¶ 48-49, ER at 20-21. Yancey's sales were unusual in both timing and size – not only did he sell nearly half his holdings, but he had not sold any shares in the preceding year. *Id.*

Throughout the Class Period, Defendants reported backlog numbers without any acknowledgement that the Company had received SWOs 2-4. *Id.* at ¶ 47, ER at 20. Although SWO2 was received no later than June of 2004, Defendants did

not disclose it during their August 24, 2004 conference call, nor did they disclose it in the September 9, 2004 10-Q. *Id.* at ¶ 30, ER at 11-12. Similarly, Defendants hid their receipt of SWOs 2-4 when they reported $143 million in backlog at the end of the fourth quarter of 2004 in the December 21, 2004 conference call, nor did they mention the stop-work orders in the 2004 10-K filed on January 14, 2005. *Id.* at ¶ 35, ER at 14-15. Defendants' failure to disclose the stop-work orders in the 10-K Report is all the more glaring since it was filed *after* the Company abandoned the portions of the Excelsior project covered by SWO3, and the Sunnyvale headquarters had become a "ghost town." *Id.* at ¶ 43, ER at 18-19.

Indeed, not only did Defendants conceal SWOs 2-4, but they affirmatively misled investors to believe that SWO1 was the only stop-work order that the Company had received:

> Almost all of our contracts contain stop-work clauses that permit the other contracting party, at any time, by written order, to stop work on all or any part of the work called for by the contract for a period of ninety days. Within the ninety-day period, the other contracting party may cancel the stop-work order and resume work or terminate all or part of the work covered by the stop-work order. During June 2004, we received a stop-work order instructing us to stop work on a portion of our largest single contract. In accordance with the instructions received from the other contracting party, we prepared a proposal that detailed the tasks that were stopped and estimated the reductions in contract costs. If all the stopped tasks are terminated, the result could be a significant reduction in orders and backlog in the period in which it occurs. There can be no assurance that stop-work orders will not be received *in future periods.*

September 9, 2004 10-Q Report, ER at 70. The 2004 10-K Report, filed on January 14, 2005, also discussed stop-work orders and their impact on the Company, specifically discussed the impact of SWO1, and stated that additional stop-work orders could be received *in future periods*. ER at 100. Thus, investors had every reason to believe that SWO1 was the *only* stop-work order the Company had *already* received, and *no* reason to know the truth: that the Company had received SWOs 2-4. *Id*. at ¶¶59-61, ER at 24.

SUMMARY OF ARGUMENT

The District Court's ruling dismissing the case with prejudice was based on several errors. First, the District Court erred in holding, as a matter of law, that Defendants' concealment of the Company's receipt of SWOs 1-4 did not render their statements about the amount of the Company's backlog figures materially misleading. By concealing the stop-work orders, Defendants' statements concerning the Company's backlog were misleading to reasonable investors.

Second, the District Court erred in holding that the specific amounts reported by Defendants as backlog were "forward-looking statements." The reported backlog amounts were present facts which quantified the amount of revenue the Company was entitled to generate under the provisions of its existing contracts. Accordingly, the backlog numbers were not "forward-looking statements" and were not entitled to protection under the statutory "safe-harbor."

Third, the District Court erred in holding that the allegations failed to give rise to a strong inference that Defendants' misrepresentations concerning backlog were made knowingly or recklessly. The facts set out in the Complaint give rise, not only to a strong inference, but to a compelling inference, that Defendants knew or recklessly ignored facts – the Company's receipt of the stop-work orders – that made their statements about backlog materially misleading to investors.

Fourth, the District Court erred in holding that the Complaint failed to properly allege "loss causation" with respect to the stock price drops in December of 2004 and February of 2005 (Defendants conceded loss causation on the September 2004 stock drop that followed disclosure of SWO1). The Complaint specifically alleged that Defendants' concealment of stop-work orders caused the price of the stock to be inflated, and that the stock price drops caused by poor revenue and earnings results reported for the last quarter of FY 2004 and the first quarter of FY 2005 were attributable, in significant part, to the revenue lost as a result of the stop-work orders. These "loss causation" allegations are clearly sufficient under *Dura Pharmaceuticals Inc. v. Broudo,* 544 U.S. 336 (2005), and *In re Daou Systems, Inc.*, 411 F.3d 1006, 1026 (9th Cir. 2005), *cert. denied,* 126 S. Ct. 1335 (2006).

Finally, the District Court erred in holding that the Complaint should be dismissed with prejudice. Contrary to the District Court's reasoning, Plaintiff's theory of fraud was not "flawed," and, to the extent that the District Court believed that additional factual details were necessary, Plaintiff should have been given the opportunity to remedy those deficiencies and file an amended complaint. The Complaint at issue was the first and only complaint filed by Plaintiff and his Counsel.

STANDARD OF REVIEW

A dismissal for failure to state a claim pursuant to Rule 12(b)(6) is reviewed *de novo. No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp. ("America West")*, 320 F.3d 920, 931 (9th Cir. 2003). In deciding a motion to dismiss, "[a]ll allegations of material fact made in the complaint are taken as true and construed in the light most favorable to the plaintiff." *Id.* Under Rule 12(b)(6), a complaint should not be dismissed unless it appears beyond doubt that the plaintiff cannot prove any set of facts in support of the claim that would entitle him or her to relief. *Id.*

The PSLRA governs the assertion of claims under Section 10(b) of the Exchange Act. The PSLRA only contains pleading requirements as to specificity (15 U.S.C. § 78u-4(b)(1)) and scienter (15 U.S.C. § 78u-4(b)(2)). The former provision only requires that complaints specify (i) each statement alleged to have been misleading, (ii) the reason or reasons why the statement is misleading, and (iii) if an allegation regarding the statement or omission is pled on information and belief, the "facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). With respect to scienter, the PSLRA only requires that the complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Under this Court's

interpretation of the PSLRA, the "required state of mind" under the Exchange Act – "scienter" – includes acting with either knowledge or "deliberate or conscious recklessness." *America West*, 320 F.3d at 931. This Court has been vigilant in overturning District Court rulings that have attempted to add requirements to the PSLRA. *See, e.g., In re Cavanaugh*, 306 F.3d 726, 731-32 (9th Cir. 2002) (reversing District Court's extra-statutory requirements for selecting a lead plaintiff under the PSLRA, noting that "Congress enacts statutes, not purposes, and courts may not depart from the statutory text because they believe some other arrangement would better serve the legislative goals."); *Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1235 (9th Cir. 2004) ("The PSLRA was designed to eliminate frivolous or sham actions, but not actions of substance. This is far from a cookie-cutter complaint.").

ARGUMENT

I. THE DISTRICT COURT ERRED IN HOLDING, AS A MATTER OF LAW, THAT DEFENDANTS' BACKLOG STATEMENTS WERE NOT MISLEADING

The Complaint alleges that Defendants' reports of backlog amounts – $111 million for the end of the third quarter of FY 2004 (which ended July 31, 2004) and $143 million for the end of the fourth quarter of FY 2004 (which ended October 31, 2004) – were materially misleading because they failed to disclose Applied Signal's receipt of the stop-work orders that had already been issued by the government on contracts included in the backlog. The District Court erred in holding, as a matter of law, that Defendants' statements concerning the Company's backlog were not misleading.

A. The Complaint Properly Alleged that Defendants' Statements Were Misleading

Under the PSLRA, Plaintiffs must "specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)1. To satisfy this requirement, Plaintiffs are simply required to specifically identify statements they allege to be false or misleading, provide information indicating how, when, and under what circumstances the statements were communicated to the public, and provide "reasonable explanations as to why they believe specific statements or omissions were false or misleading." *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d 983, 1020 (S.D. Cal. 2005). The

Complaint in this case clearly does so: the Complaint specifically alleges that Defendants' four announcements of backlog numbers were misleading, describes when, how, and under what circumstances they were made (during the August 24, 2004 conference call, in the September 9, 2004 10-Q report, in a December 21, 2004 conference call, and in the January 14, 2005 10-K report), and specifically alleges why they were misleading (because they concealed the Company's receipt of stop-work orders). Accordingly, the specificity requirements of the PSLRA were clearly met.

