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IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

IN RE RACKABLE SYSTEMS, INC.
SECURITIES LITIGATION

No. C 09-0222 CW

ORDER GRANTING
DEFENDANTS' MOTION
TO DISMISS

This is a securities fraud class action brought on behalf of purchasers of Rackable Systems, Inc.'s securities between October 30, 2006 and April 4, 2007. Defendants Rackable, Thomas Barton, Madhu Ranganathan and Todd Ford are alleged to have defrauded investors by failing to disclose materially adverse conditions of Rackable Systems. Defendants have filed a motion to dismiss Plaintiffs' Amended Complaint. Lead Plaintiff Elroy Whittaker opposes the motion. The motion was heard on November 19, 2009. Having considered all of the parties' papers and oral argument on the motion, the Court grants Defendants' motion.

BACKGROUND¹

Defendant Rackable designs, manufactures and implements computer servers and storage systems. Its customers include over 300 companies worldwide in the internet, semiconductor design,

¹All facts are taken from Lead Plaintiffs' Amended Complaint and from judicially noticeable documents and are assumed to be true for purposes of this motion.

1 enterprise software, entertainment, financial services, oil and gas
2 exploration and biotechnology industries and the federal
3 government. Rackable was founded in 1999 and conducted its initial
4 public offering in June, 2005. In May, 2009, Rackable acquired
5 Silicon Graphics, Inc. The combined entity now carries the name of
6 the newly acquired company. Defendant Barton is the former Chief
7 Executive Officer; Defendant Ranganathan is the former Chief
8 Financial Officer and Principal Finance and Accounting Officer; and
9 Defendant Ford is the former Executive President of Operations.

10 Lead Plaintiff Elroy Whittaker purports to represent a class
11 of persons and entities that bought common stock of Rackable
12 between October 30, 2006 and April 4, 2007 (Class Period).

13 In Rackable's first annual report as a public company, it
14 noted several factors that could affect its ability to stay
15 profitable. It stated that it relies on a relatively small number
16 of customers for a significant portion of its revenue. In 2005,
17 Microsoft, Yahoo! and Amazon accounted for fourteen percent,
18 twenty-two percent and twenty-four percent of Rackable's revenue
19 respectively.

20 Rackable maintains a build-to-order business model, which, as
21 it disclosed to its investors, requires it to purchase components
22 and materials for its products in spot markets. Thus, it noted
23 that its costs are sensitive to market price volatility. Rackable
24 also specifically disclosed that historically prices for DRAM² have
25 been volatile and it was becoming an increasingly larger percentage
26 of Rackable's bill of materials.

27 _____
28 ²DRAM is a type of computer memory used in Rackable's
products.

1 On February 22, 2006, Rackable disclosed that in December,
2 2005 it had identified "potential state sales and use tax
3 liabilities relating to certain of our product sales to customers
4 outside of California," which it estimated to be \$1.2 million.
5 Request for Judicial Notice, Exh. 1 at 27. Rackable stated that,
6 if it could not recover the sales tax from its customers, it would
7 have to record an additional charge to its operating results and
8 pay the sales tax out of its own funds. Id.

9 On October 30, 2006, Rackable announced that its total revenue
10 for the first three quarters was \$254.5 million, up ninety-two
11 percent from \$131.9 million for the same period in 2005.
12 Rackable's non-GAAP³ gross margin of 22.6 percent for the third
13 quarter was within its projection of twenty-two to twenty-four
14 percent. Rackable projected that its 2006 fourth quarter revenue
15 would be between \$100 and \$110 million, non-GAAP gross margins
16 would be between twenty-three and twenty-four percent, and non-GAAP
17 net income would be between \$0.25 and \$0.75 per share.

18 Rackable missed these projections. On January 16, 2007,
19 Rackable announced that its revenue for the fourth quarter would be
20 between \$105.5 and \$106.8 million, non-GAAP gross margins would be

21
22 ³SEC Regulation G regulates the use of financial measures that
23 are not prepared in accordance with generally accepted accounting
24 principles (GAAP). These are commonly referred to as "non-GAAP
25 financial measures." The non-GAAP gross margin and net income
26 excludes stock-based compensation expenses. Rackable excludes from
27 its non-GAAP gross margin and non-GAAP net income "certain
28 nonrecurring items to facilitate its review of the comparability of
the company's core operating performance on a period to period
basis because such times are not related to the company's ongoing
core operating performance as viewed by management." RJN, Exh. 9.
Rackable notes that "these non-GAAP financial measures have
limitations as an analytical tool, and are not intended to be an
alternative to financial measures prepared in accordance with
GAAP." Id.

