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Confidential Witnesses in Securities Litigation: Handle With Care

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In securities litigation, complaints that refer to and quote statements from confidential insider sources have become the norm. These insider sources are often former employees of the defendants, who are described in the complaint as "confidential witnesses," e.g., confidential witness 1 (CW1), confidential witness 2 (CW2), and so forth. The phenomenon of the confidential witness is a byproduct of the substantially heightened pleading requirements set forth in the Private Securities Litigation Reform Act (PSLRA) and imposed by decisions, such as *Tellabs v. Makor Issues & Rights.* However, the practice of relying on confidential witnesses places enormous strains on plaintiffs, the witnesses and the judicial system.

This article explores the reasons for using confidential witnesses, the required disclosures regarding the confidential witness at the pleading stage, and ways in which courts have confronted the messy factual issue of a "recanting" confidential witness.

Why Are Confidential Witnesses Necessary?

Confidential witnesses are often necessary for claims brought under Section 10(b) of the Securities Exchange Act of 1934 to satisfy the "exacting" pleading requirements imposed by the PSLRA and to survive a motion to dismiss. The PSLRA imposes two distinct pleading requirements on private securities litigation plaintiffs.

First, when alleging that defendants made a material misrepresentation or omission, the complaint must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation … is made on information and belief … state with particularity all facts on which that belief is formed."

Second, due to the fact that a Section 10(b) claim requires scienter, i.e., the intent to deceive, manipulate or defraud, the complaint must also "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." In *Tellabs*, the U.S. Supreme Court interpreted the "strong inference" requirement to signify that the "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." This is a "stringent" test that is "difficult to meet." See *Mizzaro v. Home Depot,* 544 F.3d 1230, 1257 (11th Cir. 2008)

The U.S. Court of Appeals for the Third Circuit has largely interpreted the PSLRA pleading requirements in the

same manner as those set forth in Rule 9(b) of the Federal Rules of Civil Procedure relating to fraud or mistake. See *Institutional Investors Group v. Avaya*, 564 F.3d 242, 253 (3d Cir. 2009).

A plaintiff must plead the who, what, when, where and how. The PSLRA, however, additionally requires that allegations based on information and belief be pled with particularity—describing the sources of information and the "who, what, when, where, and how of the information those sources convey." The PSLRA also departs from Rule 9(b) in its articulation of the pleading standard relating to scienter. Unlike Rule 9(b), which provides that state of mind can be averred generally, the PSLRA requires the plaintiff to plead facts with particularity giving rise to a strong inference of scienter.

To satisfy these heightened pleading requirements, a private securities litigation plaintiff must thoroughly investigate its claims in an attempt to uncover insider sources and documents that can explain the who, what, when, where, and how. It is not sufficient for a complaint to merely allege a material misstatement, the plaintiff must set forth the "true facts" that explain the reason(s) why the statement is misleading and provide, with particularity, the facts on which its information and belief as to the "true facts" are formed. See, *California Public Employees' Retirement System v. Chubb*, 394 F.3d 126, 145 (3d Cir. 2004). This can be challenging. A plaintiff in a securities litigation will typically not have direct access to, or personal knowledge of, the "true facts." This is precisely why the plaintiff alleges to have been damaged by the defendants' false or misleading statements. Further, the plaintiff does not have the benefit of formal discovery to aid in drafting the complaint.

In these circumstances, securities litigation plaintiffs will often hire investigators to reach out to current and former employees of the defendant company or its affiliates to develop the facts necessary to draft the complaint. In light of the PSLRA, use of insider witnesses has become an almost essential task for any securities litigation plaintiff to ensure that the allegations in its complaint are sufficiently supported and will survive a motion to dismiss. A securities class action complaint may refer to dozens of confidential witnesses. See e.g., *Edwards v. McDermott International,* No. 18-04330, 2021 U.S. Dist. LEXIS 213363, at *10 (S.D. Tex. Nov. 4, 2021) (Section 10(b) complaint including the statements of 24 confidential witnesses).

The use of confidential witnesses may confer a significant tactical advantage on plaintiffs during the motion to dismiss stage of securities litigation. The defendants are required to accept the allegations of the complaint as true, and thus, even if they know the allegations attributed to a confidential witness are false, they have little ability to challenge such false allegations during the motion to dismiss stage. In addition, a plaintiff's investigator may have an incentive to slant the information being provided by a confidential witness in order to strengthen a complaint and help it survive a motion to dismiss. The defendants have limited ability to challenge the veracity of a confidential witness' alleged statements on a motion to dismiss. Further, a plaintiff's investigator may speak to a number of former employees, the vast majority of whom do not provide information consistent with the plaintiff's theory of liability. In the complaint, the plaintiff will only reference the confidential witnesses who support the plaintiff's theory, and ignore the ones who refute the theory. All of these issues may undermine the court's role as PSLRA gatekeeper during the motion to dismiss, allowing more meritless cases to move forward, thus increasing the cost of litigation.

