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8  
 9 **UNITED STATES DISTRICT COURT**  
 10 **NORTHERN DISTRICT OF CALIFORNIA**

11 IN RE RACKABLE SYSTEMS, INC. )  
 12 SECURITIES LITIGATION )

Case No. C-09-0222-CW

) CLASS ACTION

13 THIS DOCUMENT RELATES TO: )  
 14 ALL ACTIONS. )

) **NOTICE OF MOTION AND MOTION**  
 ) **TO DISMISS AMENDED COMPLAINT**  
 ) **FOR VIOLATIONS OF THE FEDERAL**  
 ) **SECURITIES LAWS; MEMORANDUM**  
 ) **OF POINTS AND AUTHORITIES IN**  
 ) **SUPPORT**

) Date: October 29, 2009

) Time: 9:00 a.m.

) Courtroom: 2, 4th Floor

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1 **NOTICE OF MOTION AND MOTION**

2 TO PLAINTIFFS AND THEIR ATTORNEYS OF RECORD:

3 PLEASE TAKE NOTICE that, on October 29, 2009, at 9:00 a.m. or as soon thereafter as  
4 the matter may be heard, in the courtroom of the Honorable Claudia Wilken of the above-entitled  
5 Court, located at 1301 Clay Street, Oakland, California, defendants Rackable Systems, Inc.,  
6 Thomas K. Barton, Madhu Ranganathan and Todd R. Ford shall and hereby do move the Court  
7 for an order dismissing without leave to amend plaintiffs' Amended Complaint for Violations of  
8 the Federal Securities Laws ("Complaint").

9 This Motion is brought pursuant to the Private Securities Litigation Reform Act of 1995  
10 ("PSLRA"), and Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure, on the grounds  
11 that the Complaint fails to plead fraud with particularity and to state a claim upon which relief  
12 may be granted. This Motion will be based upon this Notice of Motion and Motion, the  
13 following Memorandum of Points and Authorities, and the Request for Judicial Notice ("RJN")  
14 filed herewith, all files and records in this action and such additional matters as may be judicially  
15 noticed by the Court or may come before the Court prior to or at the hearing on this matter.

16 **STATEMENT OF ISSUES TO BE DECIDED**

17 The issues to be decided on this Motion are whether the Complaint pleads: (1) facts with  
18 the particularity required by the PSLRA and Federal Rule of Civil Procedure 9(b) that, if true,  
19 would support the claim that defendants misstated or omitted material facts during the putative  
20 class period in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange  
21 Act") and Rule 10b-5; (2) "in great detail" facts that, if true, would support a "strong inference"  
22 of scienter as to the fraud alleged to have been committed; (3) facts that, if true, would show that  
23 defendants' forward-looking statements are not protected by the PSLRA's statutory safe harbor  
24 and the Bespeaks Caution doctrine; (4) facts that, if true, would show that plaintiffs' alleged  
25 damages were proximately caused by defendants' purported fraudulent scheme; and (5) facts that,  
26 if true, would state a claim for "control person liability" under Section 20(a) of the Exchange Act.

27  
28

## INTRODUCTION

1  
2 Rackable Systems, Inc. (“Rackable”), a leading provider of servers and storage products  
3 for large-scale data centers, operates in a highly competitive industry in which rapidly changing  
4 technology and razor-thin margins make it difficult for emerging companies to survive. Despite  
5 these challenges, Rackable rapidly grew during its early years from a small start-up to a mid-size  
6 company with almost 200 employees and over \$200 million in annual revenue when it went  
7 public in 2005. In late 2006 and early 2007, however, aggressive tactics by well-established  
8 competitors in the server market and price volatility in DRAM memory chips -- the major cost  
9 component in Rackable’s products -- caused Rackable’s profitability to suffer and its stock price  
10 to drop. Now, almost two years later, plaintiffs seek damages for securities fraud against  
11 Rackable and three of its former officers for failing to foresee the aggressive competition and  
12 price spike in DRAM memory chips, among other factors, that caused Rackable’s gross margin  
13 and earnings per share to decline during this period. The Complaint should be dismissed pursuant  
14 to the PSLRA and Federal Rules of Civil Procedure 9(b) and 12(b)(6) for four reasons.

15 First, the Complaint fails to plead particularized facts showing that any statement by a  
16 defendant was false or misleading when made. The allegations that Rackable misstated its sales  
17 and use tax liability, inventory costs, and compliance with debt covenants are unsupported by  
18 particularized facts showing that Rackable failed to apply the relevant accounting standards. Nor  
19 does the Complaint identify any contemporaneous facts inconsistent with Rackable’s financial  
20 projections. The failure to provide a “particularized explanation stating *why* the defendant’s  
21 alleged statements or omissions are deceitful” requires dismissal of the Complaint. *Metzler Inv.*  
22 *v. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1061 (9th Cir. 2008).

23 Second, the Complaint is devoid of particularized allegations giving rise to any inference  
24 that defendants acted with the intent to defraud, as required by the PSLRA. *See* 15 U.S.C. § 78u-  
25 4(b)(2). The statements of the Complaint’s six purported Confidential Witnesses (“CWs”) do not  
26 show that any defendant was aware of facts that would have rendered any statement false or  
27 misleading when made. Four of the Complaint’s CWs were not even employed by Rackable  
28 during the Class Period, rendering their statements irrelevant to defendants’ state of mind as a

1 matter of law. The other CWs are not alleged to have had any interaction or communications  
2 with defendants and therefore cannot shed light on any defendant's knowledge or intent at the  
3 time the alleged statements were made. Moreover, the Complaint's insider trading allegations  
4 negate any inference of scienter: Barton and Ranganathan did not sell any Rackable stock during  
5 the Class Period and Ford's sales are not alleged to have occurred at suspicious times or in  
6 unusual amounts.

7 Third, many of the purported misrepresentations are inactionable forward-looking  
8 statements protected by the PSLRA safe harbor and the Bespeaks Caution doctrine. As a matter  
9 of law, the Complaint cannot state a claim under the securities laws based on Rackable's  
10 projections, sales forecasts and other forward-looking statements because they were accompanied  
11 by meaningful cautionary language about potential risks and uncertainties that might affect  
12 Rackable's financial performance.

13 Fourth, the Complaint does not meet the requirements for alleging loss causation under  
14 *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), because it does not show a causal  
15 link between defendants' alleged misrepresentations, the revelation of any alleged fraud, and a  
16 drop in Rackable's stock price. The dates on which Rackable's stock price is alleged to have  
17 dropped uniformly follow the disclosure of disappointing financial results caused by  
18 unanticipated events, not the revelation of fraud.

### 19 **BACKGROUND**

20 Founded in 1999 and based in Milpitas, California, Rackable designs and sells servers and  
21 storage products for large-scale data center deployments.<sup>1</sup> RJN Ex. 6. Rackable's customers  
22 include over 300 companies worldwide in the Internet, semiconductor design, enterprise software,  
23 federal government, entertainment, financial services, oil and gas exploration and biotechnology  
24 industries. *See id.*, Ex. 11 at 2.

25 In December 2002, defendants Thomas K. Barton and Todd R. Ford joined Rackable as its  
26

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27 <sup>1</sup> On May 11, 2009, Rackable completed its acquisition of the operating assets of the former  
28 Silicon Graphics, Inc. and on May 18, 2009, changed its name to Silicon Graphics International  
Corp. and its NASDAQ stock ticker symbol to "SGI."

