

The Use of Confidential Sources In Securities Fraud Complaints

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Introduction

The Private Securities Litigation Reform Act of 1995 (“PSLRA”) poses a number of challenges for plaintiffs seeking to bring securities fraud actions. This article discusses how two of those challenges – heightened pleading standards coupled with a discovery stay – have, of necessity, led to increased reliance by plaintiffs’ attorneys on witnesses with knowledge of business misconduct (“corporate sources”), some of whom insist on cooperating with plaintiffs’ attorneys if and only if given assurances of confidentiality (“confidential sources”).

The PSLRA raised significant hurdles to bringing a securities fraud action by requiring plaintiffs to plead with particularity in their complaint (i) each statement that is alleged to have been misleading; (ii) why it is misleading; (iii) the facts on which that belief is formed; and (iv) facts giving rise to a strong inference of scienter. At the same time, the PSLRA restricted plaintiffs’ ability to obtain discovery that would allow them to plead such specifics by staying discovery upon the filing of a motion to dismiss.

As a consequence, plaintiffs seeking to bring securities fraud actions must rely on extrajudicial means of obtaining the detailed information necessary to pass muster under the heightened pleading standard; this often involves reliance on cooperative former (and sometimes current) employees of the defendant company who have knowledge of the misconduct at issue. Many of these sources, however, fear retaliation by their employer, blacklisting in the industry or unwanted intrusion by the press if their

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names are disclosed in a complaint as a source of information about the company, and would be unwilling to share their knowledge of corporate misconduct absent assurances that their identities would be protected, at least at the earliest stages of a lawsuit.

Given the need for information to satisfy the daunting pleading burden, plaintiffs' lawyers are increasingly amenable to giving assurances that the identity of confidential sources will not be disclosed in the complaint and, further, will not be disclosed absent court order or the source's permission. On the other hand, defendants in securities fraud actions naturally cast a jaundiced eye toward allegations attributed to sources whose identities are not disclosed in the complaint. They argue that these allegations should be discounted because the unnamed sources could be lying (because they have an axe to grind with the company), or what they said could be shaded by plaintiffs' counsel (who are incentivized to spin the facts provided by the sources with their most nefarious cast). Some in the defense bar have argued that courts should adopt a per se rule discounting all allegations from unnamed sources, regardless of what other details the complaint provides supporting the reliability or credibility of these allegations, and at least a handful of recent court opinions have adopted that stance. That said, in recognition of the vital role these sources have come to play in policing corporate wrongdoing, every federal Court of Appeals has held that the names of such sources need not be disclosed in securities fraud complaints.

In this article, we discuss the role played by corporate sources in private securities litigation, the reasons courts have unanimously agreed that the names of corporate sources need not be disclosed in securities fraud complaints, the framework that courts have developed for analyzing confidential source allegations, and the reasons

why a rule requiring or presuming that confidential source allegations should be discounted is inappropriate.

Background

As the Supreme Court has “long recognized, meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission.” *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499, 2504 (2007). *See also Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (“The securities statutes seek to maintain a public confidence in the marketplace ... by deterring fraud, in part, through the availability of private securities fraud actions.”). Private securities fraud actions can, however, be employed abusively against companies and individuals who have acted lawfully. *Tellabs*, 127 S.Ct. at 2504. In an attempt to check such abusive litigation, while permitting meritorious suits to proceed, Congress enacted the Private Securities Litigation Reform Act of 1995. *Id.*; *see also In re Cabletron Systems, Inc.*, 311 F.3d 11, 30 (1st Cir. 2002).

The PSLRA raised the pleading requirements in private securities fraud actions. No longer could plaintiffs plead in conclusory fashion that defendants had misled the market or acted with the requisite intent. Rather, under the PSLRA, plaintiffs are required to plead with particularity “each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, ... all facts on which that belief

is formed,” as well as “facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(1) and (2).