1 between 19.2 and 19.7 percent and non-GAAP net income would be
2 between \$0.17 and \$0.18 per share. It stated that the "primary
3 factors" for the miscalculation were (1) DRAM pricing higher than
4 anticipated, (2) intense competitive conditions that caused the
5 company to price contracts more aggressively in order to maintain
6 and expand its customer base and (3) lower than expected sales of a
7 new product, "RapidScale." RJN, Exh. 9. The next day, Rackable's
8 stock price fell from \$32.42 per share to \$19.98 per share.

9 On February 1, 2007, Rackable announced its final financial
10 results for the fourth quarter and full year of 2006. The final
11 figures announced for the 2006 fourth quarter were total revenue of
12 \$106.9 million, non-GAAP gross margins of 19.8% and non-GAAP net
13 income of \$0.19 per share. Defendant Barton explained that this
14 shortfall was due to (1) unexpectedly high prices of DRAM,
15 (2) intentional business decisions to maintain market share and win
16 business in the face of aggressive competition, (3) lower than
17 anticipated sales of RapidScale products and (4) revenue production
18 that was "backend loaded" for the quarter. Id., Exh. 24. The next
19 day, Rackable's stock fell to \$16.60 per share.

20 On February 28, 2007, Rackable disclosed that it had increased
21 its reserve for potential sales and use tax liability to \$6.5
22 million. On April 4, 2007, Rackable announced that it expected
23 revenue for the first quarter to fall within previous projections
24 of \$70 to \$75 million, but that its GAAP and non-GAAP gross margins
25 would be thirty percent lower than expected. Barton stated,
26 "Intense competitive conditions for business at our largest
27 customers continued throughout the first quarter of 2007, which
28 negatively impacted our gross margin and bottom line." After this

1 announcement, Rackable's stock price fell to \$14.25 per share.

2 On April 26, 2007, Rackable released its final results for the
3 first quarter of 2007. Its total revenue was within the projected
4 range, but it experienced a GAAP net loss of \$10.2 million.

5 Defendant Barton announced that, to address the increased
6 competition, "we have also come to the conclusion that we need to
7 accelerate a shift in our overall business model, specifically to
8 increase the level of standardization in our product line, and to
9 move from a pure build-to-order model to a configure-to order
10 model." Id., Ex. 26 at 3. The next day, Rackable's stock price
11 fell to \$11.27 per share.

12 On January 16, 2009, Plaintiffs filed this shareholder class
13 action, alleging that Defendants engaged in a fraudulent scheme to
14 inflate Rackable's value by misrepresenting its true financial
15 condition. Specifically, Plaintiffs assert that Rackable's 2006
16 fourth quarter projections were false when made and that Rackable's
17 stock price fell from January 16, 2007 to April 26, 2007 as a
18 result of the "truth" regarding Defendants' alleged
19 misrepresentations reaching the market.

20 LEGAL STANDARD

21 A complaint must contain a "short and plain statement of the
22 claim showing that the pleader is entitled to relief." Fed. R.
23 Civ. P. 8(a). When considering a motion to dismiss under Rule
24 12(b)(6) for failure to state a claim, dismissal is appropriate
25 only when the complaint does not give the defendant fair notice of
26 a legally cognizable claim and the grounds on which it rests.
27 Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 555 (2007). In
28 considering whether the complaint is sufficient to state a claim,

1 the court will take all material allegations as true and construe
2 them in the light most favorable to the plaintiff. NL Indus., Inc.
3 v. Kaplan, 792 F.2d 896, 898 (9th Cir. 1986). However, this
4 principle is inapplicable to legal conclusions; "threadbare
5 recitals of the elements of a cause of action, supported by mere
6 conclusory statements," are not taken as true. Ashcroft v. Iqbal,
7 ___ U.S. ___, 129 S. Ct. 1937, 1949-50 (2009) (citing Twombly, 550
8 U.S. at 555).

9 Although the court is generally confined to consideration of
10 the allegations in the pleadings, when the complaint is accompanied
11 by attached documents, such documents are deemed part of the
12 complaint and may be considered in evaluating the merits of a Rule
13 12(b)(6) motion. Durning v. First Boston Corp., 815 F.2d 1265,
14 1267 (9th Cir. 1987).

