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REPORT

CLASS ACTIONS

Balancing the Scales: The Use of Confidential Witnesses in Securities Class Actions

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In enacting the Private Securities Litigation Reform Act of 1995 (PSLRA), Congress placed the success of private actions to enforce the federal securities fraud laws in the hands of confidential witnesses. By requiring that plaintiffs pursuing claims under the federal securities laws plead specific information about the state of mind of defendants without the benefit of any discovery, legislators all but required that, in pleading their cases, plaintiffs rely upon confidential informants willing to place their careers in jeopardy by disclosing nonpublic information about plans to deceive investors. In the midst of a global financial meltdown precipitated by executives' misadventures with securitized debt, there has never been a greater need for these individuals to step forward.

And yet, in the months leading up to the current financial crisis, some courts and commentators have expressed a startlingly jaundiced view of the crucial role that these witnesses play in bringing securities fraud to light. Judge Posner has observed that confidential witnesses could be ''any kind of snitch, and any kind of liar . . .[making] anonymous accusations against a company.''[1] Chief Judge Easterbrook suggests that perhaps confidential sources ''have axes to grind. Perhaps they are lying.'' He warns ''[p]erhaps they don't even exist.''[2]

Reconciling the premium that the PSLRA places on the use of confidential witnesses with the skepticism of judges like Posner and Easterbrook has brought an increasing focus on the degree to which the identities of confidential witnesses can be protected in pleading complaints under the federal securities fraud laws. While courts have offered fragmentary and conflicting views on the subject in the past, recent developments in the case law reflect a growing consensus that confidential informants have an indispensable role in these actions.

The use of confidential witnesses is deeply intertwined with the evolution of private lawsuits under the federal securities laws in the U.S. There can be little doubt of the crucial part that private actions have come

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[1] Oral Argument in *Higginbotham v. Baxter International* before the U.S. Court of Appeals for the Seventh Circuit, as cited by Prof. J. Robert Brown Jr., University of Denver College of Law, in the September 28, 2007 Harvard Law School Corporate Governance Blog.

[2] *Higginbotham v. Baxter Int'l Inc.*, 495 F.3d 753, 757 (7th Cir. 2007).

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to play in ensuring the integrity of the markets. In the Supreme Court's 2007 decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Court reminded us that it had ''long recognized that 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 (SEC).''[3]

Notwithstanding Congress' reliance on private litigants to carry out the remedial goals of the securities fraud statutes, in 1995 it imposed significant new requirements regarding the strength and specificity of the factual allegations necessary to state a claim under the federal securities laws. The PSLRA requires plaintiffs bringing claims under the securities laws to identify in their complaints ''each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading.'' 15 U.S.C. Section 78u-4(b)(1). The Act further requires that, in pleading scienter, plaintiffs must ''state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'' 15 U.S.C. Section 78u-4(b)(2).

The PSLRA presents plaintiffs with one last conundrum: they are required to plead these specific facts before having the legal ability to compel a defendant to provide any information at all. Rule 15 U.S.C. § 78u-4(b)(3)(B) of the PSLRA provides an automatic stay of discovery until a securities fraud complaint survives a motion to dismiss:

> In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

Given the scant chance that evidence of a defendant's state of mind might be found in records outside of contemporaneous internal memoranda and electronic data, the PSLRA discovery stay severely limits a plaintiff's access to the most fruitful kinds of information that might provide the basis for the detailed allegations of mental state called for by the statute.[4]

Instead, private litigants seeking to carry out Congress' mandate to enforce the federal securities laws have turned to sources that are already the mainstay of public law enforcement: confidential witnesses. Courts have long observed that the U.S. system of criminal justice turns on the availability of confidential informants, and have vigorously defended their use.[5] Courts have been particularly skeptical of claims by defendants that the identities of such informants must always be disclosed:

> If a defendant may insist upon disclosure of the informant in order to test the truth of the officer's statement that there is an informant or as to what the informant related or as to the informant's reliability, we can be sure that every defendant will demand disclosure. He has nothing to lose and the prize may be the suppression of damaging evidence if the State cannot afford to reveal its source, as is so often the case . . . we accept the premise that the informer is a vital part of society's defensive arsenal. The basic rule protecting his identity rests upon that belief.