1 Chief Executive Officer and Chief Financial Officer, respectively. Ford later transitioned to  
2 Executive Vice President of Operations in December 2003. From 2002 to 2005, Rackable grew  
3 under Barton's direction from 31 full-time employees and annual revenue of \$20.4 million to 174  
4 employees and annual revenue of \$215 million. RJN Ex. 1 at 35. In June 2005, Rackable  
5 completed its initial public offering, raising aggregate net proceeds of \$67.4 million. *Id.* Six  
6 months later, defendant Madhu Ranganathan joined Rackable as Vice President of Finance. *Id.*

7 In Rackable's first annual report as a public company, it disclosed the substantial  
8 challenges to its business. Rackable disclosed that the market for its products is "highly  
9 competitive, rapidly evolving and subject to changing technology, customer needs and new  
10 product introductions." RJN Ex. 1 at 17. Rackable identified as its competitors large vendors  
11 such as Dell Inc., Hewlett-Packard Company, International Business Machines Corporation and  
12 Sun Microsystems, Inc. *Id.* Rackable further warned investors that it relies on a relatively small  
13 number of customers for a significant portion of its revenue, a trend which Rackable expected to  
14 continue. *Id.* at 37. In 2005, Microsoft, Yahoo! and Amazon.com accounted for 14%, 22% and  
15 24% of Rackable's revenue, respectively. *Id.*

16 Because Rackable's build-to-order business model requires it to obtain the components  
17 and materials for its products in spot markets, its cost structure and ability to respond to customer  
18 demand are sensitive to market price volatility for those materials. RJN Ex. 1. Rackable  
19 cautioned investors that historical prices for DRAM, already a large component of its costs, had  
20 been volatile in response to market supply and demand and that DRAM was becoming a larger  
21 percentage of its bill of materials. *Id.* at 38.

22 Rackable also disclosed that in December 2005 it had identified "potential state sales and  
23 use tax liabilities relating to certain of our product sales to customers outside of California,"  
24 which it estimated to be \$1.2 million. RJN Ex. 1 at 27. If Rackable was not able to recover the  
25 sales tax from its customers, it would have to record an additional charge to its operating results  
26 and pay the sales tax out of its own funds. *Id.*

27 Despite these challenges, Rackable continued to build its business in 2006. In September  
28 2006, Rackable acquired Terrascale Technologies, Inc., a Canadian storage technology company.

1 RJN Ex. 21. This acquisition increased the “scalability and manageability” of Rackable’s  
2 products and added “RapidScale” storage appliances to its product line. *Id.* Ex. 11 at 2, Ex. 21.

3 On October 30, 2006, Rackable announced that its total revenue for the first three quarters  
4 of 2006 was \$253.5 million, up 92% from \$131.9 million for the same period in 2005. RJN Ex.  
5 6. Rackable’s non-GAAP gross margin of 22.6% for the third quarter was within its projections  
6 of 22% to 24%. *Id.* Ex. 23 at 2. Rackable announced that it was increasing its financial  
7 projections for the fourth quarter, projecting revenue in the range of \$100 - \$110 million, non-  
8 GAAP gross margins from 23% to 24%, and non-GAAP net income from \$0.25 - \$ 0.27 per  
9 share. *Id.* Ex. 6. In its Form 10-Q, Rackable increased its gross tax liability for unpaid state sales  
10 and use tax to \$4.4 million -- although no analysts acknowledged this change. *Id.* Ex. 7 at 18.

11 On the earnings call, Barton explained that Rackable’s increased projections were based  
12 on revenues produced quarter-to-date, the current backlog of business, and “to some extent, due  
13 to our belief that the DRAM markets are softening.” RJN Ex. 23 at 9. Barton further noted that  
14 Rackable had implemented an Oracle Enterprise Resource Planning system (“ERP System”),  
15 which was designed to improve its disclosure processes and internal controls over financial  
16 reporting. *Id.* Ex. 23 at 2.

17 A combination of unexpected events, however, caused Rackable to miss its increased  
18 gross margin and EPS projections for the fourth quarter. RJN Ex. 9. Already intense competition  
19 in the server market became even more aggressive, which forced Rackable to strategically  
20 discount certain contracts to maintain and expand customer relationships. *Id.* At the same time, a  
21 price spike in the DRAM markets increased Rackable’s costs. *Id.* Rackable was unable to make  
22 up for the lower margins earned on its products due to lower-than-expected sales of the  
23 RapidScale products that it recently acquired from Terrascale. *Id.* In addition, because most of  
24 Rackable’s revenue came in at the end of the quarter, the full impact of these events was not  
25 known until after the quarter closed. RJN Ex. 10.

26 On January 16, 2007, Rackable preliminarily announced that revenue for the fourth  
27 quarter 2006 was expected to be toward the high-end of its projection (\$105.5 - \$106.8 million),  
28 but that it would not achieve its gross margin and EPS projections. RJN Ex. 9. The next day,

1 Rackable's stock price fell from \$32.42 per share to close at \$19.98 per share. Complaint ¶ 6.

2 On February 1, 2007, Rackable announced its final financial results for the fourth quarter  
3 and full year 2006. RJN Ex. 10. Although Rackable reported record annual revenue of \$360.4  
4 million for the full year, up 67.6% from 2005, it confirmed that its gross margin for the fourth  
5 quarter fell below its previously projected range. *Id.* Ex. 24 at 3. Barton explained that a \$3.9  
6 million shortfall caused Rackable to miss its gross margin projections: (i) \$1.8 million was due to  
7 "having to procure DDR memory at unexpectedly high prices," (ii) \$1.2 million was due to  
8 "intentional business decisions we made to maintain market share and win business in the face of  
9 extremely aggressive competition," (iii) \$600,000 was due to lower-than-anticipated sales of  
10 RapidScale products, and (iv) \$300,000 was due to the fact that revenue production was "backend  
11 loaded" for the quarter. *Id.* To better manage Rackable's costs, Ford stated that the company had  
12 "taken immediate action to improve the visibility in our new ERP system and are in the process of  
13 up leveling our procurement and materials planning organization." *Id.* at 5.

14 Barton stated: "[T]he competitive intensity is escalating more rapidly than we had  
15 anticipated. For example, we have seen some instances where we believe our competitors have  
16 taken deals at a significant loss to win or maintain a footprint within a specific account." RJN Ex.  
17 24 at 4. Rackable revised down its annual revenue projection for 2007 to \$450-\$525 million  
18 (from \$475-\$525 million) and its non-GAAP gross margin to 18% - 22%. *Id.* at 6. Due to  
19 expected quarter-to-quarter volatility and Rackable's uneven revenue stream, Barton announced  
20 that Rackable would no longer be providing specific quantitative quarterly projections. *Id.* at 7.

21 On the day following the earnings call, Rackable's stock price fell from \$20.34 per share  
22 to \$16.60 per share. Complaint ¶ 17. Analysts did not question the basis for Rackable's previous  
23 projections, but stated that increased competition had placed greater pressure on Rackable's gross  
24 margins. *See* RJN Ex. 32 ("Pricing pressure . . . has increased noticeably, and RACK has decided  
25 to maintain share and sacrifice margins and profitability to protect its share. This is a strategy  
26 fraught with risk . . ."), Ex. 33 ("Given the significant resources of key competitors such as Dell  
27 and HP, and their clear intention to take market share back from Rackable using pricing power,  
28 we believe the company is in a very difficult competitive position.").

1 On February 28, 2007, Rackable released its Form 10-K for 2006. In addition to the  
2 financial results discussed above, the Form 10-K disclosed that Rackable increased its reserve for  
3 potential sales and use tax liability to \$6.5 million based on additional information received from  
4 its customers. RJN Ex. 11 at 20. Plaintiffs do not allege that Rackable's stock price dropped  
5 following the release of Rackable's Form 10-K. See Complaint ¶¶ 299-302.

