UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES—GENERAL

Case No. CV 13-9174-MWF(VBKx) **Date: February 27, 2015**
Title: Mark Roberti -*v*- OSI Systems, Inc., et al.

Present: The Honorable MICHAEL W. FITZGERALD, U.S. District Judge

Deputy Clerk:	Court Reporter:
Cheryl Wynn	Not Reported
Attorneys Present for Plaintiff:	**Attorneys Present for Defendant:**
None Present	None Present

Proceedings (In Chambers): ORDER DENYING DEFENDANTS' MOTION TO DISMISS PLAINTIFF'S AMENDED CLASS ACTION COMPLAINT [49]

Before the Court is Defendants' Motion to Dismiss Plaintiff's Amended Class Action Complaint (the "Motion") filed by Defendants OSI Systems, Inc., Deepak Chopra, Alan I. Edrick, and Ajay Mehra on July 18, 2014. (Docket No. 49). The Court has reviewed and considered the papers, and held a hearing on November 3, 2014. For the reasons set forth below, the Court **DENIES** the Motion.

I. BACKGROUND

On December 12, 2013, Plaintiff Mark Roberti initiated this class action suit, individually and on behalf of all other persons similarly situated (the "Putative Class"), by filing a Complaint in this Court. (Docket No. 1). The Complaint alleged that Defendants OSI Systems, Inc. ("OSI"), OSI President, Chairman, and CEO Deepak Chopra, and OSI CFO and Executive Vice President Alan I. Edrick (collectively the "Defendants") violated the Securities Exchange Act of 1934 (the "Exchange Act") by making materially false and misleading statements regarding OSI's business, operational, and compliance policies. (*Id.*).

The Court filed an Order appointing Arkansas State Highway Employees Retirement System as Lead Plaintiff on March 17, 2014. (Docket No. 35). Lead Plaintiff then filed an Amended Class Action Complaint on May 20, 2014, adding Executive Vice President and Director Ajay Mehra as a defendant. (Docket No. 44).

The action arises from questions raised by the U.S. Department of Homeland Security ("DHS") and the Transportation Security Administration ("TSA") about contracts made with OSI subsidiary Rapiscan Systems, Inc. ("Rapiscan") for two security screening and inspection products: Advanced Imaging Technology ("AIT") full-body scanners, and Advanced Technology 2 ("AT-2") checkpoint baggage scanners. Lead Plaintiff alleges that between January 24, 2012 and December 6, 2013 (the "Class Period"), all persons who purchased or otherwise acquired OSI Systems securities were damaged by Defendants' materially false and misleading statements regarding these technologies, including allegations that OSI was intentionally manipulating government testing, and was knowingly using foreign and unapproved parts in violation of contracts with the U.S. Government. Lead Plaintiff bases these claims on its review and analysis of OSI's public filings with the SEC, the reports of securities and financial analysts concerning OSI's business, press releases, news articles, and other public statements concerning the Defendants, and interviews with numerous former OSI employees now serving as Confidential Witnesses in this action.

A. Fraud Related to Advanced Imaging Technology Contract

OSI develops and manufactures X-ray security and inspection systems to detect explosives, weapons, and other contraband, through its subsidiary and "core business segment," Rapiscan. (Amended Compl. at ¶ 2). Of OSI's $800 million in revenue in 2012 and 2013, nearly $400 million came from Rapiscan. (*Id.* at ¶ 25). Among Rapiscan's most important customers for these technologies were the Department of Homeland Security ("DHS") and the Transportation Security Administration ("TSA"). (*Id.* at ¶ 2). In fact, between 2009 and December 2013, OSI received around $267 million in work from DHS alone, and a total of $463 million in U.S. Government contracts. (*Id.* at ¶ 31).

In September 2009, TSA awarded Rapiscan a $173 million contract for potential future orders of Rapiscan's Advanced Imaging Technology ("AIT") systems, also known as "whole-body imaging" scanners, to be used for security screening in U.S. airports. (*Id.* at ¶¶ 36, 38). Following the award of this contract, OSI received various orders for its body scanner and related services. (*Id.* at ¶ 39). After deployment of

these machines in airports, however, the public began raising privacy concerns over the detailed "naked body" images produced by the AIT scanners. (*Id.* at ¶ 42). Responding to these concerns, in late 2010, TSA mandated that all AIT scanners be upgraded with Automated Target Recognition ("ATR") software, which would modify the scanner's images to display only generic figures. (*Id.* at ¶ 44). Under the 2012 FAA Modernization and Reform Act (P.L. 112-95), passed by Congress on February 14, 2012, all AIT equipment was to be updated with this ATR software by June 1, 2012. (*Id.* at ¶ 46).

