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14 **UNITED STATES DISTRICT COURT**
15 **NORTHERN DISTRICT OF CALIFORNIA**

16 ROSENBAUM CAPITAL, LLC,)

17 Plaintiff,)

18 v.)

19 JOHN E. MCNULTY, TIM)
20 STEINKOPF AND SECURE)
21 COMPUTING CORPORATION,)

22 Defendants.)

Case No. 3:07-CV-0392-SC

**PLAINTIFFS' MEMORANDUM OF LAW IN
OPPOSITION TO DEFENDANTS' MOTION
TO DISMISS**

Hearing Date: November 30, 2007

Time: 10:00 a.m.

Courtroom: 1

The Honorable Samuel Conti

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1 Lead Plaintiffs Rosenbaum Capital, LLC and T. Paul Thomas (“Plaintiffs”) submit this
 2 Memorandum of Law in Opposition to the Motion to Dismiss of Defendants Secure Computing
 3 Corporation (“Secure” or the “Company”), John E. McNulty (“McNulty”) and Tim Steinkopf
 4 (“Steinkopf”). Plaintiffs allege claims against Defendant Secure, Defendant McNulty -- Secure’s
 5 President, Chairman and Chief Executive Officer (“CEO”) -- and Defendant Steinkopf --
 6 Secure’s Senior Vice President of Operations and Chief Financial Officer (CFO) -- for violations
 7 of Sections 10(b) and 20(a) of the Securities Exchange Act and Securities and Exchange
 8 Commission (“SEC”) Rule 10b-5.

9 **I. STATEMENT OF FACTS**

10 Defendant Secure claims that it specializes in delivering the world's strongest security
 11 appliances/firewalls, strong authentication, and content management and filtering solutions. ¶7.¹
 12 On August 18, 2005, Secure announced that it had entered into a definitive agreement to acquire
 13 CyberGuard Corporation (“Cyberguard”). ¶37. CyberGuard was a global provider of security
 14 solutions that protect business-critical information assets at Global 2,000 organizations and government
 15 entities. ¶37. CyberGuard’s firewall/VPN appliances were designed to offer network security
 16 solutions by providing the combination of high security, high performance and ease of use for
 17 global customers including major banks, financial institutions, corporations and government
 18 entities. ¶37. CyberGuard’s most lucrative product line was the “The Classic.” ¶¶37, 46.

19 On May 4, 2006, the beginning of the Class Period, Secure issued a press release
 20 announcing financial guidance for the second quarter of 2006. ¶17. Among other things, the
 21 Company stated that for second quarter 2006 “[r]evenues are expected to be between \$43
 22 million to \$45 million” and “[n]on-GAAP fully diluted earnings per share ... is expected to be in
 23 the range of \$0.10 to \$0.12 per share assuming a fully diluted weighted average share count of
 24 approximately 59 million.^{2,3} ¶17.

26 _____
 27 ¹ Citations to the Class Action Amended Complaint for Violations of Federal Securities Laws are
 28 referenced herein as “¶____” or “¶¶____.”

² The May 4, 2006 press release disclosed that it had closed the merger during the first quarter

1 That same day, May 4, 2006, Secure held an earnings conference call with analysts and
 2 investors to discuss the Company's first quarter 2006 financial results. ¶18. Defendants McNulty and
 3 Steinkopf were each present and spoke for Secure throughout the call. ¶18. Defendant Steinkopf
 4 discussed Secure's financial guidance for Second quarter 2006, reiterating the Company's prediction
 5 that "[f]or the second quarter of 2006, we expect revenue to be in the range of 43 to 45 million,"
 6 "GAAP net income is expected to be in the range of \$600,000 to \$900,000" and "Q2 pro forma
 7 EPS guidance ... is expected to be approximately \$0.10 to \$0.12." ¶19. Defendant Steinkopf
 8 also commented on the purportedly successful integration of Secure with the recently acquired
 9 Cyberguard:

10 We...achieved important integration milestones in Q1. Which now has us either
 11 on target or ahead of plan in all major areas of business....**Our strong bottom**
 12 **line performance in Q1 was primarily attributable to the speed and good**
 13 **progress we achieved in integrating CyberGuard into Secure Computing....**

14 ¶19. (emphasis added). Defendant McNulty also addressed Secure's purported integration of
 15 Cyberguard and Secure:

16 We closed the largest acquisition in the Company's history and began the process
 17 of integrating Secure Computing's and CyberGuard's worldwide operations. ...

18 *We exited Q1 functioning as a well integrated single Company in all*
 19 *departments, both process wise and culturally. This is ahead of the integration*
 20 *plan. And as a result, I believe the Company is well positioned for the quarters*
 21 *ahead.*

22 ***

23 Now, I would like to take a couple minutes and comment on the progress of
 24 integrating two companies into one. *The Secure Computing and CyberGuard*
 25 *teams have done a remarkable job coming together as one. Every part of the*
 26 *Company, R&D, customer support, sales, marketing, product management,*
 27 *finance, production, HR, legal and IT are now integrated and under one*

28 and that Secure's results from operations included Cyberguard's from the date of the acquisition,
 January 12, 2006; not that it had closed March 2006, as stated by Defendants. See Defendants'
 Request for Judicial Notice at Exhibit C.

³ On May 9, 2006, Secure filed a Form 8-K with the SEC, signed by Defendant Steinkopf, which
 incorporated the May 4, 2006, press release announcing the Company's second quarter 2006 financial
 guidance. ¶17.

1 *management team. ...*

2 When we announced the acquisition, we committed to our customers that they
3 would be able to look back in a year and feel that they were better off from a
4 product and support perspective. I believe we are on target to living up to this
5 commitment. From a product perspective, all price rationalization and SKU
6 reductions were completed in Q1. ***Our integrated product road maps for both
7 UTM and SCM are either on target or ahead of schedule. The UTM product
8 road map, which we said would be finished within 90 to 120 days, was
9 completed in less than 100 days. And now both end users and channel
10 partners have access to the UTM road map under nondisclosure.***

11 ***

12 Going forward, we are utilizing Global Command Center to provide enterprise
13 management, reporting, logging and correlation to both UTM and SCM offerings.
14 ***Our SCM team is on schedule to complete its product road map by early June.***

15 ***

16 Our support organization has done an outstanding job and there has been
17 absolutely no drop-off in service to our customers. ***In fact, we believe that our
18 customers already are receiving improved support as a result of the wider
19 pool of expertise that is now available to them. The channel team has done a
20 tremendous job and has added over 100 CyberGuard partners into our
21 partners' first program.***

22 ¶20 (emphasis added).

23 On July 11, 2006, however, Secure unexpectedly announced that it expected its financial results
24 for the second quarter to fall well short of its previously issued financial guidance for that period.

25 ¶¶21-22. Specifically, Secure reported that it now anticipated “revenue for the second quarter
26 will be in the range of \$38.5 million to \$39.0 million” instead of the range of \$43 million to \$45
27 million announced on May 4, 2006, a decrease of 10.46% and 13.33%. ¶¶21-22. Secure further
28 reported that it expected “GAAP **net loss** to be in the range of \$2.3 million to \$2.8 million, prior
to the recognition of a gain related to a tax valuation allowance that was not included in
guidance” compared to the “company's prior guidance of **net income** in the range of \$600,000 to
\$900,000.” ¶¶21-22 (emphasis added). Secure also reported that “[f]ully diluted non-GAAP
earnings per share is expected to be in the range \$0.05 to \$0.06, prior to the impact of [a] tax

1 valuation allowance reversal, compared to the company's prior guidance of \$0.10 - \$0.12.” ¶¶21-
2 22.

3 That same day, on July 11, 2006, Secure held a conference call to discuss its anticipated
4 disappointing second quarter results. ¶22. Defendant McNulty attempted to explain the shortfall:

5
6 While there is no room for excuses, I would like to provide some insight into what
7 we encountered. On the last day of the quarter, we were less than 30 minutes
8 away from shipping a \$2.55 million order to a major European customer when we
9 received word from our distributor that the customer was reevaluating resellers,
and would need to hold off on the order for a couple of weeks while they went
through the process. At that point, we did not have time to overcome the setback.

10 Earlier in the last week of the quarter, we were informed of the delay and
11 approval process of a \$1.3 million order to a major U.S. customer that will be
12 shipped in Q3. These two items alone accounted for the majority of our shortfall.
We will provide some additional comments on our July 26 conference call.

13 ***

14 At this point, we're still early [in] our close process and don't have many of the
15 specific details or financial metrics. For now, I will simply say that we're terribly
disappointed and embarrassed by the shortfall.

16 ¶22.

17 Several of the analysts on the conference call were puzzled by the shortfall and/or McNulty's
18 explanation for same. See ¶¶23-27. During the question and answer session at the end of the
19 conference call, William Becklean, an analyst for Oppenheimer & Co. Inc., asked, "To what extent is
20 this related to the integration of CyberGuard and confusion on the channel, sales force, products,
21 whatever?" ¶23. Clearly, Defendants McNulty and Steinkopf were not on the same page because they
22 had conflicting answers to Becklean's question. McNulty replied, "That would be an easy excuse, Bill.
23 Subject to the analysis, I'll make a statement that I don't think that was the reason. Obviously there's
24 probably some deals that we can point to and say they flipped, but that -- we need the two weeks to --"
25 ¶23. Steinkopf interrupted McNulty and stated, "However, John will agree with this next comment. It
26 does appear to us, and again, we have to do a little bit more analysis, that the length of time to close
27
28

1 CyberGuard transaction, so we expected to close November. It slipped into January. Those additional
2 60 days approximately seems to have really hurt our momentum with those product lines...[b]ut it
3 appears that we may be suffering a little bit more deal freeze and momentum slowdown...than we
4 realized last quarter.” ¶23.

5
6 Daniel Ives, an analyst for Friedman Billings Ramsey, asked, “Tim [Steinkopf], you’re
7 telling me that a week before the quarter, you truly go – you truly believed that you were going
8 to hit your guidance number?” ¶25. Steinkopf replied, “Absolutely, I can absolutely tell you
9 that.” ¶25.

10 Analyst Ives further pressed Steinkopf for details:

11 DANIEL IVES: What I'm just trying to reconcile is that okay, you've quantified
12 \$4 million worth of deals, right? Where -- if you add that, that would have been
13 43 -- I mean, I just -- I'm just trying to understand – because you did also say that
there maybe was more delaying of deals than you expected. ...