McCray v. Ilinois. 386 U.S. 300, 306-07, 87 S. Ct. 1056, 1060 (1967).

Indeed, persons who offer confidential information in connection with law enforcement enjoy multiple protections aimed at preventing the disclosure of their identities, even in the face of the Sixth Amendment's guarantee of the right to confront one's accusers. In *Roviaro v. U.S.*,[6] the Supreme Court recognized the ''informer's privilege''—that is, ''the Government's privilege to withhold from disclosure the identity of persons who furnish information of violations of law to officers charged with enforcement of that law.'' *Id.* at 59. The Court explained that this privilege ''recognizes the obligation of citizens to communicate their knowledge of the commission of crimes to law enforcement officials and, by preserving their anonymity, encourages them to perform that obligation.'' *Id.*

Similar protections exist in the law enforcement exemptions of the Freedom of Information Act (FOIA). FOIA Exemption 7A protects the identities of witnesses offering assistance to law enforcement where disclosure might result in intimidation or coercion, while Exemption 7D provides similar protection to witnesses who choose to provide information to law enforcement officials on a confidential basis. 5 U.S.C.A. § 552(b)(7)(A) and (D).

Relying on the ample historical precedent for employing confidential witnesses to assist in law enforcement, plaintiffs bringing private securities fraud actions in the wake of the PSLRA increasingly relied upon the use of confidential informants to supply detailed allegations of fraud. Indeed, it has been suggested that, in the absence of publicly available information from SEC or Department of Justice investigations, allegations based on information provided by confidential witnesses offer the ''best hope'' of plaintiffs surviving the PSLRA pleading standards.[7]

Warring Camps. Courts quickly broke into warring camps in their views on the propriety of this practice. Judge Fern Smith's 1997 decision in *In re Silicon Graphics, Inc. Securities Litigation* was one of the first to specifically address reliance on confidential witness allegations to meet the PSLRA's pleading requirements.[8] In *Silicon Graphics*, the court had rejected a plaintiff's allegations of violations of the securities laws as insufficiently detailed under the PSLRA pleading standards and invited plaintiffs to supplement their pleadings by revealing the names of confidential sources with knowledge of the allegations in the complaint. *Id.* at *1. Plaintiffs refused this invitation, citing the need to preserve the confidentiality of these witnesses, but provided the information to the court for *in camera* review. *Id.* The court rejected this proffer and dismissed the case, stating that ''Plaintiffs have cited no

[3] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* 127 S. Ct. 2499, 2504 (2007).

[4] Some courts have suggested that under certain circumstances the PSLRA's stay provisions can be lifted even during the pendency of a motion to dismiss. *See e.g. In re Lernout & Hauspie Sec. Litig.*, 214 F. Supp.2d 100, 106 (D.Mass. 2002) (allowing limited discovery to proceed against specific defendants despite other defendants' pending motions because the specific defendants' motions to dismiss had been denied.)

[5] *See eg Roviaro v. United States*, 353 U.S. 53 (1957); *McCray*, 386 U.S. at 306-07.

[6] *Roviaro* , 353 U.S. at 53.

[7] Harold Bloomenthal and Samuel Wolff, *Securities and Federal Corporate Law*, (2008 ed.) Section 16.101.

[8] *In re Silicon Graphics Inc. Sec. Litig.*, No. 96-393, 1997 WL 337580 (N.D. Cal. June 5, 1997).

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authority, and the Court is aware of none, that allows a party to base its pleadings on secret information to which the opposition is denied access and an opportunity to respond.'' *Id.*

After Judge Smith's decision, the Second Circuit lost no time in putting its imprimatur on the use of confidential informants. In *Novak v. Kasaks*,[9] the Second Circuit considered a district court's rejection of a securities fraud complaint because it relied in part on information provided by confidential witnesses. *Id.* at 312. In a strongly-worded opinion, the appellate court rejected outright the notion that plaintiffs are obliged to reveal the names of sources providing allegations in their complaints:

> [O]ur reading of the PSLRA rejects any notion that confidential sources must be named as a general matter . . . Accordingly, where plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false. Moreover, even if personal sources must be identified, there is no requirement that they be named, provided they 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.