According to the Amended Complaint, Rapiscan encountered significant difficulties in developing the upgraded ATR software. (*Id.* at ¶ 53). Despite these difficulties, however, Defendants allegedly made numerous representations to investors that it was "business as usual" at Rapiscan, and allegedly indicated that the ATR software was already developed and "undergoing its final testing," that "could lead to more sales in the future" or "within the next few months." (*Id.* at ¶ 53). According to the Amended Complaint, Defendants were in fact nowhere close to developing software that would meet the TSA requirements. (*Id.* at ¶ 53).

Confidential Witness 1, who allegedly "worked directly on the testing of the ATR software," stated that Rapiscan "pretty much knew from the start" that it was running far behind schedule and that "[i]t was clear" to individuals that worked on the testing that "the algorithm was behind" by about a year. (*Id.* at ¶ 54). Confidential Witness 2, a Director of International Programs who worked at Rapiscan until July 2013, explained that he "was aware all along that they were . . . having trouble meeting the criteria," regarding the ATR software. (*Id.* at ¶ 56). This Confidential Witness allegedly heard some Vice Presidents "say they did not think [Rapiscan] would ever meet the Congressional deadline." (*Id.*). Confidential Witnesses 3, a Rapiscan Field Service Engineer from 2007 to December 2012 explained that there were "too many bugs" in the software and that the quality assurance staff were "not as diligent" as they should have been. (*Id.* at ¶ 59). According to Confidential Witness 1, engineers developing the software "never had management support" for properly completing the integration of the software. (*Id.* at ¶ 60).

In light of these difficulties, Rapiscan eventually requested an extension of the TSA's June 1, 2012 deadline, which TSA Administrator John Pistole granted based on the belief "that ATR certification was near." (*Id.* at ¶ 61). The Amended Complaint alleges that in order to create this impression, Rapiscan "cherry-picked" the few machines that were not encountering problems to send to TSA for testing. (*Id.* at 62). Confidential Witness 2 stated that "there was some manipulation of the data on the part of the engineers." (*Id.* at 63). Confidential Witness 4 stated that former quality assurance director Robert Mosley would have been aware of any manipulations and that this information would have been known "all the way up to the president." (*Id.*). Confidential Witness 1 stated that these problems were also documented as Issue #8117 in Rapiscan's defect tracking database, which was allegedly accessible to all OSI management. (*Id.* at 64).

The Amended Complaint alleges that even in the face of these difficulties, the "Defendants continued to knowingly or with reckless disregard represent to the market throughout 2012 that OSI was on track to comply with the TSA's directive in a timely manner, stating . . . (1) "We are actually going through some operational testing of our ATR . . . and we expect that [TSA] will be looking at potential orders within the next few months"; (2) "ATR [is] . . . undergoing its final testing as we speak"; and (3) "[W]e're currently in testing, so we've completed on our side and the customer [is] currently in testing. We're hopeful that that could happen – that could be completed any time this summer." (*Id.* at 65). According to the Amended Complaint, OSI eventually disclosed to TSA that it would not be able to meet the extended deadline of May 31, 2013; however, OSI did not make this same disclosure to investors. (*Id.* at ¶ 66).

On November 9, 2012, TSA sent OSI a show cause letter that alleged that Rapiscan had not disclosed the issues related to the development process in a timely or complete manner. (*Id.* at ¶ 67). The chairman of the House Transportation Security Subcommittee also requested information from OSI, expressing concerns that OSI "may have attempted to defraud the Government by knowingly manipulating an operational test of Automated Target Recognition (ATR) software in the field in order to have a successful outcome." (*Id.* at ¶ 68). On November 14, 2012, OSI responded

that "Rapiscan became aware of an issue related to software under development months ago and promptly notified the TSA." (*Id.* at ¶ 69). The Amended Complaint asserts that on November 15, 2012, two analysts at Oppenheimer stated that "Rapiscan manipulated test results for a software algorithm it was developing to enhance privacy features on its full body scanners." (*Id.* at ¶ 70). Additionally, on November 16, 2012, an analyst at Benchmark also indicated that "OSI simply manually selected the best sensors that came off the line for the three units sent for testing," in order to have good results. (*Id.* at ¶ 71).

On January 17, 2013, OSI announced that the TSA had cancelled the contract with Rapiscan for ATR software development, and that it planned to de-book the $5 million backlog and report a related $2.7 million impairment charge. (*Id.* at ¶ 73). That same day OSI filed with the SEC a Form 8-K signed by Defendant Edrick discussing these developments. (*Id.*). The Amended Complaint explains that on January 24, 2013, Defendant Chopra stated in a conference call that the cancellation of the contract would "allow[] [Rapiscan] to stop the R&D spending on this program for which we saw a limited future beyond the TSA." (*Id.* at ¶ 74).

