

## IN FOCUS

# COMPLEX LITIGATION

## Sometimes, the witness is a cipher

Securities fraud cases may proceed on the word of confidential informants, but there are limits.

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THE USE OF INFORMATION obtained from confidential sources in complaints alleging securities fraud under §10(b) of the Securities Exchange Act of 1934 raises important legal issues at the pleading stage. The resolution of these issues requires balancing plaintiffs' desire to protect the identity of individuals who approach them with allegations of corporate wrongdoing and fear retaliation for doing so, against defendants' need for sufficient information to address anonymous allegations on a motion to dismiss.

This article will focus on three decisions that address these issues at the pleading stage: *Makor Issues & Rights Ltd. v. Tellabs Inc.*, 513 F.3d 702 (7th Cir. 2008) (the remand of the Supreme Court's decision in *Tellabs v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007)); *In re Cabletron Systems Inc.*, 311 F.3d 11 (1st

Cir. 2002); and *Higginbotham v. Baxter International Inc.*, 495 F.3d 753 (7th Cir. 2007).

(This article does not address the question of when the names of confidential witnesses should be disclosed. Specifically, the authors do not address whether the names of confidential witnesses should be disclosed at the pleading stage.)

These decisions set forth an approach to evaluating the weight to be accorded to allegations based on information provided by confidential witnesses when determining whether a complaint has adequately pleaded scienter. Under § 10(b) and the Private Securities Litigation Reform Act (PSLRA), in order to adequately plead scienter, a plaintiff must allege facts that give rise to "a strong inference" of an intent to deceive. Moreover, the pleading of scienter must comply with the Supreme Court's directive in *Tellabs*, 127 S. Ct. at 2510, that "the inference of scienter [must be] cogent and at least as compelling as any opposing inference one could draw from the facts alleged."

In *Cabletron*, the 1st U.S. Circuit Court of Appeals established a list of factors that should be considered in evaluating the credibility of information alleged in a complaint to have been provided by confidential sources. It held that the weight accorded to the information will depend on all the circumstances alleged in the complaint concerning each source and the quality of the information provided, including, inter alia, the following:

- The means by which the confidential source came to possess the information.

- The level of detail provided by the confidential source.

- The corroborative nature of other facts alleged.

- The coherence and plausibility of the confidential source's allegations.

- The likelihood that the confidential source has personal knowledge of the information provided.

- The number of sources of the information. *Cabletron*, 311 F.3d at 28-30.

Thus, *Cabletron* calls for a review of "the totality of the circumstances" alleged about information from confidential sources to determine what, if any, weight the information should be accorded in the scienter analysis. The inference to be drawn from the facts pleaded that are derived from confidential sources should then be considered together with other facts pleaded to determine whether, as a whole, the facts meet the pleading standard for scienter set forth in the PSLRA (facts giving rise to a strong inference of scienter) and *Tellabs*.

Other courts have followed the *Cabletron* approach. See, e.g., *In re Daou Sys. Inc. Secs. Litig.*, 411 F.3d 1006, 1029 (9th Cir. 2005), cert. denied, 546 U.S. 1172 (2006). Employing the factors outlined in *Cabletron*, some courts have determined at the pleading stage that specific information provided by confidential sources lacked sufficient indicia of reliability to support a finding of scienter. See, e.g., *Limantour v. Cray Inc.*, 432 F. Supp. 2d 1129 (W.D. Wash. 2006) (vague and conclusory statements by confidential sources do not support inference of scienter); *In re Portal Software Inc. Secs. Litig.*, No. C-03-5138, 2006 WL 2385250, at \*8 (N.D. Calif. Aug. 17, 2006) ("[P]laintiffs must describe the job

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title, job description, duties, and dates of employment for the [confidential] sources.”).

The 7th Circuit addressed these issues in *Higginbotham*, 495 F.3d at 756-57. The *Higginbotham* court said that “[o]ne upshot of the approach that *Tellabs* announced is that we must discount allegations that the complaint attribute[s] to five ‘confidential witnesses,’” who in *Higginbotham* consisted of ex-employees and outside consultants of a parent company that was being sued in connection with allegedly fraudulent accounting practices conducted by its Brazilian subsidiary. *Id.* The opinion explained that “[u]sually, that discount [of confidential witness allegations] will be steep” because “[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.” *Id.* at 757.

