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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

In re CADENCE DESIGN SYSTEMS, INC.)	No. C-08-4966 SC
SECURITIES LITIGATION)	
_____)	ORDER GRANTING MOTION
	<u>TO DISMISS</u>
This Order Relates to:)	
CASE NOS. 08-4966 SC, 08-5027 SC,)	
and 08-5273 SC)	
_____)	

I. INTRODUCTION

This is a dispute involving securities fraud allegedly committed by Defendant Cadence Design Systems, Inc. ("Cadence"). The Consolidated Amended Complaint ("CAC") also names as defendants Cadence's former CEO, Michael J. Fister ("Fister"), Senior Vice President and CFO Kevin Palatnik ("Palatnik"), former Executive Vice President and CAO William Porter ("Porter"), and former Executive Vice President of Worldwide Field Operations, Kevin Bushby ("Bushby;" collectively with other individuals, "Individual Defendants," and with Cadence, "Defendants"). Docket No. 39, ¶¶ 26-29. Plaintiffs, including lead plaintiff Alaska Electrical Pension Fund, are entities that purchased or acquired Cadence's publically traded securities during a period when, they allege, Cadence's share prices were fraudulently inflated. See CAC ¶ 24.

This Court now considers a Motion to Dismiss ("Motion") filed by Defendants. Docket No. 43. Plaintiffs have submitted an

United States District Court
For the Northern District of California

1 Opposition, Docket No. 45, and Defendants have submitted a Reply,
2 Docket No. 47. Having considered the papers of all parties, the
3 Court GRANTS Defendants' Motion, and the CAC is DISMISSED WITHOUT
4 PREJUDICE.

5
6 **II. BACKGROUND**

7 Plaintiffs allege that Defendants violated Sections 10(b) and
8 20(a) of the Securities Exchange Act of 1934 ("Exchange Act"), 15
9 U.S.C. §§ 78j(b), 78t(a), and a regulation promulgated thereunder,
10 Rule 10b-5, 17 C.F.R. § 240.10b-5. CAC ¶¶ 176-82. Plaintiffs
11 claim that Defendants did this by improperly accounting for two of
12 Cadence's major transactions that took place in the first half of
13 2008, by recognizing revenue in those quarters that Cadence had
14 not yet earned, thereby overstating Cadence's earnings and
15 inflating its stock prices. See generally CAC. It is undisputed
16 that Cadence committed several accounting errors in the first and
17 second quarters of 2008 ("1Q" and "2Q," respectively), which
18 required it to restate its financial results for those quarters.
19 See Mot. at 2. Defendants maintain that Plaintiffs have failed to
20 sufficiently plead that the errors were caused by fraud. Id.

21 **A. An Overview of Cadence and its Accounting**

22 Cadence is a Delaware Corporation that develops electronic
23 design automation software and hardware for electronics companies.
24 CAC ¶ 25. It is a publically traded company, traded on the
25 NASDAQ. Id. Cadence's headquarters are located in San Jose,
26 California, although it has additional offices around the world.
27 See id. ¶¶ 25, 59(e), 67.

1 Since 2006, Cadence has been marketing its technology through
2 "EDA cards," which augment an internet-based delivery mechanism
3 for Cadence's software, and which allow its clients to utilize
4 Cadence's technology for periods of time that are determined on a
5 license-by-license basis. Id. ¶ 36. These cards are primarily
6 offered in connection with two different types of licenses: term
7 licenses and subscription licenses.¹ Id. ¶ 36. These two types
8 of licenses are different, both in terms of the scope of rights
9 that they allow the licensee, and in terms of accounting
10 recognition. As described in Cadence's 10-K for the fiscal year
11 of 2007, a term license allows Cadence's customers to "[a]ccess
12 and use all software products delivered at the outset of an
13 arrangement throughout the entire term of the arrangement,
14 generally two to four years, with no rights to return." Appendix
15 to CAC, Docket No. 40, Ex. 6 ("2007 10-K") at 30. In other words,
16 a term license allows a customer to use a defined set of software.
17 See id. Subscription licenses, on the other hand, are more open
18 ended, and allow both the "access and use [of] all software
19 products delivered at the outset of an arrangement," and the
20 additional right to "[u]se unspecified additional software
21 products that become commercially available during the term of the
22 arrangement." Id.

23 The accounting treatment for term and subscription licenses
24 differs dramatically in terms of when revenue is supposed to be
25 recognized, according to both Generally Accepted Accounting

26
27 ¹ Cadence also offers "perpetual licenses," but these licenses
28 are not material to this suit. See CAC ¶ 36.

1 Principles ("GAAP") and Cadence's internal accounting policies
2 (which purport to follow GAAP). Id. at 29-30. For a term
3 license, revenue "is recognized upon the later of the effective
4 date of the arrangement or delivery of the software product." Id.
5 at 30. That is, a term license can give Cadence the ability to
6 recognize revenue from the license right away, or at least within
7 the quarter that the license was entered into. Revenue from a
8 subscription license, on the other hand, must be recognized
9 ratably over the entire term of the license. Id. As a rough
10 hypothetical: If Cadence were to enter into one subscription
11 license and one term license, each lasting for two years and each
12 for \$8 million, Cadence could immediately recognize an \$8 million
13 revenue for the term license. However, it would only be able to
14 recognize \$1 million of revenue per quarter for the subscription
15 license. The party to the subscription license would also be
16 allowed access to future technology made available over the two-
17 year period, while the party to the term license would be more
18 restricted.