14 TIM STEINKOPF: I think, Daniel, what we would like to do is, again, these are
15 prelim results. We have a responsibility to get them out. We will do a lot more
work and have a lot more details for you on the 26th.

16 ¶26. Katherine Egbert, an analyst for Jefferies & Company Inc., obviously concerned about Secure’s
17 recent trend of acquiring new companies and, at the same time, misguiding the public, sought
18 reassurance from Secure, “You bought CyberGuard and then you missed the March quarter, and now
19 you missed again in June and you’re attempting to buy CipherTrust. What gives investors confidence
20 that this cycle is not going to repeat itself?” ¶27. In response, McNulty stated:

21 **The CyberGuard acquisition overlaps our product substantially. Because of**
22 **their acquisition, they had not integrated Webwasher. They had not**
23 **integrated SnapGear or a couple other little companies they acquired. And**
24 **the degree of difficulty for that acquisition given multiple locations, multiple**
25 **bookkeeping systems and order entry systems for us was much, much harder**
26 **than we anticipate CipherTrust to be the thing that Tim brought up relative**
27 **to the delay in closing the CyberGuard transaction caused us to stall certain**
28 **activity in the channel and in the general marketplace. We are going to**
explore that, analyzing on a line by line item the business that was in the commit
column for the quarter in every geography and all the product lines, and analyze it
by product line.

1 ¶27-28 (emphasis added).

2 Following the Company's July 11, 2006 disclosures, the price of Secure stock plummeted 38%
3 from \$8.07 per share on July 11, 2006 to \$4.99 per share on July 12, 2006 on very heavy volume of
4 over ten times the average volume, ¶29; and Jefferies & Company Inc. analyst Katherine Egbert cut
5 her rating to "Underperform" from "Hold" and slashed her target price to \$5 from \$11. ¶30.

6 In a press release issued by Secure on July 26, 2006, Defendant McNulty blamed
7 purchasing delays as a result of the CyberGuard acquisition together with the Company's
8 inability to timely-deliver completed product road maps to customers as well as slipped orders
9 for the missed guidance:

10 "Our revenue shortfall was due to a combination of larger than normal number of
11 orders slipping out of the quarter at the end of June, coupled with purchasing
12 delays by our customers as a result of the CyberGuard acquisition. Since the
13 CyberGuard transaction brought together very similar and overlapping Unified
14 Threat Management (UTM) products, customers delayed making purchasing
15 decisions as they waited for completed roadmaps that included upgrade paths for
their installed products....We also have taken the necessary actions to firm up our
sales execution processes...."

16 ¶32. Steinkopf echoed McNulty's analysis, "Looking back on the last six months, we
17 found that Secure Computing and CyberGuard customers waited for completed roadmaps
18 before making purchasing decisions." ¶33. McNulty elaborated on his statements made
19 in the July 26, 2006 press release in a conference call later that day.

20
21 "Clearly, our sales force was overly optimistic in their forecasting....**Specifically,**
22 **customers on [] both the CyberGuard side and the Secured Computing side,**
23 **particularly in the UTM segment, seemed to have frozen their purchasing**
24 **decisions....Further analysis tells us that we delayed average selling cycles of**
25 **five to seven months by three or four months. Clearly, this problem of lost**
26 **momentum in sales cycle was made worse by the delay in our closing of the**
27 **CyberGuard transaction and the uncertainties in our own sales organization**
28 **and then our customer base, stemming from the pending merger, product**
road maps, having a two extra months to fester while we could do a little to
address this....To sum up, the CyberGuard transaction brought together two
very similar and overlapping products. Customers delayed making purchasing
decisions as the[y] waited for completed road maps, that combined offerings
and defined the upgrade path for their installed products."

1 “As I mentioned earlier, CyberGuard’s product completely overlaps Secure
2 Computing’s two biggest product lines. So there was quite a bit of work to do
3 from a product roadmap perspective. **Two of the acquisitions that had**
4 **CyberGuard previously, SnapGear and Webwasher, had undergone minimal**
5 **integration steps. As a result, we had multiple locations, accounting systems,**
6 **order entry systems to integrate. We also exited two small businesses that**
7 **CyberGuard had acquired, which were inconsistent with our corporate**
8 **strategy.”**

¶34 (emphasis added).

9 Defendants knowingly led investors to believe that Secure and CyberGuard were fully
10 integrated into one company and that Secure was receiving the tangible benefits of same, the
11 Cyberguard acquisition was positively impacting Secure’s results from operations and
12 CyberGuard was a lucrative and beneficial acquisition. *See* ¶¶17-20. In reality, however, as
13 Defendants knew, and as confirmed through information provided by Plaintiffs’ confidential
14 sources, former Secure and/or CyberGuard employees, CyberGuard and Secure were not integrated
15 as one company; customers were delaying their purchasing decisions as they waited on
16 integrated product road maps; CyberGuard’s customers of “The Classic” -- Cyberguard’s most
17 profitable product which Secure had determined to discontinue -- were not transitioning to
18 Secure’s Sidewinder product or any of Secure’s products for that matter; Secure was rapidly
19 losing revenue from falling sales of CyberGuard’s primary product; and the CyberGuard
20 acquisition had not and was not developing into a profitable or productive asset. *See* ¶¶38-77.
21 The failure to disclose this and other information, made the Defendants’ Class Period statements
22 false and misleading. Moreover, as a result of this information known by the Defendants,
23 Defendants had no objectively reasonable basis to believe that the Company could meet its
24 guidance for 2nd Quarter 2006, announced by the Defendants on May 4, 2006.

27 **II. THE ALLEGATIONS OF PLAINTIFFS’ COMPLAINT ARE SUFFICIENT TO**
28 **MEET THE PLEADING REQUIREMENTS OF F.R.C.P. 9(b) AND THE PSLRA**

1 SEC Rule 10b-5 makes it unlawful for any person to use interstate commerce to, among
2 other things, “make any untrue statement of a material fact or to omit to state a material fact
3 necessary in order to make the statements made, in the light of the circumstances under which
4 they were made, not misleading.” 7 C.F.R. §240.10b-5. Those who choose to speak, must speak
5 honestly -- not in half truths, in bad faith or without a reasonable basis for their statements. *In re*
6 *Worldcom Inc. Sec. Litig.*, 294 F.Supp.2d 392, 427-28 (S.D.N.Y. 2003). When a corporation
7 does make a disclosure, whether it is voluntary or required, there is a duty to make it complete
8 and accurate. *In re Sotheby’s Holding Inc.*, 2000 W.L. 1234601 at *4 (S.D.N.Y. Aug. 31, 2000).

10 Projections and general expressions of optimism may be actionable under Rule 10b-5. *In*
11 *Apple*, 886 F.2d at 1113 Cir. 1989), *cert. denied*, 496 U.S. 943 (1990); *Warshaw v. Xoma Corp.*,
12 74 F.3d 955, 959 (9th Cir. 1996). A forecast may be actionable if any of the following factors are
13 met: (1) the statement is not generally believed, (2) there is not a reasonable foundation for the
14 belief, or (3) the speaker is aware of undisclosed facts that tend to undermine the accuracy of the
15 projection. *Apple Computer*, 886 F.2d at 1113; *In re HI/FN, Inc. Securities Litigation*, 2000
16 W.L. 33775286 at *6. (N.D.Cal. Aug. 9, 2000); *In re Intermune, Inc.*, 2004 WL 1737264 at *4
17 (N.D. Cal. June 30, 2004); *In re Infosonics Sec. Litig.*, 2007 WL 2301757 at *10 (S.D. Cal. Aug.
18 7, 2007)

21 **A. Pleading Requirements of F.R.C.P. 9(b) and the PSLRA**

22 Under Rule 9(b), Fed. R. Civ. P., and the Private Securities Litigation Reform Act
23 (“PSLRA”) plaintiffs must specify each statement alleged to have been misleading and the
24 reason or reasons why the statement is misleading. *Nursing Home Pension Fund v. Oracle*, 380
25 F.3d 1226, 1230 (9th Cir. 2004). Moreover, under the PSLRA plaintiffs must plead with
26 particularity facts raising a strong inference of the defendants’ state of mind, or scienter. 15
27 U.S.C. §78u-4(b)(2). In this Circuit, the required scienter is deliberate or conscious recklessness.
28

1 *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320
2 F.3d 920, 937 (9th Cir. 2003), *cert. denied*, 540 U.S. 966 (2003); *In re OminiVision*
3 *Technologies, Inc.*, 2005 WL 1867717 at *3 (N.D. Cal. July 29, 2005).

4 “Scienter can be established by direct or circumstantial evidence.” *Omnivision*, 2005 WL
5 1867717 at *4. In assessing whether plaintiff has sufficiently alleged scienter the court must
6 consider “whether the total of plaintiff’s allegations, even though individually lacking, are
7 sufficient to create a strong inference that defendants acted with deliberate or conscious
8 recklessness.” *Oracle*, 380 F.3d at 1234 (“considered separately, plaintiff’s allegations may not
9 create a strong inference of scienter” but “the totality of the allegations does”); *Tellabs, Inc. v.*
10 *Makor Issues & Rights, Ltd.* ____ U.S. ____, 127 S.Ct. 2499, 2509 (2007); *Am West*, 320 F.3d
11 at 938. Moreover, if “some set of facts” alleged by plaintiff accomplishes that objective it is
12 irrelevant whether another set of facts could likewise have been alleged. *In re Cylink Sec. Litig.*
13 178 F.Supp. 2d 1077, 1083 (N.D. Cal. 2001).

14 In determining whether the pleaded facts give rise to a “strong” inference of scienter, the
15 court must take into account plausible opposing inferences. *Tellabs*, 127 S.Ct. at 2509.
16 However, the inference that the defendant acted with scienter need not be irrefutable, i.e. that of
17 the “smoking-gun” genre or even the “most plausible of competing inferences.” *Id.* at 2510. The
18 complaint will survive, if a reasonable person would deem the inference of scienter cogent and as
19 compelling as any opposing inference one could draw from the facts alleged.⁴ *Id.* at 2511.