Only months later, the 7th Circuit addressed the issue again in the decision on remand in the *Tellabs* case. Noting that *Higginbotham* “was a very different case from this one,” the court gave some weight to the allegations from anonymous informants because it found that the allegations, based on all the circumstances alleged, were worthy of consideration. See *Tellabs*, 513 F.3d at 711-12. The court determined that there were numerous confidential sources listed in the *Tellabs* complaint “who from the description of their jobs were in a position to know at first hand the facts to which they are prepared to testify,” that the information they provided was “set forth in convincing detail” and that some of information was “corroborated by multiple sources.” *Id.* at 712.

### Absence of proper name

Importantly, the court said that it would be better if the confidential witnesses had been identified in the complaint because “it would be easier to determine whether they had been in a good position to know the facts that the complaint says they learned.” The court nonetheless concluded that “the absence of proper names does not invalidate the drawing of a strong inference from informants’ assertions.” *Id.*

*Higginbotham* can be viewed as stating the applicable rule when the circumstances provide less than compelling support for the credibility of confidential witness information. The *Tellabs* remand decision can be seen

as establishing the approach when the complaint contains allegations that tend to strongly support the credibility of the confidential witness’s information.

Additional recent decisions that demonstrate similar approaches to evaluating confidential source allegations include *In re Intelgroup Securities Litigation.*, No. 04-4980, 2007 WL 3376743 (D.N.J. Nov. 13, 2007). There, the court refused to consider allegations based on statements made by six witnesses who were identified only by job title. The court held that a statement that circumstances relating to the defendant’s alleged fraud were “common knowledge” within the company “lacks any imprimatur of reliability,” because the confidential witness did not explain how he or she acquired such knowledge. *Id.* at \*76.

The court found that a confidential witness’s observations as to the defendant’s accounting practices were “wholly unreliable,” as the complaint failed to explain how the source, who was not part of the defendant’s accounting department, obtained personal knowledge about the nature of the defendant’s accounting methods. *Id.* at \*80. See also *In re Dura Pharm. Inc. Secs. Litig.*, No. 99 CV 0151, 2008 WL 483613, at \*10 (S.D. Calif. Feb. 20, 2008) (holding that the confidential source was not reliable with respect to allegations of meetings among senior management and with U.S. Food and Drug Administration officials when the complaint did not explain how the source would know about such meetings); *In re Scottish Re Group Secs. Litig.*, 524 F. Supp. 2d 370, 392-93 (S.D.N.Y. 2007) (allegations were sufficiently particularized when confidential sources “occupied positions that would have allowed for relevant hands-on experience in various parts of the Company”).

Because a court must accept all well-pleaded allegations in a complaint as true, absent an evaluation of the allegations under the approaches outlined in *Higginbotham*, the *Tellabs* opinion on remand and *Cabletron*, a complaint might withstand a motion to dismiss based solely on information provided by confidential witnesses that is unreliable. For example, a complaint theoretically could survive a motion to dismiss—and a defendant could be forced to engage in expensive and protracted discovery and be subjected to economic and reputational risk—even if the confidential witnesses’s information was untrue or based on rumor or misunderstanding.

These decisions suggest that courts should apply a two-step analysis in evaluating allegations from confidential sources contained in securities complaints. First, a court should examine allegations based on information from the confidential witnesses in light of the circumstances pleaded that bear upon the reliability of the information. Courts will consider factors, such as the means by which the confidential source came to possess the information, the level of detail provided and the existence of corroborating facts, in assessing the weight to be accorded to the information. The failure to satisfy these factors will, as suggested by *Higginbotham*, result in a discounting of the allegations, which will usually be steep.

Second, the inference to be drawn from the facts pleaded concerning information obtained from confidential witnesses should be considered together with the other allegations in the complaint to determine whether the complaint as a whole meets the strong-inference pleading standard for scienter under the PSLRA and the Supreme Court’s decision in *Tellabs*. This analysis is crucial in assessing the reliability of confidential source information, because the defendants may not have the opportunity do so in discovery at the motion-to-dismiss stage. They must therefore rely on courts to distinguish between allegations that should be accorded some weight at the pleading stage and those that should not. **NLJ**