19 Needless to say, the determination of whether a large license
20 constitutes a term or subscription license may have substantial
21 effects on the revenue that Cadence recognizes over a given
22 quarter. The core of this suit is the accounting treatment of two
23 transactions. Cadence has acknowledged that two licenses were
24 incorrectly treated as term licenses even though they were in fact
25 subscription licenses. One error occurred in the first quarter of
26 2008, and another error occurred in the second quarter of 2008.

1 **B. The First Quarter of 2008**

2 Plaintiffs trace the chain of events that led to both of the
3 accounting errors back to the third quarter of 2007. According to
4 Plaintiffs, this is when Cadence began pulling revenue forward by
5 "shift[ing] its licensing model from subscription to term licenses
6 to permit Cadence to immediately recognize a substantial portion
7 of its licensing revenue up front, rather than ratably." Opp'n at
8 3; CAC ¶ 60. The "shift" involved persuading customers to enter
9 into term, rather than subscription, licenses when negotiating new
10 or renewed licensing contracts. CAC ¶ 60(d). This sometimes
11 entailed concessions that further depleted Cadence's future
12 maintenance or service revenue streams. Id. However, it allowed
13 Cadence to recognize revenue immediately, thereby boosting
14 earnings in the short term. According to Plaintiffs, this created
15 a "revenue bubble," since Cadence had a limited client pool and
16 could not enter into new contracts indefinitely; this strategy
17 therefore traded long-term income stability for short-term gain.
18 Id. ¶ 61. Plaintiffs contend that Cadence began to feel the
19 negative effects of the revenue bubble during 1Q of 2008, when it
20 recognized that it would not be able to make its revenue guidance
21 for 4Q of 2007, and lowered its guidance for 2008. Id. ¶¶ 6, 37.
22 Cadence stock fell by 33% after it announced these results, and
23 several analysts expressed pessimism regarding the company. Id.
24 at 38-40.

25 During 1Q of 2008, Cadence entered into a \$24.8 million
26 licensing agreement with an unspecified customer (the "1Q
27 agreement"). Plaintiffs believe, based on the restated financial
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1 reports and several confidential witnesses from Cadence, that the
2 contract was most likely entered into with a Japanese company,
3 possibly Fujitsu. Id. ¶ 59.² Cadence accounted for this
4 transaction as it would a term license, i.e., by recognizing all
5 \$24.8 million of the revenue in 1Q of 2008, rather than ratably
6 over the term of the agreement. Id. ¶ 55. However, the license
7 was actually entered into in contemplation of another software
8 arrangement that was not finalized until 3Q of 2008 (the "3Q
9 agreement"). Id. ¶¶ 56, 116; Appendix to CAC, Ex. 39 ("Dec. 10
10 Press Release") at 10.³ As Cadence would later conclude:

11 [T]he term license arrangement executed during the
12 first quarter and the subscription license
13 arrangement executed during the third quarter
14 collectively represented a multiple element
15 arrangement. Because the subscription arrangement
16 provides the customer with the right to use
17 unspecified additional software products that
18 become commercially available during the term of
19 the arrangement, Cadence determined that the
20 revenue relating to this multiple element
21 arrangement should be recognized during the term of
22 the arrangement, beginning in the fourth quarter of
23 2008.

24 Dec. 10 Press Release at 10.

25 Plaintiffs also allege that the agreement contemplated
26 certain "incubation technology," which had not yet been released
27 in 1Q. CAC ¶ 55. Contemplation of rights to a future technology

28 ² Plaintiffs point out that when the financial report for 1Q
of 2008 was restated, the reported revenue for Japan was most
strongly affected. CAC ¶ 59. However, Plaintiffs apparently
remain uncertain as to the identity of the customer, reciting that
a confidential witness "states that Fujitsu was likely the customer
. . . ." Id. at 27 n.6.

³ Page numbers for press releases are used as they appear on
the Exhibits.

1 further suggests that the license was more properly classified as
2 a subscription, rather than term, license.

3 Plaintiffs contend that this misclassification was
4 deliberate, and that Individual Defendants knew that the 1Q
5 agreement should have been classified as a subscription license.
6 Id. ¶ 56. Plaintiffs point out that, but for this error, Cadence
7 would not have met its revenue projections for the 1Q. Id.
8 Management recognized that this was a large and important
9 transaction for the company; indeed, Porter reflected during a
10 conference call, before the error was revealed, that "one customer
11 accounted for approximately 11% of total revenue." Id.; Appendix
12 to CAC, Ex. 10 ("1Q Conf. Call") at 4. Plaintiffs contend that
13 this was the largest deal of 1Q. CAC ¶ 57.⁴

14 This first error led to many of the statements that
15 Plaintiffs now claim were false and misleading. For example, on
16 April 23, 2008, Cadence issued a press release stating that it had
17 \$287 million in revenue, and only suffered a \$0.07 per share
18 loss during 1Q. Id. ¶ 42; Appendix to CAC, Ex. 9. On that same
19 day, Fister and Porter hosted a conference call in which they
20 repeated the erroneous financial results. CAC ¶ 45; Appendix to
21 CAC, Ex. 10. Two days later, Cadence filed its 10-Q for 1Q, which
22 again repeated the results. CAC ¶ 51; Appendix to CAC, Ex. 14

24 ⁴ Although Plaintiffs repeat this several times, there is no
25 indication that this would have been the largest deal of 1Q had it
26 been treated correctly. In its restated 10-Q for the 1Q of 2008,
27 after the error was revealed, Cadence recognized that "no one
28 customer accounted for 10% or more of total revenue during the
three months ended March 29, 2008." Appendix to CAC, Ex. 43 ("1Q
Conf. Call") at 18.

