CAHILL GORDON & REINDEL LLP
EIGHTY PINE STREET
NEW YORK, NEW YORK 10005-1702
TELEPHONE: (212) 701-3000
FACSIMILE: (212) 269-5420

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***Applied Signal*: Ninth Circuit Defines "strong inferences" for Pleading Purposes under PSLRA**

On June 5, 2008, the Ninth Circuit reinstated plaintiffs' class action suit filed against defendants, Applied Signal Technology, Inc., and two individual officers, defendants Gary Yancey and James Doyle, reversing the District Court for the Northern District of California.[1] In their Consolidated Amended Complaint, plaintiffs alleged violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the SEC thereunder, interpreting the heightened pleading standards required for securities fraud actions by the Private Securities Litigation Reform Act ("PSLRA") and for fraud claims in general by Rule 9(b) of the Federal Rules of Civil Procedure, the Court of Appeals found that the class plaintiffs pled securities fraud with sufficient particularity.

I. FACTS AND PROCEDURAL HISTORY

Applied Signal Technology, Inc. ("Applied Signal" or the "Company"), a publicly traded California corporation, is in the business of supplying various U.S. government agencies with customized communications signal processing systems. These government agencies have accounted for almost all of the Company's revenue. Approximately three-quarters of the Company's contracts were "cost reimbursement" contracts, containing a provision that allows the Company's customers to force Applied Signal to stop work on all or any part of a contract at any time through what is referred to as a "stop-work order." Within 90 days after a stop-work order is delivered to a contractor, the contracting officer must either cancel the order or terminate the work covered by the order.

The plaintiffs purchased stock in Applied Signal and six months after their purchase, the Company announced that its revenue fell 25% from the proceeding quarter. Relying on four former employers as confidential sources and on information and belief, the class plain-

[1] *Berson and Whiting* v. *Applied Signal Technology, Inc.*, No. 06-15454, 2008 WL 2278670 (9th Cir. June 5, 2008)

tiffs, alleged that the defendants' statements made during the course of conference calls with securities analysts regarding the Company's backlog were materially false and misleading because they failed to mention certain stop-work orders purportedly issued during May through December 2004 that resulted in substantial financial loss. [2]

The district court dismissed the action with prejudice, finding that the class plaintiffs failed to allege with sufficient particularity facts supporting a viable legal theory of securities fraud, and denied leave to amend their complaint as futile. Plaintiffs appealed.

II. RATIONALE OF THE COURT (as per C.J. Kozinski)

A. MISLEADING OR FALSE STATEMENTS

On appeal, the Ninth Circuit first addressed the significance of the stop-work orders and determined that the Consolidated Amended Complaint alleged with particularity that in calculating backlog, defendants' included contracts with respect to which stop-work orders had been issued. In addition the court credited the plaintiffs' allegation that stop-work orders were in effect with respect to certain contracts when defendants discussed backlog during the calls with securities analysts. Although there is no affirmative duty to disclose stop-work orders, once defendants "chose to tout the company's backlog, they were bound to do so in a manner that wouldn't mislead investors as to what that backlog consisted of."[3] The court held that, for pleading purposes, plaintiffs may rely on information from confidential sources as to the existence and effect of the orders despite defendants' contention that non-managerial company employees were not in a position to identify the stop-work orders first hand. The court found that a dispute over the timing and duration of these orders warranted discovery.

The court rejected defendants' argument that the statements made were not misleading because a reasonable investor would understand that Company backlog numbers would include unfinished contracts subject to stop-work orders. Defendants relied on disclosure in the Company's SEC filings to support their contention as well as federal regulations warning investors that customers might issue these orders.[4] The district court had concluded that the language

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2 *Berson*, 2008 WL 2278679 at *1. "Backlog" refers to future revenues relating to uncompleted portions of existing contracts. *In re Applied Signal Technology Inc., Securities*, 2006 WL at *2.

3 *Berson*, 2008 WL at *4.

4 The disclosure relied on by defendants was as follows:

> "Our backlog . . . consists of anticipated revenues from the *uncompleted portions of existing contracts* . . . . Anticipated revenues included in backlog may be realized over a multi-year period. We include a contract in backlog when the contract is signed by us

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defendants used during the conference call with analysts and issued in a public statement gave sufficient indication that defendants counted stopped work as backlog to refute plaintiffs' allegations. The Ninth Circuit, however, expected greater clarity, holding, "[a]bsent undisputed evidence that these were terms of art that investors would have understood to refer to stop-work orders, we cannot find, as a matter of law, that defendants disclosed that backlog included the [stopped work]."[5]