It is well-settled that, on a motion to dismiss, whether a statement is misleading is determined by whether the statement could have misled a reasonable investor. *Hunt v. Alliance N. Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 728 (2d Cir. 1998); *McMahan & Co. v. Wherehouse Entm't, Inc.*, 900 F.2d 576, 579-80 (2d Cir. 1990); *In re ValueVision Int'l., Inc. Sec. Litig.*, 896 F. Supp. 434, 441 (E.D. Pa. 1995). A statement is misleading if it creates the "impression" of a state of affairs that differs from one that exists. *See, e.g., Fecht v. Price Co.*, 70 F.3d 1078, 1081 (9th Cir. 1995) (reversing 12(b)(6) dismissal where complaint adequately alleged that statements created false "impression" that company was expanding its retail warehouses); *Brody v. Transitional Hospitals Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002) (affirming dismissal because statements by defendants did not give false impression).

Whether a statement is misleading, or whether adverse facts were adequately disclosed, is a question to be decided by the trier of fact. *See, e.g., Fecht,* 70 F.3d at 1081 ("[O]nly if 'reasonable minds' could not disagree that the challenged statements were not misleading should the district court dismiss under 12(b)(6)."); *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996); *In re K-Tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 897 (8th Cir. 2002); *Isquith v. Middle South Utils., Inc.*, 847 F.2d 186, 208 (5th Cir. 1988); *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d at 1021-22; *Angres v. Smallworldwide PLC,* 94 F. Supp. 2d 1167, 1174 (D. Colo. 2000); *In re Par Pharm. Sec. Litig.*, 733 F. Supp. 668, 677 (S.D.N.Y. 1990).

Defendants' failure to disclose the Company's receipt of stop-work orders rendered Defendants' representations concerning the amount of the Company's backlog misleading to reasonable investors. Defendants defined "backlog" as "anticipated revenues from the uncompleted portions of existing contracts," and characterized the backlog figures as "*firm*, subject only to the cancellation and modification provisions contained in our contracts. . . . Because of possible *future* changes in delivery schedules and cancellations of orders, backlog" may not represent actual sales for any succeeding period. 2003 10-K Report, ER at 34 (emphasis added). Based on the Company's own representations, a reasonable investor would have concluded that the backlog numbers Defendants announced during the Class Period were "firm," subject only to actions that the government

might take *in the future*. Investors had no reason to know that the government had *already* taken actions, by issuing stop-work orders, that at a minimum delayed performance of work on portions of the reported backlog (thus reducing quarterly revenue and earnings), and threatened contract cancellations.

In addition to misleading Class members by reporting backlog amounts without disclosing the Company's receipt of stop-work orders, Defendants misled Class Members through purported "warnings" about future stop-work orders. After Defendants disclosed SWO1 on September 9, 2004, reasonable investors were on notice that the Company could not then perform work and recognize revenue on $10-15 million of its previously reported backlog. However, reasonable investors had no reason to believe that the Company had received any *other* stop-work orders, or that there were any present legal impediments to the Company's ability to perform work and recognize revenue from the previously reported backlog that was *not* the subject of SWO1 (*i.e.*, other than that $10-15 million of backlog affected by SWO1). Indeed, reasonable investors had every reason to believe that *no* present legal impediment existed: The September 9, 2004 10-Q Report and the 2004 10-K Report disclosed SWO1 and stated that there was no assurance that the Company might not receive stop-work orders in addition to SWO1 *in the future*, when Defendants had *already* received stop-work orders in addition to SWO1. ER. at 118, 148. "To warn that the untoward may occur when

the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit." *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981), *aff'd in relevant part*, 459 U.S. 375 (1983); *cf. In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1115 (9th Cir. 1989) ("There is a difference between knowing that any product-in-development may run into a few snags, and knowing that a particular product has already developed problems so significant as to require months of delay.")

Courts have held that positive representations about company agreements are misleading when the company withholds information that would tend, in the eyes of reasonable investors, to lower the value of the agreements. For example, in *Plotkin v. IP Axess, Inc.*, 407 F.3d 690 (5th Cir. 2005), defendants announced strategic partnerships and agreements with two companies – Lynxus and AGPI – involving the sale of millions of dollars worth of IP Axess' products. *Id.* at 697. While the agreements actually existed, defendants failed to disclose that Lynxus was a very small company with significant financial problems, and AGPI had only recently been incorporated by the CEO of Lynxus. *Id.* at 697-98. The deal collapsed when Lynxus and AGPI were unable to pay for any of IP Axess' products under the agreements. *Id.* The Fifth Circuit found the announcement of signed, allegedly lucrative contracts misleadingly created "an inference that

IPaxess expected its partners to perform under the agreements" and "an impression that a substantial payoff would soon flow from the contracts." *Id.* at 698. Defendants' laudatory statements about their new partners were likewise misleading, since "[t]he average investor would certainly be surprised to learn that contrary to the depiction of AGPI/Lynxus in the press releases, the two companies were new, small and related to each other." *Id.* at 699. Inclusion of known information about these new partners "would tend to undermine the investor's impression of the solidity of the new contracts and would imply instead that IPaxess had embarked on a speculative venture." *Id.*

Similarly, the defendants in *Brumbaugh v. Wave Systems Corp.*, 416 F. Supp. 2d 239 (D. Mass. 2006), announced an agreement with microchip giant Intel which would "enable Intel to bundle Wave's software and services with a future Intel desktop motherboard." *Id.* at 246. Days later, Wave announced a new agreement with IBM. *Id.* at 246-47. However, neither announcement disclosed the actual terms of the agreements. *Id.* During a conference call with analysts that took place ten days after the IBM announcement, the defendants disclosed that the Intel deal was a non-exclusive licensing agreement with no minimum licensing requirements, and that the IBM agreement also involved no sales commitments. *Id.* Although the two announcements contained information that was literally true, the Court found that the announcements were misleading to investors. "[T]he

disclosure required by the securities laws is measured not by the literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers." *Id.* at 649 n.10 (quoting *Lucia v. Prospect St. High Income Portfolio, Inc.*, 36 F.3d 170, 175 (1st Cir. 1994), and *McMahan*, 900 F.2d at 579).

Similar to the misleading statements in *Plotkin* and *Brumbaugh*, Defendants' statements concerning the amounts of the Company's backlog gave reasonable investors the impression that the Company was entitled to generate the amount of revenue equal to the backlog, and that the U.S. government had not taken any action that would prevent the Company from exercising its contractual right to perform work and earn revenue under the contracts included in backlog. If investors learned that the government had issued stop-work orders on several significant contracts included in the backlog numbers, it would have tended "to undermine the investors' impression of the solidity of the [existing] contracts." *Plotkin*, 407 F.3d at 699. Just as it was misleading for defendants to announce important new agreements while withholding materially adverse information about the parties to the agreement (*Plotkin*) or the non-binding nature of the agreements (*Brumbaugh*), it was misleading for Defendants here to report backlog amounts, declare them to be "firm," and withhold information about stop-work orders that impaired the Company's ability to recognize revenue from the backlog.

B. The District Court Failed to Analyze Plaintiff's Claims that Defendants' Statements About Backlog Were Misleading

The District Court failed to analyze whether a reasonable investor could have been mislead by Defendants' statements about backlog, nor did the District Court consider whether Plaintiff's allegations satisfied the specificity requirements of the PSLRA. Rather, the District Court erroneously determined that Defendants' backlog statements were not actionable because Defendants did not have an affirmative duty to disclose the existence of the stop-work orders upon their receipt. ER at 130 (noting that securities laws do not impose a system of continuous disclosure).

Contrary to the District Court's opinion, Plaintiff did not allege that Defendants had a statutory duty to disclose stop-work orders immediately upon receipt. Instead, Plaintiff only asserted that whenever Defendants spoke to the public about the Company's backlog, Defendants should have disclosed the Company's receipt of the stop-work orders, because the Company's receipt of the stop-work orders rendered the backlog numbers misleading. *Sailors v. Northern States Power Co.*, 4 F.3d 610, 612 (8th Cir. 1993) (duty to disclose exists if defendants make a statement that is misleading in the absence of additional facts); *City of Monroe Employees Retirement System v. Bridgestone Corp.*, 399 F.3d 651, 669 (6th Cir.) (same), *cert. denied*, 126 S. Ct. 423 (2005); *In re Digital Island Sec. Litig.*, 357 F.3d 322, 329 n.10 (3d Cir. 2004); *Helwig v. Vencor, Inc.*, 251 F.3d

540, 561 (6th Cir. 2001) (en banc). "[A] company may choose silence or speech elaborated by the factual basis as then known – but it may not choose half-truths." *Helwig*, 251 F.3d at 561; *In re CV Therapeutics, Inc.*, No. C 03-03709 SI, 2004 WL 1753251, * 8-9 (N.D. Cal., Aug. 5, 2004).