1 ("1Q 10-Q"). All of the statements were false, because the
2 revenue for the 1Q agreement should not have been recognized at
3 that time.

4 **C. The Second Quarter of 2008**

5 In 2Q of 2008, Cadence made a similar error, this time with
6 respect to a \$12 million transaction (the "2Q agreement"). CAC ¶¶
7 93, 135-39. Plaintiffs do not identify any details regarding this
8 transaction, or regarding the identity of the customer. However,
9 Cadence later stated that the transaction involved a customer who
10 was simultaneously cancelling a subscription license and executing
11 a term license arrangement and hardware arrangement. Dec. 10
12 Press Release at 11. Cadence later:

13 determined that, despite the cancellation of the
14 subscription arrangement, the customer did not
15 intend to substantively cancel its right to access
16 future new technology because at the time the
17 subscription license was cancelled the customer
18 intended to reestablish its right to access future
19 new technology at a later time. Accordingly, . . .
20 \$12.0 million of revenue originally recognized in
21 the second quarter of 2008 relating to the term
22 license and hardware arrangement should be
23 recognized ratably over the term of the
24 arrangement, consistent with the way in which
25 revenue was recognized on the cancelled
26 subscription arrangement.

21 Id.

22 Plaintiffs claim that this error was the result of an intent
23 to mislead the market and inflate Cadence's revenues. CAC ¶ 94.
24 Once again, Plaintiffs point out that, but for the error, Cadence
25 would have missed its projections for 2Q. Id. ¶ 95. Plaintiffs
26 also contend that Defendants were motivated to create a "rosy
27 picture," to enhance its ability to take on debt that it needed to
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1 acquire a competitor, Mentor Graphics. Id. ¶ 71.

2 This led to a number of allegedly fraudulent and misleading
3 statements, similar to those identified by Plaintiffs with respect
4 to 1Q. For example, Cadence repeatedly and incorrectly stated
5 financial results that incorporated the improperly recognized
6 revenue -- in press releases, in its 10-Q for 2Q, and in
7 conference calls. See id. ¶¶ 75-76, 91; Appendix to CAC, Ex. 19;
8 Appendix to CAC, Ex. 20; Appendix to CAC, Ex. 24 ("2Q 10-Q").⁵
9 Also in 2Q, Cadence again lowered its guidance for 2008 from \$1.8
10 million to \$1.4 million. CAC ¶¶ 74-77.

11 **D. Subsequent Events and Disclosures**

12 On October 15, 2008, Cadence announced that Fister was
13 resigning as President, CEO, and director of Cadence, that Bushby
14 was resigning as Executive Vice President of Worldwide Field
15 Operations, and that Porter was resigning as Executive Vice
16 President and CAO. Id. ¶ 105; Appendix to CAC, Ex. 31 ("Oct. 15
17 Press Release") at 97-98. As Plaintiffs noted, "[n]one of them
18 appeared to be at retirement age, as Fister was 53, Bushy 52, and
19 Porter 53, in 2008. At the time of the termination, none of them
20 announced any other personal or professional opportunities that
21 they were going to pursue." CAC ¶ 108. The resignation of six
22 executive officers (including three non-parties to this suit) was
23 also reported in the announcement. Press Release at 97-98.

24 One week later, on October 22, 2008, Cadence issued another
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26 ⁵ Plaintiffs note that, in 2Q, Cadence also improperly
27 recorded \$18 million in cash from the accounts receivable sold from
28 the improperly recognized 1Q agreement. CAC ¶ 101.

1 press release, this time announcing that it had discovered the
2 error regarding the 1Q agreement, and that it was initiating an
3 accounting review and postponing its 3Q financial results.

4 Appendix to CAC, Ex. 32 ("Oct. 22 Press Release") at 89. The
5 announcement read in part as follows:

6 Cadence initiated the review after preliminarily
7 determining during its regular review of its third
8 quarter results that approximately \$24 million of
9 revenue relating to these contracts was recognized
10 during the first quarter of 2008, but should have
11 been recognized ratably over the duration of the
12 contracts commencing in the second quarter of 2008.
13 Cadence expects to restate its financial statements
14 for the first quarter of 2008 and the first half of
15 2008 to correct the revenue recognition with
16 respect to these contracts.

17 Id.

18 The restatements were eventually released on December 10,
19 2008. See Dec. 10 Press Release. In addition to exploring the
20 impact of the error with respect to the 1Q agreement, Cadence
21 claimed that the review uncovered the error with respect to the 2Q
22 agreement. Id. at 11.

