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When "Unfinished Business" Really Means "Lost Business": Ninth Circuit Finds A Claim Stated For Securities Fraud Based On Undisclosed Risks Involving Contract Backlog

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In a fact-specific but illuminating application of federal pleading standards for securities fraud claims, the Ninth Circuit recently held that plaintiffs stated a claim for securities fraud by alleging that the defendant company listed certain contracted work as part of its "backlog" but failed to disclose that the work had actually been halted pursuant to customer "stop-work orders" that made it unlikely that the stopped work would ever be completed. *Whiting v. Applied Signal Technology, Inc.,* 08 C.D.O.S. 6811 (9th Cir. June 5, 2008).

In *Whiting*, the Ninth Circuit examined whether the plaintiffs adequately pled their claim for securities fraud arising out of defendant Applied Signal's statements regarding work it had contracted to do but had not yet performed. Applied Signal allegedly derived nearly all of its revenues from contracts with federal government agencies, which could order Applied Signal to stop working on existing contracts for up to 90 days for any reason and at any time. Applied Signal stopped earning revenues immediately when the government agencies issued such a "stop-work order." Moreover, the agencies also allegedly had the power to unilaterally modify or cancel the contract after issuing a stop-work order, and often did so, meaning that the stop-work orders therefore signaled a heightened risk that the company would never earn additional revenues from the contracts at issue.

Specifically, the plaintiffs claimed that the defendants failed to disclose the existence of four stop-work orders the company

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had received. The plaintiffs further alleged that after the stop-work orders were issued, the defendants continued to list the contracts in Applied Signal's "backlog," which the company defined as the dollar value of all work it had contracted to do but had not yet performed. The plaintiffs claimed that the company's backlog reports misled them into believing that Applied Signal was likely to perform tens of millions of dollars worth of work that actually had been stopped and was likely to be lost forever.

The district court dismissed the plaintiffs' complaint for failure to state a claim upon which relief may be granted pursuant to Federal Rule of Civil Procedure 12(b)(6). The plaintiffs appealed to the Ninth Circuit Court of Appeals, which reversed and remanded.

Pleading Fraud With Particularity

Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act ("PSLRA") require that a plaintiff plead fraud "with particularity." This requires the plaintiff to plead the time, place and contents of the alleged misrepresentations with specificity.

The defendants claimed that the plaintiffs failed to allege sufficient facts to show that the company ever received three of the four alleged stop-work orders at issue, or that the orders actually stopped any work that was later reported in the company's backlog. The Ninth Circuit disagreed, on the grounds that the complaint identified four confidential witnesses who had worked for Applied Signal and who would testify to the existence and effect of the stop-work orders. The Court rejected the defendants' contention that the witnesses' declarations lacked foundation because they were not in a position to see the stop-work orders, because they were engineers or technical editors, and instead noted that the former employees would have been in a position to infer the existence of the orders because numerous employees would have been out of work after the orders were issued.

The Court also reasoned that the complaint adequately alleged with particularity that Applied Signal included the stopped work in its backlog, for two reasons. First, the defendants apparently admitted as much during a conference call with analysts. Second, the complaint alleged that the stop-work orders would still have been in effect at the time when the defendants were touting the company's backlog.

Were the Defendants' Disclosures Misleading?

The defendants claimed that even if the stopped work was included in the company's backlog, this would not have misled reasonable investors, who would have understood that this was just what defendants were doing, based on the company's public disclosures. The Ninth Circuit rejected this claim, and focused on language in the company's SEC filings that stated: "Our backlog...consists of anticipated revenues from the *uncompleted portions of existing contracts*...We believe the backlog figures are firm, subject only to the cancellation and modification provisions contained in our contracts." The Defendants claimed that a reasonable investor would interpret this language to mean that the company's backlog included stopped work because the contracts continue to "exist" even after a stop-work order is issued, and stopped work is uncompleted, and thus still counts as backlog, even though the company may never be allowed to complete it.