Defendants did not have to report their backlog, let alone tell investors that the backlog numbers were "firm." Once they elected to do so, however, they had a duty to disclose the adverse fact that the Company had received stop-work orders; otherwise, investors would be misled about the Company's legal right and its ability to generate revenue from the reported backlog in the short and long term. Accordingly, the District Court erred in holding that the amounts reported as backlog were not misleading as a matter of law.

II. NEITHER BACKLOG NOR STOP-WORK ORDERS WERE IMMATERIAL TO INVESTORS AS A MATTER OF LAW

Defendants' misrepresentations concerning the Company's backlog were material to reasonable investors. Misrepresentations are material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Basic, Inc. v. Levinson*, 428 U.S. 224, 231-32 (1988) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). The materiality determination is uniquely inappropriate for resolution on a motion to dismiss, because such a determination requires the Court to resolve "delicate

assessments of the inferences a 'reasonable shareholder' would draw". *TSC Industries*, 426 U.S. at 450; *Basic*, 485 U.S. at 235 n.14 (rejecting any "bright-line rule" for evaluating materiality); *America West*, 320 F.3d at 934 (same); *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 167 (2d Cir. 2000) (same). Accordingly, dismissal on materiality grounds is improper unless the immateriality of the false or misleading statement is "so obvious that reasonable minds could not differ." *Fecht*, 70 F.3d at 1080-81.

Information about the Company's receipt of stop-work orders was clearly material to any reasonable investor's understanding of backlog because stop-work orders could impair Applied Signal's ability to generate revenue from its reported backlog. Indeed, Applied Signal itself acknowledged that "[w]e depend on revenues from a few significant contracts, and any loss, cancellation, reduction, *or delay* in these contracts could harm our business." September 9, 2004 10-Q Report, ER at 69; 2004 10-K Report, ER at 100 (emphasis added). The same 10-Q report stated that "stop-work orders could negatively impact our operating results and financial condition." *Id.*, ER at 70. Accordingly, given the potential for harm to Applied Signal's business, reasonable investors would want to know of any "cancellation, reduction, or delay" in any of the contracts, such as delays caused by stop-work orders.

Defendants understood that stop-work orders were material to backlog. When Defendants finally disclosed SWO1, Defendants made that disclosure in the context of reporting the Company's backlog amounts:

> At July 30, 2004, ending backlog was approximately $110,755,000, representing a 27.2% increase from ending backlog of approximately $87,074,000 at October 31, 2003. During June 2004, we received a stop-work order instructing us to stop work on a portion of our largest single contract. . . . If all the stopped tasks are terminated, the result could be a significant reduction in orders and backlog in the period in which it occurs.

September 9, 2004 10-Q Report, ER at 68. Defendants' own statements confirm that receipt of a stop-work order was material to any representation about the amount of the Company's backlog.[4]

Since the test for materiality is whether a reasonable investor would have viewed the information as significantly altering the total mix of information available, *Basic*, 428 U.S. at 231-32, courts have typically viewed the market's

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[4] The circumstances of the August 24, 2004 conference call with analysts also suggest that Defendants recognized the materiality of the stop-work order to any representation about backlog. Despite the significance of backlog numbers to investors, Defendants chose not to disclose their backlog – or the related stop-work order – in the press release that preceded the conference call or in their prepared remarks. ER at 51-56. However, an analyst directed asked about the amount of backlog; Defendant Doyle in response informed him that the Company had $111 million backlog, but did *not* inform him about the stop-work orders. ER at 58. Nonetheless, a statement to analysts is a public statement requiring disclosure of all facts necessary to prevent the statement from being misleading. *See, e.g., Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 76, 79-82 (1st Cir. 2002) (finding liability for statements during conference calls that omitted critical facts).

reaction to disclosure of the concealed information as being probative of materiality. *See, e.g., America West,* 320 F.3d at 935 (even delayed market reaction supports finding of materiality); *S.E.C. v. Soroosh*, No. C-96-3933-VRW, 1997 WL 487434, * 6 (N.D. Cal., Aug. 5, 1997) (materiality of concealed fact may be inferred from stock drop following disclosure), *aff'd*, 166 F.3d 343 (9th Cir. 1998); *In re Compuware Sec. Litig.*, 301 F. Supp. 2d 672, 681 (E.D. Mich. 2004) (same); *In re MCI Worldcom, Inc. Sec. Litig*., 93 F. Supp. 2d 276, 281 (E.D.N.Y. 2000) (same). As noted above, in this case, when Defendants belatedly disclosed a *single* stop-work order, share prices for Applied Signal stock dropped 9 percent in a day, and plunged from $37.64 to $31.78 in just three days. Compl., ¶ 31, ER at 13. All of the gains that the stock had achieved since August 24, 2004 (when Defendants reported their backlog without mentioning SWO1) were erased. ER at 103. Since the *only* difference between what Defendants disclosed about backlog in their August 24, 2004 conference call and what they disclosed in the September 9, 2004 10-Q Report was the existence of SWO1 (Compl., ¶¶ 28, 29 and 31, ER at 10-13), the receipt of a stop-work order clearly was a materially adverse event.

The District Court's decision does not discuss materiality directly. However, the District Court's opinion repeatedly cites the significance of the *contingent* nature of stop-work orders, that is, the fact that stop-work orders do not automatically result in final contract cancellations. *See, e.g.*, Decision, ER at 127,

129, 130, 133 and 137. To the extent that the District Court's opinion can be taken as a determination that receipt of stop-work orders cannot be material – and thus cannot serve as the basis for liability – because of their contingent nature, it is inconsistent with Supreme Court precedent. Indeed, the Supreme Court in *Basic v. Levinson* expressly *rejected* the argument that contingent information (in that case, information about a possible merger) could not be material. 485 U.S. at 236.[5]

Moreover, while stop-work orders have a contingent aspect – whether they will lead to final contract cancellations – they also have an impact which is *not* contingent. Companies that receive stop work orders are required to *immediately stop work. See* 48 C.F.R. 52.242-15. Stopping work immediately reduces the revenue which Applied Signal could recognize in the current reporting period under that contract – an event that Applied Signal acknowledged as harmful to its

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[5] Courts have frequently held that Defendants cannot escape liability for misleading statements by asserting that they hoped or believed that adverse consequences would not come to pass. "Even if Defendants did not think that their improper behavior would 'catch up with them,' that does not somehow make their failure to disclose material information acceptable or negate their knowledge of the omission." *In re Campbell Soup Co. Securities Litig.*, 145 F. Supp. 2d 574, 598 (D.N.J. 2001); *see also Fugman v. Aprogenex, Inc.*, 961 F. Supp. 1190, 1196 (N.D. Ill. 1997) (no defense that defendants believed that undisclosed problem would soon be rectified); *In re Amylin Pharmaceuticals Sec. Litig.*, No. 01 CV 1455BTM (NLS), 2002 WL 31520051 (S.D. Cal., Oct. 10, 2002) (rejecting claim that upbeat statements about drug approval process were non-actionable due to the uncertainty inherent in the FDA approval process, where FDA had expressed – albeit in a preliminary fashion – reservations about the company's testing methodology).

business. September 9, 2004 10-Q Report, ER at 69; 2004 10-K Report, ER at 100. Thus, stop-work orders directly impact short-term revenue, even before any final decision is made concerning contract cancellation. *See, e.g.*, December 21, 2004 Press Release, ER at 74 (disclosing the SWO1, which still had not resulted in a cancellation, reduced the Company's opportunity to generate revenue in FY 2004). Even an investor who believed it unlikely that a stop-work order would ultimately result in a contract cancellation, therefore, would still find the existence of stop-work orders material to an assessment of when (as well as whether) the Company would turn its backlog into revenue.

In light of the facts set forth above, it was reversible error for the District Court to hold that the contingent nature of stop-work orders precluded liability for concealing stop-work orders when reporting backlog. Indeed, the stock drop following Defendants' disclosure of SWO1 proves the contrary proposition: the mere receipt of a stop-work order was highly material to reasonable investors.

III. DEFENDANTS' STATEMENTS ABOUT BACKLOG WERE NOT "FORWARD LOOKING"

The District Court erred in finding that Defendants' statements about backlog were protected by the "safe-harbor" provisions of the Private Securities Litigation Reform Act ("PSLRA"). ER at 122-28. The safe-harbor provision is inapplicable because Defendants' misleading statements about backlog were not "forward-looking" within the meaning of the PSLRA.