23 Cadence suggested that the errors were, at least in part, the
24 result of a communication and control failure. It announced that
25 "the Company has identified a material weakness relating to the
26 insufficient design and ineffective operation of certain internal
27 controls over the recognition of revenue from term license
28 agreements." Id. In its first restated 10-Q, Cadence describes
the material weakness in more detail:

The material weakness relates to both the
insufficient design and ineffective operation of
certain internal controls over the recognition of
revenue from term license agreements. Specifically,
the material weakness is comprised of the following

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components:

- Controls were not adequately designed to facilitate communication of all information pertinent to the negotiations with customers between the sales and sales finance organizations and the personnel responsible for determining the appropriate recognition of the revenue related to such license agreements. As a result, controls relative to the sales and sales finance organizations reviewing, analyzing and evaluating available information pertinent to revenue recognition for term license agreements were not operating effectively.
- Controls were not adequately designed to detect or prevent the inappropriate issuance of evaluation licenses to customers for incubation technology. Incubation technology is not commercially available for release.

1Q 10-Q at 39. The 10-Q claims that, because of these weaknesses, management did not detect that the revenue from the 1Q agreement was improperly recognized. Id.

Cadence also announced several remedial measures that it would undertake to correct the deficiencies:

- Individuals who are part of the sales process will be required to take enhanced comprehensive, ongoing compliance training specific to our policies and procedures;
- We will require additional analysis, communication, and accompanying documentation from our sales and sales finance organizations relating to recognition of revenue for term license agreements, with particular emphasis on transactions when factors are present that increase the risk that the transaction could be deemed to be a subset of a multiple element arrangement;
- We will enhance our existing processes and controls with respect to evaluation licenses that are applied to all technology being evaluated by customers; and

- We will make certain personnel changes and increase supervision and training to effectuate the changes discussed above.

Id. at 40.

After additional adjustments, Plaintiffs calculate that Cadence's product revenue was overstated by 14.2% for 1Q, and by 10.4% for 2Q. CAC ¶¶ 58, 125. Immediately following the announcements, Cadence's stock dropped by 22%. CAC ¶¶ 21.

III. Legal Standard

A. Motion to Dismiss Under 12(b)(6)

In deciding a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure, a court must "accept the plaintiffs' allegations as true and construe them in the light most favorable to plaintiffs." Gompper v. VISX, Inc., 298 F.3d 893, 895 (9th Cir. 2002). The court's review is generally "limited to the complaint, materials incorporated into the complaint by reference, and matters of which the court may take judicial notice." Metzler Inv. GMBH v. Corinthian Colleges, Inc., 540 F.3d 1049, 1061 (9th Cir. 2008) (citing Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322 (2007)).

B. Pleading Standard Under the Private Securities Litigation Reform Act of 1995 ("PSLRA")

Plaintiffs here seek to state a claim under Section 10(b) of the Exchange Act. Id. ¶¶ 176-80. This statute makes it unlawful for "any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or

1 contrivance in contravention of such rules and regulations as the
2 [Securities and Exchange] Commission may prescribe" 15
3 U.S.C. § 78j(b). One such rule prescribed by the Commission is
4 Rule 10b-5, which states that "[i]t shall be unlawful for any
5 person . . . [t]o engage in any act, practice, or course of
6 business which operates or would operate as a fraud or deceit upon
7 any person, in connection with the purchase or sale of any
8 security." 17 C.F.R. § 240.10b-5(c). Plaintiffs must plead five
9 elements to establish a violation of Rule 10b-5. Plaintiffs must
10 demonstrate "(1) a material misrepresentation or omission of fact,
11 (2) scienter, (3) a connection with the purchase or sale of a
12 security, (4) transaction and loss causation, and (5) economic
13 loss." In re Daou Sys., 411 F.3d 1006, 1014 (9th Cir. 2005).
14 Plaintiffs' pleading with respect to these elements, and scienter
15 in particular, "must satisfy the dual pleading requirements of
16 Federal Rule of Civil Procedure 9(b) and the PSLRA." Zucco
17 Partners, LLC v. Digimarc Corp., 552 F.3d 981, 990 (9th Cir.
18 2009).

19 To allege fraud under Rule 9(b) of the Federal Rules of Civil
20 Procedure, "a party must state with particularity the
21 circumstances constituting fraud or mistake. Malice, intent,
22 knowledge, and other conditions of a person's mind may be alleged
23 generally." However, the PSLRA imposes a more exacting standard
24 with respect to pleading falsity and scienter in the context of
25 securities fraud. Zucco Partners, 552 F.3d at 990-91. In
26 particular, in order to plead scienter, "the complaint shall, with
27 respect to each act or omission alleged to violate this title,

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1 state with particularity facts giving rise to a strong inference
2 that the defendant acted with the required state of mind." 15
3 U.S.C. § 78u-4(b)(2). The "required state of mind" for
4 establishing securities fraud is the knowing, intentional, or
5 deliberately reckless disclosure of false or misleading
6 statements. See Daou, 411 F.3d at 1014-15.