15 When granting a motion to dismiss, the court is generally
16 required to grant the plaintiff leave to amend, even if no request
17 to amend the pleading was made, unless amendment would be futile.
18 Cook, Perkiss & Liehe, Inc. v. N. Cal. Collection Serv. Inc., 911
19 F.2d 242, 246-47 (9th Cir. 1990). In determining whether amendment
20 would be futile, the court examines whether the complaint could be
21 amended to cure the defect requiring dismissal "without
22 contradicting any of the allegations of [the] original complaint."
23 Reddy v. Litton Indus., Inc., 912 F.2d 291, 296 (9th Cir. 1990).

24 REQUESTS FOR JUDICIAL NOTICE

25 Federal Rule of Evidence 201 allows a court to take judicial
26 notice of a fact "not subject to reasonable dispute in that it is
27 . . . capable of accurate and ready determination by resort to
28 sources whose accuracy cannot reasonably be questioned." Even

1 where judicial notice is not appropriate, courts may also properly
2 consider documents "whose contents are alleged in a complaint and
3 whose authenticity no party questions, but which are not physically
4 attached to the [plaintiff's] pleadings." Branch v. Tunnell, 14
5 F.3d 449, 454 (9th Cir. 1994).

6 The Court grants Plaintiffs' request for judicial notice of
7 Exhibits 1 through 20 of the request, 2 through 4 to the Rosen
8 declaration and grants Defendants' request because SEC filings may
9 be judicially noticed. See Dreiling v. American Exp. Co., 458 F.3d
10 942, 946 (9th Cir. 2006). The Court also grants Plaintiffs'
11 requests as to Exhibits 21 through 45, conference call statements,
12 Rackable's press releases, analyst reports and news articles, but
13 not for the truth of their contents.

14 I. Section 10(b) of the Exchange Act and Rule 10b-5

15 Section 10(b) of the Exchange Act makes it unlawful for any
16 person to "use or employ, in connection with the purchase or sale
17 of any security . . . any manipulative or deceptive device or
18 contrivance in contravention of such rules and regulations as the
19 [SEC] may prescribe." 15 U.S.C. § 78j(b); see also 17 C.F.R.
20 § 240.10b-5 (Rule 10b-5). To state a claim under § 10(b), a
21 plaintiff must allege: "(1) a misrepresentation or omission of
22 material fact, (2) scienter, (3) a connection with the purchase or
23 sale of a security, (4) transaction and loss causation, and
24 (5) economic loss." In re Gilead Sciences Securities Litig., 536
25 F.3d 1049, 1055 (9th Cir. 2008).

26 Some forms of recklessness are sufficient to satisfy the
27 element of scienter in a § 10(b) action. See Nelson v. Serwold,
28 576 F.2d 1332, 1337 (9th Cir. 1978). Within the context of § 10(b)

1 claims, the Ninth Circuit defines "recklessness" as

2 a highly unreasonable omission [or misrepresentation],
3 involving not merely simple, or even inexcusable
4 negligence, but an extreme departure from the standards
5 of ordinary care, and which presents a danger of
misleading buyers or sellers that is either known to the
defendant or is so obvious that the actor must have been
aware of it.

6 Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir.
7 1990) (en banc) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553
8 F.2d 1033, 1045 (7th Cir. 1977)). As explained by the Ninth
9 Circuit in In re Silicon Graphics Inc. Securities Litig., 183 F.3d
10 970 (9th Cir. 1999), recklessness, as defined by Hollinger, is a
11 form of intentional conduct, not merely an extreme form of
12 negligence. See Silicon Graphics, 183 F.3d at 976-77. Thus,
13 although § 10(b) claims can be based on reckless conduct, the
14 recklessness must "reflect[] some degree of intentional or
15 conscious misconduct." See id. at 977. The Silicon Graphics court
16 refers to this subspecies of recklessness as "deliberate
17 recklessness." See id. at 977.

18 Plaintiffs must plead any allegations of fraud with
19 particularity, pursuant to Rule 9(b) of the Federal Rules of Civil
20 Procedure. In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1543
21 (9th Cir. 1994) (en banc). Pursuant to the requirements of the
22 PSLRA, the complaint must "specify each statement alleged to have
23 been misleading, the reason or reasons why the statement is
24 misleading, and, if an allegation regarding the statement or
25 omission is made on information and belief, the complaint shall
26 state with particularity all facts on which that belief is formed."
27 15 U.S.C. § 78u-4(b)(1).

