Securities
Regulation Daily

Wolters Kluwer

October 24, 2018

When Improbable Claims Come from Unnamed Sources: Defense Strategies in Securities Cases Involving Confidential Witnesses

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The Private Securities Litigation Reform Act (PSLRA) and interpretive caselaw creates an extremely high pleading standard for securities fraud plaintiffs. Passed by Congress in 1995 as part of an effort to curb frivolous shareholder lawsuits, the PSLRA creates hurdles that a securities plaintiff must overcome in order to survive a dismissal challenge. For one, alleged false or misleading statements must be pleaded with particularity, and the plaintiff must plead *why* each statement was false or misleading. Further, the complaint has to create "strong inference" of scienter, *i.e.*, fraudulent intent on behalf of the person making the false or misleading statement. Under the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the inference of scienter must be "at least as compelling as any opposing inference of nonfraudulent intent." 551 U.S. 308, 314 (2007).

In an effort to meet the PSLRA's high standard, and in particular, its heightened scienter requirement, many plaintiffs' lawyers attempt to support their securities fraud allegations with reference to "confidential witnesses" who ostensibly have personal knowledge of specific statements and the behind-the-scenes circumstances in which those statements were made. Such witnesses are often employees or former employees of the defendant corporation, whom the plaintiffs portray as something akin to whistleblowers. Plaintiffs' lawyers often hide witnesses' identities by calling them "confidential witnesses" and providing only their titles and dates of employment.

A plaintiff's refusal to name the sources of its factual allegations presents unique issues for the defendant and for the court. If the plaintiff claims to have a witness who was "in the room" when an executive intentionally misled investors, then it would seem that the plaintiff's odds of surviving dismissal rise dramatically. But where the supposed witness is not identified, the court is left with little means to pressure test whether the witness is even *real* or whether he or she could plausibly have had access to the evidence of fraud that is being alleged.

Numerous examples have emerged of plaintiffs abusing so-called confidential witness in order to bolster complaints that otherwise would have been straightforwardly dismissed. In some, confidential witnesses alleged to have been highly-placed employees were later revealed to be independent contractors with no access to information relevant to the allegations. In others, confidential witnesses who were interviewed by plaintiffs over the phone but never shown a draft of the complaint or their

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supposed statements later disclaimed, in sworn affidavits, the statements that had been attributed to them. In others, plaintiffs' law firms farmed out the identification of confidential witnesses to third-party "investigators" and never made any attempt to verify the resulting (fictitious) allegations before including them in the complaint. And so on.

Courts have recognized the need to rein in these kinds of abuses. In so doing, courts—even at the appellate level—have become increasingly assiduous about carefully scrutinizing statements attributed to "confidential witnesses" early in a case:

Taking issue with particularity. In at least the Second, Third, and Ninth Circuit Courts of Appeal, a complaint that is dependent on confidential witnesses may be subject to a dismissal challenge if it does not describe a confidential witness with sufficient particularity for the court to find it "probab[le] that a person in the position occupied by the source would possess the information alleged." *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000). In *Zucco Partners, LLC v. Digimarc Corp.*, for example, the Ninth Circuit Court of Appeals upheld dismissal of a complaint where "[a] majority of the confidential witnesses base[d] their knowledge on vague hearsay," some of the witnesses were not actually employed by the company in question during the relevant time period, and other witnesses offered only "conclusory assertions." 552 F.3d 981, 996-98 (9th Cir. 2009). The Third Circuit Court of Appeals has similarly emphasized the need to "assess[] the particularity of allegations made on information and belief necessarily entails an examination of the detail provided by the confidential sources, the sources' basis of knowledge, the reliability of the sources, the corroborative nature of other facts alleged, including from other sources, the coherence and plausibility of the allegations, and similar indicia." *California Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 147 (3d Cir. 2004).

Discounting statements made confidentially. The Seventh Circuit Court of Appeals has recognized an inherent lack of credibility in "confidential witnesses" and held that "unnamed confidential sources of damaging information require a heavy discount." *City of Livonia Employees' Ret. Sys. & Local 295/Local 851 v. Boeing Co.*, 711 F.3d 754, 759 (7th Cir. 2013). As the court explained: "The sources may be ill-informed, may be acting from spite rather than knowledge, may be misrepresented, may even be nonexistent—a gimmick for obtaining discovery costly to the defendants and maybe forcing settlement or inducing more favorable settlement terms." *Id.*

Turning 12(b)(6) into "mini summary judgment." Although it may seem inconsistent with the normal strictures of a 12(b)(6) motion, in which all facts in the complaint are taken as true, some defendants have found success in identifying the plaintiff's so-called confidential sources and getting them to recant their testimony in whole or in part. In *Campo v. Sears Holdings Corp.*, for example, a motion to dismiss a securities fraud complaint was originally denied without prejudice in the Southern District of New York. However, the court permitted the defendant to depose three confidential witnesses relied on in the complaint in order to determine whether the witnesses actually supported the allegations that the plaintiff had attributed to them. The defendant then moved to dismiss a second time. In ruling on the second dismissal motion, the court rejected any confidential witness allegations in the complaint that were uncorroborated by that deposition testimony, and as a result, dismissed the case. The Second Circuit Court of Appeals affirmed. *Campo v. Sears Holdings Corp.*, 635 F. Supp. 2d 323, 330 (S.D.N.Y. 2009), aff'd, 371 F. App'x 212 (2d Cir. 2010).

Seeking sanctions for distortions and exaggerations. To the extent that a complaint's citation to supposed confidential witness statements veers into the realm of fiction, relief under Rule 11 may be appropriate. Indeed, sanctions were imposed in *City of Livonia*, discussed above. There, the court concluded: "Counsel failed to conduct a proper investigation before filing the original complaint; counsel blindly relied on their investigators and failed to verify the truth of the confidential source's allegations before including them in the second amended complaint; and counsel made repeated misrepresentations to the court as to the strength and truth of the confidential source's allegations." *City of Livonia Employees' Ret. Sys. v. Boeing Co.*, 306 F.R.D. 175, 183 (N.D. Ill. 2014).

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While the use of "confidential witnesses" remains widespread in securities fraud class actions complaints, litigants can take some comfort that courts are recognizing the attendant credibility issues and are nonetheless disposing of complaints that rely on such witnesses at the motion to dismiss stage. Accordingly, when statements are attributed to confidential or anonymous witness in securities cases, defendants can, and should, push back.