21 ⁴ In *Tellabs*, the United States Supreme Court sought “to prescribe a workable construction of the
22 strong inference standard, a reading geared to the PSLRA’s twin goals: to curb frivolous, lawyer-
23 driven litigation, while preserving investors’ ability to recover on a meritorious claim.” 127 S.
24 Ct. at 2509. The standard enunciated by the Court is not as exacting as the standard for summary
25 judgment, *id.* at 2510 n. 5, or the burden placed upon a plaintiff to prevail at trial. *Id.* at 2513.
26 The Court observed “it is improbable that Congress, without so stating, intended courts to test
27 pleadings, unaided by discovery, to determine whether there is ‘no genuine issue as to any
28 material facts.’” *Id.* at 2510 n.5. At trial, a plaintiff must prove her case by a “preponderance of
the evidence.” *Id.* at 2513. Stated otherwise, plaintiff must demonstrate at trial that it is “*more*
likely than not that the defendant acted with scienter.” *Id.* In contrast, a plaintiff alleging fraud
in a Section 10(b) action must only “plead facts rendering an inference of scienter *at least as*
likely any plausible opposing inference.” *Id.* “[T]he question is not whether plaintiff can be

1 **B. Plaintiffs Has Pled With Particularity That Defendants' Representations**
 2 **Were False And/Or Misleading And A Strong Inference Of Scienter**

3 In the present case, Plaintiff has alleged that at least the following statements made by
 4 Defendants were materially false or misleading.

- 5 • “Revenues are expected to be between \$43 million to \$45 million;” “Non-
 6 GAAP fully diluted earnings per share ... is expected to be in the range of
 \$0.10 to \$0.12 per share” (5/4/06 press release – all Defendants⁵) ¶17;
- 7 • **“Our strong bottom line performance in Q1 was primarily attributable to the**
 8 **speed and good progress we achieved in integrating Cyberguard into**
 9 **Secure;”** “For the second quarter of 2006, we expect revenue to be in the range of
 10 43 to 45 million;” “Our Q2 pro forma EPS guidance ... is expected to be
 approximately \$0.10 to \$0.12.” (5/4/06 conference call – Steinkopf and Secure
 (speaking), McNulty (failing to correct Steinkopf⁶) ¶19 (emphasis added);
- 11 • **“We exited Q1 functioning as a well integrated single Company in all**
 12 **departments, both process wise and culturally. This is ahead of the integration**
 13 **plan. And as a result, I believe the Company is well positioned for the quarters**
 14 **ahead”** (5/4/06 conference call - - McNulty and Secure (speaking), Steinkopf
 (failing to correct McNulty) ¶20 (emphasis added);
- 15 • **“The Secure Computing and CyberGuard teams have done a remarkable job**
 16 **coming together as one. Every part of the Company, R&D, customer support,**
 17 **sales, marketing, product management, finance, production, HR, legal and IT**
 18 **are now integrated and under one management team.”** (5/4/06 conference call -
 - McNulty and Secure (speaking), Steinkopf (failing to correct McNulty) ¶20;

19
 20 successful on its securities fraud claims, but rather, whether plaintiff has pled its allegations and
 21 supporting facts with particularity such that the complaint should remain for discovery.” *In re*
Nash Finch, Co. Sec. Litig., 2007 WL 12666589 at *15 (D. Minn. May 1, 2007).

22 ⁵ Under the “group pleading” doctrine there is a presumption that misleading information
 23 conveyed in annual reports, press releases, etc., are the collective actions of high ranking officers
 24 that participate in the day to day operations of a company. *Omnivision*, 2005 WL 1867717 at *5;
In re Adaptive Broadband Sec. Litig., 2002 WL 989478 at *17018 (N.D. Cal. April 2, 2002).
 25 Defendants McNulty and Steinkopf are two of the highest ranking officers of Secure and the
 statements made in the May 4th press release can attributed to them. *Id.*

26 ⁶ Defendants who silently listen as others make statements they knew to be false are liable for
 27 failing to correct a falsehood. *Barrie v. Intervice-Brite, Inc.*, 397 F. 3d 249, 262 (5th Cir. 2005).
 A high ranking company official cannot sit quietly at a conference with analysts, knowing that
 28 another official is making false statements and hope to escape liability for those statements. *Id.*
 (quoting *In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp.2d 527, 543 (D. Ohio 2000)).

- **“Our integrated product road maps for both UTM and SCM are either on target or ahead of schedule.** The UTM product road map, which we said would be finished within 90 to 120 days, was completed in less than 100 days. And now both end users and channel partners have access to the UTM road map under nondisclosure.” (5/4/06 conference call - - McNulty and Secure (speaking), Steinkopf (failing to correct McNulty). ¶20.

1. Allegations of Specific Problems Undermining Defendants’ Class Period Statements Suffice to Explain the Statements are False And Demonstrate a Strong Inference of Scienter on the Part of Defendants

Whether falsity and scienter have been adequately pled can be collapsed into a single inquiry because their analyses frequently involve the same set of facts. *Am. West*, 320 F.3d at 932. Plaintiffs may establish falsity by alleging facts demonstrating that “the statement failed to reflect the Company’s true condition at the time the statements were made.” *Fecht v. Price Co.*, 70 F.3d 1078; 1083 (9th Cir. 1995), *cert. denied*, 517 U.S. 1136 (1996); *Immune Response*, 375 F. Supp. 2d at 1020; *Checednichenkov v. Quarterdeck Corp.*, 1997 WL 809750 at *2 (C.D. Cal. Nov. 26, 1997). Allegations of “specific problems undermining a defendant’s optimistic claims suffice to explain how the claims are false,” *Cooper v. Pickett*, 137 F.3d 616, 626 (9th Cir. 1998), and support a strong inference of scienter. *Weiss v. Mentor Graphics Corp.*, 1999 WL 985141 at *16 (D. Ore. Oct. 6, 1999); *see Omnivision*, 2005 WL 1867717 at *4 (“The preferable way to show scienter is by putting forth contemporaneous reports or data which contradict misleading statements.”). “One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.” *Florida State Bd. of Admin v. Green Tree Fin. Corp.*, 270 F.3d 645, 665 (8th Cir. 2001)

a. Plaintiffs’ confidential source information undermines the Defendants’ statements and suggests a strong inference of Defendants’ knowledge or deliberate recklessness in making such statements

A complaint in a securities class action may rely on confidential sources as long as those sources are “described with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged and the complaint

1 contains adequate corroborating details.” *In re Lexar Media, Inc.*, 2005 WL 1566534 at *3 (N.D.
2 Cal. July 5, 2005) (quoting *In re Daou Systems, Inc.*, 411 F.3d 1006, 1015-16 (9th Cir. 2005),
3 *cert denied*, 126 S.Ct. 1335 (2006)). Such particularity may be met by including a job title and a
4 description of that individual’s responsibilities with the company. *Osher v. JNI Corp.*, 308
5 F.Supp.2d 1168, 1178 (S.D. Cal. 2004).

6 Plaintiffs’ particularized confidential source information, alleged in the Complaint,
7 undermines the veracity of Defendants’ Class Period statements and suggests a strong inference
8 of scienter on the part of the Defendants. Plaintiffs have provided more than sufficient
9 descriptions of their sources to support the probability they would possess the information
10 provided and alleged. As set forth below and in detail in the Complaint, these witnesses’
11 accounts are consistent and sufficiently detailed: (1) each witness worked at Secure and/or
12 Cyberguard during, or in the case of one such witness immediately following, the Class Period
13 and stated they had knowledge of the information provided, (2) each witness’ job title and
14 responsibilities support his or her knowledge of the information provided, (3) the witnesses
15 corroborate one another, and (4) the witness’ accounts are corroborated by other facts. *See* ¶¶38-
16 77. Moreover, contrary to Defendants’ suggestion, witness-based information need not be
17 admissible as evidence or sufficient to sustain plaintiffs’ claims at trial. Courts have accepted as
18 reliable factual information related to a witness’ job responsibilities, *Daou*, 411 F.3d at 1016,
19 facts a witness learned from another employee with direct knowledge, *In re Cabletron Sys., Inc.*,
20 311 F.3d 11, 31 (1st Cir. 2002) (consistent witness accounts reinforce one another), or facts based
21 on internal documents or other sources of information the witness received. *Barrie v. Intervoice-*
22 *Brite, Inc.*, 397 F.3d 249, 259 (5th Cir. 2005), *modified on other grounds*, 409 F.3d 653 (5th Cir.
23 2005). Plaintiffs have alleged corroborating detail indicating the reliability of their allegations.

24 According to Plaintiff’s confidential sources, and contrary to Defendants’ Class Period
25 Statements, the Secure/Cyberguard acquisition was unsuccessful from the beginning,
26 Cyberguard’s customers were not transitioning to products now offered by Secure, the purported
27 integration of Cyberguard into Secure was not being achieved and as a result Secure’s financial
28

1 performance was negatively impacted and its second quarter 2006 guidance lacked an
2 objectively reasonable basis. ¶¶38-77.

3 CyberGuard's main product line was "The Classic," which ran on the Unix System, a
4 system that yielded the highest level of security in the industry. ¶46. Confidential Source ("CS")
5 No. 1, a Director of Administration for Cyberguard who was a "transitional employee" at Secure
6 following the Cyberguard acquisition from January 12, 2006 through October 6, 2006, said that
7 "The Classic" was by far CyberGuard's most profitable product, accounting for the vast
8 majority, about 80%, of CyberGuard's revenue. ¶46. Regardless of "The Classic's" success,
9 Secure discontinued it around January 2006, signaling that it was positioning its products to run
10 solely on the less secure and untested Linux system. ¶47.

11 As Director of Administration, CS No. 1 was primarily responsible for: (1) order
12 processing; (2) forecasting sales for the quarter; (3) implementing methods to meet revenue
13 goals; and (4) organizing the maintenance department in customer support. ¶44. Following
14 Secure's announcement that it was discontinuing "The Classic," CS No. 1 concentrated her
15 efforts on the estimated 11,000 CyberGuard customers who had been "stuck" with a service
16 agreement for a product that was now a dead end and obsolete. ¶48. Her focus shifted to them,
17 she said, because "the obsolescence of that product panicked the customers." ¶48. CS No. 1 did
18 not believe that Secure was sophisticated enough to provide maintenance support for the Unix
19 System, namely CyberGuard's number one seller, "The Classic." ¶49. She said that if Secure
20 had streamlined CyberGuard's support staff into Secure then Secure would have been able to
21 properly support "The Classic." ¶49. However, Secure fired CyberGuard's entire customer
22 support staff making it impossible for Unix System customers to get the maintenance support
23 they needed and were told they would be provided when they purchased the product. ¶49.

