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Unmasking Confidential Witnesses?

Law360, New York (June 23, 2010) -- One hotly debated issue in securities law jurisprudence is reliance in a complaint upon information from supposed "confidential witnesses." Plaintiffs frequently use these anonymous sources to try to bolster their allegations, especially scienter allegations.

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Since the United States Supreme Court's decision in Tellabs Inc. v. Makar Issues & Rights Ltd.,[1] and the Seventh Circuit Court of Appeals' decision in Higginbotham v. Baxter International Inc.,[2] the Circuits have come closer to reconciling the treatment of confidential witnesses.

There is general agreement that plaintiffs may rely on confidential sources provided the complaint includes "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."[3]

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Such specificity is required because, as the court explained in Higginbotham, "[p]erhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist."[4]

The particularized allegations regarding the confidential witnesses must be pled in the complaint. The U.S. District Court for the Northern District of Illinois, in City of Livonia Employees' Retirement System v. The Boeing Co., recently refused to allow plaintiffs to provide the information relating to the confidential witnesses in camera.[5]

The District Court for the Southern District of Florida, in Hubbard v. BankAtlantic Bancorp Inc., similarly refused to allow information regarding confidential witnesses to be provided in camera, stating, "the Court is not persuaded that providing information in this manner would be appropriate under the PSLRA."[6]

There is also general agreement that absent highly particularized allegations, confidential witness allegations should be discounted, and often steeply so. In December 2009, the Sixth Circuit, in Konkol v. Diebold Inc., relied on Higginbotham and cautioned that "[e]ven less weight should be given to the Confidential Witnesses' allegations due to the lack of information about them."[7] A couple months earlier, in October 2009, the Sixth Circuit also "steeply discounted" the allegations of a confidential witness in Indiana State District Council of Laborers v. Omnicare Inc.[8]

The Southern District of New York has gone a step further (and has been upheld on appeal to the Second Circuit): It has ordered that confidential witnesses be deposed at the motion to dismiss stage.

Background

The District Court

In Campo v. Sears Holdings Corp.,[9] former shareholders of Kmart Holding Corporation ("Kmart") sued Sears Holdings Corporation (the legal successor to Kmart), the former chairman of Sears, and the former chief executive officer of Kmart, for alleged violations of the Securities Exchange Act of 1934.

They claimed that defendants knowingly made statements that substantially undervalued Kmart's real estate assets during and in the immediate wake of its reorganization to artificially suppress the price of the company's stock, thereby violating section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

Plaintiffs' allegations were made on information and belief and, allegedly, on the direct personal knowledge of three unnamed witnesses. Relying on allegations attributed to these confidential witnesses, plaintiffs alleged, among other things, that defendants either knew or should have known the true value of Kmart's real estate because they had access to Real Estate Marketing Strategy (REMS) reports that contained non-public detailed information concerning the value of Kmart's leaseholds.

Defendants moved to dismiss the Consolidated Class Action Complaint ("complaint") on the ground that it failed to state a legally sufficient claim. On April 15, 2008, the late Judge John E. Sprizzo denied defendants' motion without prejudice based on information in the complaint that the three confidential witnesses allegedly supplied. Judge Sprizzo ordered the depositions of the confidential witnesses to determine whether they supported the complaint's allegations and whether he should have granted defendants' motion to dismiss.[10]

District Judge Lewis Kaplan, to whom the case was reassigned, ultimately dismissed the complaint. Judge Kaplan determined that plaintiffs had not alleged adequately circumstances indicating that any of the challenged statements were false or misleading at the time they were made and that plaintiffs' allegations were insufficient to give rise to a strong inference of scienter. His opinion made specific references to the deposition testimony of the confidential witnesses.[11]

The Second Circuit Court of Appeals

Plaintiffs appealed the dismissal to the Second Circuit Court of Appeals,[12] which unanimously affirmed the judgment of the district court. Citing Tellabs and Higginbotham, the Second Circuit found that the district court did not err by ordering that the confidential witnesses be deposed:

"To assist it in resolving defendants' motion to dismiss, the district court ordered that the confidential witnesses referenced in the complaint be deposed. ... 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 nonfraudulent intent.'[13]