The statutory safe-harbor defines a "forward-looking statement," in relevant part, as "a projection of revenues, income . . . earnings . . . per share, capital expenditures, dividends, capital structure, or other financial items," or statements "of future economic performance." 15 U.S.C. § 78u-5(i)(1)(a) and (c). Statements of present fact are not protected by the Safe Harbor. *America West,* 320 F.3d at 937; *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.,* 416 F.3d 940, 947-48 (9th Cir. 2005). Representations of past or present fact and economic conditions are not covered by the safe-harbor even when connected to "forward-looking" statements. *America West,* 320 F.3d at 937.[6]

As defined by Applied Signal itself, "backlog" constitutes the amount revenue the Company is entitled to earn under its existing contracts on any given day, less the amounts that have already been recognized as revenue. For example, if on Monday the Company has contracts which authorize it to perform $100 million worth of work, it has backlog of $100 million on that day. If the Company completes portions of those projects on Tuesday, Wednesday and Thursday that entitle it to recognize $5 million in revenue, the Company has backlog of $95

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[6] "*America West* recognized that even though the forward-looking aspect of a particular statement may not be actionable, that very same statement may be actionable because of other misleading content. . . . Thus, *America West* is an example of how a single statement may communicate many different meanings, some of which may render the statement actionable." *South Ferry LP # 2 v. Killinger,* 399 F. Supp. 2d 1121, 1131-32 (W.D. Wash. 2005).

million on Friday morning. If the Company signs a contract worth $50 million on Friday afternoon, the "backlog" number jumps to $145 million. Thus, the Company's "backlog" numbers are a mathematical calculation that reflects a snapshot in time – and a statement of *present* fact. The Company – and investors – may extrapolate from those present facts to make predictions about future performance which may be protected by the safe harbor, but as *America West* demonstrates, the disclosure of the present fact – the amount of backlog – is not.[7]

The District Court erroneously concluded that Defendants' statements were "forward looking" simply because backlog "relates to *future* revenue." ER at 126. The statutory text, however, does not provide a safe harbor for statements that merely "relate" to future revenue. If it did, it would protect all statements of fact, past or present, that any reasonable investor would consider to be material, since the fundamental value of a security to a rational investor is "the net present value of its future cash flows, discounted using their risk characteristics."[8]

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[7] Defendants did, in fact, provide just such a prediction of future performance. *See* August 24, 2004 Conf. Call, ER at 60 ("we're seeing buildup that could support 20-25% year-over-year growth for a number of years to come in the top line"). This guidance is "forward-looking," and the Complaint makes no allegation that it was misleading. However, the present facts from which it was extrapolated are *not* forward-looking.

[8] Andrei Shleifer, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE, at 2 (2000). Existing facts are one set of data that investors use to value stock, but only to the extent that they bear on expected future revenue, since

The Court also erroneously determined that backlog is "by definition, merely a 'projection of revenue' or a 'prediction of future economic performance.'" ER at 126. The Company's backlog number is *not* a prediction of what revenue or sales will be in the future. If Applied Signal reported no backlog at the end of a quarter, it could still have substantial revenue and sales in the next quarter as long as it signed new contracts and made substantial performance on them. Defendants' brief to the District Court affirmatively makes this point. *See* Defendants' Motion to Dismiss Consolidated Amended Class Action Complaint, Memorandum of Points and Authorities, Docket Item No. 35, at 4 (Sept. 14, 2005) (arguing that backlog is *not* an indicator of expected revenues or of sales in any future period).[9]

"securities prices ultimately turn on expectations about future earnings . . . ." Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency,* 70 Va. L. Rev. 549, 561 (1984).

[9] Ignoring *America West*, the District Court cited the test formulated by the Eleventh Circuit in *Harris v. Ivax Corp.*, 182 F.3d 799, 805 (11th Cir. 1999): "A present-tense statement can qualify as a forward-looking statement *as long as* the truth or falsity of the statement cannot be discerned until some point in time after the statement is made." ER at 123 (emphasis added). Had the Court *applied* this standard, however, it would have reached the conclusion that Defendants' statements were *not* forward-looking. For example, if the federal government cancelled every single contract with the Company the day *after* the Company reported $500 million of backlog, the subsequent event would not mean that the Company's *prior* statement was false when it was made. Conversely, if the federal government had taken the same action the day *before* the announcement, the quantification of backlog would have been false on the day that it was made. Since future events *cannot* affect whether the Company's backlog numbers were true or false on the day that they were reported, the *Harris* test demonstrates that

Defendants' backlog numbers are no different from announcements that a company has signed particular contracts worth specific amounts – and such disclosures are not "forward-looking." For example, in *Plotkin v. IP Axess, Inc.*, 407 F.3d 690 (5th Cir. 2005), the Fifth Circuit held that defendants' announcement that they had signed a contract with one company worth at least $25 million per year, and with another company for $6.5 million, were not "forward-looking predictions," because they "referred to then-present factual conditions and thus did not fall within the safe-harbor provision of the PSLRA." *Plotkin*, 407 F.3d at 699, (citing *Griffin v. GK Intelligent Systems, Inc.*, 87 F. Supp. 2d 684, 686 (S.D. Tex. 1999)).

Statements about backlog are also analogous to statements about accounts receivable, which courts have recognized are not forward-looking. *See Westinghouse Elec. Corp. v. 21 Int'l Holdings, Inc.*, No. 92 CIV. 1430 (JSM), 1992 WL 331313 (S.D.N.Y., Nov. 4, 1992) (accounts receivable not forward-looking); *In re Complete Management Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 340 (S.D.N.Y. 2001) (same); *In re NUI Sec. Litig.*, 314 F. Supp. 2d 388, 401-06, 416 (D.N.J. 2004) (company's financial statements that failed to account for bad debt not forward-looking); *In re PSS World Medical Inc. Sec. Litig.*, 250 F. Supp. 2d

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Defendants' backlog announcements were not forward-looking statements.

1335, 1340 & 1351 (M.D. Fl. 2002) (same); *In re Telxon Corp. Sec. Litig.*, 133 F. Supp. 2d 1010, 1032 (N.D. Ohio 2000) (same). Just as future events (such as bankruptcies) can impact whether the amounts reported as accounts receivable will actually be collected, future events (such as contract cancellations or delays) can impact whether and when backlog can be recognized as revenue. Nonetheless, statements concerning the amount of a company's backlog, like statements quantifying accounts receivable, are statements of *present* fact. Backlog represents the amount of *revenue* to which a company is contractually entitled; accounts receivable represent the amount of *cash* to which the company is contractually entitled. Statements about such present facts are not "forward-looking," and accordingly are not protected by the statutory safe-harbor.

IV THE COMPLAINT PROPERLY ALLEGES SCIENTER UNDER THE PSLRA

As required by the PSLRA, the Complaint stated "with particularity facts giving rise to a strong inference" that Defendants acted knowingly or recklessly when they made the misrepresentations concerning the Company's backlog. *America West*, 320 F.3d at 931. The publication of statements by defendants who are aware of facts that suggest the statements are "misleadingly incomplete" is "classic evidence of scienter." *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d at 1022 (quoting *Aldridge*, 284 F.3d at 83). Evidence of motive also can support an inference of scienter. *See America West*, 320 F.3d at 942 (suspicious stock

sales, combined with other facts, show scienter). The Complaint alleges both "classic" scienter and suspicious stock sales.

A. The Complaint Alleges Facts Demonstrating that Defendants Knew About or Recklessly Disregarded the Company's Receipt of the Stop-Work Orders Prior to Reporting Backlog Numbers

As discussed above in Section I, Defendants' statements about backlog were materially misleading to reasonable investors because they did not disclose the Company's receipt of SWOs 1-4. The allegations in the Complaint give rise to a strong inference of scienter because Defendants knew or recklessly disregarded the fact that the Company received the stop-work orders. *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d at 1022.