24 CS No. 1 blamed Secure's second quarter 2006 guidance miss, in part, on the Company's
25 ill-conceived decision to discontinue "The Classic." ¶50, 56. By May 2006, she said, there were
26 "no new sales" of "The Classic" which caused Secure to experience lost revenues and "financial
27 losses" in the first and second quarters of 2006. ¶50. She knew about the "financial losses"
28

1 because she worked “in the customer world,” dealt with customers, and “heard things.” ¶50. She
2 explained that “by obsoleting CyberGuard’s [most profitable] product, Secure planned that those
3 CyberGuard customers using the product would automatically just transfer their allegiance to
4 Secure.” ¶50. However, she said, customers she worked with regarding contract and service
5 agreement renewals were “completely furious” and went into a “tailspin.” ¶50.

6 CS No. 4 corroborated the statements made by CS No. 1, stating that the decision to end
7 production of CyberGuard’s main product line, “The Classic,” in early 2006 “alienated”
8 customers immediately. ¶63. In fact customers who had “caught wind of the news” prior to the
9 acquisition were already expressing their anxiety about the future of their products and service
10 contracts with Secure, CS said, -- “there was a lot of concern [among CyberGuard’s customers
11 and] to actually stop production exacerbated the situation.” ¶63; *see also* ¶38. CS No. 4 was the
12 Manager of Worldwide Support at CyberGuard from early 2004 until he left Secure in June
13 2006. ¶62. He worked with Gary Ostrem, Secure’s Director of Support and Roger Barranco, the
14 Customer Support Supervisor at Secure. ¶62.

15 CS No. 2 echoed CS Nos. 1 and 3, stating that Secure’s decision to discontinue
16 CyberGuard’s most lucrative product, “The Classic,” was premeditated and “extremely stupid
17 and risky.” ¶61. It was his opinion that there was no sound basis for Secure’s assumption that
18 CyberGuard’s “The Classic” customers would migrate to Secure’s Sidewinder product. ¶61. CS
19 No. 2 served as the Global Original Equipment Manager (“OEM”) Account Manager for Cisco
20 at Secure from 2001 until September 2006. ¶57. **CS No. 2 reported to Chris Peterson, the VP
21 of OEM and Channel Sales for Secure, who reported directly to Defendant McNulty.** ¶57.

22 CS No. 3 was a Security Sales Engineer at Secure from July 2006 until November 2006;
23 his territory encompassed New Mexico, Colorado, Wyoming and Utah. ¶68. CS No. 3 reported
24 to Mike Resong (“Resong”) who, in turn, directly reported to the VP of his sales Division,
25 Michael Brubaker (“Brubaker”). ¶68. **When he joined Secure in July 2006, CS No. 3 said, he
26 learned from Resong and Brubaker that since the January 2006 acquisition of
27 CyberGuard, “The Classic” customers were not transitioning to Secure, and that if he and
28**

1 **his supervisors knew it, it must have been common knowledge at the Company, he said.**
2 ¶¶68. (emphasis added).

3 CS No. 3 was told that his main priority was to transition as many CyberGuard “The
4 Classic” customers to Secure’s Sidewinder product as possible -- “[t]here was certainly
5 desperation [to]...sell, sell, sell, he said.” ¶¶69 and n. 7. However, CS No. 3 said, during his
6 tenure there was “not one single transition” by a CyberGuard “The Classic” customer to Secure’s
7 Sidewinder product in his territory, ¶¶68, 71; and by the time he left Secure in September 2006
8 the Company had shifted its sales focus to CipherTrust, Secure’s most recently acquired
9 subsidiary, acknowledging that it could not maintain relationships with “The Classic”
10 customers. ¶¶72-73. **CS No. 3 further stated that throughout the Company the “flavor was
11 pervasive” that these transitions had been going poorly since the actual acquisition of
12 CyberGuard in January 2006.** ¶70. (emphasis added). **He said that it was common
13 knowledge and obvious that these transitions had been a failure “since day one.”** ¶70.
14 (emphasis added). In CS No. 3’s opinion, it was not as if things had been going great in the first
15 quarter of 2006 and then all of a sudden there were unexpected lost opportunities; rather, it was
16 that there had been known problems with CyberGuard customers and revenues from the
17 beginning of 2006. ¶70.

18 On May 4, 2006, the first day of the Class Period, CS No. 1 was working under and
19 reporting to Secure’s VP of Production, Ron Bohn (“Bohn”). ¶45. **Bohn’s responsibility
20 entailed overseeing the integration of CyberGuard’s product order-processing and
21 customer base.** ¶45. CS No.1 stated the “integration” of CyberGuard and Secure into one
22 company was a “hoax.” ¶52. She said she did not think that Secure was even trying to integrate
23 CyberGuard into Secure; rather Secure was attempting to shut down CyberGuard products and
24 services completely. ¶52. For example, CS No. 1 stated, she did not train one person to
25 transition into her position and was not directed to train a successor. ¶52.

26 CS No. 1 also worked closely with Prudy Henriksen, Secure’s manager of order
27 processing, Elaine Chan, Secure’s manager of service agreements and closely with Liz Lally,
28

1 Secure's Director of Legal Counsel, on export licenses. ¶53. According to CS No. 1, Secure did
2 not have a licensing department and due to a lack of licensing infrastructure did not have any
3 means to identify individual firewalls by IP address. ¶54. This "flabbergasted" CS No. 1
4 because Secure could not keep track of which clients were using what products and the
5 maintenance history of each firewall. ¶54. She was "very concerned because licenses were
6 integral to CyberGuard's sales and maintenance departments." ¶54. **CS No. 1 added that**
7 **throughout her last months at Secure she worked directly with Defendant Steinkopf**
8 **regarding CyberGuard's "procedure issues" and Steinkopf was "concerned with issues**
9 **that should have been thoroughly covered at the due diligence stage."** ¶55. (emphasis
10 added). For example, she said, "no one at Secure was up to speed on CyberGuard's registration
11 of firewalls or customer contracts." ¶55.

12 CS No. 1 expressed her belief that Defendant McNulty's May 4, 2006 announcement that
13 all of Secure's and CyberGuard's departments were "integrated and under one management
14 team" was false and misleading. ¶51. CS No. 1 regularly asked Bohn, who was going to take
15 over her position, for information regarding the direction of the Unix System, but Bohn could not
16 give her a specific answer or the name of her successor. ¶51. When she relayed this information
17 to her clients they were very upset, especially the federal government. ¶51-52 n. 3. When
18 customers would routinely request "transitional product road maps" from CS No. 1 she would
19 refer them to John Doyle, CyberGuard's VP of Marketing, who reported to the Individual
20 Defendants, because she was informed he had instructions regarding the future of CyberGuard's
21 products and services. ¶51. CS No. 1 said she believed that Secure was unable to give the
22 customers the "transitional product road maps" because Secure did not have them. ¶51.

23 CS No. 1 said she believed that Secure missed its second quarter 2006 guidance because
24 of the lack of integration of CyberGuard into Secure, Secure's failure to complete due diligence
25 prior to the acquisition and because Secure abandoned CyberGuard's most lucrative product line,
26 "The Classic." ¶56.

1 CS No. 2, the Global OEM Account Manager, confirmed that Secure and Cyberguard
2 were not integrated -- contrary to Defendants' Class Period representations --, the lack of
3 synergies between the two companies and the absence of a reasonable basis for Secure's second
4 quarter 2006 financial projections. According to CS No. 2, the acquisition of CyberGuard should
5 be a "Harvard Business School study" because "it was a PR stunt." ¶57. He explained that there
6 was no synergy in the CyberGuard acquisition and after the acquisition, the revenues of the two
7 companies flattened and senior management should have known that there was no growth in
8 sight as of the first quarter 2006. ¶57. CS No. 2 said that Secure's second quarter 2006,
9 financial guidance "was a dart throwing contest" because there "was no foundation" for any
10 figures announced, "but they [Secure's management] did have to come up with something." ¶58.
11 **He knew these things, CS No. 2 said, because he communicated freely with his boss, Chris**
12 **Peterson, Secure's VP of OEM and Channel Sales and a "very senior" executive, and**
13 **Peterson's proximity to Defendant McNulty and other senior management was "direct."**
14 ¶58. (emphasis added). CS No. 2 stated that the prevailing thought at Secure was that "anyone at
15 a senior level at Secure knew" the CyberGuard acquisition would damage Secure's bottom line
16 in 2006. ¶59. CS No. 2 stated that the most basic due diligence by Secure would have disclosed
17 CyberGuard's disjointed operational structure. ¶60. He explained that CyberGuard was really
18 just an "umbrella name" for three disjointed products/companies -- TSP, Webwasher and
19 SnapGear -- that were not integrated. ¶60. According to Confidential Source No. 2, "it was a
20 mess to acquire [CyberGuard]," ¶60, -- as belatedly admitted by Defendants at the close of the
21 Class Period, ¶27, -- because each group had different accountants, sales tracking methodologies,
22 salary schemes and benefit programs. ¶60.

23 Information provided by CS No. 5, an Enterprise Sales Manager at Secure from 2005
24 until September 2006, substantially corroborated the testimony of the other confidential
25 witnesses. CS No. 5 stated that Secure's revenue shortfall in 2nd Quarter 2006 resulted from the
26 CyberGuard acquisition. ¶64. Specifically, CS No. 5 stated that Secure's senior leadership
27 "assumed" that when Secure absorbed CyberGuard Secure would double its earnings; however,
28

1 he explained that “two plus two did not equal four...instead it was more like two plus two
2 equal[ed] one point five.” ¶64.

3 CS No. 4, the Manager of Worldwide Support, called Secure’s top management a group
4 of “very arrogant” leaders who thought they could “merge a company and get rid of products,
5 and get rid of tech support” and be in “great shape” only four months after the merger. ¶65. He
6 stated there was no reasonable basis for these assumptions. ¶65. He further related that
7 CyberGuard’s customers were “waiting for...[transitional product] roadmap[s]” from the
8 moment the pending acquisition was announced in 2005 and this caused “no movement in sales,
9 if not losses” in the beginning of 2006 because Secure was not delivering the promised and
10 requested “transitional road maps.” ¶65. The positive financial forecast made by Defendants
11 McNulty and Steinkopf on May 4, 2006 was “smoke and mirrors” without a reasonable basis, he
12 said, with the stock prices already going down, “they had to stop the bleeding.” ¶65.

