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SECURITIES CLASS ACTION LITIGATION

Back to 'Novak': Confidential Witnesses in Fraud Actions

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Since the enactment of the Private Securities Litigation Reform Act (PSLRA) in 1995, the pleading of the accounts of confidential witnesses in securities fraud complaints has become common practice. The PSLRA, which heightened the pleading requirements for securities fraud actions brought under §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, requires that a securities fraud complaint containing allegations based on information and belief 'state with particularity all facts on which that belief is formed.' [15 U.S.C. §78u-4\(b\)\(1\)](#).

The PSLRA also mandated a stay of discovery during the pendency of a motion to dismiss in all federal securities fraud cases. [15 U.S.C. §78u-4\(b\)\(3\)\(B\)](#). With heightened pleading requirements and no discovery, plaintiffs were forced to look to new ways to plead their fraud claims with specificity. As a result, plaintiffs began relying on the pleading of confidential witness accounts. Many of these confidential witnesses are former employees of the defendant corporation and wish to remain anonymous to avoid retaliation or harm to their reputation in the industry.

Defendants regularly argue that courts should disregard confidential witness allegations. Initially, defendants argued that the witnesses' names were part of 'all facts' that the PSLRA required plaintiffs to plead and, therefore, plaintiffs had to provide the witnesses' names. [FN1] When courts rejected this argument, defendants contended that the anonymity rendered confidential witnesses unreliable and precluded defendants from determining whether the witnesses were disgruntled former employees, whether the information was fabricated or whether the witnesses even existed. Predictably, there has been extensive litigation over the extent of information that plaintiffs are required to disclose in describing confidential witnesses at the pleading stage and the weight to be given to those allegations.

Case law concerning the use of confidential witnesses has been anything but uniform. In a recent decision, [Higginbotham v. Baxter Int'l Inc., 495 F.3d 753 \(7th Cir. 2007\)](#) (Higginbotham), the U.S. Court of Appeals for the Seventh Circuit discussed heavily discounting the use of confidential witnesses in securities fraud cases. Then, in [Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 711-12 \(7th Cir. 2008\)](#) (Tellabs II), the Seventh Circuit distinguished Higginbotham and held that the use of confidential witnesses 'does not invalidate the drawing of a strong inference from informants' assertions' and that confidential witnesses can be 'important sources for the allegations not only of falsity but also of scienter.' In *Mizzaro v. Home Depot*, No. 07-13810, 2008 U.S. App. LEXIS 21091, at *16 (11th Cir. Oct. 8, 2008), the Eleventh Circuit recently weighed in, holding that 'the weight to be afforded to allegations based on statements proffered by a confidential source depends on the particularity of the allegations made in each case, and confidentiality is one factor that courts may consider'; however, confidentiality 'should not eviscerate the weight given if the complaint otherwise fully describes the foundation or basis of the confidential witness' knowledge.' At bottom, as with most principles in securities litigation, the standards applied to confidential witness allegations vary.

All of this disputation, however, misses the real issue: whether confidential witness accounts need to be pleaded at all or whether a plaintiff may simply allege the facts derived from plaintiff's investigation which may come

from the accounts of confidential witnesses. Turning back to what has now become one of the seminal cases in securities litigation, [Novak v. Kasaks, 216 F.3d 300 \(2d Cir. 2000\)](#), supports the argument that plaintiffs are not required to plead the accounts of confidential witnesses in order to allege fraud with particularity and may simply allege the facts obtained from those witnesses.

Confidential Witnesses

- And Satisfying the PSLRA's Particularity Requirement. Plaintiffs' practice of pleading of confidential witness accounts can be traced back to early litigation over the interpretation of §78u-4(b)(1) of the PSLRA. This provision requires plaintiffs to identify, with particularity, 'all facts' that support a plaintiff's belief that defendants' statements were false when made. In response to defense arguments that plaintiffs needed to identify 'all facts' supporting their beliefs, plaintiffs started alleging the accounts of confidential witnesses as the source for their allegations. This naturally led to attacks as to the sufficiency of the sources.

In *Novak v. Kasaks*, the Second Circuit held, among other things, that 'notwithstanding the use of the word 'all,' [the PSLRA] does not require that plaintiffs plead with particularity every single fact upon which their beliefs concerning false or misleading statements are based.' [216 F.3d at 313](#). Instead, the PSLRA requires plaintiffs to plead with particularity 'sufficient facts' to support their information and belief allegations. [Id. at 313-14](#). Accordingly, confidential witnesses need not be named as long as the complaint relies on 'other facts' that 'provide an adequate basis for believing that the defendants' statements were false.' [Id. at 314](#). Thus, the court put the focus squarely on the quality of the facts, noting that the PSLRA 'requires plaintiffs to plead only facts and makes no mention of the sources of these facts.' [Id. at 313](#).