B. **SCIENTER**

In the Consolidated Amended Complaint, plaintiffs did not allege particular facts indicating that defendants *actually* knew about the stop-work orders. The court, however, held that plaintiffs stated with sufficient particularity facts giving rise to a *strong inference* that defendants acted with the "intent to deceive or with deliberate recklessness as to the possibility of misleading investors."[6] Defendants, relying on its earlier decision in *Read-Rite*, argued that plaintiffs' reliance on Yancey and Doyle's prominent positions in the Company as establishing a "reasonable inference" of awareness did not satisfy the PSLRA's requirement that predicate facts be pleaded with particularity.[7] The court rejected the argument. In *Read-Rite*, the alleged statements involved "cheerful predictions" that never came to pass. In *Berson*, plaintiffs' referred to defendants' *contemporaneous* knowledge that such statements were false when made.[8] The court found more analogous the facts in *America West* wherein it affirmed an inference that outside directors were aware of maintenance problems over which they had no direct management responsibility.[9] The court concluded that the allegations made by plaintiffs in *Berson* suggest a

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> and by our customer. We believe the backlog figures are 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 at any particular date is not necessarily representative of actual sales to be expected for any succeeding period, and actual sales for the year may not meet or exceed the backlog represented. We may experience significant contract cancellations that were previously booked and included in backlog." *See Id.* at *3 (emphasis added by the court).

5 *Id.*

6 *Id*. at *4; *See* 15 U.S.C. § 78u-4(b)(2); *In re Silicon Graphics, Inc. Sec. Litig.* 183 F.3d 970, 983 (9th Cir. 1999).

7 *Id*.; at*5; *In re Read-Rite Corp.,* 335 F.3d 843 (9th Cir. 2003).

8 *Id.; In re Read-Rite Corp.,* 335 F.3d at 847.

9 *Id.*; *No. 84 Employer-Teamster Joint Council Pension Trust Fund* v. *America West,* 320 F.3d 920

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stronger inference than those raised in *America West* because Yancey and Doyle were "directly responsible for Applied Signal's day-to-day operations."[10] These facts were "prominent enough that it would be 'absurd to suggest' that top management was unaware of them."[11]

C. CAUSATION OF LOSS

Berson does not answer the unsettled dispute whether Rule 8(a)(2) or Rule 9(b) of the Federal Rules of Civil Procedure governs the standard for pleading loss causation. The court, however, concluded that the Consolidated Amended Complaint gave defendants ample notice of plaintiffs' loss causation theory and provided the court with a sufficient basis in fact to support this theory. The court, assuming that Rule 9(b) governed, held that plaintiffs pled with particularity the alleged facts indicating that "but for the circumstances that the fraud concealed . . . plaintiffs' investment . . . would not have lost its value."[12]

D. SAFE HARBOR PROVISION

The PSLRA carves out a safe harbor from liability for statements that prove false if the statement "is 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 statements."[13] The defendants maintained that the statements concerning backlog were forward-looking and that the Company adequately provided cautionary language in its public filings to shield it from liability. The Ninth Circuit held that "backlog isn't a projection of earnings or a statement about future economic performance." It is instead, "a snapshot of how much work the company has under contract right now, and descriptions of the present aren't forward-looking."[14]

III. SIGNIFICANCE

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(9th Cir. 2003).

10 *Id.*

11 *Id.*

12 *Id.* at *6 (*citing Caremark, Inc.* v. *Coram Healthcare Corp*., 113 F.3d 645, 648-49 (7th Cir. 1997)).

13 15 U.S.C. § 78u-5(c)(1)(A)(i).

14 *Id.*

The PSLRA requires plaintiffs to state with particularity both facts constituting the alleged violations, and the facts evidencing scienter. The heightened pleading requirements act as a check against abusive litigation in private securities fraud actions.[15] Although Congress did not define the term "strong inference" and Circuit Courts were divided on its meaning, the Supreme Court in *Tellabs* held that in order to determine whether a complaint's allegations of scienter can survive threshold inspection for sufficiency, a court must engage in a comparative evaluation. In order to qualify as "strong," an inference of scienter must be more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.[16] The court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically and as a result, the courts retain a great deal of discretion.[17]

The Ninth Circuit did not mention *Tellabs* in its decision. At the same time, the Ninth Circuit placed considerable weight on allegations based on confidential sources.[18] Given that the purpose of the PSLRA's heightened pleading requirements was to weed out strike suits, it will be interesting to see if courts outside of the Ninth Circuit give similar weight to allegations based on unnamed sources.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jon Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com.

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15 *Tellabs Inc.* v. *Makor Issues & Rights, Ltd.* 127 S.Ct. 2499 (2007).

16 *Id*. at 2510.

17 *Id*. at 2511.

18 *Compare Higginbotham* v. *Baxter International Inc.* 495 F.3d 753, 757 (7th Cir. 2007) (interpreting *Tellabs* as instructing the courts to discount confidential sources when evaluating the allegations in their entirety); *Cornelia I. Crowell GST Trust* v. *Possis Medical, Inc.*, 519 F.3d 778, 783 (8th Cir. 2008) (requiring a level of particularity before allegations based on confidential sources may be considered); *Makor Issues & Rights Ltd.* v. *Tellabs Incorporated*, 513 F.3d 702, 711-12 (7th Cir. 2008) (26 confidential sources in a position to know).