What Must Be Disclosed in the Complaint in Terms of Insider Sources?

A confidential witness is just as the name implies—confidential. The Third Circuit has expressly held that an insider

witness referred to in a complaint does not need to be identified by a name, as long as the complaint includes "sufficient facts" to support the allegations. Adopting the reasoning of the Second Circuit, the Third Circuit concluded that a disclosure requirement would not serve a legitimate pleading purpose and could create negative public policy implications of deterring informants from coming forward or inviting retaliation against them. See, *Chubb,* 394 F.3d at 147 (citing *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000)).

To assess the allegations of confidential witnesses, courts will examine 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." A complaint should plead information sufficient enough to explain the confidential witnesses' role, the dates they learned of the relevant information, how they had access to this information, and whether their knowledge was first or second hand. Each source must be described with particularity in order to pass muster. Referencing a large number and variety of confidential witnesses "may in some instances help provide particularity" but the Third Circuit has cautioned that simply "cobbling together a litany of inadequate allegations does not render those allegations particularized." If the complaint's confidential witness allegations are not adequately particularized, then the court "must discount them steeply."

If, on the other hand, confidential witness allegations are accepted as adequately particularized, that is only the beginning of the inquiry. The court must then determine whether all of the alleged facts, taken collectively, support a finding of a statement's falsity or of a defendant's scienter consistent with the heightened pleading requirements. See, *Avaya,* 564 F.3d at 263 n.33 ("Of course, confidential witness allegations may score highly on the *Chubb* test yet fail either to establish the falsity of a statement, or to give rise to a strong inference of scienter.").

What Happens When Confidential Witnesses Repudiate the Allegations Attributed to Them?

While a confidential witness may not be publicly named in a complaint, the particularized allegations in a complaint often make the identity of that individual readily apparent to the defendant. Even if this is not the case, the identity of a confidential witness typically can be obtained in the course of discovery. See, *See Edwards v. McDermott International*, 2021 U.S. Dist. LEXIS 213363, at *11 (collecting cases reflecting the "predominant view" that the identities of confidential witnesses must be disclosed).Thus, the role of a confidential witness does not end after the complaint is filed. Thereafter, confidential witnesses can become key named witnesses in the case.

This raises an important question: If a court relies on the confidential witnesses' allegations to deny a motion to dismiss, what happens if the confidential witness later testifies that the facts and statements attributed to him were false or inaccurate?

A growing body of cases have examined the issue of a "recanting" confidential witness. The procedural posture of these cases has varied. Defendants have raised the issue of recanting confidential witnesses in the context of motions: to strike, to dismiss, to reconsider denial of a motion to dismiss, for class certification as grounds to deny the motion due to inadequate counsel, for summary judgment and for sanctions. See, *City of Livonia Employees' Retirement System v. Boeing,* 711 F.3d 754, 761 (7th Cir. 2013); *In re BankAtlantic Bancorp,* 851 F. Supp. 2d 1299, 1308-09 (S.D. Fla. 2011); *In re Dynex Capital Securities Litigation*, No. 05-1897, 2011 U.S. Dist. LEXIS 67894, at *5-6 (S.D.N.Y. Apr. 29, 2011), report and recommendation adopted, 2011 U.S. Dist. LEXIS 67756

(S.D.N.Y. June 21, 2011).

A few themes have appeared from these cases.

First, as a general rule, courts are reluctant to dismiss an action based on the declaration or deposition testimony of a recanting confidential witness. Courts often view the repudiation of statements attributed to them in the complaint as raising questions of credibility that should be explored in discovery, or not sufficiently in contradiction to the allegations in the complaint as to retain sufficient plausibility. Further, discrepancies in testimony do not necessarily reveal sanctionable misconduct. Courts have recognized that situations could arise in which witnesses are lured by plaintiffs' investigators into stating "facts" that are really just surmises and later pressured by defendants' counsel to outright deny such statements. Further, courts have noted that discrepancies could be "attributed to a witness' changing memory or, in the case of a whistleblowing confidential witness, the desire to remain in a former employer's good graces once the protection of confidentiality has been removed."

Second, an exception to this general rule applies when the defendant is able to present the court with clear and undisputed evidence that the confidential witness' allegations in the complaint are false, such as when it would be impossible for a confidential witness to have personal knowledge regarding certain facts because the witness did not work at the defendant company at that time or would not have had access to such information.