7 The "strong inference" standard does not require that the
8 "inference that the defendant acted with scienter . . . be
9 irrefutable, i.e., of the 'smoking-gun' genre, or even the most
10 plausible of competing inferences" Tellabs, 551 U.S. at
11 324 (citation and quotation marks omitted). Nevertheless, "to
12 determine whether a complaint's scienter allegations can survive
13 threshold inspection for sufficiency, a court governed by [the
14 PSLRA] must engage in a comparative evaluation; it must consider,
15 not only inferences urged by the plaintiff . . . but also
16 competing inferences rationally drawn from the facts alleged."
17 Id. at 314. The plaintiff must plead facts such that "a
18 reasonable person would deem the inference of scienter cogent and
19 at least as compelling as any opposing inference one could draw
20 from the facts alleged." Id. at 324. The Ninth Circuit has set
21 out a "dual inquiry" to determine whether a "strong inference"
22 exists: First, "determine whether any of the plaintiff's
23 allegations, standing alone, are sufficient to create a strong
24 inference of scienter; second, if no individual allegations are
25 sufficient, . . . conduct a 'holistic' review of the same
26 allegations to determine whether the insufficient allegations
27 combine to create a strong inference of intentional or deliberate

1 reckless." Zucco Partners, 552 F.3d at 992.

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3 **IV. DISCUSSION**

4 Defendants' Motion focuses primarily on whether Plaintiffs
5 have sufficiently plead scienter. Defendants do not here
6 challenge the sufficiency of the CAC with respect to the
7 connection between the false statements and the purchase of
8 securities, loss causation, or damages. Plaintiffs have plead a
9 number of facts that they hope can support a strong inference of
10 scienter. The Court will address each of these facts separately
11 below, and then assess these facts holistically.⁶

12 **A. Violations of GAAP and Internal Accounting Policies**

13 Plaintiffs point to the fact that Cadence violated GAAP, as
14 well as its own policies, to support an inference of scienter.
15 Opp'n at 13-14, 16-17. Cadence has admittedly done both of these
16 things, as evidenced by the financial restatements. However, the
17 Ninth Circuit has repeatedly held that "the mere publication of
18 inaccurate accounting figures, or a failure to follow GAAP,
19 without more, does not establish scienter." Provenz v. Miller,
20 102 F.3d 1478, 1490 (9th Cir. 1996) (citation omitted). Instead,
21 "plaintiffs must allege facts showing that . . . the defendants
22 knew specific facts at the time that rendered their accounting
23 determinations fraudulent." Rudolph v. UTStarcom, 560 F. Supp. 2d
24 880, 889 (N.D. Cal. 2008).

25
26 _____
27 ⁶ Because of the Court's conclusion with respect to scienter,
28 it does not reach Defendants' limited argument with regard to
falsity. See Mot. at 24.

1 In order to establish scienter in this particular case,
2 Plaintiffs must plead facts that supports an inference that
3 Defendants were actually aware that (or reckless with respect to
4 whether) the accounting was incorrect.⁷ In particular, Plaintiffs
5 must plead facts that suggests that Defendants were aware that it
6 was inappropriate to classify the 1Q and 2Q agreements as term
7 licenses. Defendants would have known this only if they were
8 aware of certain details of the transactions. With respect to the
9 1Q agreement, there must be a strong inference that Defendants
10 knew (or at least suspected) that the 1Q agreement was entered
11 into in contemplation of a future subscription license, or that it
12 involved a technology that was not yet released for commercial
13 use. With respect to the 2Q agreement, Plaintiffs must allege
14 facts that suggest that Defendants knew (or at least suspected)
15 that the licensee intended to retain certain rights to use future
16 technology, which it had enjoyed under a subscription licenses
17 that it simultaneously cancelled. Plaintiffs' allegations must,
18 when taken as a whole, give rise to a "strong inference" that
19 Defendants were aware of these details -- otherwise, Defendants
20 would have no way of knowing that the licenses were improperly

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24 ⁷ With respect to the scienter of Cadence itself, although the
25 Ninth Circuit has apparently left room for Plaintiffs to plead
26 "collective scienter" in some narrow circumstances, it has strongly
27 suggested that Plaintiffs must state facts that support a strong
28 inference that "at least *some* corporate official knew of the
falsity" See Glazer Capital Mgmt., LP v. Magistri, 549
F.3d 736, 744-45 (9th Cir. 2008) (citation omitted) (emphasis in
original).

1 classified.⁸

2 **B. Confidential Witness Accounts**

3 The CAC is liberally peppered with the claims of, and
4 asserted "corroboration" by, seven confidential witnesses ("CWs").
5 The Ninth Circuit recently recounted the standards for evaluating
6 complaints that rely upon CWs under the PSLRA. "First, the
7 confidential witnesses whose statements are introduced to
8 establish scienter must be described with sufficient particularity
9 to establish their reliability and personal knowledge. Second,
10 those statements which are reported by confidential witnesses with
11 sufficient reliability and personal knowledge must themselves be
12 indicative of scienter." Zucco Partners, 552 F.3d at 995.
13 Conclusory allegations that a defendant "must have known" about
14 particular wrongdoing are, standing alone, generally insufficient.
15 See Zucco Partners, 552 F.3d at 998.