Plaintiffs must attempt to meet these rigorous pleading standards without the benefit of discovery. They cannot compel witnesses to testify, or parties to produce documents, prior to a complaint being filed. And because the PSLRA provides for an automatic stay of discovery upon the filing of a motion to dismiss, 15 U.S.C. § 78u-4(b)(3), plaintiffs are effectively precluded from obtaining such discovery to buttress a filed complaint. As a consequence, plaintiffs often must rely on the voluntary cooperation of persons with knowledge of the wrongs committed by high-level corporate officers to plead securities fraud with particularity.

Corporate Sources And The Fear Of Retaliation

Corporate sources often fear that they will suffer retaliation – such as an adverse action by their employer or being “blacklisted” by other employers – if their cooperation with plaintiffs becomes known. This fear is not without basis. The need for protection of corporate whistleblowers has been widely recognized, and formed an integral part of the Public Company Accounting Reform and Investor Protection Act of 2002 (“Sarbanes Oxley”). Among its measures, Sarbanes Oxley created a civil remedy for employees of public companies who faced retaliation for cooperating with governmental investigations or participating in or otherwise assisting private securities fraud actions. 18 U.S.C. § 1514A. It also enacted severe criminal penalties for “interference with the lawful employment or livelihood” of employees who provide information relating to a federal offense, 18 U.S.C. § 1513(e), and required audit committees to “establish procedures for . . . the confidential, anonymous submission by

employees of the issuer of concerns regarding questionable accounting or auditing matters.” 15 U.S.C. §78j-1(m)(4)(B).

While Sarbanes Oxley provides important remedies for corporate sources faced with retaliatory acts by their employer, federal courts have long recognized that “the most effective protection from retaliation is the anonymity of the informer.” *See, e.g., Wirtz v. Cont’l Fin. & Loan Co. of West End*, 326 F.2d 561, 563-64 (5th Cir. 1964). “The statutory prohibition against retaliation provides little comfort to an employee faced with the possibility of subtle pressures by an employer, which pressures may be so difficult to prove when seeking to enforce the prohibition.” *Mitchell v. Roma*, 265 F.2d 633, 637 (3d Cir. 1959). Corporate sources are far better served “by concealing their identities than by relying on the deterrent effect of *post hoc* remedies under [a statutory] anti-retaliation provision.” *Does I thru XXIII v. Advanced Textile Corp.*, 214 F.3d 1058, 1071 (9th Cir. 2000) (citation omitted); *accord Dole v. Local 1942, Int’l Bhd. of Elec. Workers*, 870 F.2d 368, 372 (7th Cir. 1989) (“The most effective means of protection, and by derivation the most effective means of fostering citizen cooperation, is bestowing anonymity on the informant, thus maintaining the status of the informant’s strategic position and also encouraging others similarly situated who have not yet offered their assistance.”)

In recognition of corporate sources’ legitimate fear of retaliation and the public policy of encouraging corporate sources to speak out against wrongdoing, courts have repeatedly upheld the use of confidential sources in private securities fraud litigation. As the First Circuit recently stated:

Scienter requires wrongdoing by high-level company officials; low-level employees or consultants may well

know of the wrongdoing and wish to disclose it but fear retaliation if their names appear among the accusers. Legislatures, both federal and state, have recognized similar fears in enacting anti-retaliation statutes and in encouraging whistleblowers. Some allowance at the motion to dismiss stage for consideration of confidential sources in litigation is consistent with those policies.

New Jersey Carpenters Pension & Annuity Funds v. Biogen Idec, Inc., 537 F.3d 35, 52 (1st Cir. 2008). *Accord Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000) (“Imposing a general requirement of disclosure of confidential sources serves no legitimate pleading purpose while it could deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them.”); *California Public Employees’ Retirement System v. Chubb Corp.*, 394 F.3d 126, 147 (3d Cir. 2004) (same); *In re Cabletron Systems, Inc.*, 311 F.3d at 30 (1st Cir. 2002) (“A blanket ban on unnamed sources presents obvious policy problems. Employees or others in possession of important information about corporate malfeasance may be discouraged from stepping forward if they must be identified at the earliest stage of a lawsuit”).