The Second Circuit further pointed out that, because Rule 11 requires that there be a good faith basis for the factual and legal contentions in a complaint, "the district court's use of the confidential witnesses' testimony to test the good faith basis of plaintiffs' compliance with Tellabs was permissible. The court made no credibility determinations, nor did it weigh competing testimony. To the contrary, it relied upon the deposition testimony for the limited purpose of determining whether the confidential witnesses acknowledged the statements attributed to them in the complaint."[14]

In assessing whether plaintiffs adequately alleged scienter, the Second Circuit relied, in part, on the "testimony" of the confidential witnesses. The court noted, for example, that "CW1" "expressly disclaimed" allegations attributed to him in the complaint.[15]

The court also explained that neither of the confidential witnesses "offered testimony supporting plaintiffs' allegations that the REMS reports contained information regarding the value of Kmart's leaseholds ..."[16] The Second Circuit concluded that "plaintiffs' complaint fails to give rise to a strong inference of scienter and that dismissal of the section 10(b) and Rule 10b-5 claims was proper."[17]

Implications of Campo

Many securities litigators believe Campo is a step in the right direction.

First, plaintiffs may be more careful in attributing information to confidential witnesses if they know such witnesses could be deposed at the motion to dismiss stage.

Second, since "[t]here is no 'informer's privilege' in civil litigation,"[18] defendants are entitled to learn the identity of confidential witnesses during discovery. Why, then, conceal their names at the pleading stage? In securities litigation, the motion to dismiss serves a critically important gate-keeping purpose. If plaintiffs can withstand a motion to dismiss, a defendant may elect to settle — not because the case has merit, but to avoid the immense cost of discovery and distraction to the company.

If a motion to dismiss is denied based upon statements attributed to a confidential witness who later disclaims or denies those statements, the company will likely have to wait until summary judgment (perhaps many months or years down the road) to demonstrate the inconsistency to the court. But that frustrates the PSLRA, which was enacted to weed out meritless securities fraud claims at the motion to dismiss stage, not on summary judgment.

Only time will tell whether more courts will allow confidential witnesses to be deposed for the limited purpose of testing the accuracy and sufficiency of a securities fraud complaint. But what does appear to be clear is that confidential witness allegations will continue to be severely scrutinized.

—-By Joseph C. Weinstein (pictured) and Joseph P. Rodgers, Squire Sanders & Dempsey LLP

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

[2] 495 F.3d 753 (7th Cir. 2007).

[3] Institutional Investors Group v. Avaya Inc., 564 F.3d 242, 263 (3d Cir. 2009).

[4] 495 F.3d at 757.

[5] No. 09 C 7143, slip op. (May 25, 2010).

[6] 625 F. Supp. 2d 1267, 1284 n.13 (S.D. Fla. 2008). In In re DOT Hill Systems Corp. Securities Litigation, 594 F. Supp. 2d 1150, 1162 (S.D. Cal. 2008), the District Court for the Southern District of California similarly stated that "[t]he Court has found no precedent in the law of federal securities fraud allowing in camera review of details about confidential witnesses (as plaintiffs propose) instead of pleading those details within the complaint."

[7] 590 F.3d 390, 399 (6th Cir. 2009).

[8] 583 F.3d 935, 946 (6th Cir. 2009).

[9] 635 F. Supp. 2d 323 (S.D.N.Y. 2009).

[10] Id. at 330 n. 54.

[11] Id. at 336 n. 96, 97, 98.

[12] Campo v. Sears Holdings Corp., 2010 U.S. App. LEXIS 7043 (2d Cir. Apr. 6, 2010).

[13] Id. at 7 n.4.

[14] Id.

[15] Id. at *11.

[16] Id. at *10.

[17] Id. at *12.

[18] Higginbotham, 495 F.3d at 757; Hubbard v. BankAtlantic Bancorp, Inc., 2009 U.S. Dist. LEXIS 112190, at *15 (S.D. Fla. Nov. 17, 2009) ("If Congress wished to create an informer's privilege for confidential witnesses in PSLRA case, it knew how to do so and could have done so.").