6 In the first quarter of 2007, aggressive competition continued to cause Rackable's  
7 profitability to suffer. On April 4, 2007, Rackable announced that it expected revenue for the first  
8 quarter to fall within previous projections of \$70 - \$75 million, but that its GAAP and non-GAAP  
9 gross margins would be 30% lower than expected. RJN Ex. 12. Barton stated: "Intense  
10 competitive conditions for business at our largest customers continued throughout the first quarter  
11 of 2007, which negatively impacted our gross margin and bottom line." *Id.* Barton outlined three  
12 initiatives to address the increased competition. *Id.* Ex. 25 at 2. First, Rackable would stabilize  
13 gross margins in its largest accounts. *Id.* Second, it would cultivate a broader base of business to  
14 reduce its dependence on those largest accounts for revenue. *Id.* Third, Rackable would expand  
15 its efforts to market and develop "higher value, higher margin" products using its RapidScale  
16 technology and high-performance computing capabilities. *Id.* at 3.

17 After this announcement, Rackable's stock price fell to \$14.24 per share. Complaint ¶ 22.  
18 Again, however, analysts cited increased competition with companies such as Hewlett Packard,  
19 Dell, IBM and Sun Microsystems as responsible for the decline in Rackable's gross margins --  
20 not that the Company had concealed any information from the market. See RJN Ex. 36 ("We  
21 remain cautious on Rack's shares as it's tough going in the land of giants."), Ex. 35 ("Given  
22 [management's comments during Rackable's December investor conference call], we believe  
23 management has been extremely clear as to its dire competitive position.").

24 Rackable released its final financial results for 1Q07 on April 26, 2007. RJN Ex. 14.  
25 Total revenue was \$72 million, within the projected range, but GAAP gross margin was 12.5%,  
26 compared to 23.1% for the first quarter 2006. *Id.* The decline in Rackable's gross margin caused  
27 a GAAP net loss of \$10.2 million for the first quarter. *Id.* On the same day, Barton announced  
28 that to address the increased competition, "we have also come to the conclusion that we need to

1 accelerate a shift in our overall business model, specifically to increase the level of  
 2 standardization in our product line, and to move from a pure build-to-order model to a configure-  
 3 to-order model.” *Id.* Ex. 26 at 3. “This has profound implications for how we manage the  
 4 Company going forward, and I expect it to deliver very significant improvements in our operating  
 5 model over time.” *Id.*

6 Analysts acknowledged Rackable’s move towards more “standardized” configurations of  
 7 its products, but remained concerned due to expectations that “[i]ntense pricing pressure” would  
 8 continue “for the foreseeable future.” RJN Ex. 39; *see also* Ex. 38 (“We believe the large miss in  
 9 Q1 was driven by continued intense competitive pricing by Dell at the Company’s largest  
 10 customers . . . .”), Ex. 37 (“We continue to recommend that investors sell their shares in RACK as  
 11 the company is facing strong competition from HP and Dell and the company will likely not  
 12 achieve profitability in the immediate future.”). On April 27, 2007, Rackable’s stock price fell to  
 13 \$11.27 per share, down from the previous day’s close of \$12.58 per share. Complaint ¶ 185.

14 Nearly two years later, on January 16, 2009, plaintiffs filed this purported shareholder  
 15 class action alleging that beginning on October 30, 2006, defendants engaged in a fraudulent  
 16 scheme to inflate Rackable’s stock price by misrepresenting Rackable’s true financial condition  
 17 and future prospects. The Complaint specifically alleges that defendants made false and  
 18 misleading statements regarding Rackable’s (1) gross margin and Earnings Per Share (“EPS”)  
 19 projections for the fourth quarter of 2006, (2) collection of sales and use taxes from its customers,  
 20 (3) inventory procurement system, (4) ERP System, (5) relationship with its top three customers,  
 21 (6) projected sales of RapidScale products, and (7) compliance with the debt covenants on its line  
 22 of credit. Complaint ¶¶ 84-122. The Complaint alleges that Rackable’s stock price fell from  
 23 January 16, 2007 through April 26, 2007 as a result of the “truth” regarding defendants’ alleged  
 24 misrepresentations reaching the market.

## 25 ARGUMENT

### 26 **I. THE COMPLAINT DOES NOT ALLEGE FALSE OR MISLEADING** 27 **STATEMENTS WITH THE PARTICULARITY REQUIRED BY THE PSLRA** 28 **AND RULE 9**

The PSLRA mandates that a securities fraud complaint shall (1) “specify each statement

1 alleged to have been misleading,” (2) specify “the reason or reasons why the statement is  
 2 misleading,” and, (3) “if an allegation regarding the statement or omission is made on information  
 3 and belief, the complaint shall state with particularity all facts on which that belief is formed.” 15  
 4 U.S.C. § 78u-4(b)(1); *see also* Fed. R. Civ. P. 9(b) (“[A] party must state with particularity the  
 5 circumstances constituting fraud or mistake.”). Moreover, a complaint must demonstrate a  
 6 plausible entitlement to relief to survive a motion to dismiss. *Bell Atl. Corp. v. Twombly*, 127 S.  
 7 Ct. 1955, 1967 (2007). “[W]here the well-pleaded facts do not permit the court to infer more than  
 8 the mere possibility of misconduct,” the complaint has not shown “that the pleader is entitled to  
 9 relief.” *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1950 (2009) (quoting Fed. R. Civ. Proc. 8(a)(2)).

10 As detailed below, the Complaint fails to meet the heightened pleading requirements of  
 11 the PSLRA and Rule 9(b).

12 **A. The Complaint Fails to Demonstrate That Defendants’ Gross Margin and**  
 13 **EPS Projections Were False or Misleading**

14 The Complaint alleges that Rackable’s gross margin and EPS projections for the fourth  
 15 quarter of 2006 were false and misleading, but fails to allege contemporaneous facts  
 16 demonstrating that Rackable did not have a reasonable basis for these projections when they were  
 17 made. Instead, the Complaint alleges that defendants must have known these projections were  
 18 false based on risks that materialized later in the quarter that prevented Rackable from achieving  
 19 its projections. Such “fraud by hindsight” allegations do not demonstrate falsity as a matter of  
 20 law. *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1084-85 (9th Cir. 2002) (“The purpose of  
 21 [the PSLRA’s] heightened pleading requirement was generally to eliminate abusive securities  
 22 litigation and particularly to put an end to the practice of pleading ‘fraud by hindsight.’”); *In re*  
 23 *Syntex Corp. Secs. Litig.*, 95 F.3d 922, 934 (9th Cir. Cal. 1996) (“Because Defendants’  
 24 predictions proved to be wrong in hindsight does not render the statements untrue when made.”).<sup>2</sup>

25 \_\_\_\_\_  
 26 <sup>2</sup> As discussed below in Section II.C., Rackable’s financial projections are forward-looking  
 27 statements protected by the PSLRA’s safe harbor and the Bespeaks Caution doctrine because (a)  
 28 they were accompanied by meaningful cautionary language, and (b) the Complaint has not  
 alleged that Rackable’s management had actual knowledge that they were false or misleading  
 when made. Defendants therefore cannot be held liable for these projections as a matter of law.

1           The Complaint alleges that Rackable’s gross margin and EPS projections were false when  
2 made because defendants purportedly knew that Rackable’s profitability during the quarter would  
3 be negatively affected by the billing of sales and use tax to its customers, increased inventory  
4 costs, and the discounting of a contract with one of Rackable’s largest customers. Complaint ¶¶  
5 85, 87-88. The Complaint further alleges that defendants did not have accurate information  
6 regarding Rackable’s costs during the quarter, and therefore did not have a “good faith” basis for  
7 their projections, due to deficient internal controls and improper implementation of its ERP  
8 system. *See, e.g.*, Complaint ¶¶ 86(a), 90(b). The Complaint is devoid of allegations, however,  
9 regarding the methodology that Rackable used to calculate its projections and how that  
10 methodology failed to take into account any of these factors. These details are essential to  
11 showing the falsity of Rackable’s projections.

