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RECENT TRENDS REGARDING THE USE OF CONFIDENTIAL WITNESSES IN SECURITIES LITIGATION

Recent decisions by the courts have shown what the authors describe as a "growing distrust" of confidential witnesses. Discovery concerning confidential witnesses has been compelled at earlier stages in litigation, and cases have been dismissed when confidential witnesses recanted information attributed to them by plaintiffs as the basis for allegations in complaints.

By Paul C. Gluckow and David B. Edwards *

Confidential witnesses have been increasingly relied upon as a means to attempt to satisfy the heightened pleadings standards of the Private Securities Litigation Reform Act ("PSLRA"). But confidential witnesses have become an ever more complicated tactic for plaintiffs since the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, which held that courts must take into account plausible opposing inferences when deciding whether scienter is adequately pled in a complaint.[1] In addition to the ongoing debates about the extent to which confidential witnesses can be trusted[2] and whether their allegations must be discounted,[3] several recent decisions may signal that courts are viewing confidential witnesses more critically in certain other respects.

[1] 551 U.S. 308 (2007).

[2] *See, e.g.*, *Higginbotham v. Baxter Int'l Inc.*, 495 F.3d 753, 756-57 (7th Cir. 2007) ("[I]t is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences. Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist.").

[3] *See, e.g.*, *Glaser v. The9, Ltd.*, 772 F. Supp. 2d 573, 590 n.12 (S.D.N.Y. 2011) ("It appears that a split exists in this District as to whether the use of confidential witnesses to plead securities fraud cases remains viable following the Supreme Court's decision in *Tellabs*. *Compare In re MRU*, 2011 WL 650792, at *14 (Berman, J.) ('Plaintiff's reliance on confidential witnesses . . . must be discounted . . . .' (citing *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 756-57 (7th Cir. 2007) (citing *Tellabs*, 551 U.S. at 314, 127 S.Ct. 2499))), *with In re PXRE*, 600 F. Supp. 2d at 526 (Sullivan, J.) (quoting *Higginbotham*, but stating, '[t]he Court declines to follow this approach absent guidance from the Second Circuit, and will continue to consider allegations based on information provided by confidential sources without discounting those allegations due *solely* to the anonymity of the information's source,' and collecting cases).").

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First, there has been a string of recent decisions holding that confidential witnesses in securities litigations must be named and identified during traditional discovery. Second, two cases, *Campo v. Sears Holdings Corp.*,[4] and *City of Livonia Emps.' Ret. Sys. v. Boeing Co.*,[5] have taken particularly novel approaches to analyzing, and ultimately dismissing, securities litigations based on complications that arose from plaintiffs' use of confidential witnesses.

DISCLOSURE OF CONFIDENTIAL WITNESSESS DURING DISCOVERY – RECENT SOUTHERN DISTRICT OF NEW YORK CASES

It is largely undisputed that plaintiffs must include the names of confidential witnesses (often among many other names) in their initial Rule 26(a) disclosures as individuals with relevant information,[6] but there has been some disagreement as to whether plaintiffs must also identify which of the disclosed individuals were relied upon as confidential witnesses.[7] A string of recent cases in the Southern District of New York, from three different judges, signals that court's growing reticence to allow confidential witnesses to remain confidential throughout the entirety of the litigation.[8]

Plumbers & Pipefitters Local Union No. 630 Pension-Annuity Trust Fund v. Arbitron kicked off this recent run of cases last November with a lengthy rejection of the work product doctrine as a means for protecting the identities of confidential witnesses.[9] As an initial matter, the *Arbitron* court held that identifying the witnesses would not reveal attorney work product, because the witnesses' names were already disclosed and requiring plaintiffs to simply identify them would, at most, allow opposing counsel to guess at the mental impressions of plaintiffs' counsel. Importantly, the court held that identification would not reveal to defendants which witnesses plaintiffs' counsel thought were most helpful to the case and would not expose trial strategies that were not already self-evident from the complaint. In addition, the court found that non-disclosure would not actually protect the witnesses' identities in the long term, but only serve to elongate the discovery process by burdening defendants with the responsibility of deposing every individual revealed in the Rule 26(a) disclosures in order to determine who was a confidential witness. Finally, the court noted that to the extent the work product doctrine applied, the plaintiffs waived it by "showcasing" the confidential witnesses in the complaint. In summarizing its holding, the court noted that while "entirely proper and common for a plaintiff to rely on confidential witnesses in a complaint . . . . once the discovery phase begins, the balance of interests shifts. The priority becomes reciprocal and robust fact-gathering as the parties seek to discover relevant evidence."[10]

In January and March of 2012, two more cases – *In re Am. Int'l Grp., Inc. 2008 Sec. Litig.* and *In re Bear Stearns Co., Inc. Sec., Derivative & ERISA Litig.* – echoed *Arbitron*'s reasoning and also found that the work product doctrine did not apply to the identities of

[4] 635 F. Supp. 2d 323, 324-25 (S.D.N.Y. 2009).