Third, some courts have employed creative procedural and case management devices to test confidential witness allegations. For example, in *Campo v. Sears Holdings*, the district court ordered that the confidential witnesses referenced in the complaint be deposed to assist the court in deciding defendants' motion to dismiss. The Second Circuit found that the district court's reliance upon this deposition testimony "for the limited purpose of determining whether the confidential witnesses acknowledged the statements attributed to them in the complaint" was a permissible way to weigh to test the good faith basis of plaintiff's allegations supporting an inference of scienter. Other courts have refused to consider recanting declarations on a motion to dismiss and instead opted to limit initial discovery—after the discovery stay imposed by the PSLRA was lifted—to depositions of the confidential witnesses to test the veracity of their statements. In *In re Millennial Media Securities Litigation*, the court, when faced with plaintiffs' request to amend the complaint to remove allegations by a certain confidential witness who no longer wished to be cited in the complaint, ordered that plaintiffs' counsel and the confidential witness submit an affidavit describing how the witness came to be quoted in the complaint. In *City of Pontiac General Employees' Retirement v. Lockheed Martin*, the district court sua sponte ordered five recanting confidential witnesses and the plaintiff's investigator to appear in court and provide testimony in connection with the defendants' motion for summary judgment. These tools have allowed courts to delve into the veracity of confidential witness statements and explore potential ethical violations.

Fourth, courts are troubled by plaintiffs' practice of filing complaints utilizing information obtained by investigators through interviews of confidential witnesses without having any attorney contact the witnesses. To be clear, courts have not discouraged this practice and have recognized that it is a common and cost-effective manner of investigating claims. However, more than one court has noted that it is a "best practice" for counsel to notify the confidential witness of their intention to designate the individual as a confidential witness in the complaint and verify statements that the counsel intends to attribute to that witness. Courts have made clear that sanctions will be imposed in egregious cases where plaintiffs' counsel fails to do so and/or ignores serious red flags. Courts have also emphasized that repeated misconduct by a given law firm will support future Rule 11 sanctions.

Fifth, courts seem to have accepted that the problems associated with confidential witnesses are an unavoidable consequence of the PSLRA and the Supreme Court's decision in *Tellabs*. As the U.S. District Court for the Southern District of New York noted:

"It seems highly unlikely that Congress or the Supreme Court, in demanding a fair amount of evidentiary detail in securities class action complaints, intended to turn plaintiffs' counsel into corporate "private eyes" who would entice naïve or disgruntled employees into gossip sessions that might help support a federal lawsuit. Nor did they likely intend to place such employees in the unenviable position of having to account to their employers for such indiscretions, whether or not their statements were accurate. But, as it is, the combined effect of the PSLRA and cases like *Tellabs* are likely to make such problems endemic."

How Should Confidential Witnesses Be Handled?

For better or worse, confidential witnesses have become a fixture of private securities litigation. With the heightened pleading standards imposed by the PSLRA and *Tellabs*, plaintiffs often have no choice but to engage in pre-pleading investigations designed to identify witnesses, whose statements can be cited throughout the complaint, in the hopes that these allegations will be enough to survive a motion to dismiss. However, in their zeal to get past the pleadings stage, plaintiffs counsel must be mindful of the obligations imposed on them by Rule 11. Plaintiffs counsel needs to work carefully with investigators to ensure that appropriate mechanisms are in place to confirm the accuracy of the statements attributed to confidential witnesses. Although it may not be strictly required by Rule 11, confidential witnesses should be informed that plaintiffs counsel may designate the individual as a confidential witness in the complaint and may attribute statements and quotes to that individual. Before filing a complaint that refers to the confidential witness, the confidential witness should be shown a copy of the complaint and asked to verify the accuracy of allegations relating to that individual. Further, plaintiffs counsel or the investigator should advise the confidential witness of the possibility that the individuals' name might be disclosed during the course of discovery. Following these best practices will help prevent inaccuracies, provide compelling evidence that the complaint comports with the Rule 11 requirements, and reduce the likelihood that the confidential witness will later attempt to recant his or her testimony or refuse to participate in the litigation.

When facing a complaint laden with confidential witness allegations, defense counsel should carefully scrutinize these allegations and consider whether they raise confidentiality or privilege concerns. Defense counsel should take steps to contact the confidential witnesses to determine if they actually said what is attributed to them. If material discrepancies are identified, defense counsel should try to obtain recanting declarations from the confidential witnesses as soon as possible. Defendants should advocate for limited discovery in connection with a motion to dismiss to test the veracity of the confidential witnesses' statements. If potential discrepancies relating to the confidential witness allegations are uncovered after a decision on a motion to dismiss, defendants should ask for an order staying all deadlines and limiting initial discovery to depositions of the confidential witnesses. Such discovery could reveal significant problems in the complaint relating to the very statements relied upon by the court as a basis for denying a motion to dismiss. By staging discovery in this manner and teeing up a motion for reconsideration, the defendants could succeed in having a case dismissed or settled before a battle on class certification and merits discovery.

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