28 Further, pursuant to the requirements of the PSLRA, a

1 complaint must "state with particularity facts giving rise to a
2 strong inference that the defendant acted with the required state
3 of mind." 15 U.S.C. § 78u-4(b)(2). The PSLRA thus requires that a
4 plaintiff plead with particularity "facts giving rise to a strong
5 inference that the defendant acted with," at a minimum, deliberate
6 recklessness. See 15 U.S.C. § 78u-4(b)(2); Silicon Graphics, 183
7 F.3d at 977. Facts that establish a motive and opportunity, or
8 circumstantial evidence of "simple recklessness," are not
9 sufficient to create a strong inference of deliberate recklessness.
10 See Silicon Graphics, 183 F.3d at 979. To satisfy the heightened
11 pleading requirement of the PSLRA for scienter, plaintiffs "must
12 state specific facts indicating no less than a degree of
13 recklessness that strongly suggests actual intent." Id.

14 A. Misrepresentation or Omission of a Material Fact

15 To state a claim pursuant to § 10(b) of the Exchange Act,
16 Plaintiffs must allege, among other things, a misrepresentation or
17 omission of a material fact. Plaintiffs assert that Defendants
18 made false and misleading statements about Rackable's (1) gross
19 margin and earnings per share (EPS) projections for the fourth
20 quarter of 2006, (2) collection of sales and use taxes from its
21 customers, (3) inventory procurement system, (4) ERP system,⁴
22 (5) relationship with its top three customers and (6) projected
23 sales of RapidScale products. The Court addresses each of these
24 allegations in turn.

25 1. Gross Margin and Earnings Per Share Projections

26 Plaintiffs allege that Rackable's gross margin and EPS

27 _____
28 ⁴ERP is an electronic resource planning system designed by
Oracle to better track Rackable's costs and revenues.

1 projections were false when made because Defendants knew that its
2 profitability during the quarter would be negatively affected by
3 the billing of sales and use tax to its customers, increased
4 inventory costs and the discounting of a contract with one of its
5 customers. Complaint ¶¶ 85, 87-88. However, Plaintiffs fail to
6 allege contemporaneous facts that show that Defendants did not have
7 a reasonable basis for these projections when they were made.
8 Plaintiffs assert that, because risks materialized later in the
9 quarter, risks which caused Rackable to fall short of its
10 projections, Defendants must have known that the projections were
11 false at the time that they made them. Yet, Plaintiffs cannot
12 simply rely on a "fraud by hindsight" theory to demonstrate
13 falsity. In re Vantive Corp. Sec. Litig., 283 F.3d 1079, 1084-85
14 (9th Cir. 2002) ("The purpose of [the PSLRA's] heightened pleading
15 requirement was generally to eliminate abusive securities
16 litigation and particularly to put an end to the practice of
17 pleading 'fraud by hindsight.'"); In re Sytex Corp. Sec. Litig., 95
18 F.3d 922, 934 (9th Cir. 1996) ("Because Defendants' predictions
19 proved to be wrong in hindsight does not render the statements
20 untrue when made."). Plaintiffs must plead specific facts from
21 which a reasonable inference can be made that Defendants knew their
22 projections about their gross margin and EPS were false at the time
23 that they made them. Plaintiffs have not done so here.

24 2. Sales and Use Tax

25 Plaintiffs claim that Rackable's financial statements and
26 projections were false and misleading because Defendants
27 understated its sales and use tax liability. Plaintiffs allege
28 that Defendants should have disclosed the uncollected taxes and

1 related penalties with the SEC earlier in the class period.
2 However, Rackable did not settle its outstanding sales and use tax
3 liability to the state of California until after the second quarter
4 of 2007. Complaint ¶ 24; RJN, Exh. 19 at 24. Rackable could not
5 have recorded the amount of this settlement as an expense before it
6 was determined through the settlement process.

7 Plaintiffs also allege that Defendants should have disclosed,
8 in advance, that Rackable would begin charging sales and use taxes
9 to its California customers in the fourth quarter of 2006.
10 Plaintiffs argue that this tax prevented Rackable from pricing its
11 products competitively and that failing to disclose this
12 information misled investors. However, the Complaint does not
13 contain any allegations demonstrating that sales tax charges
14 impacted Rackable's gross margins at any time during the Class
15 Period. Moreover, Rackable first notified the market of its
16 potential sales and use tax liability in February, 2006. Rackable
17 continued to disclose information about its tax liability and the
18 risk that it might not be able to collect unpaid sales tax from its
19 customers. Thus, Plaintiffs have not adequately alleged with
20 particularity that any statements regarding Rackable's sales and
21 use tax liability were false or misleading.