13 CS No. 2 confirmed that “the guy who did the numbers [referenced by McNulty during
14 the July 11, 2006 conference call] was at the World Cup,” but as an excuse for the missed
15 guidance it “makes no sense.” ¶66. He explained that the financial results in the announcement
16 in July 2006 “could not have just happened, one or two bad things did not happen to cause the
17 miss.” ¶66. According to CS No. 2, those losses had been brewing for months. ¶66.

18 Citing *Higginbotham v. Baxter, Int’l, Inc.*, ___ F. 3d___, 2007 WL 2142298 (7th Cir.
19 July 27, 2007), Defendants argue that the information from Plaintiffs’ confidential sources
20 should be “substantially discounted” because the names of the sources have not been disclosed.
21 Such, however, is neither the law of this Circuit, *see Daou*, 411 F. 3d at 1015-16, nor consistent
22 with the principles enunciated in *Tellabs*. Faced with a Rule 12(b)(6) motion to dismiss a §10(b)
23 action, courts must, as with any motion to dismiss for failure to plead a claim, accept all factual
24 allegations in the complaint as true. *Tellabs*, 127 S.Ct. at 2509. “ At this stage in the litigation ...
25 factual issues concerning the credibility and weight of the employee statements will be construed
26 in favor of Plaintiff.” *Lefkoe v. Jos. A. Bank Clothiers*, No. WMN-06-1892, slip op. at 13 (D.
27 Md. Sept. 10, 2007) (rejecting defendants’ argument that “employee statements should be
28

1 accorded less weight due to their confidential nature”) (citing *Tellabs*, 127 S.Ct. at 2509), Exhibit
2 1, attached. .

3 In short the facts alleged by Plaintiffs, including Plaintiffs’ confidential source
4 information, show that Defendants’ statements were false when made – and that defendants
5 knew it, or were deliberately recklessly in not knowing it --- by describing with particularity the
6 who, what, when, where, how and why required by Rule 9(b) and the PSLRA.

7 **b. The Importance of the Matters alleged to be False and Misleading Supports**
8 **Strong Inference of Scienter**

9 “[I]t may be inferred that facts critical to a business’s core operations or an important
10 transaction are known to a company’s key officers.”⁷ *In re Northpoint Comm Group, Inc., Sec.*
11 *Litig.*, 184 F.Supp.2d 991, 998 (N.D. Cal. 2001); *In re Northpoint Comm Group, Inc., Sec. Litig.*,
12 221 F.Supp. 2d 1090, 1104 (N.D. Cal. 2002) (CFO’s scienter inferred because of CFO’s position
13 and the fact that the fraud involved significant financial aspect of the business); *South Ferry LP #*
14 *2 v. Killinger*, 399 F.Supp.2d 1121, 1139, 1141 (W.D. Wash. 2005). Clearly, Defendants
15 considered the integration of Cyberguard, “the largest acquisition in the Company’s history,”
16 ¶20, into Secure to be important to the success of Secure’s core business operations. In
17 addition to being obvious this can be inferred by the fact Defendants McNulty and Steinkopf
18 made several statements expressly addressing the purported success of same during Secure’s
19

21 _____
22 ⁷ Although persons’ positions within a company cannot, alone, establish scienter, the fact that
23 those persons are the “most senior executive[s] of the Company is a fact relevant in [the]
24 weighing of the totality of the allegations.” *Adams v. Kinder-Morgan, Inc.*, *Adams*, 340 F.3d
25 1083, 1106 (10th Cir.2003). This is even more true when the disclosures involve matters of
26 importance to the company. *See Plotkin v. IP Axess Inc.*, 407 F.3d 690, 700 (5th Cir. 2005) (“It is
27 reasonable to assume, given the importance of these deals [with Lynxus/AGPI] to the company,
28 that IPaxess would have . . . discovered details about their poor financial condition . . . [of]
Lynxus.); *In re Elec. Data Sys. Corp. Secs. & ERISA Litig.*, 298 F. Supp.2d 544, 557 (E.D. Tex.
2004) (“contract’s sheer magnitude and importance to EDS support an inference that Brown and
Daley, the CEO and CFO, would know its status”);.

1 May 4, 2006 earnings conference call. *See* ¶¶19-20; *South Ferry*, 399 F.Supp.2d at 1141. Thus,
2 knowledge of Secure’s failure to integrate Cyberguard into Secure can be inferred with respect
3 to Defendants McNulty and Steinkopf, Secure’s CEO and CFO, respectively. *Id.* The
4 transition of Cyberguard’s “The Classic” customers – customers that accounted for 80% of
5 Secure’s revenues, ¶46, – to Secure products was similarly an important piece of the integration
6 process and critical to the success of Secure; McNulty and Steinkopf’s knowledge that such a
7 transition was not being achieved can also be inferred. *Id.* *South Ferry*, at 1141.

9 Finally, to the extent that Defendant McNulty and Steinkopf’s knowledge that
10 Cyberguard had not been integrated into Secure cannot be inferred Defendants’ representations
11 that integration of the two companies had been achieved “without the requisite knowledge
12 would be actionably reckless.” *Id.* at 1142. Officers of public companies have a duty to verify
13 the accuracy of their statements concerning important matters that will be relied upon by the
14 public and investors. *See South Ferry*, 300 F.Supp. 2d at 1141.

16 In short Plaintiffs have alleged a strong inference of scienter on the part of the Individual
17 Defendants and Secure. The inference that the defendant acted with scienter need not be
18 “irrefutable” or even the “most plausible of competing inferences.” *Tellabs*, 127 S.Ct. 2510. The
19 inference of scienter alleged here is cogent and at least as compelling as any opposing inference
20 one could draw from the facts alleged, and that is all that is required at this point in the
21 litigation.⁸ *Tellabs*, 127 S.Ct. at 2510; *Lefkoe*, slip op. at 17.

24 ⁸ A plaintiff may allege scienter on the part of a corporate defendant without pleading
25 scienter against any particular employees of the corporation. *In re Dynex Capital, Inc. Sec.*
26 *Litig.*, 2006 WL 314524, at *9 (S.D.N.Y. Feb. 10, 2006); *In re Worldcom, Inc. Sec. Litig., Inc.*,
27 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) *see Duncan v. Pencer*, 1996 WL 19043, at *11-15
28 (S.D.N.Y. Jan. 18, 1996); *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 206-07
(E.D.N.Y. 2000) Here, Plaintiffs have alleged a strong inference of scienter on the part of the
Individual Defendants and also thereby Secure. Plaintiffs have also alleged a strong inference of

1 **2. The Absence of Insider Stock Sales does not Negate a Strong Inference of**
 2 **Scienter**

3 Defendants contend that the lack of stock sales by the Individual Defendants “means that
 4 the Complaint lacks the required strong inference of scienter.” Defendants are simply wrong.
 5 The fact that Defendants did not sell stock during the Class Period does not negate an inference
 6 of scienter. *See Tellabs*, 127 S. Ct. at 2511 (“While it is true, that motive can be a relevant
 7 consideration, and personal financial gain may weigh heavily in favor of a scienter
 8 inference...the absence of a motive is not fatal”) (rejecting defendants’ argument that the lack of
 9 class period stock sales was dispositive of the scienter issue). *See McKesson*, 126 F. Supp. 2d
 10 1248, 1269 (N.D. Cal. 2000) (a motive for fraud, such as personal gain, is not a required element
 11 of scienter or fraud in general); *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1191 n.12 (10th Cir.
 12 2003) (not proper to infer by fact that some defendants did not sell shares during the
 13 class period that they lacked the motive to defraud investors); *Adaptive Broadband*, 2002
 14 WL 989478 at *16 (“But under the circumstances, when Plaintiff relied on the misstated
 15 revenues and purchased stock at inflated prices, the fact that Defendants did not sell their own
 16 stock matters little.”).

17 **3. Defendants’ Class Period Misrepresentations and Omissions are not**
 18 **protected by the PSLRA Safe Harbor Provision or Bespeaks Caution**
 19 **Doctrine**

20 **a. Defendants’ Integration Statements are not forward looking and are**
 21 **actionable**

22 Examples of “forward-looking statements” include “a projection of revenues,” “a
 23 statement of the plans and objectives of management ... including plans or
 24 objectives relating to the products or services of the issuer [of securities],” and “a
 25 statement of future economic performance, including any such statement
 26 contained in a discussion and analysis of financial condition by the management.”
 27 15 U.S.C. § 78u-5(i)(1)(A)-(C).

28 *Yanek v. Staar Surgical Co.*, 388 F. Supp.2d 1110, 1122 (C. D. Cal. 2005). The PSLRA’s safe

scienter on the part of Secure as a firm.

1 harbor will not immunize a defendant from liability for statements that misrepresent historical or
2 present facts. *See, e.g., South Ferry*, 399 F. Supp. 2d at 1133. (Statement that defendants had
3 “identified the issues that led to [net losses] and have implemented measures to address them”
4 was a present tense statement not protected by the safe harbor); *In re CV Therapeutics, Inc. Sec.*
5 *Litig.*, 2004 WL 1753 251 at *10 (N.D. Cal. Aug. 5, 2004).

6
7 At the May 4, 2006, earnings conference call, Defendant Steinkopf made numerous
8 statements with regard to the success the Company had achieved with the Secure/Cyberguard
9 integration. ¶19. These statements were false and misleading at the time they were made. At the
10 same May 4, 2006, conference call, Defendant McNulty made similar statements on behalf of
11 Secure Computing. ¶20. Because McNulty and Steinkopf’s integration statements were based in
12 historical or present fact, they cannot qualify as forward-looking statements and are therefore
13 ineligible for the protection of the safe harbor provision or the bespeaks caution doctrine.⁹
14

15 Defendants, in their brief, largely ignore their integration misrepresentations, choosing
16 instead to focus their attack on the financial results projections. These statements made by
17 Defendants, ¶¶38-77, however, were clearly false as confirmed by numerous confidential
18 witnesses, ¶¶38-7,3 and as partially admitted by Defendants. ¶¶23, 27, 33-34.
19

20 Defendants contend that their boilerplate warnings in earlier SEC filings of the possibility
21 that the Secure/Cyberguard integration might not be successful, insulates them from their
22

23
24 ⁹ For instance Plaintiffs allege that the Defendants misrepresented that Secure and Cyberguard
25 “exited Q1 functioning as a well integrated single Company in all departments,” “every part of
26 the Company, R&D, customer support, sales, marketing, product management, finance,
27 production, HR, legal and IT are now integrated and under one management team,” and “[o]ur
28 strong bottomline performance in Q2 was primarily attributable to the speed and good progress
we achieved in integrating Cyberguard into Secure...,” ¶¶19-20. These, and Defendants’ other
integration statements, represent present and historical facts, clearly outside the reach of the safe
harbor provision or the bespeaks caution doctrine.