At least one district court in the U.S. District Court for the Southern District of New York interpreted *Novak* as endorsing a broad approach to the PSLRA's particularity requirement, which does not require plaintiffs to identify documentary or personal sources in securities fraud complaints. See [In re Philip Servs. Corp. Sec. Litig., 383 F.Supp.2d 463, 478-79 \(S.D.N.Y. 2004\)](#). Instead, the court explained that under *Novak*, the court must look to whether the factual allegations, considered as a whole, 'provide an adequate basis for believing that the defendants' statements were false,' without requiring that the complaint identify the sources of the factual allegations. [Id. at 479](#). The court suggested that in some cases 'the level of factual specificity or the corroborative nature of other facts alleged in a securities fraud complaint might be enough to place defendants on notice of the misconduct alleged and permit them to defend against the charge.' [Id. at 478](#). The court reasoned that this broad interpretation is most consistent with *Novak's* acknowledgment that the PSLRA 'requires plaintiffs to plead only facts and makes no mention of the sources of these facts.' *Id.* The court further explained that 'requiring plaintiffs to identify the sources of their factual allegations would, in effect, compel them to plead evidence in their complaint, thereby undoing the principle of notice pleading that underlies the Federal Rules of Civil Procedure.' *Id.*

The Tenth Circuit in [Adams v. Kinder-Morgan Inc., 340 F.3d 1083 \(10th Cir. 2003\)](#) (*Adams*), adopted a similarly broad interpretation of *Novak* and applied a 'common-sense, case-by-case approach' in determining whether the PSLRA's particularity requirement has been met 'without adding a per se judicial requirement that the source of facts must always be alleged' to support allegations in a complaint. [340 F.3d at 1102](#). The Tenth Circuit noted that the PSLRA only requires the pleading of all 'facts' upon which a plaintiff's beliefs are based, not the sources of those facts. [Id. at 1101](#). The court explained that, 'requiring the allegation of the sources, either documentary or personal, of all facts alleged is...too restrictive a response to the requirement of pleading facts with particularity.' *Id.* Similar to *In re Philip*, the court in *Adams* recognized that 'requiring plaintiffs to identify the source of the facts they allege is to require, in effect, that the plaintiffs plead their evidence in their complaint.' *Id.* Accordingly, the court remained focused on the specificity of the alleged facts, holding that, '[i]n deciding whether the factual allegations support a reasonable belief that fraud occurred, courts should evaluate the facts alleged as a whole, ' including 'the level of detail, number, and coherence and plausibility of the allegations' and 'whether the

allegations are specific enough to be verified or refuted by a defendant without requiring the complaint to disclose how the plaintiff learned of such facts.' [Id at 1102-1103.](#)

Proper Analysis

- Of Confidential Witness Allegations Post-'Tellabs.' In *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court held that in determining whether a securities fraud complaint meets the requirements of the PSLRA and whether 'the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences.' [127 S.Ct. 2499, 2509 \(2007\)](#). Although Tellabs dealt with the issue of pleading scienter, it is pertinent to the issue of confidential witness allegations as confidential witness accounts and the facts therefrom have been considered in determining whether scienter is sufficiently alleged.

In considering the sufficiency of scienter allegations, the Supreme Court held that allegations must be 'accepted as true and taken collectively, would [allow] a reasonable person [to] deem the inference of scienter at least as strong as any opposing inference.' *Id.* at 2511. Justice Samuel Alito noted in his dissent that this holding required courts to accept all allegations as true, even those that the Court may find lack particularity. *Id.* at 2517. Thus, under Tellabs, and consistent with Novak, plaintiffs should not have to allege the accounts of confidential witnesses because the facts derived from those accounts are to be accepted as true by the district court and then assessed for pleading sufficiency.

Conclusion

As a practical matter, such a rule makes sense. How at the motion to dismiss stage, can a court evaluate a witness' account? Witness accounts are for discovery. Although defendants will inevitably continue to argue that plaintiffs are required to plead detailed information concerning the source of their allegations (i.e., the names and details of the confidential witnesses) the PSLRA does not require plaintiffs to describe confidential sources with particularity.

Plaintiffs should continue to press for the broad interpretation of Novak that, as advanced by *In re Philip and Adams*, calls for the determination of whether the facts themselves provide a sufficient basis for the complaint's allegations, without requiring that the complaint identify the sources of those allegations. These cases are consistent with the PSLRA and notice pleading requirements because they focus on the sufficiency of the specificity of the facts as a whole, on case by case basis as counseled by Tellabs.

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FN1. See, e.g., [In re Philip Servs. Corp. Sec. Litig.](#), 383 F.Supp.2d 463, 477 (S.D.N.Y. 2004); *In re Nat'l Golf Props. Sec. Litig.*, No. CV 02-1383- GHK (RZx), 2003 U.S. Dist. LEXIS 4321, at *19 (C.D. Cal. March 18, 2003); [In re PSS World Med. Inc. Sec. Litig.](#), 250 F.Supp.2d 1335, 1346 (M.D. Fla. 2002).

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