Id. at 313-14.

The years following the Second Circuit's decision in *Novak* saw a protracted battle between courts influenced by the wholesale rejection of anonymous sources set out in *Silicon Graphics* and those courts that were persuaded by the reasoning of the Second Circuit in *Novak*.

The First Circuit discussed at length the merits of both approaches in its 2002 decision in *In re Cabletron Systems Inc.*[10] In affirming a district court's denial of a motion to dismiss a complaint based in large part on information supplied by confidential witnesses, the court explicitly rejected *Silicon Graphics'* suggestion that confidential sources must be named as a general matter. *Id.* at 29. The Cabletron court explained that a rule prohibiting the use of unnamed sources during the earliest stages of lawsuits may discourage employees with knowledge of corporate malfeasance from stepping forward. *Id.* Such a rule, held the court, would be inconsistent with the PSLRA's intention ''to erect barriers to frivolous strike suits, but not to make meritorious claims impossible to bring.'' *Id.*

By 2007, it was apparent that proponents of the *Novak* approach were carrying the day. The reasoning of that decision had been adopted by all but the Sixth, Seventh, and Eleventh Circuits, with the Fourth Circuit remaining ambivalent.[11]

New Life. Then, little more than a year ago, new life was unexpectedly breathed into the dispute by a Supreme Court decision that is silent about the use of confidential witnesses. In *Tellabs, Inc. v. Makor Issues & Rights Ltd.*,[12] the Supreme Court was confronted with a securities fraud class action complaint which relied in part on information derived from 27 confidential informants. *Id.* at 2501. The District Court dismissed the plaintiffs' complaint as lacking sufficient particularity under the PSLRA. *Id.* The Seventh Circuit reversed, holding that the shareholder plaintiffs had pleaded both fraud and the defendants' scienter with sufficient specificity. *Id.*

In reviewing the Seventh Circuit's determination, the Supreme Court offered a new articulation of the PSLRA's pleading standard: To qualify as ''strong'' for the purposes of the PSLRA, ''an inference of scienter must be more than merely plausible or reasonable-it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.'' *Id.* at 2502. Beyond imposing this comparative, rather than absolute standard of pleading, the court took no issue with the shareholder plaintiffs' use of confidential witnesses.

After years spent in the dwindling minority of courts rejecting the use of confidential witnesses, the Seventh Circuit was quick to seize on the *Tellabs* decision as support for its opposition to the use of anonymous sources in complaints. Just months after the *Tellabs* decision was released the Seventh Circuit issued its opinion in *Higginbotham v. Baxter International Inc.*,[13] the appeal of a district court's order dismissing a complaint which relied in part on information from five former employees of the defendant company who acted as confidential witnesses. *Id.* at 756. In spite of the fact that *Tellabs* was silent on the use of confidential witnesses, the Higginbotham Court held that ''[o]ne upshot of the approach that *Tellabs* announced is that we must discount allegations that the complaint attributes to five confidential witnesses.'' *Id.* at 757. It warned, ominously, that ''[u]sually that discount must be steep.'' *Id.*

While the result in *Higginbotham* was consistent with the Seventh Circuit's already entrenched rejection of the use of anonymous sources in complaints, commentators have suggested that it was hardly compelled by the text of *Tellabs* itself. In the aftermath of the Seventh Circuit's opinion, Professor Robert Brown pointed out in the Harvard Law School Corporate Governance Blog that the pleading standard enunciated in *Tellabs* is in fact consistent with the approach employed by courts adopting the *Novak* analysis. He urged that *Tellabs* ''only requires that a securities complaint be considered in its entirety before deciding whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter'' and that ''to single out confidential witness statements for discounting is the antithesis of this approach.''[14]