Indeed, every Circuit Court of Appeal that has considered the propriety of using confidential sources in a securities fraud complaint has held the practice permissible. *In re Cabletron*, 311 F.3d at 29-30 (1st Cir. 2002); *Novak*, 216 F.3d at 313-314 (2d Cir. 2000); *Chubb*, 394 F.3d at 146-147 (3d Cir. 2004); *Teachers’ Retirement System of Louisiana v. Hunter*, 477 F.3d 162, 174 (4th Cir. 2007); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 353-54 (5th Cir. 2002); *Ley v. Visteon Corp.*, 543 F.3d 801, 811 (6th Cir. 2008); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 711-12 (7th Cir. 2008); *Florida State Bd. Of Administration v. Green Tree Financial Corp.*, 270 F.3d 645, 667-68 (8th Cir. 2001); *In re Daou Systems, Inc.*, 411 F.3d 1006,

1015 (9th Cir. 2005); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1099-1100 (10th Cir. 2003); *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1239-40 (11th Cir. 2008).

Weighing Confidential Source Allegations In Securities Complaints

While factual allegations based on information received from confidential sources must be considered true for purposes of a motion to dismiss, the weight accorded to such allegations will depend on the facts and circumstances alleged in the complaint concerning the confidential source and the information s/he provided.

Courts consider whether the confidential source and the information attributed to him or her “are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.” *Novak*, 216 F.3d at 314; *see also In re Daou Systems*, 411 F.3d at 1015; *Chubb*, 394 F.3d at 146; *Kinder-Morgan*, 340 F.3d at 1099; *In re Cabletron*, 311 F.3d at 29; *ABC Arbitrage*, 291 F.3d at 353. To determine whether such a probability exists, courts consider (i) how the confidential source came to possess the information alleged; (ii) whether the confidential source has personal knowledge of the information; (iii) whether the confidential source allegations are coherent and plausible; (iv) how detailed the confidential source’s information is; (v) whether the information provided by the confidential source is corroborated by other facts or sources; and (vi) the number of sources of the information. *See In re Daou Systems, Inc.*, 411 F.3d at 1015; *Chubb*, 394 F.3d at 147; *Kinder-Morgan*, 340 F.3d at 1102-03; *In re Cabletron*, 311 F.3d at 29-30; *ABC Arbitrage*, 291 F.3d at 357-58. In endorsing this case-by-case approach to dealing with confidential source allegations, federal appellate courts have expressed their confidence in the ability of trial courts to handle the responsibility delegated to them. *See*

In re Cabletron, 311 F.3d at 30 (“courts can competently make a careful evaluation of securities fraud pleadings based on anonymous sources, and separate frivolous complaints from those with potential merit”).

The proposition advanced by some members of the defense bar -- that all confidential source allegations should be substantially discounted -- finds its strongest (and arguably most strident) support in the Seventh Circuit’s decision in *Higginbotham v. Baxter*, 495 F.3d 753 (7th Cir. 2007). *Higginbotham*, however, is a classic case of bad facts making bad law and, in the authors’ view, is an opinion noteworthy for its intemperate language – which a different Seventh Circuit panel effectively abandoned a short time later in *Makor Issues & Rights, Ltd. v. Tellabs Inc.* (“*Tellabs II*”), 513 F.3d 702, 712 (7th Cir. 2008). In *Higginbotham*, the plaintiffs sued a U.S.-based parent company (Baxter) for the securities fraud committed by its foreign subsidiary. The only basis for imputing to Baxter knowledge of its subsidiary’s fraud was allegations made by five confidential sources. These sources were sparsely described in the complaint as three ex-employees of Baxter and two consultants,² and the *Higginbotham* panel found their allegations weak, even when considered in the light most favorable to the plaintiffs. 495 F.3d at 758. At oral argument, the *Higginbotham* panel asked “when the identity of these five [sources] would be revealed and how their stories could be tested” and was told “that the sources’ identity would never be revealed” and thus “their stories could not be checked.”³ *Id.* at 757. Apparently incensed by what it felt was an improper attempt by

² See *Tellabs II*, 513 F.3d at 712.