12           To mask the lack of any facts demonstrating that defendants’ class period statements were  
13 false when made, the Complaint relies extensively on Rackable’s subsequent explanations to the  
14 market about the reasons it did not achieve its gross margin and EPS projections. Such  
15 disclosures have no bearing on whether defendants were aware of contemporaneous facts  
16 inconsistent with their alleged misstatements. *See In re Read-Rite Corp. Sec. Litig.*, 335 F.3d  
17 843, 847 (9th Cir. 2003) (defendant’s post-class period statement regarding relationship with  
18 major customer was a “later, sobering revelation,” which did not turn the defendant’s “earlier,  
19 cheerier statement into a falsehood”). As a result, defendants’ *post hoc* disclosures are  
20 insufficient to show that any prior statements were false when made.

21           **B. The Complaint Fails To Demonstrate That Defendants’ Statements**  
22           **Regarding Sales and Use Taxes Were False or Misleading**

23           The Complaint alleges that Rackable’s financial statements and projections were false and  
24 misleading and violated GAAP because Rackable understated its sales and use tax liability during  
25 the Class Period. Plaintiffs fail to support these assertions, however, with particularized facts  
26 showing that the accounting for Rackable’s sales and use tax liability was ever inaccurate.  
27 Rackable notified the market of its potential sales and use tax liability in its 2005 Form 10-K  
28 annual report. RJN Ex. 1 at 27. By the beginning of the Class Period, Rackable had revised its

1 sales and use tax receivable to \$4.4 million. RJN Ex. 7 at 18. The Complaint does not contain  
2 any allegations showing that defendants were aware of information inconsistent with this  
3 receivable or that defendants believed that Rackable would not recover the full amount of this  
4 receivable from its customers. *See In re Wet Seal, Inc. Sec. Litig.*, 518 F. Supp. 2d 1148, 1160-62  
5 (C.D. Cal. 2007) (dismissing claims for failure to plead GAAP violations with particularity).

6 The Complaint alleges that Rackable's receivable as of 3Q06 should have included an  
7 additional \$2.1 million because Rackable later revised the receivable to \$6.5 million in its 2006  
8 Form 10-K, filed on February 28, 2007. RJN Ex. 11. Rackable explained in the Form 10-K that  
9 the increase in the receivable "was a result of additional information received during the year  
10 relating to customers and their self-assessment process." *Id.* at 20. The Complaint contains no  
11 allegations regarding the specific information Rackable received, when it was received, or how  
12 Rackable calculated its sales and use tax receivable *before or after* this upward revision.

13 The same deficiency undercuts the Complaint's allegation that Rackable should have  
14 recorded earlier in the Class Period the "\$3.6 million in charges for uncollected sales and use  
15 taxes and related interest and/or penalties," which Rackable recorded as a general administrative  
16 expense for the full year 2007. Complaint ¶ 24. Rackable recorded approximately \$2 million of  
17 this amount as an expense in the first quarter of 2007. RJN Ex. 15 at 21. The Complaint does not  
18 allege with particularity why Rackable should have charged this amount as an expense in 2006 or  
19 any additional amount related to its sales and use tax liability any earlier in 2007. Moreover, the  
20 contention that Rackable should have recorded these charges earlier is contradicted by the  
21 Complaint's own allegations. Rackable did not settle its outstanding sales and use tax liability to  
22 the State of California until after the second quarter of 2007. Complaint ¶ 24; RJN Ex. 19 at 24.  
23 Rackable could not have recorded the amount of this settlement as an expense before it was  
24 determined through the settlement process.

25 The Complaint asserts that Rackable should have disclosed in 4Q06 that it had just begun  
26 billing sales and use taxes to its California customers. Plaintiffs allege that this disclosure was  
27 warranted because it must have affected Rackable's ability to price its products competitively.  
28 *See, e.g.*, Complaint ¶¶ 85(b), 93(b)(iii), 114. There are, however, no allegations demonstrating

1 that Rackable's customers did not already incorporate sales and use tax into Rackable's pricing or  
2 that Rackable failed to account for this factor in its financial projections.

3 **C. The Complaint Fails To Demonstrate That Defendants' Statements**  
4 **Regarding Rackable's Inventory Procurement System Were False or**  
5 **Misleading**

6 The Complaint alleges that Rackable did not disclose the risks created by its inventory  
7 procurement system and that its financial statements and projections were false and misleading  
8 because Rackable failed to properly account for excess and obsolete inventory. There is no basis  
9 for the allegation that the market was not informed of Rackable's inventory procurement system  
10 and its potential risks. Rackable consistently informed investors that its "products incorporate  
11 open standard, commoditized components and materials that we obtain in spot markets, and, as a  
12 result, our cost structure and our ability to respond in a timely manner to customer demand are  
13 sensitive to volatility of the market prices for these components and materials." RJN Ex. 4 at 28,  
14 Ex. 1 at 5. Rackable reminded investors of these risks throughout the Class Period. Ex. 7 at 32,  
15 Ex. 11 at 14. Rackable cannot be held liable for "concealing" information that was already  
16 known to investors. *See In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1409 (9th Cir. 1996).

17 The Complaint alleges defendants knew that Rackable could not achieve its 4Q06 gross  
18 margin and EPS projections because its procurement system was certain to generate increased  
19 inventory costs. To the contrary, when Rackable's projections were made, defendants disclosed  
20 only that they believed the DRAM memory chip market was softening. *Id.* Ex. 23 at 9. Later, an  
21 unexpected "spike" in memory chip prices impacted Rackable's ability to meet these projections.  
22 *Id.* Ex. 24 at 4. The Complaint does not contain any allegations showing that defendants knew  
23 the manner in which markets for power supplies, memory chips and other inventory would  
24 fluctuate during the quarter.

25 Finally, the Complaint alleges that Rackable should have written off approximately \$20.6  
26 million of inventory in the fourth quarter 2006 that it ultimately wrote off in the second quarter  
27 2007. Complaint ¶ 26. Plaintiffs rely on the statements of confidential witnesses to support this  
28 allegation, but their vague statements regarding excess inventory lack the particularity required to

1 show that Rackable's financial statements were false or misleading when made.<sup>3</sup> *See Zucco*  
 2 *Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 999 (9th Cir. 2009) (disagreement among  
 3 employees regarding proper scrap rates for obsolete inventory is not enough to establish scienter).

4 CW5, a contract employee from 2008 through January 2009, determined well after the  
 5 Class Period that Rackable had not properly set-up the inventory "module" in its ERP System and  
 6 that there was "a lot" of unused inventory in its warehouse. Complaint ¶ 267. The Complaint  
 7 does not explain, however, how deficiencies in the ERP System detected in 2008 and excess  
 8 inventory identified in 2008 have any bearing on the information underlying Rackable's write-  
 9 down of inventory over a year earlier. Even leaving aside this deficiency, the Court should not  
 10 give any weight to the alleged statements of CW5 because s/he was not employed during the  
 11 Class Period and therefore does not have personal knowledge of any information relevant to the  
 12 Complaint's claims. *See Zucco Partners*, 552 F.3d at 996 (rejecting statements of two CWs who  
 13 were not employed by the company during the relevant period and therefore had only secondhand  
 14 information); *Brodsky v. Yahoo! Inc.*, No. C 08-02150 CW, 2009 WL 1766002, at \*6 (N.D. Cal.  
 15 June 18, 2009) (rejecting two CWs' statements regarding false revenue reporting because they  
 16 were not Yahoo! employees for most of the Class Period); *In re Silicon Storage Tech., Inc.*, No. C  
 17 05-0295 PJH, 2006 WL 648683, at \*10 (N.D. Cal. Mar. 10, 2006) (CWs not employed during  
 18 class period are not in a position to know relevant facts).

