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Closer Scrutiny Of 'Confidential Informants'

Law360, New York (April 15, 2009) -- Given the current economic climate, many companies have found it necessary to reduce the size of their work force.

These same companies may also be experiencing a decline in their stock prices as a result of the less than favorable economic conditions. Regrettably, any significant stock price decline may lead to the filing of a securities fraud class action.

If a lawsuit is filed under these facts, it is a virtual certainty that the resulting complaint will be based in large measure on information supposedly gleaned from former employees who will be described as "confidential witnesses" or "confidential informants."

Plaintiffs' counsel regularly employ private investigators to locate former employees in the hopes of discovering information that may be used to attempt to satisfy the heightened pleading requirements that apply to securities fraud claims under the Private Securities Litigation Reform Act (the "Reform Act").[1]

As described below, the Reform Act requires that plaintiffs plead in detail the circumstances of the alleged fraud as well as the basis for their beliefs that a fraud has occurred.[2]

Plaintiffs are also required to plead a strong inference of fraudulent intent — or "scienter" — on the part of each defendant named in the case.[3]

Allegations based on information from confidential sources are often used in an attempt to satisfy these requirements, but are particularly prone to abuse and, thus, require greater scrutiny, as recent court decisions have acknowledged.

Indeed, as discussed below, the law on confidential informants has evolved in a way that is particularly favorable to defendants who face complaints that either implicitly or explicitly attempt to rely on such individuals.

The pleading requirements for confidential informant allegations seek to prevent meritless claims from proceeding to discovery based on the word of unnamed informants, who it may later be revealed had no reasonable basis for knowing "the facts" alleged.

Indeed, it is often the case that the sufficiency of the complaint will turn on information supposedly derived from confidential sources whose identity and work history may be deliberately obscured in the complaint and who may have serious axes to grind with their former employer.

As described below, recent cases provide important safeguards to protect companies and their executives against abuses of this pleading tactic.

Requirements for Pleading Based on Confidential Informants

Allegations based on confidential informants have been common place in securities class actions for many years.

In the wake of the passage of the Reform Act, courts were often called upon to assess whether such allegations met the threshold pleading requirements of the act.

Every Circuit Court to have considered the issue has held that, to survive a motion to dismiss, the plaintiffs must come forward with sufficient corroborating detail to support the probability that the purported informants would have relevant information concerning the defendants' actions.[4]

Courts, for example, often require information such as the confidential informant's job title, work location, individual responsibilities, and specific employment dates.[5]

Courts also look to the detail (or lack thereof) of the information each informant is reported to have provided, whether the statements attributed to them have been corroborated by other sources, and the number of the sources cited in the complaint.[6]

The failure to provide adequate support demonstrating both the informants' personal knowledge and reliability presents sufficient grounds standing alone for dismissal of the complaint.[7]

Moreover, the detail supplied by the confidential informants must be more than corporate "name dropping." In other words, the mere fact that an informant can regurgitate the names of a company's computer systems or internal reports is insufficient to satisfy the particularity pleading requirements of the Reform Act.[8]

The information provided must also rise above the level of mere speculation, vague hearsay and "water cooler gossip." [9] And, if the desired goal is to use the allegations to attempt to plead scienter, the information provided by the confidential informants must directly link the individual defendants to the alleged fraud.[10]

Recent Favorable Trends in the Case Law

In 2007, the Supreme Court issued its first decision on the Reform Act's scienter pleading requirement:

Tellabs Inc. v. Makor Issues & Rights Ltd.[11]

That decision sparked a renewed interest by courts in performing a more exacting review of complaints that rely on information from confidential sources.

Several courts applying Tellabs have held that a heavily reliance on confidential informants frustrates the requirement in Tellabs that the district court must weigh competing inferences to determine whether the plaintiffs have shown the required compelling or cogent inference of fraud.[12]

Indeed, both the Fifth and Seventh Circuits have now held that Tellabs requires a court to apply a stricter standard to confidential informant allegations in the form of a "steep" discount automatically applied to such allegations.[13]

The Seventh Circuit has observed that this additional scrutiny is necessary because "[i]t is hard to see how information from anonymous sources could [ever] be deemed 'compelling' or how we could take account of plausible opposing inferences." [14]

This is so because confidential sources may "have axes to grind[,] ... [be] lying[, or] ... perhaps they don't even exit." [15] In sum, allowing sources to be cloaked with anonymity "obstruct[s] the judiciary's ability to implement the [Reform Act]." [16]

The Covert Use of Confidential Informants

In recent cases, a new tactic has arisen, largely in response to the post-Tellabs case law acknowledging the dangers associated with heavy reliance on confidential informant allegations.

In some cases, plaintiffs have filed complaints that attempt to downplay the extent of their reliance on purported confidential informants in the hopes of avoiding the scrutiny that would necessarily accompany the use of this disfavored pleading technique.

In these complaints, plaintiffs simply do not identify any source for their allegations of nonpublic facts, even though they do not claim to have personal knowledge of the "facts" alleged and would have no means of knowing such information unless they spoke with someone previously affiliated with the company.

This tactic is, however, doomed to failure if the Reform Act is faithfully applied. Where allegations of fraud are not made on personal knowledge or otherwise based on public record facts, the Reform Act requires that the plaintiff must provide "all facts" on which these "information and belief" allegations are based.[17]

Thus, silence as to the basis for information and belief allegations is simply not an option for plaintiffs under the act.[18] Courts have correctly observed that plaintiffs cannot side step the mandatory pleading requirements of the Reform Act simply by failing to acknowledge their existence.[19]

Where the plaintiffs refuse to explain how they would have any means of knowing the nonpublic facts alleged, this omission should be a "red flag" to the court that further detail must be pled before the case may proceed.