[5] No. 09-7143, 2011 WL 824604 (N.D. Ill. Mar. 7, 2011).

[6] *See, e.g., Plumbers & Pipefitters Local Union No. 630 Pension-Annuity Trust Fund v. Arbitron, Inc.*, 278 F.R.D. 335, 338 (S.D.N.Y. 2011).

[7] *See, e.g., In re SLM Corp. Sec. Litig.*, No. 08-1029, 2011 WL 611854, at *1 (S.D.N.Y. Feb. 15, 2011) (holding that the work product doctrine protected plaintiffs from identifying which individuals disclosed pursuant to Rule 26(a) were confidential witnesses); *In re Veeco Instruments, Inc. Sec. Litig.*, No. 05-0169, 2007 WL 274800, at *1 (S.D.N.Y. Jan. 29, 2007).

[8] *See In re Am. Int'l Grp., Inc. 2008 Sec. Litig.*, No. 08 Civ. 4772, 2012 WL 1134142, at *3-5 (S.D.N.Y. Mar. 6, 2012); *In re Bear Stearns Co., Inc. Sec., Derivative & ERISA Litig.*, No. 08-02793, 2012 WL 259326, at *2-3 (S.D.N.Y. Jan. 27, 2012); *Plumbers*, 278 F.R.D. at 338-344.

[9] The court also addressed and rejected the applicability of protective orders to guard against the risk of retribution by confidential witnesses' current, future, or past employers. *Plumbers*, 278 F.R.D. at 344. The court noted that the witnesses failed to demonstrate a reliable, non-conclusory basis for a risk of retaliation and thus were not entitled to entry of a protective order. *Id.*

[10] *Plumbers*, 278 F.R.D. at 341.

confidential witnesses, or if it did, the protection was overcome by the burden that would be imposed on defendants to ascertain which individuals were confidential witnesses. In doing so, *In re Bear Stearns* noted that the "case law regarding the application of the work product doctrine to motions to compel the names of a witness, referenced but not named in the complaint, is not uniform."[11] But nonetheless, the court found against the work product doctrine, in part "based on this District's most recent jurisprudence . . . ."[12] Similarly, the *AIG* Court relied on the reasoning in *Arbitron* and ordered the plaintiffs to identify the confidential witnesses.

DISCOVERY OF CONFIDENTIAL WITNESSES AT THE MOTION TO DISMISS STAGE - *CAMPO V. SEARS HOLDINGS CORP.*

The decisions in *Arbitron*, *AIG*, and *In re Bear Stearns* all involved efforts to unmask confidential witnesses *after* motions to dismiss had been denied and during the formal discovery process. However, a recent Second Circuit decision may have altered the typical timing dynamic by approving of depositions of confidential witnesses in connection with defendants' motion to dismiss to determine whether "confidential witnesses acknowledged the statements attributed to them in the complaint."[13]

Campo involved a putative class action brought on behalf of former shareholders who alleged that Kmart Corporation withheld information about the value of its real estate to suppress the price of its shares.[14] Importantly, the plaintiffs' complaint relied largely on three confidential witnesses to allege conscious misbehavior or recklessness to establish scienter. The court denied the defendants' initial motion to dismiss, but did so without prejudice, and permitted the defendants to depose the confidential witnesses to determine whether they supported the allegations in the complaint or whether the court should have granted defendants' motion to dismiss. The depositions revealed that the confidential witnesses' statements could not support the allegations in the complaint, because, among other things, none of the confidential witnesses had any contact with the alleged wrongdoers and two of them had left the company before the alleged class period had even begun. Accordingly, the court granted the defendants' renewed motion to dismiss for failure to state a claim.

On appeal, the Second Circuit approved of the district court's order requiring "that the confidential witnesses referenced in the complaint be deposed" to assist the court in resolving defendants' motion to dismiss. The Second Circuit commented that the "anonymity of the sources of plaintiffs' factual allegations concerning scienter frustrates the requirement, announced in *Tellabs*, that a court weigh competing inferences to determine whether a complaint gives rise to an inference of scienter that is 'cogent and at least as compelling as any opposing inference of non-fraudulent intent.'"[15] The Second Circuit also found that because Federal Rule 11 "requires that there be a good faith basis for the factual and legal contentions contained in a pleading, the district court's use of the confidential witnesses' testimony to test the good faith basis of plaintiffs' compliance with *Tellabs* was permissible."[16] The Second Circuit emphasized that the district court did not make credibility determinations or weigh competing testimony, but instead merely "relied upon the deposition testimony for the limited purpose of determining whether the confidential witnesses acknowledged the statements attributed to them in the complaint."[17] Indeed, the Second Circuit itself relied on the depositions to affirm the dismissal order given that the testimony of the confidential witnesses did not support plaintiffs' allegations of scienter. The only court to date that has addressed the ruling in *Campo* has rejected it as, among other things, an overbroad reading of *Tellabs*.[18]