1 affirmative misrepresentations to the contrary in the May 4, 2006 conference call. *See*
2 *Defendants' Motion* at 2 n.3, 11-12. As set forth above, however, Defendants' integration
3 statements are not forward looking and therefore not subject to the protection of the PSLRA safe
4 harbor or bespeaks caution doctrine. In any event "cautionary language cannot be "meaningful"
5 when Defendants know that potential risks they have identified have already occurred, and that
6 positive statements they are making are false." *Nash Finch*, 2007 WL 1266658 at *11; *see In re*
7 *See Beyond Techs, Corp., Sec. Litig.* 266 F.Supp.2d 1150, 1165 (C.D. Cal. 2003) ("If the forward
8 looking statement is made with actual knowledge it is false or misleading, the accompanying
9 cautionary language can only be meaningful if it either states the belief of the speaker that it is
10 false or misleading or, at the very least, clearly articulates the reasons why it is false or
11 misleading."). No such disclosures were made here.
12

13
14 Courts have found statements concerning the successful integration of a company, similar
15 to those made by Defendants here, actionable under the federal securities law, when facts alleged
16 by plaintiffs show them to be false or misleading. *See, e.g., Nash Finch*, 2007 WL 1266658 at
17 *19-20; and *generally; South Ferry*, 399 F.Supp. 2d at 1136, 1140-42; *In re Aetna, Inc. Sec.*
18 *Litig.*, 34 F.Supp. 2d 935, 944-45 (E.D. Pa. 1999); *In re Ins. Management Solutions Group, Inc.*,
19 2001 WL 34106903 at * 3-4, 8, 11 (M.D. Fla. July 1, 2001).
20

21 **b. Secure's cautionary warnings are insufficient to insulate Defendants'**
22 **forward looking statements**

23 Unlike Defendants' integration statements Defendants' revenue and earnings projections
24 for second quarter 2006 were forward-looking statements. These statements, too, however, are
25 not insulated by the PSLRA safe harbor or the bespeaks caution doctrine.

26 First, a forward looking statement is not protected unless it is accompanied by
27 meaningful cautionary statements identifying important factors that could cause actual results to
28 differ materially from those in the forward looking statement. *CV Therapeutics*, 2004 WL

1 1753251 at *10. Boilerplate or generic warnings are generally inadequate to garner safe harbor
2 protection.⁴ Here as in *Yanek v. Staal*, “...[t]he factors enumerated do not adequately disclose
3 the actual risks involved, and do not invoke the protection of the safe harbor provision.” 388 F.
4 Supp. 2d at 1123. Here as in *Yanek*, the overly general cautionary statements made at the
5 conference calls and in Secure’s filings with the SEC do not meaningfully address the risks
6 related to the ongoing difficulties of which Defendants were aware with regard to how the
7 Secure/CyberGuard integration was progressing, nor how these difficulties were significantly
8 impacting Secure’s bottom line.⁵ ¶¶38-77.

9 Second, the revenue projections and business forecasts were directly predicated upon
10 Defendants’ false integration statements and Plaintiffs here have met the PSLRA’s burden of
11 pleading a “strong inference” of Defendants’ *actual* knowledge,⁶ and not merely constructive
12 knowledge, that any forward-looking statements were false. 15 U.S.C. § 78u-4(b)(2); 15 U.S.C.
13 § 78u-5(c)(1)(B)(I); *see also In re AOL Time Warner, Inc. Securities and ERISA Litigation*, 381
14 F Supp. 2d 192 (D.N.Y. 2004) (income projections were not forward looking statements,
15 protected from securities fraud liability under safe harbor provision of PSLRA when they were
16 accompanied by knowingly false allegations that revenue growth had been “very healthy.”)

17
18 ⁴*See, e.g., In re Immune Response Sec. Litig.*, 375 F. Supp. 2d 983 (D. Cal. 2005) (holding that
19 cautionary statements failed to specify the risks involved and therefore did not qualify as a
20 meaningful cautionary statement); *Dutton v. D & K Healthcare Resources*, 2006 WL 1778884
21 (W.D. Mo. 2006) (holding that cautionary language was “too generalized and boilerplate to make
22 such language meaningful to the ordinary investor and thus, the subject statements are not
23 protected by the safe harbor provision of the PSLRA”).

24 ⁵ Plaintiffs have pled sufficient facts that Defendants Steinkopf and McNulty were aware of the
25 lack of integration of Cyberguard into Secure and customer transitions from “The Classic” to the
26 “Sidewinder” product and the problems this was causing with confusion in the channel. At the
27 time the Defendants’ financial guidance disclosures were made, Defendants knew or reasonably
28 should have known that the lack of transition to the “Sidewinder” product from the popular and
profitable “Classic” product would undeniably affect second quarter sales. *See generally* CAAC
¶¶ 11, 14, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 32-77, 80.

⁶ *See* ¶¶ 11, 14, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 32-77, 80.

1 Because a speaker rarely, if ever, will admit that he knew that his statement could never
2 become true in the future, the actual knowledge analysis generally turns on why the speaker had
3 to know that the statement was false. *Weiss v. Mentor Graphics Corp.*, 1999 WL 985141 at *15.

4 That analysis necessarily involves determining what facts the speaker knew at the
5 time and whether the speaker reasonably applied those facts to his forward-
6 looking statement. Was the speaker aware of any contrary information and did the
7 speaker, through the exercise of reason, know that the contrary information made
8 his statement false?

9 *Id.* Given their knowledge of how the integration was progressing with Cyberguard, the
10 difficulties with transitioning customers from “The Classic,” etc., McNulty and Steinkopf had to
11 know that their forward-looking financial guidance was false. *Id.* at *16. If the Defendants
12 knew that their statements were false when made, as Plaintiffs have alleged here, no amount of
13 cautionary language can place those statements in the safe harbor. *See Seebeyond*, 266
14 F.Supp.2d. at 1165-66. The safe harbor provides no protection to someone who warns his hiking
15 companion to walk slowly because there might be a ditch ahead when he knows with near
16 certainty that the Grand Canyon lies one foot away.” *In re Worldcom, Inc. Sec. Litig.* 294,
17 F.Supp.2d at 477.

18 Plaintiffs have pled sufficient facts that show that Defendants, when they spoke, were
19 aware of contrary information and had reason to know that this contrary information made their
20 statements false. All of the statements at issue are actionable under the federal securities laws.

21 **III. CONCLUSION**

22 For the reasons set forth above Defendants’ Motion to Dismiss should be denied.
23 Plaintiffs have alleged facts sufficient to meet the requirements of Rule 9(b) and the PSLRA.
24 “The PSLRA was designed to eliminate frivolous and sham actions, but not actions of
25 substance.” *Oracle*, 280 F.3d at 1235. In the alternative Plaintiffs request leave to amend to cure
26 any perceived deficiencies in their Amended Complaint. *See Eminence Capital, LLC v. Aspeon,*
27 *Inc.*, 316 F.3d 1048 (9th Cir. 2003).

Dated: October 1, 2007

Respectfully submitted,

s/ William B. Federman

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CERTIFICATE OF SERVICE

I hereby certify that on October 1, 2007, a true and correct copy of the above and foregoing instrument was mailed postage prepaid to the following attorneys:

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EXHIBIT 1

**IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND**

ROY T. LEFKOE :
Individually and on Behalf :
of Others Similarly Situated :
v. : Civil No. WMN-06-1892
: :
JOS. A. BANK CLOTHIERS et al. :
:

MEMORANDUM

Before the Court is the motion of Defendants Jos. A. Bank Clothiers, Inc. ("Jos. A. Bank" or the "Company"), Robert N. Wildrick, David E. Ullman, and R. Neal Black (collectively referred to as the "Individual Defendants"), to dismiss the amended, consolidated class action complaint. Paper No. 56. Plaintiffs have opposed the motion and Defendants have replied. Papers No. 60, 61.¹ Upon a review of the pleadings and applicable case law, the Court determines that no hearing is necessary (Local Rule 105.6) and that Defendants' motion will be denied.

I. FACTS AND PROCEDURAL BACKGROUND

Jos. A. Bank is a clothing retailer established in 1905 which has retail stores in forty states, a mail order catalog, and extensive internet operations. Jos. A. Bank derives most of

¹ Plaintiffs have also filed a Motion for Leave To File A Sur-Reply Memorandum in Further Opposition to the Motion To Dismiss. Paper No. 62. Defendants have filed a motion opposing this request, to which Plaintiffs responded. Papers No. 63, 66. The Court will accept the pleadings and consider them in accordance with Local Rule 105.2(a).

its revenue from its retail stores and has a policy of keeping high levels of inventory in those stores.² The Company disseminates reports on an almost daily basis to regional managers, sales managers, planners, and sales associates regarding the purchase, allocation, transfer, and management of inventory. Inventory controls and related gross profit margins are often evaluated as a benchmark of the Company's financial well-being and, as a result, Jos. A. Bank executives are actively involved in the budgeting and planning process for ordering merchandise.³

In their Complaint, Plaintiffs allege that, beginning on December 5, 2005, Defendants issued a series of statements which falsely reassured public investors that Jos. A. Bank's gross profit margins would increase substantially throughout the final two quarters of fiscal year (FY) 2005 and into the first quarter of FY 2006. These statements also allegedly omitted knowledge of the Company's excessive levels of inventory consisting primarily of merchandise in the Fall/Winter 2005 clothing line. The excess inventory allegedly resulted from a combination of the Company's

² Plaintiffs allege that Jos. A. Bank considers "inventory availability" to be one of its so-called "Four Pillars of Success." Am. Compl. ¶ 34.