On May 20, 2013, OSI announced that DHS had issued a Notice of Proposed Debarment in connection with TSA's show cause letter. (*Id.* at ¶ 75). OSI's General Counsel filed a Form 8-K with the SEC that same day, indicating that this Notice "alleges that Rapiscan failed to disclose a defect with the Products and replaced hardware in the Products without being granted proper governmental approval." (*Id.* at ¶ 75). On June 21, 2013, OSI and DHS announced that they had entered into a 30-month Administrative Agreement to resolve the Notice of Proposed Debarment. (*Id.* at ¶ 76). Rapiscan had agreed to certain compliance upgrades and organizational improvements, had made certain personnel changes, and had created additional positions dedicated to compliance and quality assurance. (*Id.*).

B. Fraud Related to Checkpoint Baggage and Parcel Scanners Contract

The Amended Complaint also alleges a separate fraud involving OSI's checkpoint baggage and parcel scanners. On September 16, 2010, OSI announced that

the TSA had awarded it a $325 million contract for this type of equipment, including Rapiscan's 620DV model. (*Id.* at ¶¶ 47). This contract required all parts to be manufactured and assembled in the United States, and prohibited changes to parts or configurations of the scanners without prior government approval. (*Id.* at ¶¶ 50, 78). Following the award of this contract, TSA ordered and Rapiscan delivered millions of dollars worth of 620DVs to the U.S. Government. (*Id.* at ¶ 49).

According to the Amended Complaint, however, Rapiscan began using unapproved X-ray generators manufactured in China to assemble and repair these scanners, and concealed this contractual violation by labeling the unapproved components with the same part number as the originally approved component. (*Id.* at ¶ 80). In total, OSI delivered at least 250 devices with these unapproved components. (*Id.*).

The Amended Complaint alleges that after OSI replaced some of its employees following the revelation of the ATR software issue described above, the new employees quickly discovered that Rapiscan was using unapproved parts in the 620DVs. (*Id.* at ¶ 81). Nevertheless, OSI bid on a new $67 million 620DV contract. (*Id.* at ¶ 81). According to the Amended Complaint, "[f]ormer employees confirmed that Rapiscan routinely changed the configuration of one of its products without gaining approval from the TSA in violation of the contracts' terms." (*Id.* at ¶ 83). Confidential Witness 4 stated that "[t]here just were rumors that [Rapiscan] would just go ahead and make the changes they needed, if it was a minor one." (*Id.*). Confidential Witness 3 indicated that Rapiscan's quality assurance program suffered from severe deficiencies. (*Id.* at ¶ 84).

TSA issued Rapiscan a show cause letter on November 20, 2013, in relation to the use of these unapproved components. (*Id.* at ¶ 85). The Amended Complaint alleges that Defendants did not disclose this second show cause letter to their investors until nineteen days later on December 9, 2013. (*Id.*). TSA canceled the $67 million contract on December 4, 2013. (*Id.* at ¶ 86). On December 8, 2013, OSI issued a press release stating that "[w]hile the component change was vetted by Rapiscan's internal quality assurance, it did not meet the contractual requirement of obtaining TSA's

approval in advance." (*Id.* at ¶ 88). An analyst at Stephens concluded that this issue stemmed from "personnel and compliance shortfalls." (*Id.*). An analyst at Quillin wrote that "long before the [$67 million] bid, [Rapiscan] had swapped out a component of its checkpoint x-ray systems without concurrently notifying the TSA of the change." (*Id.* at ¶ 89). Several individuals were allegedly let go after this came to light. (*Id.* at ¶ 90).

C. Shareholder Lawsuit

Lead Plaintiff is now bringing claims under sections 10(b), 20(a) and 20(A) of the Securities Exchange Act (15 U.S.C. §§ 78j(b), 78t(a) and 78t-1), along with Rule 10b-5 promulgated thereunder (17 C.F.R. § 240.10b-5), alleging that Defendants' conduct caused a decline in the market value of OSI Systems securities and that the decline in value caused significant losses and damage to shareholders. (*Id*. at ¶1). Defendants brought a Motion to Dismiss Plaintiff's Amended Class Action Complaint on July 18, 2014. (Docket No. 49). Lead Plaintiff filed an Opposition to Defendants' Motion to Dismiss the Amended Complaint on August 29, 2014. (Docket No. 51). Defendants filed a Reply in Support of their Motion to Dismiss Plaintiff's Amended Class Action Complaint on September 26, 2014. (Docket No. 52).