19 **D. The Complaint Fails To Demonstrate That Defendants' Statements**  
 20 **Regarding Rackable's ERP System Were False or Misleading**

21 The Complaint alleges that defendants misrepresented that Rackable's ERP System  
 22 provided sufficient visibility into Rackable's inventory and other costs to support Rackable's  
 23 financial statements and projections. *See* Complaint ¶¶ 14, 83, 86, 133, 149, 190, 267. The  
 24 Complaint does not allege, however, that defendants were aware of any alleged deficiencies in the  
 25

26 <sup>3</sup> Complaint ¶ 263(d) (CW1 observed that excess materials ordered from suppliers "never moved  
 27 from their stocking location," and sat in warehouses "year after year."), ¶ 264(d) (CW2 alleged to  
 28 have "observed that Rackable appeared to have a lot of excess inventory"), and ¶ 268(c) (CW6  
 alleged that "Rackable was left with ordering more materials than required" due to "certain"  
 suppliers' minimum purchase requirements).

1 ERP System when their statements were made. Plaintiffs rely on defendants' own statements  
2 regarding improvements to be made to the ERP System and CW5's audit of the ERP System in  
3 2008 and 2009 to support their theory that it did not "function effectively" -- and defendants  
4 knew it -- during the Class Period. To the contrary, defendants' statements demonstrate that they  
5 were *not* aware that the ERP System required material improvements until after Rackable had  
6 issued its 4Q06 gross margin and EPS projections. *See* RJN Ex. 24 at 5. (issues regarding higher  
7 than anticipated overhead costs "were not known at the time of the Q3 earnings call" and "[i]n  
8 response, we have taken immediate action to improve the visibility of our new ERP system").

9 **E. The Complaint Fails To Demonstrate That Defendants' Statements**  
10 **Regarding Rackable's Top Three Customers Were False or Misleading**

11 The Complaint alleges that individual defendants Barton and Ranganathan made false and  
12 misleading statements during Rackable's October 30, 2006 earnings conference call by stating  
13 that Rackable's relationship with its top three customers remained "pretty strong" and "solid,"  
14 respectively. Complaint ¶¶ 94, 104. The Complaint alleges that these statements were false and  
15 misleading because later in the fourth quarter Rackable provided a steep discount to one of its top  
16 three customers due to intense competition. Complaint ¶¶ 123, 130; RJN Ex. 24. This allegation  
17 fails not only because the fact that a customer obtains a discount does not mean that a relationship  
18 with that customer is not "pretty strong" or "solid," but also because, like the rest of the  
19 Complaint's allegations, it fails to show that either Barton or Ranganathan were aware of facts  
20 inconsistent with their statements at the time they were made. *See Brodsky*, 2009 WL 1766002,  
21 at \*10 (plaintiffs failed to show how circumstances at the time of alleged false statement were  
22 inconsistent with that statement). These statements also constitute the kind of general optimism  
23 that courts routinely find inactionable under the securities laws. *See, e.g., Rosenzweig v. Azurix*  
24 *Corp.*, 332 F.3d 854, 869 (5th Cir. 2003) (dismissing statement that "Our fundamentals are  
25 strong" as inactionable); *Brodsky*, 2009 WL 1766002, at \*5 (dismissing statement that "all the  
26 pieces are coming together" as inactionable); *In re Downey Sec. Litig.*, Case No. CV 08-3261-  
27 JFW, 2009 WL 736802, at \*6 (C.D. Cal. March 18, 2009) (Statements regarding company's  
28 "strong" capital position are "far too vague to be actionable under the PSLRA."); *In re Calpine*

1 *Corp.*, 288 F. Supp. 2d 1054, 1088 (N.D. Cal. 2003) (Words such as “strong”, “healthy”, and  
2 “solid” could not “form a basis for Plaintiffs’ Exchange Act claims.”).

3 F. **The Complaint Fails To Demonstrate That Defendants’ Statements**  
4 **Regarding Rackable’s Projected Sales of RapidScale Products Were False or**  
5 **Misleading**

6 The Complaint’s allegation that Rackable had no basis for its projected \$20 million in  
7 sales of RapidScale products in 2007 suffers from the same failure to allege contemporaneous  
8 facts inconsistent with the projection that plague the rest of the plaintiffs’ allegations.

9 To support this allegation, the Complaint relies exclusively on a statement by Mark  
10 Barrenechea -- named Rackable’s CEO on April 29, 2007 -- during an earnings conference call  
11 on July 26, 2007. Complaint ¶¶ 191-192. When asked whether Rackable still projected \$20  
12 million in revenue from sales of RapidScale products, Barrenechea stated:

13 [W]e needed a second release of the product which we accelerated  
14 RapidScale 2.2. which is now a GA. [sic] When we looked at how  
15 we were selling, we added subject matter experts this quarter as an  
16 overlay organization, helped the general sales force sell . . . But  
17 when you look at the \$20 million earlier projection, the execution  
18 wasn’t there to support those projections and not in alignment. And  
19 whereas we are not going to break out specifically the new  
20 [R.]apid[S]cale projections, I remain optimistic that we will do well  
21 this year. But at the end of the day, the \$20 million projection – the  
22 execution wasn’t there to support the projection.

23 Complaint ¶ 192; RJN Ex. 27 at 10.

24 Barrenechea did not state that there was no support for Rackable’s earlier projection when  
25 made, and the Complaint does not contain any allegations explaining why Barrenechea’s insight,  
26 which he gained after immersing himself in Rackable’s operations for 90 days, should be imputed  
27 to Rackable’s management at the beginning of the Class Period. *See* Complaint ¶ 191; RJN Ex.  
28 17 (Barrenechea spent first 90 days as CEO “immersed” in the “operational aspects of the  
company and [its] supply chain.”).

G. **The Complaint Fails To Demonstrate That Defendants’ Statements**  
**Regarding Rackable’s Compliance With Its Debt Covenants Were False or**  
**Misleading**

The Complaint alleges that Rackable should have disclosed that it was in breach of its  
debt covenants in its Form 10-Q for the third quarter of 2006 because it allegedly did not meet the

1 minimum profitability requirement, among other covenants, of its line of credit. This allegation is  
2 based on the flawed premise that Rackable should have (a) taken charges to its books in 3Q06 for  
3 uncollected sales and use taxes that it had yet to resolve and (b) written off inventory that it had  
4 not identified as obsolete or unusable.

5 Rackable entered into the line of credit in September 2006, more than six months after it  
6 disclosed its sales and use tax liability in its Form 10-K. Complaint ¶ 115 (citing 2006 3Q-10Q at  
7 18). Rackable, however, disclosed in its Form 10-Q that it was not in compliance with its  
8 minimum quarterly profitability covenant *and that its bank had provided a waiver of that*  
9 *covenant*. Complaint ¶ 188. The Complaint is devoid of any allegations regarding the  
10 understanding that the bank reached with Rackable concerning its sales and use tax liability  
11 before extending its line of credit and therefore does not allege that any statements about  
12 Rackable's line of credit were false or misleading.

## 13 **II. THE COMPLAINT FAILS TO PLEAD A STRONG INFERENCE OF SCIENTER**

14 The Complaint should be dismissed because it does not satisfy the PSLRA's requirement  
15 that it "state with particularity facts giving rise to a strong inference that the defendant acted with  
16 the required state of mind," i.e., with scienter. 15 U.S.C. § 78u-4(b)(2). To satisfy this  
17 requirement, the Complaint must describe conduct that constitutes, at a minimum, "deliberate  
18 recklessness," a standard tantamount to fraudulent intent. *In re Silicon Graphics, Inc. Sec. Litig.*,  
19 183 F.3d 970, 976-77 (9th Cir. 1999). The Complaint must further allege "in great detail" all  
20 sources of information alleged to corroborate its allegations of fraudulent intent. *Id.* at 985.