³ Defendant Robert N. Wildrick is the Company's Chief Executive Officer, Defendant David E. Ullman is the Chief Financial Officer, and Defendant R. Neal Black is the Chief Merchandising Officer.

overestimation of customer demand for the products, geographical problems in store expansion plans, and overly ambitious time-lines for opening of new retail locations.

Plaintiffs contend that Jos. A. Bank executives were aware of the inventory surplus problems and began heavily discounting the Fall/Winter 2005 merchandise to sell the clothing.⁴ These discounts resulted in increased sales of the surplus merchandise, however, the aggressive pricing strategy allegedly eroded the Company's overall profit margin. The discounts had the additional effect of negatively impacting the sale of higher margin clothes from the Spring/Summer 2006 line and the core clothing line.

Though aware of the negative financial results of the inventory surplus and promotional activity, Plaintiffs allege that from December 2005 to June 2006, the Company made misleading financial statements concerning inventory and gross margin problems. On December 5, 2005, the Company filed a form 10-Q with the United States Securities and Exchange Commission (SEC) containing the financial results for the third quarter of FY 2005. That filing reported increases in earnings per share and in gross profit margin. The filing reported no problems with

⁴ Plaintiffs allege that, to liquidate the excessive inventory, the Company embarked on an unprecedented promotional scheme, offering drastic markdowns, combining multiple sales, and keeping sales and clearance tables on the floor longer than normal. Am. Compl. ¶¶ 65-74.

respect to inventory, noting that "the Company's strong gross profit margins enable the Company to sell substantially all of its products at levels above cost." Am. Compl. ¶ 102. In a conference call held the same day among Company executives and securities analysts, the individual Defendants each made remarks reflecting their expectations for a strong fourth quarter. Id. at ¶¶ 104-05.

At the close of the fiscal months December 2005, January 2006, February 2006, March 2006, and April 2006, the Company issued press releases announcing financial results. In each press release, the Company reported an increase in total sales versus the comparable period in the prior fiscal year. The press release announcing results for the fiscal month December 2005 also expressed the Company's expectation that earnings per share for FY 2005 would meet the consensus analyst estimate of an increase in comparison to earnings per share in FY 2004. The release announcing results for the fiscal month January 2006 reported an increase in total sales for the fourth quarter of FY 2005.

In addition to false or misleading statements put forth in the press releases, Plaintiffs allege that on February 22, 2006, Ullman attended an institutional investor's conference on behalf of Jos. A. Bank where he participated in a question and answer session with the audience. There, Ullman addressed the Company's

desire to decrease its level of promotional activity while maintaining its inventory and its upscale appeal. Plaintiffs contend that, in light of Ullman's knowledge of Jos. A. Bank's excess inventory and resultant increased promotional activity, these statements were materially false and misleading. Am. Compl. ¶ 117.

On April 12, 2006, the Company filed its form 10-K with the SEC, reporting its financial results for FY 2005. In it, the Company noted, as it did in its form 10-Q filed in December 2005, that the strong gross profit margins enabled sales of products at levels above cost. A press release issued the same day reflected the information contained in the form 10-K, reporting increases in net income and earnings per share and confirmed that total sales increased in the fourth quarter of FY 2005 as compared with sales in the same prior year period. On April 13, 2006, Wildrick, Ullman, and Black participated in a conference call to discuss the 10-K filing. During the call, they expressed confidence in the Company's inventory situation and optimism for continued growth. Plaintiffs allege that the filings and the statements made during the conference call belied Defendants' knowledge that prices on the Fall/Winter 2005 clothing line had been substantially lowered, and misled investors regarding the

excesses in inventory.⁵ On May 4, 2006, the Company filed its Annual Report for FY 2005 with the SEC which included a copy of the form 10-K filed on April 12, 2006. The report also contained a "Letter to Stockholders" signed by Wildrick summarizing the Company's financial performance for FY 2005. Plaintiffs allege that both the letter and the information contained in the Annual Report were also misleading.

On June 7, 2006, the Company filed its Form 10-Q, reporting financial results for the first quarter of FY 2006. The June 10-Q reported a decrease in both net income and earnings per share in comparison with the first quarter of FY 2005. The Company attributed the decline to a decrease in gross profit margins due to increased sales of promotional fall products and lower sales of core merchandise. These financial results were repeated in a June 8, 2006, press release. Following the announcement, Jos. A. Bank stock fell approximately 29% with a trading volume more than 20 times that of the previous day.

The instant suit was initially filed on July 24, 2006, and on November 20, 2006, this Court consolidated the action and

⁵ In addition to their general contention that Defendants' filings were false or misleading, Plaintiffs also contend that the financial reports Defendants filed with the SEC during the relevant class period violated the generally accepted accounting principles (GAAP). Those principles are accepted by the accounting profession as the conventions, rules, and procedures necessary to define accepted accounting practices. Financial statements filed with the SEC that are not prepared in conformity with GAAP are presumed to be misleading or inaccurate. 17 C.F.R. § 210.4-01(a)(1).

appointed the Massachusetts Labor Annuity Fund ("MLAF") as lead plaintiff. On February 23, 2007, Plaintiffs filed an Amended Complaint, alleging that Defendants violated § 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by making false or misleading statements in connection with the sale of securities. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

Plaintiffs also allege that the Individual Defendants violated § 20(a) of the Exchange Act, which assigns joint and several liability to a person who controls another who violates a securities regulation. 15 U.S.C. § 78t(a). In the instant motion, Defendants contend that Plaintiffs have failed to plead their causes of action with the particularity required under the Exchange Act and the Private Securities Litigation Reform Act (PSLRA).

II. STANDARD OF LAW

Generally, a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) should be granted if it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief. Conley v. Gibson, 355 U.S. 41, 45-46 (1957).⁶ Unique requirements exist, however, for class

⁶ In deciding a Rule 12(b)(6) motion, the Court will consider the facts stated in the complaint as well as the documents attached to the complaint. In re Criimi Mae, Inc. Sec. Litig., 94 F.Supp.2d 652, 656 (D. Md. 2000). The Court may also consider documents referred to in the complaint and relied upon by the plaintiff in bringing the action. Id.

actions alleging securities fraud. The PSLRA provides that in pleading a material misrepresentation or omission in violation of § 10(b) of the Exchange Act and Rule 10b-5, the plaintiff must plead specific facts. 15 U.S.C. § 78u-4(b)(1) (providing that the complaint must 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"). Additionally, because Rule 9(b) of the Federal Rules of Civil Procedure requires that all allegations of fraud be stated with particularity, where fraudulent financial projections are alleged, the heightened pleading requirements of Rule 9(b) must be satisfied.⁷ Keeney v. Larkin, 306 F. Supp. 2d 522, 527 (D. Md. 2003). Further, in alleging scienter, as required under § 10(b) and Rule 10b-5, the plaintiff must, "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." 15 U.S.C. § 78u-4(b)(2). Any complaint not meeting the pleading requirements

⁷ Rule 9(b) provides that "in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. P. 9(b). Under Rule 9(b), the "circumstances" required to be pled with particularity are "the time, place, and contents of the false representations, as well as the identity of the person making the misrepresentation and what he obtained thereby." Harrison v. Westinghouse Savannah River Co., 176 F.3d 776, 784 (4th Cir. 1999).

may be dismissed. Id. § 78u-4(b)(3)(A).

"Thus, while the Federal Rules generally allow a court, in ruling on a motion to dismiss under Rule 12(b)(6), to take into account any set of facts that could be proved consistent with the allegations of the complaint, even though such facts have not been alleged in the complaint, the PSLRA modifies this scheme (1) by requiring a plaintiff to plead facts to state a claim and (2) by authorizing the court to assume that the plaintiff has indeed stated all of the facts upon which he bases his allegation of a misrepresentation or omission." Teachers' Ret. Sys. of La. v. Hunter, 477 F.3d 162, 172 (4th Cir. 2007) (citing 15 U.S.C. § 78u-4(b)(1)). As with any motion to dismiss for failure to state a claim, however, the Court will accept the facts alleged in the complaint as true. Tellabs, Inc. v. Makor Issues & Rights, Ltd., - U.S. -, 127 S. Ct. 2499, 2509 (2007).

III. DISCUSSION

A. False Statements or Omissions of Material Fact

Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, prohibit fraud in the sale purchase or sale of securities.⁸ To state a claim under § 10(b) of the Exchange Act

⁸ Section 10(b) of the Exchange Act forbids the "use or employ, in connection with the purchase or sale of any security . . . , [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b). Rule 10b-5 provides:

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

and Rule 10b-5, a plaintiff must allege that "(1) the defendant made a false statement or omission of material fact (2) with scienter (3) upon which the plaintiff justifiably relied⁹ (4) that proximately caused the plaintiff's damages." Hillson Partners Ltd. v. Adage, Inc., 42 F.3d 204, 208 (4th Cir. 1994); 15 U.S.C. § 78u-4(b).

In satisfying the first element of a § 10(b) claim, a plaintiff must point to a factual statement or omission. Longman v. Food Lion, Inc., 197 F.3d 675, 682-83 (4th Cir. 1999) (noting that a factual statement is "one that is demonstrable as being true or false"). The statement identified "must be false, or the omission must render public statements misleading" and "any statement or omission of fact must be material." Id. "[A] fact

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.

17 C.F.R. § 240.10b-5.

⁹ Where, as here, a plaintiff pursues a securities fraud action based on a fraud-on-the-market theory, it is not necessary to prove individual reliance on the false or misleading statements. Criimi Mae, 94 F. Supp. 2d at 656.

stated or omitted is material if there is a substantial likelihood that a reasonable purchaser or seller of a security (1) would consider the fact important in deciding whether to buy or sell the security or (2) would have viewed the total mix of information made available to be significantly altered by disclosure of the fact." Id. (citing Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988)).

Defendants first argue that Plaintiffs have failed to satisfy the first element of a § 10(b) claim because the Complaint "does not explain how the statements are supposedly false[.]" Mot. to Dismiss 16; In re Criimi Mae, Inc., 94 F. Supp. 2d at 657 (noting that "[p]articularity of pleading is required with regard to . . . the manner in which the statements are false and the specific facts raising an inference of fraud"). To adequately plead falsity in accordance with the first element of a § 10(b) claim, a plaintiff must: "(1) specify the statements that the plaintiff contends were fraudulent; (2) identify the speaker; (3) state where and when the statements were made; and (4) explain why the statements were fraudulent." In re Humphrey Hospitality Trust, Inc. Sec. Litig., 219 F. Supp. 2d 675, 682 (D. Md. 2002) (internal quotations omitted).