³ Though *Higginbotham* is not entirely clear on the point, it appears that plaintiffs’ counsel was not intending to rely on these sources at any later stage of the suit and thus not planning to name them in its initial disclosures. Where plaintiffs intend to, or wish to preserve their ability to, call

plaintiffs' counsel to rely on weak confidential source allegations that they had no intention of proving as a tactic to survive a motion to dismiss, the *Higginbotham* panel not only rejected the allegations presented, but took a dim view of confidential source allegations generally. The panel opined that it was "hard to see how information from anonymous sources could be deemed 'compelling' or how [it] could take account of plausible opposing inferences," concluding that "allegations from 'confidential witnesses' must be 'discounted'" and that "[u]sually that discount will be steep." *Id.* at 757.⁴

In *Makor Issues & Rights, Ltd. v. Tellabs Inc.* ("*Tellabs II*"), the Seventh Circuit revisited the scope of *Higginbotham*'s broad per se rule discounting all confidential source allegations, and essentially overruled it by cabining *Higginbotham* to the particular facts of that case. 513 F.3d at 711-12. The *Tellabs II* complaint contained allegations from twenty-six different confidential sources, each of whom was in a position to know the facts alleged, and whose information was set forth in "convincing detail." *Id.* at 712. Moreover, some of the information provided by these confidential sources was corroborated by multiple sources. *Id.* Faced with such a particularized complaint, the *Tellabs II* court walked away from *Higginbotham*'s pronouncements about confidential informant sources.

sources at trial, these informants must be named as persons likely to have discoverable information in initial disclosures. *See* Fed.R.Civ.P. 26(a)(1)(A). They do not, however, have to be identified as the sources when they are named in the initial disclosures.

⁴ Notably, these sweeping generalizations were not necessary to reach the result that the confidential source allegations in this complaint should be discounted. As noted above, the *Higginbotham* court found the confidential source allegations to be weak, even when considered in the light most favorable to plaintiffs. 495 F.3d at 758. In addition, as the Seventh Circuit later noted in *Tellabs II*, the descriptions in the complaint of these confidential sources were sparse. 513 F.3d at 712 (the witnesses were described merely as three ex-employees of Baxter and two consultants).

[A]llegations based on anonymous informants are very difficult to assess. This concern led us to suggest in *Higginbotham v. Baxter Int'l, Inc.* ... that such allegations must be steeply discounted. But that was a very different case from this one.

Id. at 712 (emphasis added). Whereas the *Higginbotham* court found it “hard to see how information from anonymous sources could be deemed ‘compelling,’” the *Tellabs II* court had no such difficulty, concluding that “the absence of proper names does not invalidate the drawing of a strong inference from informants’ assertions.” *Id.*

The First Circuit has similarly rejected *Higginbotham*’s broad per se rule discounting all confidential source allegations. *New Jersey Carpenters Pension & Annuity Funds*, 537 F.3d at 52. The First Circuit emphatically declined “to adopt a rule which would exclude confidential source allegations which have every indication both that the source had access to information and that the information has the earmarks of credibility, simply because the identity of the source is not initially revealed” or “to exclude consideration of such information from the evaluation of whether plaintiffs’ strong inferences of scienter are at least as plausible as defendants’ inferences.” *Id.*⁵ As the Eleventh Circuit recently stated, confidentiality “should not eviscerate the weight given [to the source’s allegation] if the complaint otherwise fully describes the foundation or basis of the confidential witness’s knowledge, including the position(s) held, the proximity to the offending conduct, and the relevant time frame.” *Mizzaro*, 544 F.3d at 1240.