If these allegations came from a credible source positioned to have personal knowledge of the facts alleged, then the plaintiffs should have no difficulty in amending their complaint to include such information.

Without the missing information, however, the court cannot perform its duty of assessing compliance with the mandatory pleading requirements of the Reform Act and/or weighing competing inferences as required under Tellabs.

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[1] 15 U.S.C. §§ 78u-4 et seq.

[2] Under the Reform Act, a plaintiff must "specify each statement alleged to have been misleading" and the "reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). Also, when allegations of misstatements or omissions are made "on information and belief," as opposed to personal knowledge, "the complaint shall state with particularity all facts on which that belief is formed." *Id.*

[3] The Reform Act specifically requires that "the complaint shall, with respect to each act or omission alleged ..., state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

[4] See, e.g., *Zucco Partners LLC v. Digimarc Corp.*, 552 F.3d 981, 995-1000 (9th Cir. 2009); *Mizzaro v. Home Depot Inc.*, 544 F.3d 1230, 1239-40 (11th Cir. 2008); *Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group Inc.*, 537 F.3d 527, 535 (5th Cir. 2008); *N.J. Carpenters Pension & Annuity Funds v. Biogen IDEC Inc.* 537 F.3d 35, 51-53 (1st Cir. 2008); *Ley v. Visteon Corp.*, 543 F.3d 801, 811 (6th Cir. 2008); *Teachers' Ret. Sys. of La. v. Hunter*, 477 F.3d 162, 174 (4th Cir. 2007); *Cal. Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 147-56 (3d Cir. 2004).

[5] See, e.g., *Shaw Group*, 537 F.3d at 538; *Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 552 (5th Cir. 2007).

[6] See, e.g., *In re Huffys Corp. Sec. Litig.*, 577 F. Supp. 2d 968, 993 (S.D. Ohio 2008); *In re Dot Hill Sys. Corp. Sec. Litig.*, 594 F. Supp. 2d 1150, 1157 (S.D. Cal. 2008).

[7] See, e.g., *Zucco Partners*, 552 F.3d at 996.

[8] See, e.g., *Hubbard v. BankAtlantic Bancorp, Inc.*, No. 07-61542-CIV, 2008 WL 5250271, at *13-*15 (S.D. Fla. Dec. 12, 2008) (rejecting as insufficient allegations identifying certain internal company reports, committees, and meetings supposedly derived from former employees).

[9] See, e.g., *Zucco Partners*, 552 F.3d at 996-98; see also *Dot Hill Sys.*, 594 F. Supp. 2d at 1163 (rejecting confidential witness allegations from sources of questionable reliability such as "hallway conversations" and vague claims of common knowledge.').

[10] See, e.g., *Mizzaro*, 544 F.3d at 1247-48 (rejecting confidential informant allegations as a basis for pleading scienter where none of the informants claimed to know or have ever met the individual defendants nor stated that "any one of the individual defendants ever discussed the alleged fraud or even knew about it."); *In re Diebold Sec. Litig.*, No. 5:05CV2873, 2008 WL 3927467, at *6 (N.D. Ohio Aug. 22, 2008) (Reform Act not satisfied where "the complaint is lacking in factual particulars that any confidential witness had knowledge regarding exactly what information was known by each individual [d]efendant.')

[11] 551 U.S. 308 (2007).

[12] See, e.g., *Higginbotham v. Baxter Int'l Inc.*, 495 F.3d 753, 757 (7th Cir. 2007); see also *Shaw Group*, 537 F.3d at 535 (noting that "[f]ollowing *Tellabs*, courts must discount allegations from confidential sources [because] [s]uch sources afford no basis for drawing the plausible competing inferences required by *Tellabs*.')

[13] *Higginbotham*, 495 F.3d at 757.

[14] *Id.*

[15] *Id.*

[16] *Id.*; see also *Diebold*, 2008 WL 3927467, at *7 (recognizing that "courts have been hesitant to place reliance on an anonymous source when the Supreme Court has required courts to consider all possible motives, and only to recognize scienter if it is 'cogent' and 'compelling' in the wake of *Tellabs*.')

[17] 15 U.S.C. § 78u-4(b)(1).

[18] See, e.g., *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156, 1166 (9th Cir. 2009) (holding that plaintiff's allegations regarding defendants' statements at board meetings and on other occasions were insufficient due to the failure "to reveal 'the sources of her information'" or otherwise explain how she gained knowledge of these communications); *R2 Invs. LDC v. Phillips*, 401 F.3d 638, 646 n.10 (5th Cir. 2005) (allegations of telephone conversation not considered where plaintiff did not explain the factual basis for its belief that defendants had participated in the conversation in question); *Roth v. OfficeMax Inc.*, 527 F.

Supp. 2d 791, 802 n.13 (N.D. Ill. 2007) (allegations that defendant personally instructed employees to engage in over-billing practices were rejected because “[p]laintiffs have not specified how they know this [conversation occurred] ...”).

[19] See, e.g., Rubke, 551 F.3d at 1166; R2 Invs., 401 F.3d at 646 n.10; Roth, 527 F. Supp. 2d at 802.

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