Bloomberg BNA

Securities Regulation & Law Report™

JURISDICTION AND PROCEDURE

Best Practice for Dealing With Confidential Witness Allegations in Securities Fraud Complaints: The Implications of *In re Millennial Media* and Other Recent Decisions




By Charles Davidow, Richard Rosen, Andrew Ehrlich and Audra Soloway

The recent decision in *In re Millennial Media, Inc. Securities Litigation*, No. 14 Civ. 7923 (PAE), 2015 BL 169156 (S.D.N.Y. May 29, 2015), is the latest in a growing body of case law attempting to combat the abusive use of confidential witness allegations by plaintiffs in federal securities complaints. It is also the first to set forth guideposts for what constitutes the lawful and ethical use of confidential witness statements. The following alert discusses *Millennial Media* and the current state of the case law on this topic, as well as some helpful practices for defense attorneys in investigating confidential witness allegations and using the recent favorable precedent in this area to draw a court's attention to unmeritorious confidential witness allegations at an early stage of the litigation.

Charles Davidow, Richard Rosen, Andrew Ehrlich and Audra Soloway are Partners at Paul, Weiss, Rifkind, Wharton & Garrison LLP. The authors thank Katherine Kelly Fell, a litigation associate with the firm, and Alexander Leone and James Hwang, summer associates with the firm, for their contributions to this article.

Background

The use of confidential witness statements in securities fraud complaints has been a response by the plaintiffs' bar to statutory and judicial efforts to rein in abusive litigation. Due to the Private Securities Litigation Reform Act of 1995's ("PSLRA") discovery stay during the pendency of a motion to dismiss, plaintiffs must meet the high pleading bar set by the PSLRA and subsequent case law interpreting the PSLRA without the benefit of discovery.[1] Because the costs of defending a case – and thus its settlement value – increase dramatically if the case survives a motion to dismiss, plaintiffs have turned to the device of confidential witness allegations to meet their pleading burden. They do so by including in the complaint allegations purportedly based

[1] *See* 15 U.S.C. § 78u-4(b)(3)(B) (discovery stay); 15 U.S.C. § § 78u-4(b)(1)(B), (2)(A) (requiring plaintiffs to specify the reasons why each alleged misstatement is misleading and "state with particularity facts" supporting an inference of scienter); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007) (requiring facts supporting an inference of scienter that is "at least as compelling as any opposing inference of nonfraudulent intent").

 ISSN 0037-0665

on the accounts of unnamed witnesses associated with the defendant and knowledgeable about the events at issue – '' 'dirt' [obtained] from dissatisfied corporate employees.'' *City of Pontiac Gen. Emps.' Ret. Sys.* v. *Lockheed Martin Corp.*, 952 F. Supp. 2d 633, 635 (S.D.N.Y. 2013). Plaintiffs need not include the names of their sources in a complaint ''provided they are described . . . with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.'' *Novak* v. *Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000). The witness accounts are commonly collected by hired investigators or junior personnel in the office of plaintiffs' counsel.

Such allegations are difficult to challenge on a motion to dismiss, because courts are required to accept factual allegations as true and plaintiffs' counsel routinely refuse to identify their confidential witnesses unless compelled by the court. This device can enable plaintiffs to defeat motions to dismiss. *See, e.g.*, *City of Livonia Emps.' Ret. Sys. & Local 295/Local 851* v. *Boeing Co.*, 711 F.3d 754, 757 (7th Cir. 2013) (noting that the improper use of confidential witness allegations, by plaintiff's counsel, was the ''only barrier to dismissal'' of the complaint).

The power and limited scrutiny of confidential witness allegations have resulted, in some cases, in complaints that include untrue, unconfirmed or mischaracterized statements from confidential witnesses. Courts have criticized or sanctioned plaintiffs' attorneys for these unethical practices. *See, e.g.*, *City of Pontiac*, 952 F. Supp. 2d at 638 (criticizing the practice of ''entic[ing] naive or disgruntled employees into gossip sessions that might help support a federal lawsuit''); *City of Livonia Emps.' Ret. Sys.* v. *Boeing Co.*, No. 09 C 7143, 2014 BL 239543, at *10 (N.D. Ill. Aug. 21, 2014) (sanctioning plaintiff's counsel for ''reckless and unjustified'' failure ''to verify . . . [CW] allegations so as to remain ignorant of the truth.'').