22 3. Inventory Procurement System

23 The complaint alleges that Rackable's financial statements and
24 projections were false and misleading because it failed to account
25 properly for excess and obsolete inventory. Specifically,
26 Plaintiffs allege that, by December 31, 2006, Defendants knew, but
27 failed to disclose, that Rackable's customers would not purchase
28 its products above their listed prices, and, therefore, Rackable

1 should have written off this inventory as a loss. Plaintiffs
2 support this allegation with statements from confidential witnesses
3 (CW) 1 and 2. These CWs allege that "Rackable appeared to have a
4 lot of excess inventory." Complaint ¶ 264. However, such vague
5 assertions do not establish that Rackable failed to account
6 properly for excess or obsolete inventory or that the decision to
7 write off inventory should have been made earlier. Moreover, as
8 alleged in the Complaint, on several occasions Defendants warned
9 investors that Rackable was holding its inventory of memory chips
10 for anticipated customer orders, but that if the "technology shift
11 happen[s] sooner than anticipated, a write off would be required."
12 See Complaint ¶¶ 151, 175, 177.

13 Further, when Rackable wrote down its inventory in the second
14 quarter of 2007, it disclosed the following reasons for its
15 decision: (1) a "significant reduction in our forecasted usage for
16 the next twelve months," (2) a "customer driven, technology
17 platform shift from AMD to Intel" and (3) "lower than expected
18 revenue from 2007 and a shift in customer preference to next
19 generation power supplies created an excess in power supplies on
20 hand." RJN, Exh. 18 at 20-21. Plaintiffs have not alleged with
21 particularity any facts to refute these explanations.

22 4. ERP System

23 Plaintiffs assert that Defendants misrepresented that
24 Rackable's ERP System failed adequately to track Rackable's
25 inventory and other costs to support its financial statements and
26 projections. However, Plaintiffs do not allege that Defendants
27 were aware of any alleged deficiencies in the ERP System when
28 financial statements and projections were made. Plaintiffs rely on

1 Rackable's internal recommendations to improve the system, but
2 these recommendations were made well after the Class Period and do
3 not prove that Defendants misrepresented the ERP System's
4 effectiveness.

5 5. Relationship with Top Customers

6 Plaintiffs allege that Defendants Barton and Ranganthan made
7 false and misleading statements during an October 30, 2006 earnings
8 conference call when they stated that Rackable's relationship with
9 its top three customers remained "pretty strong" and "solid."
10 Complaint ¶¶ 94, 104. To support their allegation, Plaintiffs rely
11 on the fact that four months after this statement was made,
12 Rackable provided a large discount to one of its top three
13 customers in order to prevent that customer from going to a
14 competitor. Giving a customer a discount does not mean that a
15 relationship with that customer is not "pretty strong" and "solid."
16 Moreover, Plaintiffs have failed to allege how this statement was
17 false or misleading at the time that it was made. Defendants'
18 general statements of optimism are not actionable under securities
19 laws. See Glen Holly Entertainment, Inc. v. Tektronix, Inc., 352
20 F.3d 367, 379 (9th Cir. 2003); Wenger v. Lumisys, Inc., 2 F. Supp.
21 2d 1231, 1245 (N.D. Cal. 1998) ("No matter how untrue a statement
22 may be, it is not actionable if it is not the type of statement
23 that would significantly alter the total mix of information
24 available to investors.") (quotation marks and citation omitted);
25 In re VeriFone Sec. Litig., 784 F. Supp. 1471, 1481 (N.D. Cal.
26 1992), aff'd, 11 F.3d 865 (9th Cir. 1993) ("Professional investors,
27 and most amateur investors as well, know how to devalue the
28 optimism of corporate executives, who have a personal stake in the

1 future success of the Company.").

2 6. Rapidscale Products

3 Plaintiffs allege that Defendants misled investors by
4 projecting \$20 million in sales of RapidScale products in 2007.
5 Midway through 2007, newly appointed CEO Mark Barrenechea stated
6 that "the execution wasn't there to support [the \$20 million]
7 projection." However, failing to meet a projection does not make
8 the projection a misrepresentation. As with many of the
9 allegations above, Plaintiffs fail to allege contemporaneous facts
10 inconsistent with the projection.