21 In assessing whether allegations give rise to a strong inference of scienter, the Court must  
22 consider "plausible . . . nonculpable explanations for the defendant's conduct," as well as  
23 inferences favoring the plaintiff. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499,  
24 2504 (2007). If the inference of scienter is not both "cogent and compelling," the Complaint  
25 must be dismissed. *Id.* at 2510. As to Rackable, the Complaint must show that the individual  
26 corporate officer making the statement acted with scienter. *See Glazer Capital Mgmt., LP v.*  
27 *Magistri*, 549 F.3d 736, 744-45 (9th Cir. 2008) (plaintiffs must plead scienter as to the individual  
28 defendant who made the alleged false statement absent extreme circumstances).

1 The Complaint alleges that Defendants must have known that their statements were false  
 2 or misleading when made because Rackable did not achieve its forecasted financial results and  
 3 should have known that increasing competition would cause its profitability to suffer. These  
 4 allegations are insufficient on their face because “fraud by hindsight is not actionable” under the  
 5 securities laws. *Ronconi v. Larkin*, 253 F.3d 423, 430 n.12 (9th Cir. 2001).

6 **A. The Complaint Does Not Allege With Particularity Facts Demonstrating That**  
 7 **Any Of The Individual Defendants Had Fraudulent Intent**

8 The Complaint fails to create any inference of scienter -- and falls far short of the “cogent  
 9 and compelling” inference required under *Tellabs* -- because it does not specify how any of the  
 10 individual defendants were aware, at the time the statements were made, that any of Rackable’s  
 11 statements were false or misleading. *See In re Vantive*, 283 F.3d at 1085 (dismissing complaint  
 12 for failure to allege “contemporaneous facts in sufficient detail and in a manner that would create  
 13 a strong inference that the alleged adverse facts were known at the time of the challenged  
 14 statements”). For this reason alone, the Complaint must be dismissed.

15 The Complaint’s six confidential witnesses fail to demonstrate that the Complaint alleges  
 16 even a plausible entitlement to relief, much less that it satisfies the heightened pleading  
 17 requirements of the PSLRA. *See Twombly*, 127 S. Ct. at 1967; *see also Tellabs*, 127 S. Ct. at  
 18 2511 (“[O]missions and ambiguities count against inferring scienter.”). Four of the confidential  
 19 witnesses -- CW1, CW3, CW5 and CW6 -- were not employed at Rackable during the Class  
 20 Period, making it impossible for them to have personal knowledge of the defendants’ relevant  
 21 state of mind.<sup>4</sup> *See Zucco Partners*, 552 F.3d at 996; *Brodsky*, 2009 WL 1766002, at \*10; *In re*  
 22 *Silicon Storage Tech.*, 2006 WL 648683, at \*10.

23 CW2 and CW4, the only CWs who were employed by Rackable during the Class Period,  
 24 do not assert any facts that support an inference of scienter because they are not alleged “to have  
 25 had any interaction or communication with any of the defendants, or to have provided any

26 \_\_\_\_\_  
 27 <sup>4</sup> The dates of employment for CW1, CW3, CW5 and CW6 are as follows: CW1 (2003 through  
 28 “the beginning of 2006”), CW3 (1999 through “the beginning of 2006”), CW5 (January 2009  
 through April 2009), and CW6 (“beginning of 2008” through January 2009). *See* Complaint ¶¶  
 263, 265, 267 and 268, respectively.

1 defendant with information, or to have heard or read any statement by any defendant, that  
2 contradicted or even cast doubt on a public statement made during the class period.” *McCasland*  
3 *v. FormFactor, Inc.*, No. C 07-5545 SI, 2008 WL 2951275, at \*8 (N.D. Cal. July 25, 2008).

4 Neither CW2 nor CW4 communicated with any individual defendant.

5 Moreover, the statements attributed to CW2 and CW4 that Rackable was “always” short  
6 of components and that “[o]nce orders were accepted by customers, only then did Rackable  
7 usually order supply materials” do not contradict defendants’ statements. Complaint ¶¶ 264(d) &  
8 266(a). Rackable disclosed this precise information to investors long before the Class Period  
9 began.<sup>5</sup> CW4’s statement that he did not collect sales tax from customers does not shed any light  
10 on how defendants calculated Rackable’s sales and use tax liability or whether defendants’  
11 statements to the market on this issue were inaccurate in any respect. Complaint ¶ 266(b). The  
12 remaining allegations attributed to CW2 and CW4 are too vague to support an inference of  
13 scienter, if they are even relevant to plaintiffs’ claims. *See id.* ¶ 264 (alleging a “high rate of  
14 returned products” and that Rackable was unable to “get back” evaluation units “on loan” to  
15 potential customers), ¶ 266 (alleging that “commodity items” were quoted at “double market  
16 prices” and later adjusted to market price).

17 The Complaint’s allegations that Barton and Ranganathan signed Sarbanes-Oxley  
18 certifications does not give rise to a strong inference of scienter. Complaint ¶¶ 257-60. The  
19 Ninth Circuit has held that “Sarbanes-Oxley certification is only probative of scienter if the  
20 person signing the certification was severely reckless in certifying the accuracy of the financial  
21 statements.” *Glazer Capital Mgmt.*, 549 F.3d at 747; *see also Zucco Partners*, 552 F.3d at 1004  
22 (rejecting plaintiff’s “invitation to undermine the PSLRA’s distinct requirements for pleading  
23 falsity and scienter, and hold[ing] that [] Sarbanes-Oxley certifications are not enough to create a  
24 strong inference of scienter and do not make [plaintiff’s] otherwise insufficient allegations more  
25

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26 <sup>5</sup> *See* RJN Ex. 4 at 28 (“[B]ecause our procurement model involves our ability to maintain a low  
27 inventory and to acquire materials and components as needed, and because we do not enter into  
28 long-term supply contracts for these materials and components, we may be in a position in which  
our ability to effectively and efficiently respond to customer orders may be constrained by the  
then-current availability or the terms and pricing of these materials and components.”).

1 compelling by their presence in the same complaint”). None of the Complaint’s allegations that  
2 defendants violated GAAP or any other disclosure obligations are supported by particularized  
3 allegations from reliable sources -- as not one CW is alleged to have worked in accounting or  
4 finance while at Rackable. *See* Complaint ¶¶ 200-260 and *Silicon Graphics*, 183 F.3d at 985.  
5 And importantly, there is no allegation that Rackable restated its financial results or that its  
6 financial reporting was anything other than entirely accurate.

7 The Complaint also alleges that defendants were motivated to commit fraud to keep  
8 Rackable in compliance with its debt covenants under its line of credit, which required, among  
9 other things, that Rackable maintain a certain level of net income. Complaint ¶¶ 281-284.  
10 Rackable never had any borrowings under this line of credit during the Class Period, however,  
11 and therefore no “motive” existed to misrepresent its compliance with these covenants. RJN Ex.  
12 7 at 18, Ex. 11 at 49, Ex. 15 at 17. In any event, such generalized allegations of “motive and  
13 opportunity” cannot support an inference of scienter as a matter of law. *See Silicon Graphics*,  
14 183 F.3d at 979 (“[P]laintiffs proceeding under the PSLRA can no longer aver intent in general  
15 terms of mere ‘motive and opportunity’ or ‘recklessness.’”).

16 The Complaint also resorts to the conclusory allegation that the individual defendants  
17 must have had fraudulent intent based on their positions within Rackable. *See* Compl. ¶¶ 269-  
18 273. Courts consistently reject such allegations where, as here, they are not supported by  
19 particularized allegations: “[C]orporate management’s general awareness of the day-to-day  
20 workings of the company’s business does not establish scienter—at least absent some additional  
21 allegation of specific information conveyed to management and related to the fraud.” *Metzler*,  
22 540 F.3d at 1068; *see also Brodsky*, 2009 WL 1766002, at \*10 (defendants’ high level positions  
23 do not provide a strong inference of scienter). CW4’s allegations that “management” held “daily  
24 management meetings” and reviewed “ERP Reports” do not contain the required specificity to  
25 establish scienter. Complaint ¶ 273; *see Silicon Graphics*, 183 F.3d at 988 (allowing a plaintiff  
26 “to go forward with a case based on general allegations of ‘negative internal reports’ would  
27 expose all those companies to securities litigation whenever their stock prices dropped”). Nor  
28 does the Complaint allege the “rare circumstances where the nature of the relevant fact is of such

1 prominence that it would be ‘absurd’ to suggest that management was without knowledge of the  
2 matter.” *South Ferry LP v. Killinger*, 542 F.3d 776, 786 (9th Cir. 2008).