POTENTIAL DANGERS OF USING CONFIDENTIAL WITNESSES - *CITY OF LIVONIA EMPS.' RET. SYS. V. BOEING CO.*

Even if a plaintiff can avoid being forced to reveal the identities of confidential witnesses early in a case, two factors often make confidential witnesses a treacherous endeavor in the long run. First, to satisfy *Tellabs*, plaintiffs must plead sufficient information about a confidential witness to establish the witness' credibility while simultaneously disguising that same information to protect the witness' identity. Second, when

[11] *In re Bear Stearns*, 2012 WL 259326, at *3.

[12] *Id.*

[13] *Campo v. Sears Holding Corp.*, 371 Fed. Appx. 212, 216 n.4 (2d Cir. 2010).

[14] *Campo*, 635 F. Supp. 2d at 324-25.

[15] *Campo*, 371 Fed. Appx. at 217 n.4.

[16] *Id.*

[17] *Id.*

[18] *See In re Cell Therapeutics, Inc.*, 2010 WL 4791808, at *2 (W.D. Wash. Nov. 18, 2010).

eventually confronted, confidential witnesses may recant, either contradicting or denying the statements attributed to them or the background information used to describe them in the complaint. At best, a recanting confidential witness creates discrepancies that plaintiffs can attempt to explain away through faulty memory, the passage of time, or a whistleblower's desire to stay in the good graces of the defendant.[19] But, at worst – in *City of Livonia Emps.' Ret. Sys. v. Boeing Co.*,[20] for example – a recanting confidential witness can result in dismissal and/or sanctions due to lack of adequate evidentiary support.

The *Boeing* case had, as colorfully described by the district court, "a cast of characters . . . worthy of a contemporary novel," and featured a confidential witness that allegedly had first-hand information that executives had deceived investors.[21] However, after the defendants' motion to dismiss was denied and the confidential witness was interviewed and deposed, the confidential witness categorically denied the information attributed to him and further denied even being an employee of Boeing as was claimed in the complaint.

The court, displeased with the plaintiffs' apparent deception, granted a motion for reconsideration of the defendants' motion to dismiss. In doing so, the court held that "[i]t matters not whether, as plaintiffs argue, [the former confidential witness] told their investigators the truth, but he is lying now for ulterior motives. The reality is that the informational basis for [the allegations] is at best unreliable and at worst fraudulent, whether it is [the former confidential witness] or plaintiffs' investigators who are lying."[22] Notably, *Boeing*'s dismissal for failure to meet the pleading standards occurred in spite of post-motion to dismiss discovery that arguably dispensed with the need for the confidential witness. As the court held, this argument begs the question: was it error under the PSLRA to deny defendants' motion to dismiss the complaint?

Boeing's strong reaction to the complaint's lack of adequate evidentiary support has been echoed in other decisions. For example, one court has sanctioned plaintiffs for incorrectly stating that a confidential witness was employed within a certain division of a corporate defendant when it was revealed through discovery that she actually worked in a separate division where she had no access to the relevant information.[23] In another case, a Rule 11 violation was found where plaintiffs pled a specific number in an allegation where confidential witnesses testified that they had only given plaintiffs averages or guesses.[24] However, fallout from recanting or undermined confidential witnesses may diminish after litigation has significantly progressed. In at least one case, a court has refused to dismiss a case after class certification was granted because "it would unfairly penalize class members who played no role in [any confidential witness] wrongdoing."[25]

CONCLUSION

Recent cases have shown a growing distrust of confidential witnesses. Even in the more routine decisions, courts have moved toward embracing full disclosure of the identities of confidential witnesses during traditional discovery. And where confidential witnesses have recanted, *Campo* and *Boeing* have demonstrated the willingness of courts to revisit their decision that the pleadings satisfied the standards of the PSLRA. ■

[19] *See, e.g., In re BankAtlantic Bancorp, Inc. Sec. Litig.*, No. 07-61542, slip op. at 20-24 (S.D. Fla. Aug. 2, 2011).

[20] No. 09-7143, 2011 WL 824604 (N.D. Ill. Mar. 7, 2011).

[21] *Id.* at *1.

[22] *Id.* at *4.

[23] *In re BankAtlantic Bancorp, Inc. Sec. Litig.*, No. 07-61542 (S.D. Fla. Aug. 2, 2011).

[24] *In re Star Gas Sec. Litig.*, 745 F. Supp. 2d 26, 36-37 (D. Conn. 2010).

[25] *In re Dynex Capital, Inc. Sec. Litig.*, No. 05-1897, 2011 WL 2581755, at *3 (S.D.N.Y. Apr. 29, 2011).