11 B. Forward-Looking Statements

12 Defendants' projections and forward-looking statements are
13 inactionable under the PSLRA's safe harbor and the "bespeaks
14 caution" doctrine. Forward-looking statements are not actionable
15 if they are accompanied by meaningful cautionary language.
16 Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v.
17 Clorox Co., 353 F.3d 1125, 1133-34 (9th Cir. 2004). Defendants'
18 projections about the fourth quarter of 2006 and the 2007 fiscal
19 year easily meet the definition of a forward-looking statement
20 because they are statements containing a "projection of revenues,
21 income (including income loss), earnings (including earnings loss)
22 per share, capital expenditures, dividends, capital structure, or
23 other financial items." 15 U.S.C. § 78-u5i(i)(1)(A). And, these
24 forward-looking statements were consistently accompanied by such
25 cautionary language. See RJN Exs. 5, 6, 9, 10-12, 23-24.

26 Even if unaccompanied by cautionary language, forward-looking
27 statements cannot support liability unless they are made with
28 actual knowledge of their falsity. See 15 U.S.C.

1 § 78u-5(c)(1)(A)(i). As described below, Plaintiffs have not plead
2 with particularity Defendants' actual knowledge of falsity.

3 C. Requisite Mental State

4 A complaint must "state with particularity facts giving rise
5 to a strong inference that the defendant acted with the required
6 state of mind." 15 U.S.C. § 78u-4(b)(2). When evaluating the
7 strength of an inference, "the court's job is not to scrutinize
8 each allegation in isolation but to assess all the allegations
9 holistically." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551
10 U.S. 308, 325 (2007). "The inference of scienter must be more than
11 merely 'reasonable' or 'permissible' -- it must be cogent and
12 compelling, thus strong in light of other explanations." Id. at
13 324. A complaint will survive "only if a reasonable person would
14 deem the inference of scienter cogent and at least as compelling as
15 any opposing inference one could draw from the facts alleged." Id.
16 However, "the inference that the defendant acted with scienter need
17 not be irrefutable, i.e., of the 'smoking-gun' genre, or even the
18 'most plausible of competing inferences.'" Id.

19 Plaintiffs allege that there is a strong inference that
20 Defendants acted with scienter because of Defendants'
21 (1) interactions with CWs, (2) motive to commit fraud,
22 (3) departures from Rackable and (4) involvement in Rackable's core
23 operations.

24 1. Confidential Witnesses

25 The six confidential witnesses described in the complaint fail
26 to support an inference of scienter. Four of the confidential
27 witnesses -- CW1, CW3, CW5 and CW6 -- were not employed at Rackable
28 during the Class Period, which makes it unlikely that they had

1 personal knowledge of Defendants' relevant state of mind. See
2 Zucco Partners v. Digimarc, 552 F.3d 981, 996 (9th Cir. 2009);
3 Brodsky v. Yahoo!, Inc., 2009 WL 176002, at *10 (N.D. Cal.). The
4 two remaining CWs who were employed by Rackable during the Class
5 Period are not alleged "to have had any interaction or
6 communication with any of the defendants, or to have provided any
7 defendant with information, or to have heard or read any statement
8 by any defendant, that contradicted or even cast doubt on a public
9 statement made during the class period." McCasland v. FormFactor,
10 Inc., 2008 WL 2951275, at *8 (N.D. Cal.).

11 Further, the CWs only provide vague assertions about the
12 financial conditions at Rackable. For instance, CW1, CW2 and CW3
13 allege that Rackable had excess inventory and lacked certain
14 components necessary to meet customer demand, but they do not state
15 how these observations lead to the inference that Defendants acted
16 deliberately recklessly or with fraudulent intent. CW 4 alleges
17 that, in June, 2006, he was aware of purchase orders in which sales
18 tax was not being charged to customers. But, there are no
19 indications in the complaint of how large these purchase orders
20 were or any allegations showing that such purchases were not
21 accounted for in Rackable's reserve for unpaid sales and use tax.