The Ninth Circuit rejected the defendants' contention, and ruled that it was just as plausible that investors would interpret the quoted language to apply only to work still in progress or work yet to be started on ongoing contracts. Moreover, the Court noted, although the company's disclosures referred to its customers' rights to cancel or modify existing contracts, the disclosures said nothing about the customers' right to stop work and immediately interrupt the company's revenue streams. Perhaps most importantly, the company's disclosures spoke of as-yet-unrealized risks and contingencies, and did not alert investors that some of the risks may already have come to fruition or that what the company referred to as backlog included work that was substantially delayed and at serious risk of being cancelled altogether.

Significantly, the Court also noted that the defendants otherwise had no affirmative duty to disclose the stop-work orders. The Court noted that if the defendants had not disclosed the backlog reports, then their failure to mention the stop-work orders might not have misled anyone – but once defendants chose to tout the company's backlog, they were bound to do so in a manner that would not mislead investors as to what that backlog consisted of.

Permissible Inferences Concerning the Individual Defendants' State of Mind

The PSLRA requires plaintiffs to "state with particularity facts giving rise to a strong inference" that defendants acted with the intent to deceive or with deliberate recklessness. The plaintiffs in *Whiting* did not allege any particular facts showing

that the company's CEO and CFO (who were both named as defendants) knew about the stop-work orders. Instead, the Court noted, "plaintiffs *infer* that these high-level managers must have known about the orders because of their devastating effect upon the corporation's revenue." The Ninth Circuit examined each stop-work order and in each case concluded that it was reasonable to infer that the individual defendants must have known about it, either because of the dollar value of the work that was halted, meetings that were held to renegotiate one contract at issue, the number of employees who were reassigned after a stop-work order was issued, or the fact that one stop-work order came from a particularly difficult client that had previously cancelled other large contracts. The Court concluded that these facts were prominent enough that it would be "absurd to suggest" that top management was unaware of them (citing *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West*, 320 F.3d 920, 943 n.21 (9th Cir. 2003)). The Court distinguished In re *Read-Rite Corp*., 335 F.3d 843 (9th Cir. 2003) on the ground that the plaintiffs here had alleged particular facts (the stop-work orders) that support the inference that the backlog statements were misleading – and known to be so – at the time they were made.

Loss Causation

Plaintiffs in a securities fraud case must allege that the defendants' misleading statements caused them to suffer a "later economic loss." *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005). Put another way, the plaintiffs must allege facts that show that the drop in the price of the company's shares was due to the defendants' misrepresentations. Here, the Ninth Circuit ruled that the plaintiffs satisfied that requirement by alleging that the stop-work orders halted a significant amount of work, that the reduced workload caused a 25% reduction in the company's revenue, and that the revenue reduction later caused a 16% reduction in the company's stock price. The Court rejected the defendants' contention that the plaintiffs were required to precisely allege which parts of which contracts the stop-work orders affected.

Backlog Statements Are Not Forward-Looking

Finally, the defendants argued that liability based on the backlog statements was barred under the PSLRA because the statements were "forward-looking." As the Court noted dismissively, however, the company's "backlog is, instead, a snapshot of how much work the company has under contract right now, and descriptions of the present aren't forward-

looking."

Lessons Learned

Whiting provides a cautionary tale for corporate counsel. The company provided disclosures concerning its contracted work backlog, but did not explicitly disclose that the backlog included tens of millions of dollars worth of work that it had been ordered to delay or stop and that might well be lost forever. This gave the plaintiffs the opening they needed to survive a motion to dismiss because, in the Court's view, a reasonable investor could infer from the disclosures that the backlog only included work that the company was likely to complete, and thus reflected likely future revenue, though the work and the related revenue might never materialize. Interestingly, the court indicated that the company was not required to disclose facts regarding its backlog at all, i.e., that it was otherwise under no affirmative duty to do so. But once the company chose to do so, it was under an obligation to provide full and accurate disclosures regarding the true status of the contracts – and related risks – reflected in that backlog.

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