In re Millennial Media Decision

In *Millennial Media*, Judge Engelmayer of the Southern District of New York addressed such abusive uses of confidential witness testimony. The case involved allegations that a digital advertising company had made false and misleading statements about its technological capabilities and outlook, which plaintiffs maintained artificially inflated its stock price. Plaintiffs' initial complaint attributed information to eleven confidential witnesses. However, days before defendants' motion to dismiss was due, plaintiffs sought leave to file an amended complaint removing all references to Confidential Witness #4 (''CW-4''). Plaintiffs explained to the court that, after the complaint was filed, CW-4 informed plaintiffs that he did not wish to be quoted in the complaint. The court granted plaintiffs' request to file an amended complaint, but ordered plaintiffs to provide affidavits from (1) a ''personally knowledgeable attorney'' explaining the circumstances under which CW-4 had come to be included in the complaint, and (2) CW-4, ''recounting . . . his version of the events.'' After reviewing the materials submitted to the court pursuant to this order, the court found that CW-4 had only been interviewed once through an investigator, that he had not been told in advance that he would be quoted in a complaint, that he had expressed his wish not to be quoted in the complaint, and that he disputed the accuracy of various statements that were attributed to him.

The court also reviewed unsolicited materials submitted to the court by defendants regarding their investigation into *other* confidential witnesses cited in the complaint. The materials cast doubt on the accuracy of the statements in the complaint attributed to those witnesses and raised questions about whether those witnesses had consented to their statements being included in the complaint. In response to this filing, the court ordered plaintiffs to provide additional affidavits, similar to those concerning CW-4, for the remaining confidential witnesses.

In response to the court's order, plaintiffs' counsel filed affidavits demonstrating (1) that plaintiffs' counsel had never spoken to ten of the eleven confidential witnesses cited in the complaint, (2) that none of the witnesses had been notified that they would be cited in the complaint, (3) that three confidential witnesses (other than CW-4) asked to be removed from the complaint after plaintiffs' counsel contacted them regarding the court's order and (4) that certain confidential witnesses, although they had consented to being quoted in the complaint, indicated that their statements in the complaint were inaccurate or misleading in context. Concurrent with these affidavits, plaintiffs' counsel filed a notice of voluntary dismissal of the complaint.

Judge Engelmayer concluded that a failure by counsel to ''attempt to confirm with . . . [a] witness the statements that counsel propose[ ] to attribute to him and to assure that the [c]omplaint is presenting these statements'' runs afoul of Fed. R. Civ. P. 11's requirement that counsel conduct ''an inquiry reasonable under the circumstances'' into whether the factual contentions in the complaint have evidentiary support. 2015 BL 169156 at *12-13. Specifically, the court held that counsels' reliance on investigators ''create[s] significant potential for inaccuracy'' and that counsel must use diligence ''to check, and double-check'' that any factual assertions are correct prior to including them in a complaint. *Id.* at *7, 13.[2] It further instructed that counsel must give confidential witnesses ''an opportunity to verify, or refute, that . . . [their] quotes were accurate or presented in fair context.'' *Id.* at *7.

Similarly, the court held that fairness to the witness and ''basic decency'' requires that a witness be informed that his statements would be included in a complaint prior to its filing. *Id.* at *15. Judge Engelmayer reasoned that the designation of witnesses as confidential does not ensure their anonymity and that a failure to ''take into account how [the witness] might be affected [if his designation led] . . . to his identification'' was below the standards that the court expects of an attorney. *Id.* at *16.[3] The court stressed that witnesses

[2] *See id.* at *13 (''[C]ommon sense explains why an investigator's memo of an initial witness interview is an inadequate substitute for counsel's independent confirmation of accuracy. The investigator may have taken notes hurriedly while conducting the interview, unaided by a tape recorder and unassisted by a colleague. The witness may have been interviewed before a nuanced understanding of the facts and context, and before counsel's theory of illegality, took shape. And the investigator may have mistaken hearsay, opinion, or conjecture for facts, or the investigator's interview memo may not have carefully distinguished between them.'').