3 Plaintiffs’ reliance on the “group pleading” doctrine is also unavailing. As this Court has  
4 recognized, the group pleading doctrine -- which would have the Court presume that the  
5 company’s public filings are the result of the collective actions of management -- “is no longer  
6 viable in light of the PSLRA’s heightened pleading standards’ requiring plaintiffs to allege  
7 particularized facts regarding individual defendants.” *McCasland*, 2008 WL 2951275, at \*11  
8 (collecting cases); *see also Glazer*, 549 F.3d at 743-45 (rejecting group pleading doctrine as  
9 inconsistent with PSLRA, without deciding whether it might apply in extreme circumstances).

10 **B. The Complaint’s Allegations Regarding the Individual Defendants’**  
11 **Compensation and Stock Sales Do Not Support Any Inference of Scienter**

12 The Complaint alleges that defendants were motivated to commit fraud to obtain  
13 additional compensation from the company and to sell their holdings of Rackable stock at inflated  
14 prices. Under settled law, the existence of performance-based compensation and bonuses,  
15 without more, does not establish scienter. *In re Syncor Int’l Corp. Sec. Litig.*, 239 Fed. Appx.  
16 318, 321 (9th Cir. 2007) (“Allegations that defendants had a motive to inflate Syncor’s stock,  
17 through bonus incentives tied to stock price, similarly fail to show scienter.”). The Complaint  
18 does not allege that Rackable structured the individual defendants’ compensation in a manner that  
19 would cause them to earn extraordinary compensation when compared to that received by officers  
20 at comparable companies.

21 Of the individual defendants, the Complaint alleges that only Ford sold any stock during  
22 the Class Period. *See Ronconi v. Larkin*, 253 F.3d at 436 (“One insider’s well timed sales do not  
23 support the ‘strong inference’ required by the statute where the rest of the equally knowledgeable  
24 insiders act in a way inconsistent with the [fraudulent inference] . . .”). Ford sold 100,000 shares  
25 during the Class Period, but there is no indication of how Ford’s stock sales compare to his sales  
26 before the Class Period. Insider stock sales are not probative of scienter unless plaintiffs first  
27 establish that such sales were either “unusual” or “suspicious” and “dramatically out of line with  
28 prior trading practices at times calculated to maximize the personal benefit from undisclosed

1 inside information.” *Silicon Graphics*, 183 F.3d at 986 (quoting *In re Apple Computer Sec. Litig.*,  
2 886 F.2d 1109, 1117 (9th Cir. 1989)). The Ninth Circuit recently reaffirmed that “for individual  
3 defendants’ stock sales to raise an inference of scienter, plaintiffs must provide a ‘meaningful  
4 trading history’ for purposes of comparison to the stock sales within the class period.” *Zucco*  
5 *Partners*, 552 F.3d at 1005. Even if it is not available, for reasons beyond a plaintiff’s control,  
6 the plaintiff is not excused from pleading the relevant trading history. *Id.* Ford’s stock sales  
7 cannot create any inference of scienter because the Complaint lacks this essential information.

8 Moreover, the timing of Ford’s stock sales during the Class Period itself undercuts any  
9 inference of scienter. Ford sold 55,000 shares between October 30, 2006 and January 16, 2007  
10 (when plaintiffs allege that the “truth” regarding the alleged fraud began to be revealed) at prices  
11 ranging from \$33.85 to \$34.50 per share. Ford sold nearly as many shares (52,000), however,  
12 from January 16, 2007 through the end of the Class Period, at prices ranging from \$18.20 to  
13 \$13.00. These trades are inconsistent with plaintiffs’ supposition that defendants were trying to  
14 maximize their profit from an artificially inflated stock price. “Insider stock sales become  
15 suspicious ‘only when the level of trading is dramatically out of line with prior trading practices  
16 at times calculated to maximize the personal benefit from undisclosed inside information.’”  
17 *Brodsky*, 2009 WL 1766002, at \*10 (emphasis added) (quoting *In re Vantive*, 283 F.3d at 1092).

18 That Barton and Ranganathan did not sell any stock during the Class period further  
19 undermines any inference of scienter. It does not make economic sense for a corporate officer to  
20 engage in a fraudulent scheme to inflate a company’s stock price and then retain substantial  
21 amounts of the stock as the alleged truth leaks into the market place and the stock price declines  
22 precipitously. Courts have held that such facts weaken an inference of scienter. *See, e.g.*,  
23 *Thornton v. Micrografx, Inc.*, 878 F. Supp. 931, 938 (N.D. Tex. 1995) (“Why would the  
24 Defendants expend so much time and effort to conceal facts and misrepresent information . . . ,  
25 successfully orchestrating the artificial inflation . . . and then sit back while the stock slides daily  
26 for seven weeks to half that price to begin enjoying the fruits of their fraud by selling stock?”  
27 (emphasis omitted)); *In re Credit Acceptance Corp. Sec. Litig.*, 50 F. Supp. 2d 662, 677 (E.D.  
28 Mich. 1999) (“It seems unlikely that [defendant] would engage in a scheme to inflate the

1 company's earnings after he sold his stock early on in the class period, and yet fail to sell any of  
2 his remaining shares at artificially inflated prices.”)<sup>6</sup>

3 The Complaint seeks to bolster its insider trading allegations by including the stock sales  
4 of non-defendant William P. Garvey, Rackable's former General Counsel. Complaint, ¶ 285.  
5 Because Garvey is not alleged to have made any false statements, his stock sales do not “give rise  
6 to a strong inference of deliberate recklessness.” *Silicon Graphics*, 183 F.3d 970 at 987-88 (sales  
7 by defendant who did not make false statement did not support inference of scienter); *see also*  
8 *Vantive*, 283 F.3d at 1095 (VP's sale of 48% of holdings did not support inference of scienter).

9 **C. Defendants' Forward-Looking Statements Are Protected By The PSLRA's**  
10 **Safe Harbor And The Bespeaks Caution Doctrine**

11 The Complaint describes each category of purported false and misleading statements in  
12 terms of why they allegedly undercut Rackable's gross margin and EPS projections. Such  
13 financial projections are classic forward-looking statements for which Rackable is protected from  
14 liability under the PSLRA's statutory safe harbor and the Bespeaks Caution doctrine.

15 The PSLRA's safe harbor establishes two independent bases upon which a court must  
16 dismiss claims based on forward-looking statements. First, forward-looking statements are  
17 absolutely immunized from liability if they are accompanied by meaningful cautionary language.  
18 *Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125,  
19 1133-34 (9th Cir. 2004). Cautionary language may accompany the statements themselves, or  
20 may be set forth in referenced documents, such as SEC filings. *E.g., id.* at 1133; *Wet Seal*, 518 F.  
21 Supp. 2d at 1169. Second, even if unaccompanied by cautionary language, forward-looking  
22 statements cannot support liability unless they are made with actual knowledge of their falsity.  
23 *See* 15 U.S.C. § 78u-5(c)(1)(A)(i); *Clorox*, 353 F.3d at 1134. The Bespeaks Caution doctrine also  
24 immunizes forward-looking statements when accompanied by meaningful cautionary language.

25 \_\_\_\_\_  
26 <sup>6</sup> The allegations that Barton exercised stock options in 2006 does not create an inference of  
27 scienter. *See* Complaint ¶ 278. Contrary to what the Complaint suggests, Barton did not realize  
28 any proceeds from the exercise of stock options during the Class Period. Barton exercised the  
200,000 options referenced in the Complaint and sold the underlying stock in March 2006. *See*  
RJN Ex. 40.