The Complaint contains allegations specific to each stop-work order that raise a strong inference that Defendants were aware of them upon receipt. With respect to Stop-Work Order No. 1, the Complaint alleges the following facts: (1) The government issued SWO1 in June, *months* before the August 24, 2004 conference call. Compl., ¶ 29, ER at 10-11; (2) Two non-military U.S. intelligence agencies alone accounted for 80 percent of sales. Compl., ¶ 24, ER at 9; (3) SWO1 was issued by one of these two critically important intelligence agency customers. Compl., ¶ 29, ER at 11; (4) SWO1 impacted the Company's largest single contract. *Id.;* (5) SWO1 stopped work worth somewhere between $10-15 million dollars – between 9 percent and 13.5 percent of the Company's then-existing backlog of

$111 million. *Id.;* (6) Defendants disclosed the existence of the stop-work order two weeks after the August 24, 2004 conference call; it is unlikely that they knew of the June stop-work order on September 9, 2004, but had not known of it only two weeks earlier; *Id.;*[10] (7) When they belatedly reported the existence of SWO1 in the September 9, 2004 10-Q report, Defendants did not indicate in any way that they had only just learned about it. *Id.*

The following additional facts contribute to an inference that Defendants knew of the existence of SWO2: (1) SWO2 involved a significant contract worth about $8 million – approximately 7.2 percent of the company's then-existing backlog. Compl., ¶ 30, ER at 11-12; (2) The government issued SWO2 after Applied Signal had proven unable to meet the requirements of the contract, and several meetings had failed to resolve the issues between the parties. *Id.;* (3) As with SWO1, SWO2 was issued in late May or early June, 2004, months before either the August 24, 2004 or September 9, 2004 backlog disclosures.

The following additional facts support the inference that Defendants were aware of SW03: (1) SWO3 was issued by one of Applied Signal's largest customers. Compl., ¶ 35, ER at 14; (2) Two different Applied Signal facilities

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[10] *See, e.g., Ronconi v. Larkin,* 253 F.3d 423, 437 (9th Cir. 2001) (temporal proximity between fraudulent statement or omission and later disclosure can bolster scienter allegation, even though it is insufficient to establish scienter in the absence of other facts). Here, there is ample additional evidence of scienter.

were working on the "Excelsior" contract affected by SWO3 – including the Company's Sunnyvale, California facility, where 50-75 workers were involved in the project. *Id.;* (3) the Sunnyvale, California facility includes Applied Signal's corporate headquarters. Compl., ¶ 7, ER at 4; (4) the "Excelsior" contract was worth approximately $20 million. *Id.* at ¶ 25, ER at 14; (5) SWO3 was issued in August or September of 2004 – three months before the December 21, 2004 press release and conference call touting $143 million in backlog, and four months prior to the filing of the 2004 10-K report in January, 2005 that made the same backlog claim. *Id.;* (6) After receiving SWO3, the Company discontinued work for about a week, then determined to continue work on the project through the end of the calendar year *without customer funding.* Compl., ¶ 43, ER at 18-19. This was a significant decision because it meant that not only did Applied Signal lose the revenue fro 50-75 workers for a significant period of time, but it still paid their salaries; (7) the project was abandoned after the end of the calendar year, and the Sunnyvale headquarters facility, where 50-75 people had been working on the project, became a "ghost town." *Id.;* (8) The markets' dramatic reaction to the disclosure of SWO1 in September of 2004 demonstrated the importance that the market attached to the mere receipt of stop-work orders; thereafter, it is even less likely that Defendants would have been ignorant of additional stop-work orders received from the government.

The inference of scienter for SWO4 is based on the following additional facts: (1) SWO4 was the result of the government finding that Applied Signal was not complying with reporting requirements in the contract. Compl., ¶ 35, ER at 14-15. This was particularly significant since the company acknowledged in its 10-K filings that:

> [i]f we are unable to comply with complex government regulations governing . . . contracting practices, we could be disqualified as a supplier to the United States Government . . . [which would, in turn, mean that] we would lose most, if not all, of our customers, revenues from sales of our products would decline significantly, and our ability to continue operations would be seriously jeopardized."

2003 10K Report, ER at 36-37; (2) Following the issuance of SWO4, the Applied Signal employee who was in charge of the project was demoted. Compl., ¶ 35, ER at 15; (3) the customer who issued SWO4 had cancelled other large contracts with Applied Signal in the past. *Id.*

These factual allegations are sufficient to support a strong inference that the Defendants knew of the existence of all of the stop-work orders. In *America West*, this Court strongly rejected an argument by outside directors that plaintiffs had failed to allege any facts showing that they knew about America West's maintenance issues or communications with the FAA. The outside directors argued that these were management issues that "never rose to the level of Board discussions or communications to any shareholders." 329 F.3d at 943, n.21. This Court strongly disagreed, stating:

> This argument is patently incredible. It is absurd to suggest that the Board of Directors would not discuss either the repurchasing authorization for millions of dollars worth of stock or the FAA investigations, especially considering the fact that the FAA had indicated that it was considering penalties of up to $11 million.

Id.

The instant case is, if anything, even stronger. The stop-work orders all affected U.S. government contracts, and the U.S. government accounted for virtually all of Applied Signal's sales. Compl., ¶ 24, ER at 9. As the Company itself acknowledged, its "dependence on large orders from a relatively small number of customers makes [its] relationship with each customer critical to [its] business." 2004 10-K Report, ER at 100. Moreover, Defendants specifically assured investors that "[m]anagement reviews contract performance, costs incurred, and estimated completion costs regularly." September 9, 2004 10-Q Report, ER at 67. Such a review would necessarily uncover any extant stop-work order. It is extremely unlikely that Defendants would have been unaware of stop-work orders from the U.S. government under these circumstances.

The *America West* court found that it was patently unreasonable to infer that outside directors would not be aware of matters that were particularly important to the company, such as governmental safety investigations and penalties which could total $11 million. If *outside directors* must be presumed to be aware of such significant events, it necessarily follows that the same is true of *senior*

management. Indeed, the size of the penalty at issue in *America West* – $11 million – was at the low end of the $10-15 million range that Defendants reported for the impact of *just one* of the stop-work orders at issue here, and the impact of such a loss to Applied Signal (with less than 500 employees and revenue of $143 million for FY 2004) is obviously much greater than an equivalent loss to a much larger company like America West. *See, e.g.*, *In re Commtouch Software Ltd. Sec. Litig.*, No. C 01-00719, 2002 WL 31417998 (N.D. Cal. July 24, 2002) ("In a company of Commtouch's modest size, it is unlikely that [$500,000 transactions] would fly below the radar of top management, particularly the CEO and CFO. To the contrary, these are exactly the sort of transactions one would expect these officers to scrutinize closely from Day One."). The presumption here is strengthened by the fact that Applied Signal's SEC filings assured investors that management regularly reviewed information about contract performance, incurred costs, and estimated completion costs. ER at 67.

It is also patently unreasonable to assume that the government would not have informed top management of the stop-work orders. As noted by one District Court, "[i]n *America West*, the 'bad news' would have come from a source outside of the company – the [FAA]. In its communications with the defendant company it is most likely that the FAA communicated directly with senior management and/or the board." *In re Lockheed Martin Corp. Sec. Litig.*, 272 F. Supp. 2d 944, 957 n.6

(C.D. Cal. 2003).[11] This is not a case about whether arcane accounting issues might have been hidden from top management by unscrupulous lower-level employees. Defendants Yancey and Beattie would have been the *first* to know of stop-work orders, not the last.

The District Court's scienter analysis with respect to SWO1 does not address most of the facts set out in the Complaint and analyzed above. The Court focused solely upon the allegation that neither Yancey nor Doyle denied that they knew about SWO1 from the time that it was issued. ER at 131. Further, the Court held that Defendants' lack of stock sales between August 24, 2004 and September 9, 2004 when SWO1 was revealed, as well as Defendants' disclosure of SWO1 two weeks after the August 24, 2004 conference call, cut against an inference of scienter. However, stock sales are *not* required to establish scienter, and a lack of stock sales does not negate scienter. *America West*, 329 F.3d at 944.[12]

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[11] Tellingly, the *Lockheed* court also notes that "while the FAA fine [in *America West*] might have been ultimately appealable, the FAA communications would have left no dispute as to the amount of the initial assessment." *Id.* Here too, while the Company might have been able to convince the government to lift the stop-work orders, there would have been little doubt as to what portions of the contracts were affected, and what the value of those portions would be.

[12] While the timing of Defendants' corrective disclosure and their lack of stock sales go to Defendants' possible *motive* for making misleading statements, Plaintiff did not attempt to establish scienter for SWO1 by "motive and opportunity" evidence. Rather, as discussed above, the complaint showed that Defendants *knew* about the stop work orders that rendered their "backlog" statements misleading.