Declined to Follow. Many courts have declined to follow the Seventh Circuit's suggestion in *Higginbotham* that *Tellabs* places strict limitation on the use of confidential witnesses. *In Rosenbaum Capital, LLC v. McNulty*, 549 F. Supp. 2d 1185 (N.D.Cal. 2008), the court rejected defendants' motion to dismiss a securities fraud complaint based in part on information provided by four confidential sources described with particularity. *Id.* at 1194. Defendants in the case had cited to *Higginbotham* for the proposition that, in light of *Tellabs*, ''confidential sources by definition cannot give rise to a

[9] *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000).
[10] *In re Cabletron Sys. Inc.*, 311 F.3d 11 (11th Cir. 2002).
[11] Harold S. Bloomenthal, *Securities Law Handbook*, (2007-08 ed.) Section 29:53:10 (surveying cases).
[12] *Tellabs*, 127 S. Ct. at 2499.
[13] *Higginbotham*, 495 F.3d at 753.
[14] Prof. Robert Brown Jr., ''The Tellabs Excuse and Confidential Witnesses'', Harvard Law School Corporate Governance Blog, http://blogs.law.harvard.edu./corpgov/2007/09/28/the-tellabs-excuse-and-confidential-witnesses/, posted September 28, 2007.

cogent and compelling inference of scienter.'' *Id.* at 1192.

Judge Conti made short work of this argument, holding that he saw in *Tellabs* no reason to depart from the Ninth Circuit's existing rule permitting the use of confidential sources in complaints, so long as sufficient corroborating details are supplied. *Id.* In rejecting the reasoning of *Higginbotham*, the court looked to the Fifth Circuit's decision in *Central Laborers' Pension Fund v. Integrated Electrical Services Inc.*[15] In *Central Laborers*, an appeal from the dismissal of a securities fraud complaint, the Fifth Circuit made explicit reference to the new comparative pleading standard the Supreme Court set out in *Tellabs*, but went on to observe that ''[c]onfidential source statements are a permissible basis on which to make an inference of scienter.'' *Id.* at 551-52.

Notably, the Seventh Circuit itself quickly backpedaled from its position in *Higginbotham* in considering the *Tellabs v. Makor* case on remand from the Supreme Court.[16] In taking up the case on remand, the appellate court sharply limited its prior holding in *Higginbotham*, explaining that the earlier decision's apparent rejection of the use of confidential witnesses was limited to cases where no other corroborating details are pleaded. It explained that in *Higginbotham*

> There was no basis other than the confidential sources, described merely as three ex-employees of Baxter and two consultants, for a strong inference that the subsidiary had failed to conceal the fraud from its parent and thus that the management of the parent had been aware of the fraud during the period covered by the complaint.

Id. at 712.

In so holding, the Seventh Circuit substantially reconciled its approach to confidential witnesses with that of the Second Circuit as set out in *Novak*, which held that complaints may rely upon allegations based on confidential sources so long as additional facts are supplied, including information corroborating the confidential witness' access to relevant information.

Subsequent district court decisions have noted the Seventh Circuit's retrenchment from the position it had staked out in *Higginbotham*. The court in *In re Amgen Securities Litigation*,[17] reviewing both *Higginbotham* and the opinion on remand in *Tellabs II*, explained that *Higginbotham*'s ''steep discount'' should be reserved for complaints where no corroboration exists for allegations supplied by confidential informants. The *Amgen* court quoted *Tellabs II* for its holding that ''the absence of proper names does not invalidate the drawing of a strong inference from informants' assertion.'' *Id.*

A district court in the Sixth Circuit similarly concluded recently that *Higginbotham*'s skepticism about confidential witnesses has largely given way. In *In re Huffy Corp. Securities Litigation*,[18] the district court denied in part a motion to dismiss a securities fraud complaint based on information supplied by confidential sources. *Id.* at *45. In concluding that it would adhere to the approach to confidential witnesses articulated in *Tellabs II* and *Amgen*, the district court explicitly cited to *Novak*, and stated:

> Therefore, when deciding whether to consider the statements attributed to confidential or anonymous witnesses in the Amended Complaint . . . this Court will examine the descriptions of each of those individuals' jobs to ascertain whether any would have been in a position to have gained first hand knowledge of the facts attributed to him or her, and the detail of the information each is reported to have provided. In addition, the Court will consider whether the statements attributed to confidential witnesses have been corroborated.