22 2. Motive

23 Plaintiffs allege that Defendants were highly motivated to
24 conceal adverse facts about Rackable from the public.
25 Specifically, Plaintiffs allege that Defendants' insider sales of
26 stocks since the IPO support an inference of scienter. However,
27 only one Defendant, Ford, is alleged to have sold any stock during
28 the Class Period; and he sold more stock before the Class Period

1 than during the Class Period. In re Apple Computer Sec. Litig.,
2 886 F.2d 1109, 1117 (9th Cir. 1989) ("Large sales of stock before
3 the class period are inconsistent with plaintiffs' theory that
4 defendants attempted to drive up the price of Apple stock during
5 the class period.") (emphasis in original). Insider stock sales
6 become suspicious "only when the level of trading is dramatically
7 out of line with prior trading practices at times calculated to
8 maximize the personal benefit from undisclosed inside information."
9 In re Vantive Corporation Securities Litig., 283 F.3d at 1092.
10 Ford sold 55,000 shares between October 30, 2006 and January 16,
11 2007 at \$33.85 to \$34.50 per share. This is when Plaintiffs allege
12 that the fraud began to be revealed to the market. However,
13 Defendant Ford sold almost as many shares, 52,000, from January 17,
14 2007 through the end of the Class Period, at prices ranging from
15 \$18.20 to \$13.00. These sales do not reflect an intention to
16 maximize profits from an artificially inflated stock price.
17 Further, the fact that Defendants Barton and Ranganathan did not
18 sell any stock during the Class Period further undermines deriving
19 an inference of scienter from stock sales.

20 Plaintiffs assert that stock sales of Rackable's former
21 general counsel, William Garvey, create the inference of scienter.
22 However, Mr. Garvey is not a defendant in this case and is not
23 alleged to have made any false statements. Plaintiffs have not
24 alleged how these sales impute scienter to Defendants.

25 Plaintiffs also argue that Defendants' compensation packages
26 support an inference of scienter because they were "extraordinary
27 by any measure." Opposition at 14. Plaintiffs allege that
28 Defendants were motivated to commit fraud to obtain additional

1 compensation from Rackable and to sell their company stock at
2 inflated prices. Compared to the industry norms, there is nothing
3 remarkable about the type or amount of compensation paid to
4 Defendants.

5 Plaintiffs lastly argue that Defendants' motive to commit
6 fraud is reflected in their compliance with Rackable's loan
7 covenants under its line of credit. Plaintiffs allege that
8 Defendants inflated Rackable's financial results so that it did not
9 have to draw down on its line of credit. However, Plaintiffs do
10 not cite any case law to support their assertion that the existence
11 of a loan covenant supports an inference of scienter.

12 3. Departures from Rackable

13 The Ninth Circuit has stated that "resignations, terminations,
14 and other allegations of corporate reshuffling may in some
15 circumstances be indicative of scienter" Zucco Partners,
16 552 F.3d at 1002. However, these factors are not indicative of
17 scienter unless accompanied by allegations that they are related to
18 wrongdoing during the Class Period. See In re Cornerstone Propane
19 Partners, L.P. Sec. Litig., 355 F. Supp. 2d 1069, 1093 (N.D. Cal.
20 2005) ("[N]otable departures are not in and of themselves evidence
21 of scienter. Most major stock losses are often accompanied by
22 management departures, and it would be unwise for courts to
23 penalize directors for these decisions."); In re U.S. Aggregates,
24 Inc. Sec. Litig., 235 F. Supp. 2d 1063, 1074 (N.D. Cal. 2002)
25 ("after a restatement of earnings and a subsequent loan default, it
26 is unremarkable that the Company would seek to change its
27 management team"). Here, Plaintiffs do not allege that Defendants'
28 resignations were related to any findings of misconduct.

1 4. Core Operations

2 Allegations regarding management's role in a company "may be
3 used in any form along with other allegations that, when read
4 together, raise an inference that is 'cogent and compelling, thus
5 strong in light of other explanations.'" South Ferry LP v.
6 Killinger, 542 F.3d 776, 785 (9th Cir. 2008) (quoting Tellabs, 551
7 U.S. at 324); Zucco, 522 F.3d at 1001, 1007. These allegations may
8 conceivably satisfy the PSLRA standard "without accompanying
9 particularized allegations, in rare circumstances where the nature
10 of the relevant fact is of such prominence that it would be
11 'absurd' to suggest that management was without knowledge of the
12 matter." South Ferry, 542 F.3d at 786.