II. DISCUSSION

"A Rule 12(b)(6) dismissal is proper only where there is either a lack of a cognizable legal theory or the absence of sufficient facts alleged under a cognizable legal theory." *Brown v. China Integrated Energy, Inc.*, 875 F. Supp. 2d 1096, 1102 (C.D. Cal. 2012) (internal quotation omitted). In reviewing a motion to dismiss, the Court must accept all factual allegations pleaded in the complaint as true. *Id.*

Securities fraud class actions are held to the heightened pleading requirements of the Private Securities Litigation Reform Act (the "PSLRA") and Federal Rule of Civil Procedure 9(b). *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 313, (2007) (reversing dismissal of securities fraud class action and clarifying that plaintiff alleging fraud in § 10(b) action need only plead facts rendering inference of scienter at least as

likely as any plausible opposing inference). "The PSLRA requires plaintiffs to state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter, i.e., the defendant's intention to deceive, manipulate, or defraud." *Id.* at 313 (internal quotation omitted).

Specifically, a complaint must "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading," and "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). Additionally, a complaint must "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). The Ninth Circuit provides a two-part inquiry for scienter: (1) "whether any of the allegations, standing alone, are sufficient to create a strong inference of scienter," and (2) "if no individual allegation is sufficient . . . whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness." *New Mexico State Inv. Council v. Ernst & Young*, 641 F.3d 1089, 1095 (9th Cir. 2011) (citing *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 991–92 (9th Cir. 2009)). The requisite state of mind must be a "departure from the standards of ordinary care that presents a danger of misleading buyers that is either known to the defendant or so obvious that the actor must have been aware of it." *Zucco*, 552 F.3d at 991 (internal quotations omitted).

In sum, a complaint "must contain allegations of specific 'contemporaneous statements or conditions' that demonstrate the intentional or the deliberately reckless false or misleading nature of the statements when made." *Ronconi v. Larkin*, 253 F.3d 423, 432 (9th Cir. 2001) (affirming the dismissal of a securities fraud class action on the ground that optimistic statements made eight months before merger and conclusory allegations that statements were false when made were insufficient to raise a strong inference that defendants intentionally or with deliberate recklessness made false or misleading statements to investors). "If a plaintiff fails to plead either the alleged misleading statements or scienter with particularity, the complaint must be dismissed." *In re Immune Response Sec. Litig.*, 375 F. Supp. 2d 983, 1018 (S.D. Cal. 2005) (internal quotation omitted) (denying motions to dismiss securities class action because, among other things, investors sufficiently stated facts that supported strong

inference that representations were false or misleading when made and cautionary statements were too generic to invoke safe harbor protection). These heightened requirements "prevent[] a plaintiff from skirting dismissal by filing a complaint laden with vague allegations of deception unaccompanied by a particularized explanation stating why the defendant's alleged statements or omissions are deceitful." *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1061 (9th Cir. 2008) (affirming dismissal of putative securities fraud class action because, among other things, investors failed to allege loss causation, investors failed to adequately plead scienter, and complaint lacked specificity required to adequately allege falsity). On the other hand, "courts must be careful not to set the hurdles so high that even meritorious actions cannot survive a motion to dismiss. Such a regime would defeat the remedial goals of the federal securities laws." *Id.*

A. Request for Judicial Notice

As an initial matter, Defendants request the Court take judicial notice of the documents attached as Exhibits A-CC to the Declaration of Anita P. Wu. (Docket No. 48). These exhibits include documents referenced in Lead Plaintiff's Amended Complaint, such as transcripts from hearings before the House of Representatives' Subcommittee on Transportation Security, analyst reports, news articles, Administrative Agreements signed by Rapiscan, and transcripts of conference calls with OSI investors. (*See* Wu Decl. at 1-2 (Docket No. 50)). These exhibits also include public filings with the Securities and Exchange Commission. (*Id.*).

In deciding the present Motion, the Court "must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice." *Tellabs*, 551 U.S. at 322. Judicial notice may be taken of any adjudicative fact that "can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201(b)(2).

The Court **GRANTS** Defendants' unopposed Request for Judicial Notice. SEC filings are generally subject to judicial notice. *Metzler*, 540 F.3d at 1064 n.7 (citing *Dreiling v. Am. Exp. Co.*, 458 F.3d 942, 946 n.2 (9th Cir. 2006)). Courts can also take judicial notice of conference call transcripts, which are "publicly available and . . . disclosed to the market." *Rosenbaum Cap., LLC v. McNulty*, 549 F. Supp. 2d 1185, 1189 (N.D. Cal. 2009). Finally, a "court may take judicial notice of a document if it relied on in the complaint . . . and its authenticity is not disputed." *In re Northpoint Comm's Group, Inc.*, 221 F. Supp. 2d 1090 (N.D. Cal. 2002).