1 *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994).

2 All defendants' forward-looking statements cited in the Complaint were accompanied by  
3 meaningful cautionary language and are therefore inactionable as a matter of law. *See* RJN Ex. 6,  
4 Ex. 23, Ex. 5, Ex. 10, Ex. 24, Ex. 9, Ex. 11, and Ex. 12. Cautionary language need not identify  
5 the specific risks that materialized so long as it "mention[s] *important* factors of similar  
6 significance to those actually realized." *See In re Copper Mountain Sec. Litig.*, 311 F. Supp. 2d  
7 857, 882 (N.D. Cal. 2004). Rackable's cautionary language satisfies these requirements.  
8 Rackable's press release containing its fourth quarter 2006 financial guidance, for example, all  
9 warn that they contain forward-looking statements and identify specific risks that might cause  
10 Rackable's actual results to differ. *See* RJN Ex. 6, referencing Ex. 4.

11 Moreover, given that the Complaint has not pled that defendants acted with scienter, it has  
12 necessarily failed to plead with particularity that defendants had any "actual knowledge" that any  
13 statement was false when made. Therefore, defendants' forward-looking statements are  
14 immunized by both prongs of the PSLRA's safe harbor as well as the Bespeaks Caution doctrine.

### 15 **III. THE COMPLAINT DOES NOT PLEAD LOSS CAUSATION**

16 The Complaint's allegations also fail because they do not plead loss causation, i.e., that  
17 the "truth" regarding any of the alleged misrepresentations was subsequently revealed to the  
18 market and caused Rackable's stock price to decline. *See Dura Pharm.*, 125 S. Ct. at 1633. In  
19 *Dura*, the Supreme Court held that innumerable factors other than fraud can cause a stock price  
20 decline including "changed economic circumstances, changed investor expectations, new  
21 industry-specific or firm-specific facts, conditions, or other events, which taken separately or  
22 together account for some or all of that lower price." *Id.* at 1632. Accordingly, plaintiffs must  
23 show that the market "learned of and reacted to [the alleged] fraud, as opposed to merely reacting  
24 to reports of the defendant's poor financial health generally." *Metzler*, 540 F.3d at 1063.

25 The Complaint alleges that the "truth" regarding defendants' alleged misrepresentations  
26 was revealed to the market through a series of partial corrective disclosures "on or about" January  
27 16, 2007, February 2, 2007, April 4, 2007, and April 24, 2007. Complaint ¶ 301. These alleged  
28 disclosures reveal, however, that Rackable's stock price fell in response to disappointing financial

1 results caused by unexpected inventory costs and aggressive competition. The disclosures do not  
2 reveal—as they must to show loss causation—that defendants fraudulently misrepresented  
3 Rackable’s prior financial statements and projections.

4 **A. Defendants’ January 16, 2007 Statements Are Not Corrective Disclosures**

5 The Complaint contends that the “truth” began to be revealed on January 16, 2007, when  
6 Rackable announced its preliminary fourth quarter financial results, which included that, although  
7 Rackable met its total revenue projection for 4Q06, it did not meet its gross margin and EPS  
8 projections. Complaint ¶¶ 91-92. The assertion that this release was a corrective disclosure is a  
9 classic attempt to plead loss causation based on a stock price decline in response to disappointing  
10 financial results. *Metzler* makes clear that such allegations are insufficient. 540 F.3d at 1063-64.

11 Rackable identified three factors that impacted its gross margin for 4Q06: (1) “higher  
12 than anticipated” DDR memory pricing, (2) “[i]ntense competitive conditions that caused the  
13 company to price contracts more aggressively,” and (3) “[l]ower than expected” sales of  
14 RapidScale products. RJN Ex. 9. Disclosure of these factors does not reveal that Rackable’s  
15 gross margin and EPS projections were fraudulently misstated. To the contrary, all three factors  
16 refer to unexpected events, which occurred after Rackable issued its projections.

17 **B. Defendants’ February 1, 2007 Statements Are Not Corrective Disclosures**

18 The Complaint alleges that Rackable’s stock price fell further on February 2, 2007, in  
19 response to additional corrective disclosures in Rackable’s February 1, 2007 press release and  
20 conference call on the same day announcing final results for the fourth quarter and full year 2006.  
21 Complaint ¶ 17; RJN Ex. 10, Ex. 24. Defendants’ statements in this press release and conference  
22 call, however, do not reveal that any of their previous statements were fraudulent.

23 Rackable’s press release reiterated that Rackable had record revenue in the fourth quarter,  
24 but missed its gross margin and EPS projections. RJN Ex. 10. During the conference call,  
25 defendants identified the same three factors disclosed on January 16, 2007 as contributing to the  
26 shortfall, plus one additional factor -- that Rackable’s business was “backend loaded” during the  
27 quarter. *Id.* Ex. 24 at 3. This additional disclosure, like the others, does not reveal fraud. *See*  
28 *Metzler*, 540 F.3d at 1063; *accord In re Tellium, Inc. Sec. Litig.*, No. Civ. A. 02cv5878 FLW,

1 2005 WL 2090254, at \*4 (D.N.J. Aug. 26, 2005) (“*Dura* itself makes clear that loss causation is  
2 not pled upon allegations of drops in stock price following an announcement of bad news that  
3 does not disclose the fraud.”). And Ford’s statement during the conference call that Rackable  
4 “should have realized the impact of [higher than anticipated overhead costs] earlier in the quarter”  
5 is at most an admission of mismanagement, not the revelation of fraud. *See In re Impac Mortg.*  
6 *Holdings, Inc. Sec. Litig.*, 554 F. Supp. 2d 1083, 1087 (C.D. Cal. 2008) (corporate  
7 mismanagement is not actionable under the securities laws); *Harrison v. Rubenstein*, No. 02 CIV.  
8 9356 (DAB), 2007 WL 582955, at \*13 (S.D.N.Y. Feb. 26, 2007) (“Allegations of  
9 mismanagement do not state a claim for securities fraud.” (internal quotation marks omitted)).

10 **C. Defendants’ April 4, 2007 Statements Are Not Corrective Disclosures**

11 On April 4, 2007, Rackable issued a press release announcing “[t]otal revenue for the first  
12 quarter of 2007 is expected to be in the range of its previous projections of \$70-75 million.  
13 However, the company now expects GAAP and non-GAAP gross margin for the first quarter to  
14 be approximately 30% lower than previously communicated expectations.” RJN Ex. 12. The  
15 Complaint alleges the stock price decline following this press release was caused by the  
16 revelation of defendants’ alleged fraud, and not the fact that Rackable announced lower than  
17 previously expected gross margin results. Nothing in this press release or that was said during the  
18 related conference call, however, purports to “correct” any of defendants’ previous statements.  
19 *See* RJN Ex. 12, Ex. 25.

20 The Cannacord-Adams analyst report following this press release demonstrates that  
21 investors understood that market forces caused Rackable to revise its gross margin expectations.  
22 *See* Complaint ¶ 174 (“[O]nce again competition made a sizeable impact on Rackable’s business  
23 model . . . DRAM pricing has collapsed over the last three months . . . We believe this drove  
24 Rackable’s gross margins significantly lower . . . as it had to keep pace with pricing from Dell  
25 and HP.”) There is no indication that the market’s reaction was caused by recognition that  
26 Rackable’s previous projections were fraudulently overstated. *See Metzler*, 540 F.3d at 1063-64  
27 (plaintiff cannot plead fraud through “euphemism”); *Lentell v. Merrill Lynch & Co.*, 396 F.3d  
28 161, 173 (2d Cir. 2005) (corrective disclosure must reveal some aspect of alleged fraud).