⁵ The Fifth Circuit has cited *Higginbotham* for the proposition that allegations based on confidential sources must be discounted, though it proceeded to address all the facts and circumstances concerning the confidential informant and the information provided when weighing the information. *Indiana Electrical Workers’ Pension Trust Fund IBEW v. Shaw Group, Inc.*, 2008 WL 2894793 (5th Cir. 2008). The Sixth Circuit has also cited *Higginbotham*’s proposition in passing. *Ley*, 543 F.3d at 811 (6th Cir. 2008). Neither Circuit has addressed the Seventh Circuit’s subsequent opinion in *Tellabs II* or independently analyzed the proposition.

Defendants' concern that witnesses who know that their identity will not be disclosed in a publicly filed complaint at the outset of a case (but may be disclosed at a later stage of the proceeding) are more likely to lie may have merit.⁶ But it is clear, in our experience and the experience of other plaintiffs' attorneys, that many truthful witnesses with knowledge of corporate wrongdoing would not come forward absent such assurances of confidentiality. As a matter of public policy, courts have decided that the importance of encouraging such witnesses to come forward to expose corporate fraud outweighs the possibility that a particular lawsuit may go forward based in part on the statement of a witness who is willing to lie. And, as discussed above, courts have minimized the risk to defendants by requiring that plaintiffs plead sufficient information about both the source of the information and the information itself "to support the probability that a person in the position occupied by the source would possess the information alleged." *Novak*, 216 F.3d at 314. One related concern -- that plaintiffs' counsel might shade the truth when describing the information provided by the confidential source or perhaps even fabricate the existence of the source (as the *Higginbotham* panel rhetorically suggested) -- is of course addressed by Rule 11 of the Federal Rules of Civil Procedure, as well as the pertinent rules of professional responsibility. Rule 11 requires attorneys to have a good faith belief that their factual allegations have evidentiary support when filing pleadings, and provides for sanctions if they do not. *See also* 15 U.S.C. §78u-4(c) (PSLRA provision requiring the court presiding over securities fraud suits to include in the record specific findings regarding

⁶ Studies attempting to ascertain the validity of this proposition have not yet been published. Even where a confidential source recants the allegation attributed to him or her at a deposition, it can be difficult to know whether the witness is recanting because s/he was lying to (or misquoted by) plaintiffs' attorneys at the outset of the case or whether s/he is now abandoning a statement out of fear of retaliation.

each attorney's compliance with Rule 11). Thus, there is already ample deterrent to plaintiffs' attorneys engaging in such antics. *See, e.g., Florida State Board of Administration v. Green Tree Financial Corp.*, 270 F.3d 645, 668 (8th Cir. 2001) (declining to require confidential witnesses to be named because Rule 11 "already [provides] a mechanism ... to deter and punish fabrication").

It is important to place the defendants' concerns in perspective. Under the PSLRA, plaintiffs seeking to bring securities fraud claims already face higher pleading standards than plaintiffs in any other civil action. They are precluded from using discovery to obtain the evidence to meet those pleading standards. Confidential sources are often the only source of non-public information plaintiffs can use to provide the detailed information Congress wanted before allowing securities fraud cases to go forward. A rule that requires courts to discount all such allegations, including those that have every indication of reliability, would convert the PSLRA from a statute that checks abusive securities fraud actions to one that bars virtually all securities fraud actions. This was not Congress's intent.

Conclusion

Courts analyzing confidential source allegations look at a number of factors when determining how much weight to give these allegations for purposes of determining whether the complaint adequately pleads scienter. The suggestion by some defense counsel that the courts should abandon this approach in favor of a per se rule that all confidential source allegations be substantially discounted is unwarranted. It would lead to the incongruous result that detailed allegations with every indicia of reliability

would be discounted, and would effectively preclude meritorious actions from being brought, contrary to the goals of the PSLRA.