B. Section 10(b)

To state a claim under Section 10(b) of the Exchange Act, a plaintiff must allege the following elements: (i) a material misrepresentation (or omission); (ii) scienter (a wrongful state of mind); (iii) a connection with the purchase or sale of a security; (iv) reliance (also known as "transaction causation"); (v) economic loss; and (vi) loss causation (a causal connection between the material misrepresentation and the loss). *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

Defendants challenge Lead Plaintiff's Amended Complaint on two of these elements. First, Defendants argue that Lead Plaintiff fails to allege an actionable misstatement, because the statements alleged in the Amended Complaint are "puffing," forward-looking statements, or opinion statements that are nonactionable, and in any event, Lead Plaintiff fails to adequately plead the falsity of current or historical fact statements. Second, Defendants argue that Lead Plaintiff fails to establish a strong inference of scienter.

1. *Falsity*

"To be actionable under the securities laws, an omission must be misleading; in other words it must affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists." *Brody v. Transitional Hosp. Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002). In general, "whether a public statement is misleading, or whether adverse facts were adequately disclosed is a mixed question to

be decided by the trier of fact." *Fecht v. Price Co.*, 70 F.3d 1078, 1081 (9th Cir. 1995) (superseded by statute on other grounds) (citing *Durning v. First Boston Corp.*, 815 F.2d 1265, 1268 (9th Cir. 1987)). "[O]nly if the adequacy of the disclosure . . . is so obvious that reasonable minds could not differ are these issues appropriately resolved as a matter of law." *Id.* (internal quotations omitted).

Lead Plaintiff asserts that Defendants made specific statements that concealed Rapiscan's inability to develop ATR software. Specifically, Lead Plaintiff points out that in January 2012, Defendant Mehra stated that OSI was working with TSA, was going through operational testing of the ATR software, and expected "that [TSA] will be looking at potential orders within the next few months." (Amended Compl. at ¶ 21). In April 2012, Defendant Edrick told investors that the ATR software was "undergoing its final testing as we speak," (*id.* at ¶ 93), and six weeks later, again indicated that the ATR software was "in testing right now, and we think that could lead to more sales in the future" (*id.* at ¶ 94). Upon further questioning, Defendant Edrick indicated that "we've completed our side" of development of the ATR software. (*Id.* at ¶ 95).

In fact, it appears that by at least May 2012, Rapiscan was already aware of problems with the ATR software (Wu Decl., Ex. D at 2), and had to seek an extension of the original June 1, 2012 Congressional deadline for installing ATR software (Amended Compl. at ¶ 61). Moreover, the Amended Complaint includes statements from Confidential Witnesses who state that Rapiscan was aware of some of these problems from early on in testing, and in fact "cherry-picked" machines during testing, which is consistent with the theory that Rapiscan was concealing these issues. (*Id.* at ¶¶ 54, 56, 57, 63).

Lead Plaintiff also asserts that Defendants made specific statements that concealed Rapiscan's use of an unapproved component in their baggage screeners. Specifically, it points to a statement by Defendant Mehra on April 17, 2012, that OSI had begun fulfilling a 5-year, $325 million contract for baggage screeners, and that "we expect we'll see more orders over the course of the next several years . . . as the TSA replaces their checkpoint machines." (*Id.* at ¶ 102). In June 2012, Defendant

Edrick stated that the baggage scanners "continue[] to be a very strong product line for us." (*Id.* at ¶ 104). On December 13, 2012, Defendant Edrick indicated that the contract with the government on the baggage scanners "should also continue to generate revenues for us for this product." (*Id.* at ¶ 105). Moreover, on October 13, 2013, Defendant Chopra told analysts that the $67 million TSA order for additional baggage screeners was included in Rapiscan's backlog. (*Id.* at ¶ 109).

Lead Plaintiff indicates that these statements are all misleading because Rapiscan was "knowingly" using an unapproved component "inappropriately labeled with the same part number as the originally approved component." (*Id.* at ¶ 87). Lead Plaintiff asserts that this component switch occurred before the problems with the ATR software came to light and before Rapiscan even bid on the order for additional baggage screeners. (*Id.* at ¶ 89).