Id. at *19.

Disclosure During Discovery? While there can now be little doubt regarding the propriety of relying on confidential witnesses in drafting complaints, lively dispute still exists over the extent to which the identities of confidential witnesses must be disclosed during the discovery phase of securities fraud cases.[19] Much of this ongoing battle has turned on whether courts should accept attorney work product privilege as a basis for protecting the identities of confidential witnesses during the discovery phase of litigation.

This argument has met with some success in cases such as *In re MTI Technologies Corporation Securities Litigation*, in which the Central District of California concluded that disclosing the identities of confidential witnesses during discovery would permit opposing counsel to ''infer which witnesses counsel considers important, revealing mental impressions and trial strategy.''[20]

Other cases reject outright the notion that the identities of these witnesses can ever be protected from discovery under the aegis of attorney work product. In *Mazur v. Lampert*, the Southern District of Florida granted defendants' motion to compel the disclosure of the identities of confidential witnesses relied upon in plaintiffs' complaint, holding that ''under the plain language of [Rule 26], a claim of work product protection in response to an interrogatory asking for the identity of specific witnesses identified in a complaint must fail.''[21] Recent case law and scholarship avoid this dispute over the scope of attorney work product altogether and instead take a middle road that considers both Rule 26 of the Federal Rules of Civil Procedure and the well-developed jurisprudence regarding confidentiality of informants in criminal cases as a possible framework for analysis.

These courts and commentators suggest that factors developed to assist in the use of confidential witnesses in criminal cases provide useful guidance to courts considering disputes over the disclosure of witnesses in private securities fraud cases. Under this test, a defen-

[15] *Central Laborers' Pension Fund v. Integrated Electrical Serv. Inc.*, 497 F.3d 546 (5th Cir. 2007).

[16] *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702 (7th Cir. 2008) (''*Tellabs II*'').

[17] *In re Amgen Inc. Sec. Litig.*, 544 F. Supp. 2d 1009, 1032 (C.D. Cal. 2008).

[18] *In re Huffy Corp. Sec. Litig.*, No. 3:05CV028, 2008 WL 4323486 (S.D. Ohio Sept. 17, 2008).

[19] There is little controversy over the proposition that, if the testimony of a confidential witness is to be used at trial or summary judgment, defendants have a right to the disclosure of that person's identity.

[20] *In re MTI Tech. Corp. Sec. Litig. II*, No. 00-0745, 2002 WL 32344347, at *5 (C.D. Cal. June 13, 2002); *see also Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Sys., Inc.*, No. C01-20418 JW, 2005 WL 1459555 (N.D. Cal. June 21, 2005) (concluding that witnesses' identities reveal counsel's mental impressions and trial strategy and therefore work product protections apply).

[21] *Mazur v. Lampert*, No. 04-61159, 2007 WL 917271, *3 (S.D. Fla. Mar. 25, 2007).

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dant's right to the disclosure of the identity of a confidential witness under Rule 26 is weighed against the informants' need for protection, the key role played by confidential witnesses in private litigation under the securities fraud laws, and the importance of promoting the deterrent goals set out in these statutes. Because of the crucial role that confidential informants have come to play in maintaining the transparency of the U.S. financial markets, courts applying this balancing test may prove to be reluctant to require disclosure of the identities of confidential informants even during the discovery phase of litigation.[22]

Given the immense scope of the investigations into our current financial crisis and the key contributions that confidential witnesses will make in them, there can be no doubt that in the near future we will see additional development in the protections that courts offer to encourage these whistle-blowers to come forward.

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[22] *See* Ethan D. Wohl, ''Confidential Informants in Private Litigation: Balancing Interests in Anonymity and Disclosure'' *Fordham Journal of Corporate and Financial Law*, Vol. XII p. 551 (2007), and cases cited therein, including *In re Cigna Corp. Sec. Litig.*, No. Civ. A. 02-8088, 2006 WL 263631 (E.D. Pa. Jan. 31, 2006).