The District Court also held that the Complaint did not sufficiently allege facts sufficient to infer that Yancey or Doyle knew of SWOs 2-4. ER at 131. This would require the Court to assume, however, that the CEO and CFO of the Company were unaware of stop-work orders from some of their largest customers, that they were unaware that a government agency found that they were not properly complying with reporting requirements; that they were unaware that a project manager was demoted for the problems that lead to SWO4; that they did not follow their announced policy of reviewing contract performance and anticipated costs; that they were unaware that 50-75 workers – a significant portion of Applied Signal's total workforce of less than 500 people – were working on a project without government funding (and therefore at complete financial risk to Applied Signal) for a period of months; and, perhaps most tellingly, that they would not have known that the 50-75 workers left the Sunnyvale facility – the very place where Yancey and Doyle worked – at the end of 2004. As in *America West*, it is "patently absurd" to suppose that all of this happened without the CEO and CFO having any awareness of it.[13]

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[13] The District Court also improperly raised the bar for pleading scienter, indicating that plaintiff had failed to plead facts demonstrating "that Yancey and Doyle deliberately attempted to deceive stockholders by providing false or misleading information pertaining to the Company's backlog." ER at 131-32. However, plaintiffs are not required to demonstrate a willful intent to defraud. *Vernazza v. S.E.C.*, 327 F.3d 851, 860 (9th Cir. 2003), *citing Nelson v. Serwold*, 576 F.2d 1332,

America West demonstrates that the PSLRA's "strong inference of scienter" requirement does not compel courts to accept patently absurd inferences advanced by defendants to defeat a complaint. It is absurd to suggest that a CEO and a CFO would be unaware of stop-work orders from their most important customers affecting more than nine percent of their reported backlog. Accordingly, the District Court should not have dismissed on these grounds.

B. Yancey's Stock Sales Contribute to An Inference of Scienter With Respect to Defendants' Fourth Quarter, 2004 Backlog Announcement

The inference that Defendants acted with scienter when they made their materially misleading statements about backlog in the December 21, 2004 conference call and the 2004 10-K Report are bolstered by CEO Yancey's stock sales, which were suspicious in both timing and amount. "Unusual trading or trading at suspicious times or in suspicious amounts by corporate insiders has long been recognized as probative of scienter." *In re Daou Systems, Inc., ("Daou"),* 411 F.3d 1006, 1022 (9th Cir. 2005) (internal citations and quotations omitted).

Over the course of several weeks in January of 2005, Yancey sold over 43 percent of his Company stock holdings, for $4.6 million. Compl., ¶¶ 48-49, ER at

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1337 (9th Cir. 1978). It is sufficient to plead, as plaintiff here has done, that Defendants were aware of facts – the receipt of stop-work orders – that suggested that their statements about backlog were "misleadingly incomplete." *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d at 1022 (internal quotations omitted).

20-21. The timing of Yancey's sales is extremely suspicious, for several reasons. First, the portion of the Excelsior project affected by SWO3, which had continued for months without customer funding, was abandoned at the end of December, 2004, and the Sunnyvale, California headquarters had become a ghost town. Compl, ¶ 43, ER at 18-19. Yancey's stock sales began within *days* of this significant development. Second, Yancey's sales occurred during the last month of the quarter (which ended on January 31, 2005). *Id.* at ¶ 48, ER at 20-21. This Court found timing of stock sales to be suspicious when it occurred approximately a month before the end of a poor quarter (and the announcement of poor quarterly results). *Nursing Home Pension Fund, Local 144 v. Oracle Corp.,* 380 F.3d 1226, 1282 (9th Cir. 2004). Finally, Yancey sold no Applied Signal stock at all during 2004. Compl., ¶ 48, ER at 20. Thus, the January 2005 sales were suspicious in timing and amount.

The District Court improperly held that Yancey's stock sales did not contribute to an inference of scienter because Yancey did not sell at the height of the market, but rather, only sold after the Company reported disappointing results for the fourth quarter of 2004. ER at 132. While Yancey's sales missed the Class Period's high point of $37.86 by three to four dollars, he did quite well compared to people who sold at $23.24 after the Company's poor first quarter performance was disclosed in late February, 2006, and came much closer to selling at the top of

the market than the defendants in *Daou*, 411 F.3d at 1024 (maximum sales at $22.86 for one defendant compared to peak price of $34.375, supported inference of scienter).

The District Court also held that the timing of Yancey's stock sales (January, 2005) was not suspicious; because the Court found that the Complaint lacked "*facts* showing that the stop-work orders had any impact on the Company's recognized revenue or earnings for the first quarter of FY05." ER at 132. The District Court did not address the Complaint's specific allegations that Applied Signal continued work on the Excelsior project, despite SWO3 and *without customer funding*, from September of 2004 until December of 2004, and that, at the end of December 2004, the project was abandoned and the Sunnyvale facility became a "ghost town." The fourth quarter of FY 2004 ended on October 31, 2004, and the first quarter of FY 2005 ended on January 31, 2005; thus, the unfunded work on the "Excelsior" project spanned at least a month of the earlier quarter and two months of the later one. Plaintiffs' commitment of a sizeable portion of their workforce to unfunded work for a period of months clearly supports the Complaint's specific allegation that Applied Signal's disappointing performance in the first quarter of FY 2005 (Nov. 1, 2004 – January 31, 2005) was "the result, in whole or in part, of Stop-Work Order No. 3 and Stop-Work Order No. 4 . . . ." Compl., ¶ 61, ER at 24. By ignoring these facts, the District Court's

opinion "failed to accept Plaintiff's allegations as true and construe them in the light most favorable to Plaintiffs." *America West,* 320 F.3d at 935.

Since Yancey sold a significant amount and percentage of stock at a suspicious time, and since these sales were inconsistent with his prior trading activity, his stock sales provide additional and strong evidence of scienter.[14] Even without the stock sales, however, the Complaint provides ample evidence that Defendants knew about or recklessly disregarded facts – the receipt of stop-work orders – that rendered their backlog numbers misleading. Nothing more is required to properly allege scienter.

V. THE COMPLAINT ADEQUATELY ALLEGES LOSS CAUSATION

The District Court erroneously held that the Complaint failed to plead loss causation with respect to Defendants' failure to disclose SWOs 2, 3, and 4 in connection with their statements about backlog. ER at 132-33.[15] The Court

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[14] The District Court noted that Defendant Doyle did not sell any stock during this period. ER at 132. This is only one factor in the "mix" and hardly dispositive. *See, e.g., America West*, 320 F.3d at 944 (finding that "[s]cienter can be established even if the officers who made the misleading statements did not sell stock during the class period.")

[15] The District Court acknowledged that even Defendants conceded that the Complaint adequately pled loss causation with respect to SWO1. ER at 132 n.11. The concession is scarcely surprising in light of the dramatic decline in Applied Signal's stock price following Defendants' late disclosure of SWO1.

correctly understood the basis for plaintiff's loss causation claim: "Plaintiff vigorously contends, in his Opposition brief, that the stop-work orders were the actual cause of the losses in revenue" in the fourth quarter of 2004 and the first quarter in 2005. ER at 133. However, the Court held that the Complaint did not *state* that there was a connection between the stop-work orders and the loss of revenue, and did not support such an allegation with facts. *Id.* [16]

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[16] The opinion thus suggests that the Court would have upheld Plaintiff's loss causation theory if it had found facts in the Complaint to support it. In this, the Court was clearly correct. Cases subsequent to *Dura* have unambiguously found loss causation adequately pled where plaintiffs allege a stock drop that was caused by disclosure of poor financial results that are the materialization of the fraud, even when the fraud itself remains hidden. *See, e.g., Daou*., 411 F.3d at 1026 (rejecting the district court's requirement of express "negative public statements, announcements or disclosures at the time the stock dropped that Defendants were engaged in improper accounting practices" to allege loss causation, the Court of Appeals held it was sufficient under *Dura* to allege that stock drop was caused by reporting negative financial results that were the "direct result of prematurely recognizing revenue"); *Plumbers & Pipefitters Local 572 Pension Fund et al. v. Cisco Systems Inc. ("Cisco Systems"),* 411 F. Supp. 2d 1172, 1178 (N.D. Cal. 2005) (loss causation allegations sufficient which alleged stock drop following disclosure of poor economic performance resulting from conditions fraudulently concealed from investors); *In re Loewen Group Inc. Sec. Litig.*, 395 F. Supp. 2d. 211, 218 (E.D. Pa. 2005) (*Dura* does not require corrective disclosure followed by decline in stock price); *Teamsters Local 445 Freight Division Pension Fund v. Bombardier Inc*., 2005 U.S. Dist. LEXIS 19506, at *58 (S.D.N.Y. Sept. 6, 2005) (drop in value of securities when company reported decreased earnings expectations was sufficient to allege "loss causation" under *Dura*, where plaintiff alleged that the decreased earnings expectations were caused by the materialization of concealed adverse facts; no requirement that complaint allege that a "corrective disclosure was revealed to the market"); *Sekuk Global Enters. v. KVH Indus. Inc*., No. Civ.A. 04-306ML2005, WL 1924202, * 17 (D.R.I. Aug. 11, 2005) (loss causation properly alleged where stock price fell on news of reduced quarterly