Defendants challenge that these statements are actionable. First, Defendants argue that many of the alleged statements are "mere puffing," or are opinion statements. (Mot. at 9, 16). In the Ninth Circuit, "vague, generalized assertions of corporate optimism or statements of 'mere puffing' are not actionable material misrepresentations under federal securities laws." *In re Impac Mortg. Holdings, Inc. Sec. Litig.*, 554 F. Supp. 2d 1083, 1096 (C.D. Cal. 2008) (concluding that CEO's statements that company was expecting "solid" loan origination and acquisition in the forthcoming year were mere puffery not actionable as material misrepresentations); *see also In re Cutera Sec. Litig.*, 610 F.3d 1103, 1111 (9th Cir. 2010) ("When valuing corporations . . . investors do not rely on vague statements of optimism like "good," "well-regarded," or other feel good monikers. This mildly optimistic, subjective assessment hardly amounts to a securities violation."). Additionally, in the Ninth Circuit opinion statements can give rise to a claim "only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading." *Rubke v. Capital Bancorp, Ltd.*, 551 F.3d 1156, 1162 (9th Cir. 2009).

While Lead Plaintiff does rely in part on statements that merely reflect corporate optimism, other alleged statements provide specific details to investors about the status of specific products. For example, the Amended Complaint asserts that Defendant

Edrick indicated that "we've completed our side" of development of the ATR software, when in fact the company was far from completion. In addition, the Amended Complaint asserts that Defendant Chopra told analysts that the $67 million TSA order for additional baggage screeners was included in Rapiscan's backlog, when by that point Defendants knew that they were not in compliance with the government contract and disclosing this fact would likely lead to the cancellation of the order. Taking the facts in the Amended Complaint as true, these comments, among others, were not vague and optimistic, but specific and materially misleading at the time they were made.

Second, Defendants assert that Lead Plaintiff's statements are non-actionable forward-looking statements. Under the PSLRA's safe harbor, forward-looking statements are not actionable if either (1) they are identified as such and accompanied by meaningful cautionary language, or (2) plaintiff fails to allege particularized facts demonstrating that the statements were made with actual knowledge of their falsity. 15 U.S.C. § 78u-5(c)(1); *In re Cutera Sec. Litig.*, 610 F.3d 1103, 1111-12 (9th Cir. 2010). Defendants argue that the statements provided in the Amended Complaint are "forward-looking statements reflecting Defendants' hopes or expectations about the completion of ATR software testing or Rapiscan's receipt of future orders for baggage scanners," and that these statements are accompanied by cautionary language. (Mot. at 10–11).

Lead Plaintiff, however, is alleging the *omission of present facts* with respect to the challenged statements. Another court has previously explained that, "to the extent Plaintiffs [] challenge Defendants' alleged *omission of present facts* with respect to the challenged statements, the PSLRA's safe harbor does not apply." *Mallen v. Alphatec Holdings, Inc.*, 861 F. Supp. 2d 1111, 1126 (S.D. Cal. 2012) (concluding that defendants' statements that the company had "already begun to realize synergies from the Scient'x acquisition" and "we anticipate that our revenues throughout the balance of 2010 *will continue to grow*" were not protected by the PSLRA safe harbor for "forward-looking" statements, but dismissing the case on other grounds). "The fact that defendants used those inadequately disclosed historical facts to support unsound projections does not shield their alleged misrepresentations as forward-looking

statements." *In re CV Therapeutics, Inc.*, No. 03-03709 SI, 2004 WL 1753251, at *10 (N.D. Cal. Aug. 5, 2004).

Finally, Defendants argue that Lead Plaintiff has failed to adequately plead the falsity of current or historical fact statements. The Court disagrees, and concludes that Defendants' alleged statements were misleading because they "created an impression of a state of affairs that differ[ed] in a material way from the one that actually exist[ed]." *Reese v. Malone*, 747 F.3d 557 (9th Cir. 2014) (concluding that the statement of the BP Vice President that there was a "low manageable corrosion" rate was misleading and not merely incomplete because the company in fact had evidence of high corrosion levels); *see also In re Immune Response*, 375 F. Supp. 2d at 1020 (optimistic statements about new drug under development were misleading because they failed to reflect the drug's true condition at the time the statements were made).

Taken as a whole, the crux of Lead Plaintiff's claim is that Defendants consistently misrepresented the strength of the two product lines at issue, thus portraying Rapiscan's contracts with the government in "an unduly optimistic light." *In re Immune Response*, 375 F. Supp. 2d at 1020. Lead Plaintiff has pointed to specific elements of particular statements and then provided reasonable explanations as to why it believes these specific statements to be false or misleading. The specific references to SEC filings, analyst reports, press releases, news articles, and interviews with numerous former OSI employees "are sufficiently particular, and that is all that the PSLRA requires." *Id.* Lead Plaintiff "ha[s] clearly served the PSLRA's purpose by putting Defendants on notice of the specific misstatements and omissions at issue." *Id.*

This conclusion extends to Lead Plaintiff's allegations of accounting fraud under GAAP and allegations that Defendants' SOX and internal control certifications were false. The nature of these allegations is sufficiently particular and specific to satisfy the pleading requirements of the PSLRA.