16 The CAC provides a detailed background, history, and the
17 title for each of the CWs. CAC ¶ 45. For example, CW1 is a
18 former Sales Administrator for Cadence, who held that position for
19 fifteen years, and received and entered orders from Cadence's
20 Sales/Finance organization. Id. ¶ 45(a). CW2 is a former Vice
21 President of Finance, who served for eight years, and who reported
22 to a Controller that reported to Palatnik. Id. ¶ 45(a). The
23 Court finds that the description of each CW is adequate to support

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25 ⁸ Conceivably, one might also infer knowledge or recklessness
26 if Plaintiffs had pled that Defendants had access to more
27 generalized signs of misconduct surrounding the transactions, such
28 as warnings from accounts or disagreements among employees.
Plaintiffs plead no such facts, however.

1 the generalized accounts that they provide.

2 The next question is whether the CW accounts are actually
3 indicative of scienter. No CW resembles a "whistle blower," or
4 alleges that anyone within Cadence instructed them to do anything
5 wrong. At most, several CWs suggest that several of the
6 Individual Defendants "must have known" about the transactions
7 generally, or must have approved of the transaction or the
8 accounting for them at some level. Id. ¶ 59. To support this,
9 the CWs describe the general accounting or approval practices
10 within Cadence, as well as the various roles of the Individual
11 Defendants. See, e.g., CAC ¶ 59.

12 No CW specifically ties any Defendant to the accounting
13 determinations at issue. Several CWs suggest that the revenue
14 recognition determinations would have been made in the San Jose
15 office, and according to CW3, it was the Revenue Accounting group
16 in particular who "ensured the revenue was documented as ratable
17 or upfront." Id. ¶ 59(b). This group was overseen by a Vice
18 President of Finance who reported to Palatnik. Id. CW4 states
19 that, "given the size of the contracts" in question, "defendants
20 had knowledge of them by at least approving the deals." Id. ¶
21 59(c). CW2 suggests that deals of this magnitude "would
22 definitely" have been reviewed by Porter as well as Palatnik. Id.
23 ¶ 59(a). CW7 states that "Porter or Palatnik 'signed off on big
24 stuff' in terms of revenue recognition." Id. ¶ 59(e). There is
25 no indication of what "signing off" or approval within Cadence
26 "would have" entailed, or what level of detail the Individual
27 Defendants would have likely been exposed to.

1 Similarly, CW1 and CW7 describe Cadence's forecasting
2 bookings and financial reporting systems, which they claim the
3 senior executives had access to. Id. ¶ 62. However, there is no
4 description as to the level of detail in these systems (except to
5 state vaguely that "Cadence had always been 'very meticulous'
6 about deals coming in"), or whether the key facts that rendered
7 Cadence's accounting inaccurate were actually included in these
8 reports, or even whether these facts "would have" normally been
9 reflected in the systems. Id. ¶ 62(a). None of the CWs suggest
10 that these systems reflected that either of the licenses at issue
11 were or should have been subscription licenses at any time. The
12 mere fact that these systems would have reflected that a \$24.8
13 million deal was in the pipeline, and that it involved either a
14 term or subscription license, would not have raised a red flag for
15 Defendants.

16 Finally, several CWs claim that various Individual Defendants
17 often worked closely with, or "put [their] time in with
18 customers." See id. ¶ 65. For example, CW2 states that Fister
19 was commonly involved in deal negotiations with customers and that
20 Bushby was definitely involved in helping negotiate deals with
21 customers. Id. ¶ 59(a). These statements do not link any
22 Defendant with any particular customer or deal, however. The
23 closest that any CW comes is to suggest that "Fister and Porter
24 regularly met with Japanese Customers." Id. ¶ 65(a). These
25 statements do not offer any more than a basis for speculating that
26 Individual Defendants may have worked, at some level, on the deals
27 that involved the licenses that were incorrectly classified.

1 In summary, the CW reports do not provide any concrete
2 allegations that Individual Defendants actually knew about the
3 accounting errors, or that they were familiar with the key details
4 of the 1Q or 2Q agreements, such that they could have identified
5 them as subscription contracts. Their value to Plaintiffs is
6 diminished by this lack of detail -- it is difficult to discern
7 exactly how familiar any Individual Defendant "must have been"
8 with the key transactions, particularly given the fact that
9 Individual Defendants may have only been connected to the 1Q and
10 2Q agreements through a long chain that "involved multiple
11 personnel and levels of review." CAC ¶ 98.⁹ Standing alone, these
12 accounts cannot support a strong inference of scienter. However,
13 the Court will consider these accounts as part of its holistic
14 review of the entire CAC, in Part IV.F, *infra*. See *Tellabs*, 551
15 U.S. at 322 ("[C]ourts must consider the complaint in its entirety
16").