The District Court's assertion that the Complaint does not *allege* loss causation is simply incorrect. The Complaint repeatedly alleges that Defendants' misrepresentations concerning backlog inflated the stock price, and Paragraph 62 of the Complaint alleges that the price of Applied Signal stock declined substantially when Defendants reported poor financial results for the fourth quarter of 2004 and the first quarter of 2005 which were due, in whole or in significant part, to the adverse impact on the Company of SWOs 2-4. ER at 24-25. Lower revenues in the fourth quarter of FY 2004 and the first quarter of FY 2005 were the materialization of the revenue lost from the concealed stop-work orders, and thus the factual allegations describing the stock drops following the announcement of these poor financial results are proper loss causation alllegations. *Daou,* 411 F.3d at 1026. These allegations are clearly 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).

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revenues, even though company did not expressly attribute sales reduction to decreased sales of product alleged to be subject of scheme to manipulate revenues through channel stuffing, fictitious sales, and shipment of defective products); *In re Parmalat Sec. Litig.*, 375 F. Supp. 2d 278, 305-06 (S.D.N.Y. 2005) (loss causation does not require a corrective disclosure followed by decline in price).

Even if fact pleading, rather than notice pleading, were required – and it is not – the allegations of the Complaint are adequate.[17] For example, the Complaint alleges that SWO3 caused Applied Signal to lose revenues related to the "Excelsior" project beginning in September 2004 and continuing through at least December of 2004, when the affected portions of the project were abandoned altogether. Compl., ¶ 43, ER at 17-18. The 50-75 workers impacted by this decision in the Sunnyvale, California headquarters alone represent 10-15 percent of Applied Signal's *total* workforce. Compl., ¶¶ 38-40, ER at 16-17. These employees were not redeployed to other projects during the September, 2004 to December, 2004 time period; thus Applied Signal could not bill their time to other projects. That they could be engaged for *months* on work which was stopped by governmental order, and abandon it at the end of the period, *without* significantly affecting revenue for the quarters in question, defies reason.

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[17] The *Dura* court "assume[d], at least for argument's sake, that neither the Rules nor securities statutes impose any" pleading requirements for loss causation beyond those of Rule 8. *Id.* at 346. The Court's assumption is clearly correct: the securities statutes, including the PSLRA, do not contain any language suggesting that plaintiffs have an enhanced burden in pleading loss causation. Fed. R. Civ. Proc. 9(b) contains a heightened pleading standard for "all averments of fraud or mistake," but only with respect to "the circumstances constituting fraud or mistake." The causal connection between a defendant's misstatements and a plaintiff's loss is not such a circumstance. Accordingly, Rule 8(a) governs, requiring only "a short and plain statement of the claim showing that the pleader is entitled to relief." *Cisco Systems*, 411 F. Supp. 2d at 1177; *In re NYSE Specialists Sec. Litig.*, 405 F. Supp. 2d 281, 315 (S.D.N.Y. 2005).

The District Court, however, disregarded the factual allegations in the Complaint, incorrectly finding them "undermined" by government regulations which make stop-work orders contingent, and by the fact that revenues included in backlog "are typically realized over a multi-year period." ER at 133. While government regulations make the *ultimate* outcome of stop-work orders contingent, however, those same regulations provide that they have an *immediate* short-term impact: "Upon receipt of the order, the Contract shall immediately comply with its terms and take all reasonable steps to minimize the incurrence of costs allocable to the work covered by the order during the period of stoppage." Decision, ER at 107 (quoting 48 C.F.R. 52.242-15). While it is *possible* that a *hypothetical* stop-work order might only affect portions of contracts that are not scheduled to be worked on for months or even years, that was not what happened in this case, as set forth in the Complaint.[18] The Complaint alleges that the stop-work orders at issue in *this* case had an immediate impact, which materialized in the poor financial results that were reported for the fourth quarter of FY 2004 and

[18] Even the hypothetical possibility that the government would issue stop-work orders months in advance of the work at issue appears remote. Since stop-work orders expire after 90 days unless the parties agree to a longer period (*see* C.F.R. § 52.242.15(a)), issuing stop-work orders months in advance of scheduled work would be counterproductive.

the first quarter of FY 2005, and caused significant stock drops and losses to Class Members.

Not only is the District Court's analysis contrary to the principles articulated in *Daou*, the District Court's factual findings are akin to those which this Court rejected in *America West*. There, the District Court "reasoned that Plaintiffs 'completely ignore[d] the other factual events that occurred during the class period and the impact of those events on America West and its stock prices." 320 F.3d at 935. This Court disagreed:

> [I]n reaching this finding, the District Court *failed to accept Plaintiff's allegations as true and construe them in the light most favorable to Plaintiffs*. In their Second Amended Complaint, Plaintiffs pleaded with sufficient particularity its allegations that America West's missed earnings were caused in part by its deferral of maintenance costs . . . . Although not the sole cause, it appears that the ongoing maintenance issues cited by Plaintiffs may have played a substantial role.

Id. at 935-36 (citations omitted, emphasis added). In short, while Defendants may attempt to prove – at a later date – that their misrepresentations did not cause the losses suffered by the Class, a motion to dismiss is not the proper place to test that argument. The District Court erred by ignoring facts properly pled in the Complaint, making factual determinations concerning the cause of the losses suffered by the Class and the reasons for the stock price drops.

VI. THE DISTRICT COURT ERRED IN DISMISSING THE COMPLAINT WITH PREJUDICE

For the reasons set forth above, Defendants' Motion to Dismiss should have been denied. The Complaint adequately alleges all of the elements of a securities fraud case as required by the Federal Rules and the PSLRA. In the event that the District Court found some element to have been inadequately pleaded, however, the proper course would have been to permit the plaintiff to file an amended complaint. Dismissal without leave to amend "is improper unless it is clear that the complaint could not be saved by any amendment." *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 946 (9th Cir. 2005).

The District Court's first rationale for dismissing without leave to amend was its erroneous belief that the Plaintiff's "*theory* of fraud" was legally flawed and "premised on either a fundamental misunderstanding of Applied Signal's business model, at best, or a blatant misrepresentation of the pertinent facts." ER at 137. The Court's attack on either counsels' competence or integrity (*id.*) was wholly unwarranted. Plaintiff does not "misunderstand" Applied Signal's business model, nor did he – or his counsel – misrepresent any facts. The "theory" of the Complaint is that it was materially misleading to make representations concerning the amount of the backlog without disclosure of the fact that the Company had received stop-work orders adversely affecting that backlog.

The District Court's alternative reasons for refusing leave to amend are factually incorrect and are, in any event, inconsistent with *Livid*. The District Court stated that granting leave to amend would be "highly prejudicial to Defendants" because "Plaintiff has already changed his theory of fraud twice" and Defendants should not be required "to defend against an amorphous, 'moving target' securities fraud case that is not well thought-out or well supported." ER at 137. Plaintiff *never* changed his theory, nor did he have the opportunity to do so. While completely unrelated plaintiffs and counsel filed initial complaints in the case, the Complaint dismissed by the District Court was the only one that Plaintiff Whiting or Lead Counsel ever filed against Applied Signal. It is ironic that the District Court would penalize the Lead Plaintiff and counsel for doing an independent investigation prior to filing an amended complaint, rather than simply adopting wholesale complaints prepared by another firm; what Lead Plaintiff and his counsel did is precisely what was intended by the PSLRA. In addition, the resulting Complaint is more narrowly focused than the original complaints and has a *shorter* class period. Finally, it is difficult to see how Defendants were prejudiced, since they were never required to *respond* to the initial complaints; the Complaint dismissed by the District Court was the *only* complaint to which Defendants were ever required to respond.