As to the allegations of GAAP violations, the Amended Complaint alleges that OSI did not properly account for charges and expenses related to the development of the ATR software and the cancellation of the $67 million order for AT-2 baggage

screeners. (Amended Compl. at ¶¶ 112–25). Lead Plaintiff alleges that OSI was required to record those changes in the reporting period ending December 31, 2011, at the latest, as that is when the charges allegedly became probable and estimable. The Amended Complaint alleges that it was improper for Defendants to spread those charges over several periods, lessening the impact of the charges. (*Id.*). Second, the Amended Complaint charges that Defendants improperly classified those charges as "impairment, restructuring and other charges," thus obscuring from investors the full extent of OSI's problems. (*Id.* at ¶¶ 140–42). Third, and as explained below, Lead Plaintiff asserts that it was improper for Rapiscan to include the $67 million order for additional baggage screeners in their backlog when in fact they were aware they were in violation of the terms of the contract. (*Id.* at ¶ 137). Fourth, clearly articulates alleged wrongdoing when OSI treated as capitalized expenses the costs of developing the ATR software even though such development costs should only be capitalized after technological feasibility. (*Id.* at ¶¶ 138–39). The Court concludes that these allegations are detailed and stem from the same detailed scheme discussed above.

The allegations of Chopra and Edrick's false and misleading SOX and internal-control certifications arise out of the same basic facts discussed at length above: that Defendants omitted material information in making their financial reports. The fact that OSI received a clean audit opinion and that the financial statements were not restated does not alone immunize public companies and their principal officers from securities fraud claims that otherwise meet the specificity requirements of the PSLRA. *See In re New Century Sec. Litig.*, 588 F. Supp. 2d, 1206, 1231 (C.D. Cal. 2008) ("[T]he fact that [the company's] independent auditor may have approved the accounting methods will not shielf [the officers] from liability for deception such methods may have caused."); *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83 (1st Cir. 2002) ("[T]he fact that the financial statements for the year in question were not restated does not end [plaintiff's] case when he has otherwise met the pleading requirement of the PSLRA.").

As Lead Plaintiff provides lengthy and detailed allegations that OSI "affirmatively create[d] an impression of a state of affairs which differ[ed] in a material way from the one that actually exist[ed]," the Court concludes that the

Amended Complaint has sufficiently plead falsity to survive the present Motion to Dismiss. *Police Retirement Sys. of St. Louis v. Intuitive Surgical, Inc.*, 759 F.3d 1051, 1061 (9th Cir. 2014) (internal citation omitted).

2. *Scienter*

In addition to falsity, the PSLRA requires that a complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u–4(b)(2)(A). To satisfy the requisite state of mind element, "a complaint must allege that the defendant[] made false or misleading statements either intentionally or with deliberate recklessness." *Zucco*, 552 F.3d at 991.

In *Tellabs*, the Supreme Court clarified the inquiry for determining whether a plaintiff's allegations are sufficient to establish scienter. 551 U.S. at 321. Accepting all factual allegations in the complaint as true, a court must "consider the complaint in its entirety," and determine "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id.* at 322–23 (emphasis in the original). Under the *Tellabs* analysis, "[a] complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id*. at 324.

Following *Tellabs*, this Court will thus conduct a dual inquiry: first, the Court will determine "whether any of the allegations, standing alone, are sufficient to create a strong inference of scienter," and second, "if no individual allegations are sufficient, [the Court] will conduct a 'holistic' review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness." *Zucco*, 552 F.3d at 992.

The Court concludes that none of the statements or evidence in the Amended Complaint independently establishes scienter. However, viewed holistically, the

allegations in the Amended Complaint sufficiently bolster the inference of scienter to survive the Motion to Dismiss.

In relation to the ATR software, Lead Plaintiff provides a statement from Defendants indicating that "Rapiscan became aware of an issue related to software under development months ago." (Amended Compl. at ¶ 99). This statement was made less than six months after Defendant Edrick indicated the ATR software was in final testing, and thus is supportive of scienter. *See Reese*, 747 F.3d at 574 ("Temporal proximity of an allegedly fraudulent statement or omission and a later disclosure can be circumstantial evidence of scienter.").