17 C. The Size and Importance of the 1Q and 2Q Agreements, and
18 Individual Defendants' Position Within Cadence

19 Plaintiffs argue that the restatements of revenue may, in and
20 of themselves, provide evidence of scienter. Opp'n at 14-16.
21 They point to the size of the transactions in question -- the
22 largest in 1Q and among the largest in 2Q -- as well as the

23
24 ⁹ To illustrate, according to CW2, a contract with a Japanese
25 customer would first be reviewed by the CFO equivalent in Japan.
26 CAC ¶ 59(a). The company also retained translators that allowed
27 the San Jose office to play an unspecified role, but which
28 apparently were necessary to facilitate accounting for the
contract. *Id.* Then the contracts would be reviewed by accounting
personnel in San Jose. *Id.* After this step, the "contracts and
associated accounting" would finally be reviewed by Palatnik. *Id.*

1 Individual Defendants' positions within the company, and their
2 hands-on approach to dealing with clients. Id. The Ninth Circuit
3 has previously rejected complaints that allege that "facts
4 critical to a business's core operations or an important
5 transaction generally are so apparent that their knowledge may be
6 attributed to the company and its key officers." Zucco Partners,
7 552 F.3d at 1000 (quoting In re Read-Rite Corp. Sec. Litig., 335
8 F.3d 843, 848 (9th Cir. 2003)). This argument is sometimes
9 referred to as the "core operations inference." See South Ferry
10 LP v. Killinger, 542 F.3d 776, 784 (9th Cir. 2008). On its own,
11 this inference generally does not suffice to state a claim under
12 the PSLRA, however the Ninth Circuit has spelled out two
13 exceptions, which Plaintiffs argue are both applicable to these
14 facts. Opp'n at 14.

15 First, the inference may be combined with allegations
16 regarding management's role in the company that are "particular
17 and suggest that the defendants had actual access to the disputed
18 information" Zucco Partners, 552 F.3d at 1000 (quotation
19 marks and citation omitted). Plaintiffs recite several comments
20 from CWs and Individual Defendants alike to suggest that
21 Individual Defendants "spent time" with customers. See, e.g., CAC
22 ¶ 65. They also describe the general roles that Individual
23 Defendants had within the approval process, largely through CW
24 accounts. See Part IV.B, supra. The Court has already discussed
25 this information, and it concludes that, in and of itself,
26 Plaintiffs have insufficiently described roles that would give
27 rise to a strong inference that Defendants possessed the relevant
28

1 facts. None of these statements suggest that any defendant was
2 deeply involved in the details of any particular transaction, or
3 was involved with the customers in question, such that they were
4 likely to know first hand the facts that were key to categorizing
5 the 1Q and 2Q agreements.

6 The second exception that may allow plaintiffs to rely on the
7 "core operations inference" allows an inference of scienter "where
8 the nature of the relevant fact is of such prominence that it
9 would be absurd to suggest that management was without knowledge
10 of the matter." Id. at 1001. This is not such a case. This is
11 not a situation in which key customers threatened to halt or
12 discontinue key contracts, such that the management must have been
13 put on notice. C.f. Berson v. Applied Signal Tech., Inc., 527
14 F.3d 982 (9th Cir. 2008) (finding it "absurd" to suggest that
15 management was unaware of major government stop-work orders, where
16 company relied exclusively on government for revenues). Rather,
17 this is a case in which the details of licensing negotiations, and
18 the relationship of license agreements with other arrangements,
19 affected the way that the agreements should have been accounted
20 for. As the Ninth Circuit stated in Zucco Partners, the
21 "misrepresentations are largely definitional, [so] the falsity of
22 the original representations would not be immediately obvious to
23 corporate management" unless they were familiar with the details
24 of the underlying agreements. 552 F.3d at 1001 (rejecting core
25 operations inference and contrasting Berson). Consequently, the
26 Court concludes that the core operations inference cannot apply
27 here, although the Court shall consider the size of the

1 misstatements and the fact of the restatements in the context of
2 the entire CAC.

3 **D. Defendants' Motive to Manipulate the Accounting**

4 Plaintiffs point out that Defendants had a strong incentive
5 to meet Wall Street expectations and Cadence's own guidance.
6 Opp'n at 18-19. As previously noted, Cadence would have missed
7 its own guidance in 1Q and 2Q if it had not been for the
8 accounting errors. See Part II.B-C, supra. Plaintiffs also claim
9 that Cadence needed to present a "rosy picture" in order to
10 acquire the debt necessary to consummate the acquisition of Mentor
11 Graphics. CAC ¶ 69-71.

12 Although the CAC here articulates a coherent explanation for
13 why Defendants may have committed fraud, this is not enough to
14 state a claim for securities fraud under the PSLRA.

15 "[A]llegations of a motive to present better financial statements
16 to secure credit or to engage in similar business activities are
17 insufficient to establish a strong inference of scienter." In re
18 Calpine Corp. Secs. Litig., 288 F. Supp. 2d 1054, 1087 (N.D. Cal.
19 2003) (citing Lipton v. Pathogenesis Corp., 284 F.3d 1027, 1038
20 (9th Cir. 2002); In re Vantive Corp. Sec. Litig., 283 F.3d 1079,
21 1097 (9th Cir. 2002)). These facts certainly make the inference
22 of scienter more compelling than it otherwise would have been, but
23 they do not suffice to make a strong showing of scienter. See In
24 re Silicon Graphics Sec. Litig., 183 F.3d 970, 974 (9th Cir.
25 1999)("[A]lthough facts showing mere recklessness or a motive to
26 commit fraud and opportunity to do so may provide some reasonable
27 inference of intent, they are not sufficient to establish a strong

1 inference of deliberate recklessness.").