The District Court also incorrectly reasoned that it was proper to dismiss with prejudice "given the length of time that has passed since the initial complaint was filed" because "Plaintiff has been on notice with regard to the defects of his Consolidated Amended Complaint since September 14, 2005, when Defendants filed the instant Motion to Dismiss." ER at 137. As authority for this, the District Court cites *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1038-39 (9th Cir. 2002), apparently overlooking this Court's specific holding in that case: "[A]s leave to amend is to be freely granted when justice so requires, *we do* ***not*** base our opinion on the failure to amend before the adverse ruling. *It is* ***not*** *unreasonable* that plaintiffs may seek amendment after an adverse ruling . . . ." (emphasis added). Plaintiff did not amend following Defendants' filing of their Motion to Dismiss because Plaintiff believed (and still believes) that Defendants' arguments were without merit. As this Court specifically held, it was not unreasonable for Plaintiff to wait until receiving a ruling before seeking to file an amended complaint.

CONCLUSION

For the reasons set forth above, Plaintiff respectfully submits that the District Court erred in dismissing the Complaint, and erred further in dismissing the Complaint with prejudice. Accordingly, Plaintiff requests that the District Court's judgment be reversed and the case remanded with direction that the Motion to Dismiss be denied.

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15 U.S.C.A. § 78j

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

(a)(1) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
(2) Paragraph (1) of this subsection shall not apply to security futures products.
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rules promulgated under subsection (b) of this section that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading), and judicial precedents decided under subsection (b) of this section and rules promulgated thereunder that prohibit fraud, manipulation, or insider trading, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities. Judicial precedents decided under section 77q(a) of this title and sections 78i, 78o, 78p, 78t, and 78u-1of this title, and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities.

15 U.S.C.A. § 78t(a)

§ 78t. Liability of controlling persons and persons who aid and abet violations

(a) Joint and several liability; good faith defense

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78u-4(b) (excerpt)

(b) Requirements for securities fraud actions

(1) Misleading statements and omissions

In any private action arising under this chapter in which the plaintiff alleges that the defendant--

> **(A)** made an untrue statement of a material fact; or
>
> **(B)** omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) Motion to dismiss; stay of discovery

> (A) Dismissal for failure to meet pleading requirements
>
> In any private action arising under this chapter, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.

15 U.S.C.A. § 78u-5 (excerpt)

§ 78u-5. Application of safe harbor for forward-looking statements

(a) Applicability

This section shall apply only to a forward-looking statement made by--

(1) an issuer that, at the time that the statement is made, is subject to the reporting requirements of section 78m(a) of this title or section 78o(d) of this title;
(2) a person acting on behalf of such issuer;
(3) an outside reviewer retained by such issuer making a statement on behalf of such issuer; or
(4) an underwriter, with respect to information provided by such issuer or information derived from information provided by such issuer.

(b) Exclusions

Except to the extent otherwise specifically provided by rule, regulation, or order of the Commission, this section shall not apply to a forward-looking statement--

(1) that is made with respect to the business or operations of the issuer, if the issuer--
(A) during the 3-year period preceding the date on which the statement was first made--
(i) was convicted of any felony or misdemeanor described in clauses (i) through (iv) of section 78o(b)(4)(B) of this title; or
(ii) has been made the subject of a judicial or administrative decree or order arising out of a governmental action that--
(I) prohibits future violations of the antifraud provisions of the securities laws;
(II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or
(III) determines that the issuer violated the antifraud provisions of the securities laws;
(B) makes the forward-looking statement in connection with an offering of securities by a blank check company;
(C) issues penny stock;
(D) makes the forward-looking statement in connection with a rollup transaction; or

(E) makes the forward-looking statement in connection with a going private transaction; or
(2) that is--
(A) included in a financial statement prepared in accordance with generally accepted accounting principles;
(B) contained in a registration statement of, or otherwise issued by, an investment company;
(C) made in connection with a tender offer;
(D) made in connection with an initial public offering;
(E) made in connection with an offering by, or relating to the operations of, a partnership, limited liability company, or a direct participation investment program; or
(F) made in a disclosure of beneficial ownership in a report required to be filed with the Commission pursuant to section 78m(d) of this title.

(c) Safe harbor

(1) In general

Except as provided in subsection (b) of this section, in any private action arising under this chapter that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) of this section shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that--
(A) the forward-looking statement is--
(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
(ii) immaterial; or
(B) the plaintiff fails to prove that the forward-looking statement--
(i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or
(ii) if made by a business entity; was--
(I) made by or with the approval of an executive officer of that entity; and
(II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.

(2) Oral forward-looking statements

In the case of an oral forward-looking statement made by an issuer that is subject to the reporting requirements of section 78m(a) of this title or section 78o(d) of this title, or by a person acting on behalf of such issuer, the requirement set forth in paragraph (1)(A) shall be deemed to be satisfied--

(A) if the oral forward-looking statement is accompanied by a cautionary statement--

(i) that the particular oral statement is a forward-looking statement; and

(ii) that the actual results might differ materially from those projected in the forward-looking statement; and

(B) if--

(i) the oral forward-looking statement is accompanied by an oral statement that additional information concerning factors that could cause actual results to materially differ from those in the forward-looking statement is contained in a readily available written document, or portion thereof;

(ii) the accompanying oral statement referred to in clause (i) identifies the document, or portion thereof, that contains the additional information about those factors relating to the forward-looking statement; and

(iii) the information contained in that written document is a cautionary statement that satisfies the standard established in paragraph (1)(A).

17 C.F.R. § 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

48 C.F.R. § 52.242-15

52.242-15 Stop-Work Order.

As prescribed in 42.1305(b), insert the following clause. The "90-day" period stated in the clause may be reduced to less than 90 days.

STOP-WORK ORDER (AUG 1989)

(a) The Contracting Officer may, at any time, by written order to the Contractor, require the Contractor to stop all, or any part, of the work called for by this contract for a period of 90 days after the order is delivered to the Contractor, and for any further period to which the parties may agree. The order shall be specifically identified as a stop-work order issued under this clause. Upon receipt of the order, the Contractor shall immediately comply with its terms and take all reasonable steps to minimize the incurrence of costs allocable to the work covered by the order during the period of work stoppage. Within a period of 90 days after a stop-work order is delivered to the Contractor, or within any extension of that period to which the parties shall have agreed, the Contracting Officer shall either--

(1) Cancel the stop-work order; or

(2) Terminate the work covered by the order as provided in the Default, or the Termination for Convenience of the Government, clause of this contract.

(b) If a stop-work order issued under this clause is canceled or the period of the order or any extension thereof expires, the Contractor shall resume work. The Contracting Officer shall make an equitable adjustment in the delivery schedule or contract price, or both, and the contract shall be modified, in writing, accordingly, if--

(1) The stop-work order results in an increase in the time required for, or in the Contractor's cost properly allocable to, the performance of any part of this contract; and

(2) The Contractor asserts its right to the adjustment within 30 days after the end of the period of work stoppage; provided, that, if the Contracting Officer decides the facts justify the action, the Contracting Officer may receive and act upon a proposal submitted at any time before final payment under this contract.

(c) If a stop-work order is not canceled and the work covered by the order is terminated for the convenience of the Government, the Contracting Officer shall allow reasonable costs resulting from the stop-work order in arriving at the termination settlement.

(d) If a stop-work order is not canceled and the work covered by the order is terminated for default, the Contracting Officer shall allow, by equitable adjustment or otherwise, reasonable costs resulting from the stop-work order.

(End of clause)

Alternate I (APR 1984). If this clause is inserted in a cost-reimbursement contract, substitute in paragraph (a)(2) the words "the Termination clause of this contract" for the words "the Default, or the Termination for Convenience of the Government clause of this contract." In paragraph (b) substitute the words "an equitable adjustment in the delivery schedule, the estimated cost, the fee, or a combination thereof, and in any other terms of the contract that may be affected" for the words "an equitable adjustment in the delivery schedule or contract price, or both."

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))**:

x 1. Pursuant to Fed. R. App. P. 32(a)(7)(C) and Ninth Circuit Rule 32-1, the attached opening/~~answering/reply/cross-appeal~~ brief is

x Proportionately spaced, and has a typeface of 14 points or more and contains 13,423 words

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____ Monospaced, has 10.5 or fewer characters per inch and contains _____ words or _____ lines of text (opening, answering and the second and third briefs filed in cross-appeals must not exceed 14,000 words or 1,300 lines of text; reply briefs must not exceed 7,000 words or 650 lines of text).

__2. The attached brief is **not** subject to the type-volume limitations of Fed. R. App. P. 32(a)(7)(B) because

____ This brief complies with Fed. R. App. P. 32(a)(1)-(7) and is a principal brief of no more than 30 pages or a reply brief of no more than 15 pages;

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