This inference is buttressed by specific statements from confidential witnesses connecting the problems to the management. For example, Confidential Witness 1, a Senior Test Engineer who worked on the ATR testing, stated that Rapiscan "pretty much knew from the start" that the software was running far behind schedule, and indicated that "for most of my testing we were about a year behind" the original schedule. (Amended Compl. at ¶ 54). Confidential Witness 2, who worked at OSI until July 2013, indicated that he "was aware all along that they were trying and having trouble meeting the criteria" for the ATR software, that "the company knew all along that it was a difficult process," and that Rapiscan "never even got close to having the issue solved." (*Id.* at ¶ 56). Significantly, Confidential Witness 2 confirmed that OSI "cherry-picked a few machines that were working better [than others]," which clearly establishes knowledge of the problem and knowing obfuscation. (*Id.* at ¶ 63). Confidential Witness 4, who worked at Rapiscan until January 2013, stated that Quality Director Robert Mosey would have known of any manipulations and that the knowledge would have risen "all the way up to the president and even [CEO]." (*Id.* at ¶ 63).

Moreover, an inference of scienter can be established by the fact that the Defendants touched on the specific issue of ATR testing and readiness in their public statements. As the Ninth Circuit has previously explained, an assertion that defendants were unaware of the alleged issues can be "directly contradicted by the fact that [they] specifically addressed it in [their] statement[s]." *Reese*, 747 F.3d at 571. By making

"detailed factual statement[s], contradicting important data to which [the Individual Defendants] had access, a strong inference arises that [they] knowingly misled the public as to its clear meaning." *Id.* at 572.

The Amended Complaint similarly creates a strong inference of scienter as to the use of foreign parts in Rapiscan's AT-2 baggage scanners. First, Lead Plaintiff explains that Defendants admit that the use of the unapproved part in the machines "was vetted by Rapiscan's internal quality assurance," but never raised with TSA as required under the contract. (Amended Compl. at ¶¶ 9, 88, 195). Confidential Witness 4 indicates that the quality-assurance department was "not an independent organization" (*id.* at ¶ 84), and that he or she was aware that Rapiscan "would just go ahead an make" configuration changes without TSA approval (*id.* at ¶ 83).

Moreover, when allegations pertain to a company's core operations, the Ninth Circuit permits an inference of scienter. *Reese*, 747 F.3d at 575 (internal citation omitted). According to the Ninth Circuit in *Reese*, allegations regarding management's role "may independently satisfy the PSLRA where they are particular and suggest that defendants had actual access to the disputed information," or "such allegations may be sufficient, without accompanying particularized allegations, where the nature of the relevant fact is of such prominence that it would be absurd to suggest that management was without knowledge of the matter." *Id.* at 575-76.

Both of these scenarios apply: ***First***, Defendants allegedly had "actual access" to Rapiscan's defect database, which listed the problems encountered in ATR software development. (Amended Compl. at ¶¶ 64, 165). *See Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1230 (9th Cir. 2004) ("The most direct way to show both that a statement was false when made and that the party making the statement knew that it was false is via contemporaneous reports or data, available to the party, which contradict the statement."). ***Second***, Rapiscan was OSI's largest and most profitable division and the individual Defendants regularly attributed OSI's success and growth to Rapiscan. The technology at issue was the focus of intense media scrutiny at the time, and according to the Amended Complaint, the government contracts involved were "very closely controlled within [an] inner circle of executives

that consisted of Chopra, Edrick and Mehra." (Amended Compl. at ¶ 165). It is thus "absurd" to suggest that the individual Defendants were not aware of issues relating to these divisions.

Alternatively, Lead Plaintiff argues that Defendants' trading history supports a strong inference of scienter. "Unusual" or "suspicious" stock sales that are "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information" are supportive of scienter. *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001). Here, however, each Defendant's total holdings actually increased over the Class Period. (Wu Decl. at ¶¶ 14-15; Exs. AA-CC). Other courts have concluded that an increase in total holdings "hardly suggest[s] that the defendants sought to dump their shares at an inflated price." *Cozzarelli v. Inspire Pharms.*, 549 F.3d 618, 628 (4th Cir. 2008). The Court agrees.

Nevertheless, when considered holistically, the facts alleged in the Amended Complaint create an inference of scienter sufficient even under the PSLRA and Rule 9(b). Moreover, since the Amended Complaint adequately pleads scienter as to the individual executives and directors, this scienter can be imputed to the OSI as a corporation. *See Immune Response*, 375 F. Supp. 2d at 1022 ("Since the Complaint adequately pleads scienter, it is imputed to the Company."); *In re Apple Computer Inc. Sec. Litig.*, 127 Fed. Appx. 296, 303 (9th Cir. 2005) ("A corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter at the time that he or she makes the statement.").

C. Section 10(b)

Defendants argue that if Lead Plaintiff failed to plead a primary violation, its remaining claims should also fail as a matter of law. *See Zucco*, 552 F.3d at 990. However, the Court concluded that Lead Plaintiff had established a primary violation. This argument is therefore unavailing.

III. CONCLUSION

The Motion is **DENIED**. Defendants shall answer the Amended Complaint on or before **March 30, 2015.**

IT IS SO ORDERED.