2 **E. The Resignation of Executive Officers**

3 Plaintiffs claim that the resignation of six executive
4 officers in October of 2008, which came one week prior to
5 Cadence's announcement that it would need to restate its financial
6 statements, strengthens the inference of scienter. Opp'n at 22.
7 "Where a resignation occurs slightly before or after the defendant
8 corporation issues a restatement, a plaintiff must plead facts
9 refuting the reasonable assumption that the resignation occurred
10 as a result of [the] restatement's issuance itself in order for a
11 resignation to be strongly indicative of scienter. Zucco
12 Partners, 552 F.3d at 1002 (citing In re U.S. Aggregates, Inc.
13 Sec. Litig., 235 F. Supp. 2d 1063, 1074 (N.D. Cal. 2002)). In
14 other words, "a plaintiff must allege sufficient information to
15 differentiate between a suspicious change in personnel and a
16 benign one." Id.

17 Here, Plaintiffs cite a number of facts suggesting that the
18 three Individual Defendants who resigned were forced out. For
19 example, none of the three were at retirement age, and none
20 announced post-resignation plans. CAC ¶ 108. However, as
21 Plaintiffs have amply demonstrated, Cadence's performance leading
22 up to the restatement had not been stellar, and immediately after
23 the resignations, an analyst commented that the "leadership paid
24 the price for its poor performance this year." Appendix to CAC,
25 Ex. 33. It is therefore quite plausible to infer that the
26 resignations, however forced, were the result of the company's
27 poor performance and management. This could have been accentuated

1 by the discovery of an innocent or negligent accounting failure,
2 just as it could have followed the exposure of fraud. The Court
3 finds that the resignations were not, in and of themselves,
4 strongly indicative of scienter.

5 **F. "Holistic" Review**

6 When taken collectively, Plaintiffs' allegations do not raise
7 a strong inference that Defendants intentionally falsified
8 Cadence's financial reports. The fact that the 1Q and 2Q
9 agreements were quite large does lend credence to Plaintiffs'
10 argument, as one would expect Cadence personnel to be more
11 thorough in such situations. Plaintiffs have also established a
12 coherent motive to commit fraud. Finally, Plaintiffs have
13 certainly created a strong inference that Defendants were aware of
14 the 1Q and 2Q agreements generally. However, the inference of
15 scienter is fatally undermined by Plaintiffs' inability to connect
16 any of the Individual Defendants, or any particular person at
17 Cadence, with the 1Q and 2Q agreements, except in remote or
18 speculative ways that may or may not have entailed knowledge of
19 the specific facts that rendered the accounting classifications
20 incorrect. This deficiency leaves a gap, for which Plaintiffs
21 provide little more than motive and opportunity to bridge. There
22 is little basis to infer that any Defendant had knowledge of the
23 facts that rendered the recognition of revenue improper (unless
24 one were to presume that the Defendants had knowledge of all of
25 the details that surround all of the company's major agreements).

26 The Court finds that the inference of a specific intent to
27 defraud the public remains weaker than the inference that, as
28

1 Cadence claimed, there was simply a control deficiency within the
2 troubled Company, which was not discovered until the accountants
3 started reviewing the 3Q agreement that, as it turned out, was
4 connected with the 1Q agreement. Plaintiffs' first cause of
5 action, for violation of Sections 10(b) of the Exchange Act, 15
6 U.S.C. §§ 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, is
7 therefore DISMISSED.¹⁰

8 **G. Control Liability**

9 Plaintiffs also bring a claim against Individual Defendants
10 for control liability under Section 20(a) of the Exchange Act, 15
11 U.S.C. § 78t(a). Under this section, "a defendant employee of a
12 corporation who has violated the securities laws will be jointly
13 and severally liable to the plaintiff, as long as the plaintiff
14 demonstrates a primary violation of federal securities law and
15 that the defendant exercised actual power or control over the
16 primary violator." Zucco Partners, 552 F.3d at 990 (citation and
17 quotation marks omitted).

18 "Section 20(a) claims may be dismissed summarily . . . if a
19 plaintiff fails to adequately plead a primary violation of section
20 10(b)." Id. (citing In re Verifone Sec. Litig., 11 F.3d 865, 872
21 (9th Cir. 1993)). Plaintiffs have failed to plead a primary
22 violation of securities laws or regulations. Plaintiffs' second
23 cause of action for violation of Section 20(a) of the Exchange
24

25 ¹⁰ Because the Court resolves this Motion on the basis of
26 scienter, it does not reach Defendants' Request for Judicial
27 Notice, Docket No. 43 Ex. 2. This request relates to Cadence's
28 share price over the proposed class period, and the Court finds
these facts to be unrelated to the question of scienter.

1 Act, 15 U.S.C. §§ 78t(a), is therefore DISMISSED.

2

3 **V. CONCLUSION**

4 Because Plaintiffs have failed to allege facts that give rise
5 to a strong inference that Defendants intentionally falsified
6 Cadence's financial data, the Consolidated Amended Complaint is
7 hereby DISMISSED WITHOUT PREJUDICE. Plaintiffs may file a Second
8 Amendment Complaint within thirty (30) days of this Order.

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10 IT IS SO ORDERED.

11

12 September 11, 2009

13


UNITED STATES DISTRICT JUDGE

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