Here, Plaintiffs have adequately specified the content of the alleged misrepresentations and misleading omissions. See Am. Compl. ¶¶ 108-39. Plaintiffs contend that, on approximately 12

separate occasions, Defendants affirmatively misrepresented inventory issues and omitted from public statements their knowledge of the Company's excessive levels of inventory over the class period, its need to steeply discount inventory, and the resulting harm to sales of core merchandise and the Spring 2006 line. Id. For each alleged misrepresentation, Plaintiffs have identified the speaker and stated where and when the statements or omissions were made. Id. Plaintiffs further allege that the statements and omissions were fraudulent or misleading because they concealed the fact that the Company's inventories of Fall/Winter 2005 merchandise had swelled to unprecedented levels, forcing the Company to take drastic action to liquidate the merchandise. Id. ¶¶ 45-63. In making such allegations, Plaintiffs have contrasted the statements and omissions alleged in the Complaint with the alleged personal knowledge of Defendants. See, e.g., Am. Compl. ¶¶ 45-59, 60-63, 71-77, 88-84. For example, with respect to Defendants' February 22, 2006, statements regarding Defendants' comfort with the Company's inventory and promotional activity and an expected increase in gross profit margins, Plaintiffs allege that, at the time, Defendant Ullman knew "that gross profit margins were dramatically decreasing due to the steep price discounts, virtually continuous sales, and other aggressive pricing strategies undertaken by the Company to alleviate the excessive

Fall/Winter 2005 inventories[.]” Am. Compl. ¶¶ 117-118.

In further support of their contention that Defendants statements were false or misleading, Plaintiffs provide statements from 18 former Company employees regarding specific inventory practices. See In re Cree Sec. Litig., 333 F.Supp.2d at 472 (“As a general matter, a plaintiff may rely on confidential sources to substantiate his claims for securities fraud.”). While the identity of the employees remains confidential, Plaintiffs have provided titles and job descriptions and the statements presented from the witnesses arise from their individual personal knowledge and concern the core facts underlying the Complaint. See In re Trex Co., Inc. Sec. Litig., 454 F.Supp.2d 560, 573 (4th Cir. 2006) (“A confidential witnesses’ testimony can be used in pleading under the PSLRA so long as the testimony involves facts of which the witnesses had personal knowledge.”). Defendants argue that the employee statements should be accorded less weight due to their confidential nature. At this stage in the litigation, however, factual issues concerning the credibility and weight of the employee statements will be construed in favor of Plaintiffs. See Tellabs, Inc., 127 S. Ct. at 2509.

Finally, Plaintiffs argue that a reasonable investor would have relied on Defendants’ statements and omissions as reflecting consequential facts about the Company. Thus, Plaintiffs contend that the alleged statements and omissions satisfy the materiality

component of a § 10(b) claim. Defendants argue that the alleged statements constitute immaterial "puffery" upon which no reasonable investor would rely in making investment decisions. See Longman v. Food Lion, Inc., 197 F.3d 675, 683 (4th Cir. 1999) (noting that "opinion or puffery will often not be actionable, [however], in particular contexts when it is both factual and material, it may be actionable"). Were Defendant's alleged comments limited merely to expressions of optimism or vague generalizations, Plaintiffs would have been unable to satisfy the materiality requirement. Plaintiffs have alleged, however, specific statements concerning forecasts of growth in earnings and sales, and confidence in inventory. See, e.g., Am. Compl. ¶¶ 109, 113, 133. Plaintiffs have also alleged specific failures to disclose the excessive inventory build-up and the resultant need to engage in steep discounting. Id. at ¶¶ 105, 109. Thus, the Court finds that Plaintiffs have alleged material misrepresentations and omissions in satisfaction of the first element of § 10(b).¹⁰

¹⁰ Defendants also contend that the alleged misrepresentations are inactionable as they were accompanied by meaningful cautionary language, in accordance with the safe harbor provision of the PSLRA. See 15 U.S.C. § 78u-5(c)(1)(A)(i) (precluding from liability forward-looking statements "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement"). Plaintiffs contend that many of the challenged statements and omissions are not forward-looking. See Am. Compl. §§ 105, 109, 113, 117. Additionally, the adequacy of cautionary language is a question of fact, and, typically, is not a question to be

B. Scierter

Under the PSLRA, a plaintiff must "state with particularity the 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). Allegations of scierter will survive a motion to dismiss "only if a reasonable person would deem the inference of scierter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." Tellabs, Inc., 127 S. Ct. at 2510. In determining whether a plaintiff has met this requirement, the Court will accept all factual allegations in the Complaint as true, will consider the Complaint in its entirety, along with other sources courts normally examine when ruling on a Rule 12(b)(6) motion, and will take into account all plausible opposing inferences. Id. at 2509-10.

Here, Plaintiffs support their allegation of scierter by arguing that Defendants, via their individual positions within the Company, possessed the power and authority to control the content of the Company's public statements. See Am. Compl. ¶ 23. Plaintiffs also allege that Defendants knew of the excessive inventory levels during the class period and knew that an unprecedented level of promotional activity would be required to liquidate that inventory. In support of those contentions, Plaintiffs cite numerous internal reports used for forecasting,

resolved on a motion to dismiss. See Blatt v. Corn Products Intern., Inc., No. 05-C-3033, 2006 WL 1697013, at *5 (N.D. Ill. June 14, 2006).

purchasing, transferring, and managing inventory, to which Defendants each had access. Am. Compl. ¶ 38. Finally, Plaintiffs allege that Defendant Wildrick's sale of 74% of his common stock in the Company during the class period, for an alleged profit of \$36 million, supports an inference of scienter. See In re Oxford Health Plans, Inc., 187 F.R.D. 133, 140 (S.D.N.Y. 1999) (noting that "[t]here is no guide for determining whether certain insider trades are unusual or suspicious in amount. Large volume trades may be suspicious[,] but where a corporate insider sells only a small fraction of his or her shares in the corporation, the inference of scienter is weakened.").

In arguing that Plaintiffs have failed to allege scienter with the requisite specificity, Defendants primarily contend that Wildrick's stock sales during the relevant class period cannot support a strong inference of scienter. Defendants argue that, because neither Ullman nor Black sold any stock during the same period, any inference of fraud must be negated. See In re Humphrey Hospitality Trust, Inc. Sec. Litig., 219 F. Supp. 2d 675, 686 (D. Md. 2002) (noting that "Courts have found that where some defendants did not profit from the alleged fraud, any inference of scienter is negated as to all the defendants"). In Humphrey, however, the allegation of scienter rested entirely on the allegation that one of the defendants had sold 5% of his holdings during the relevant class period. The volume and percentage of Wildrick's sale are much larger than those alleged

in Humphrey, and Plaintiffs' allegations of scienter do not rest solely on Wildrick's stock sale.¹¹ Defendants do not challenge that they had access to reports which would have reflected the inventory build-up and resultant need for massive promotional activity. Considering Plaintiffs' allegations in their entirety, the Court finds that, at this stage in the litigation, Plaintiffs have alleged facts sufficient to support an inference of scienter at least as compelling as any opposing inference. See Arnlund v. Deloitte & Touche LLP, 199 F. Supp. 2d 461, 475 (E.D. Va. 2002) (noting that "it must be remembered that a plaintiff generally must frame the facts respecting [scienter] without the benefit of discovery, and therefore, most often, allegations about a defendant's culpable state of mind must be drawn from limited state of mind evidence augmented by circumstantial facts and logical inferences).

C. Loss Causation

The PSLRA requires a plaintiff to prove "that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). "Loss causation is not one of the elements with respect to which the PSLRA imposes a more stringent pleading

¹¹ Defendants also contend that Wildrick's sales of stock were made pursuant to a Rule 10b5-1 trading plan, under which the sales were scheduled in advance of the class period. Raising the affirmative defense of trading under a 10b5-1 trading, however, is "typically premature . . . in a motion to dismiss." In re Cardinal Health Inc. Sec. Litig., 426 F. Supp. 2d 688, 734 (S.D. Ohio 2006).

requirement." Teachers' Retirement Sys. Of LA v. Hunter, 477 F.3d 162, 185 (4th Cir. 2007). In satisfying the pleading requirements for the element of loss causation under a § 10(b) claim, a plaintiff must allege "that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss." Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 346 (2005).

Here, Plaintiffs allege that the Company's numerous class-period misrepresentations and omissions, as well as the Company's alleged violations of GAAP, created an inaccurate picture of the Company's financial condition. Defendants contend that Plaintiffs allegations of loss causation cannot be supported by the alleged GAAP violations, as those alleged violations were never corrected or disclosed to the public. See In re Daou Systems, Inc., 411 F.3d 1006, 1027 (9th Cir. 2005) (noting that, where loss is suffered prior to revelations of the Company's allegedly fraudulent accounting practices, such loss cannot be considered causally related to those practices). Plaintiffs' allegations of loss causation, however, encompass more than the alleged GAAP violations. Plaintiffs broadly allege that Defendants' misrepresentations and omissions throughout the class period concealed the true financial status of the Company. As a result of this concealment, upon revelation of the true financial status of the Company via the June 7, 2006, statement disclosing

a decline in gross profit margins, the Company's stock price fell approximately 29%. These broad allegations are sufficient to satisfy the loss causation pleading requirements for a § 10(b) claim at this stage in the litigation. See id. (holding that "assertions of a steep drop in [the company's] stock price following the revelation of [the company's] true financial situation are sufficient to enable the complaint to survive a motion to dismiss").

IV. CONCLUSION

For the foregoing reasons, Defendants motion to dismiss will be denied.¹² A separate order consistent with this Memorandum will follow.

/s/

William M. Nickerson
Senior United States District Judge

Dated: September 10, 2007

¹² Defendants predicated their challenge to the sufficiency of Plaintiffs' claim under § 20(a) of the Exchange Act on the assumption of Plaintiffs' failure to state a well-pled § 10(b) claim. As Defendants' motion to dismiss fails with respect to the § 10(b) claim, it will also be denied with respect to the § 20(a) claim.