13 The Ninth Circuit described such a "rare circumstance" in
14 Berson v. Applied Signal Technology, Inc., 527 F.3d 982 (9th Cir.
15 2008). There, the plaintiffs alleged facts which contradicted the
16 defendants' statements about the company's revenue stream. The
17 company had received four stop-work orders that had a "devastating
18 effect" on the company's revenue. Id. at 987. The court permitted
19 an inference of scienter from the defendants' involvement in the
20 company's core operations because these facts were of such
21 prominence "that it would be 'absurd to suggest' that top
22 management was unaware of them." Id. at 989.

23 Here, Plaintiffs fail to plead any similar facts of such
24 magnitude that it would be absurd to suggest that Defendants were
25 unaware of them. At most, Plaintiffs allege that "management" held
26 "daily management meetings" and reviewed "ERP reports;" but these
27 assertions do not contain the required specificity to establish
28 scienter. Complaint ¶ 273.

1 D. Loss Causation

2 "Loss causation is the causal connection between the
3 [defendant's] material misrepresentation and the [plaintiff's]
4 loss." Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005).
5 "The complaint must allege that the practices that the plaintiff
6 contends are fraudulent were revealed to the market and caused the
7 resulting losses." Metzler Investment v. Corinthian Colleges, 540
8 F.3d 1049, 1063 (9th Cir. 2008). The complaint must allege that
9 the company's "share price fell significantly after the truth
10 became known." Dura Pharms, 544 U.S. at 347. "So long as the
11 complaint alleges facts that, if taken as true, plausibly establish
12 loss causation, a Rule 12(b)(6) dismissal is inappropriate." In re
13 Gilead Sciences Securities Litig., 536 F.3d 1049, 1057 (9th Cir.
14 2008). The loss causation element "'simply calls for enough facts
15 to raise a reasonable expectation that discovery will reveal
16 evidence of' loss causation." Id. (quoting Bell Atl., 550 U.S. at
17 556).

18 All of Defendants' statements that allegedly reveal the
19 "truth" of the fraud Defendants committed upon the market disclose
20 negative news about Rackable's financial condition, its future
21 prospects or about the competition in the computer server industry
22 in general. However, these statements do not reveal the necessary
23 causal link between the alleged fraud and the drop in Rackable's
24 stock price. Instead, they rely on a correlation between
25 Rackable's announcement of financial results and a decrease in
26 stock price. Such allegations do not plead loss causation: "So
27 long as there is a drop in a stock's price, a plaintiff will always
28 be able to contend that the market 'understood' a defendant's

1 statement precipitating a loss as a coded message revealing the
2 fraud. Enabling a plaintiff to proceed on such a theory would
3 effectively resurrect what Dura discredited" Metzler, 540
4 F.3d at 1064. Accordingly, Plaintiffs have not adequately plead
5 loss causation.

6 II. Section 20(a) of the Exchange Act

7 Plaintiffs allege control person liability against Defendants
8 based on Section 20(a) of the Exchange Act, which states,

9 Every person who, directly or indirectly, controls any person
10 liable under any provision of this chapter or of any rule or
11 regulation thereunder shall also be liable jointly and
12 severally with and to the same extent as such controlled
13 person to any person to whom such controlled person is liable,
14 unless the controlling person acted in good faith and did not
15 directly or indirectly induce the act or acts constituting the
16 violation or cause of action.

17 15 U.S.C. § 78t(a).

18 To prove a prima facie case under Section 20(a), a plaintiff
19 must prove: (1) "a primary violation of federal securities law" and
20 (2) "that the defendant exercised actual power or control over the
21 primary violator." Howard v. Everex Sys., Inc., 228 F.3d 1057,
22 1065 (9th Cir. 2000). "[I]n order to make out a prima facie case,
23 it is not necessary to show actual participation or the exercise of
24 power; however, a defendant is entitled to a good faith defense if
25 he can show no scienter and an effective lack of participation."

26 Id. Because Plaintiffs failed to plead a primary securities
27 violation, Plaintiffs have also failed to plead a violation of
28 Section 20(a).

CONCLUSION

For the foregoing reasons, the Court grants Defendants' motion
to dismiss Plaintiffs' Complaint (Docket No. 17), and grants leave

1 to amend in accordance with this order. Plaintiffs shall serve and
2 file their second amended complaint, and Defendants will respond,
3 in accordance with the schedule outlined in the stipulation filed
4 on December 28, 2009 (Docket No. 45). Any motion to dismiss will
5 be decided on the papers unless the Court sets it for a hearing. A
6 case management conference will be held on May 11, 2010.

7 IT IS SO ORDERED.

8 Dated: 01/13/10



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CLAUDIA WILKEN
United States District Judge

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