[3] *See also id.* at *13, 14 (''This Court, and a growing number of courts, have held that after a Complaint survives a motion to dismiss and a case reaches the discovery phase, the balance of interests shifts, as between the interest of the witness

   ISSN 0037-0665

have a right to expect counsel to ''consider thoughtfully, for each person who submits to an interview, whether the consequences of potentially outing that person are justified—genuinely justified—by counsel's duty of zealous representation of their clients.'' *Id.*

Other Decisions Regarding Abusive Confidential Witness Practices

Judge Engelmayer's decision is the first to set forth specific steps that counsel should follow with respect to the inclusion of confidential witness statements in a complaint. But the decision is just the latest in a series in which courts have sought assurances from plaintiffs' counsel that the confidential witness statements are accurate. For example, in *Campo v. Sears Holdings Corp.*, 635 F. Supp. 2d 323 (S.D.N.Y. 2009), the court noted on the motion to dismiss that plaintiffs' allegations were thin and hinged on the confidential witnesses' statements. *Id.* at 334–36. Accordingly, the court denied defendants' motion to dismiss, but did so without prejudice, and simultaneously ordered limited discovery into the confidential witnesses' allegations. *Id.* at 330 n.54. After depositions of the confidential witnesses and oral argument on whether the motion to dismiss should have been granted, the court dismissed the complaint, holding that the statements from the confidential witnesses in deposition failed to corroborate their statements supporting scienter in the complaint. *Id.* at 335. On appeal, the Second Circuit affirmed, reasoning that the ''anonymity of the sources of plaintiffs' factual allegations concerning scienter frustrates the [*Tellabs*] requirement [ ] that a court weigh competing inferences.'' *Campo* v. *Sears Holdings Corp.*, 371 F. App'x 212, 216 n.4 (2d Cir. 2010). Therefore, ''the district court's use of the confidential witnesses' [deposition] testimony to test the good faith basis of plaintiffs' compliance with *Tellabs* was permissible'' because Fed. R. Civ. P. 11 required it. *Id.*

Millennial Media and *Campo* involved court-requested discovery into the veracity of confidential witness statements; but courts have also been receptive on occasion to the inclusion, in a motion to dismiss, of affidavits from defendants regarding their independent investigations into the veracity of a plaintiff's confidential witness allegations. For example, in *In re St. Jude Med., Inc. Sec. Litig.*, 836 F. Supp. 2d 878 (D. Minn. 2011), defendants identified and located one of the confidential witnesses cited in the plaintiff's complaint and submitted, with their motion to dismiss, the confidential witness's affidavit asserting that the complaint misrepresented what she had told the plaintiffs. *Id.* at 901 n.9. Although the court noted it was wary of ''the propriety of addressing the factual accuracy of an affidavit on a Rule 12(b)(6) motion,'' it ultimately ignored the few allegations attributed solely to that witness in considering the motion. *Id.*.

Other courts have granted a motion for reconsideration under Fed. R. Civ. P. 54(b) where a motion to dismiss was denied but defendants subsequently obtained evidence through discovery that the confidential witness statements in the complaint were false. For example, in *City of Livonia*, the court permitted defendants' motion for reconsideration based on evidence that ''[m]aterial facts concerning the confidential source's position and personal knowledge were misrepresented by plaintiffs.'' *City of Livonia Emps.' Ret. Sys.* v. *The Boeing Co.*, No. 09 C 7143, 2011 BL 57531, at *5 (N.D. Ill. Mar. 7, 2011), *aff'd in part, vacated on other grounds by City of Livonia*, 711 F.3d at 754. There, the court dismissed the complaint on the motion for reconsideration and reasoned that its previous ''orders denying dismissal relied on false information concerning . . . [the confidential witness's] position and his personal knowledge,'' but that this information ''should not only have been steeply discounted, it should not have been considered at all'' on a motion to dismiss. *Id.*

Analysis

The *Millennial Media* decision is the first to go beyond responding to evidence of false confidential witness allegations and actually provide guidance as to the prophylactic steps that plaintiffs' counsel should take to ensure their accuracy when preparing a complaint. This guidance will not prevent deliberate falsification or exaggeration in such allegations – that remains a challenge for defense counsel to ferret out. However, if followed, this guidance will reduce the likelihood of misunderstandings or miscommunications that may cause erroneous allegations because it requires plaintiffs' counsel to ''check, and double-check'' that any factual assertions are correct prior to including them in a complaint, including by ''confirm[ing] with . . . [their] witnesses the facts and quotations that . . . [they] propose[ ] to attribute to them.'' 2015 BL 169156, at *12, 13.

Moreover, the procedures set out in the opinion—which the court describes as a ''best practice[,] if not an ethical imperative'' and which include an instruction to plaintiffs' counsel that they should inform confidential witnesses that their statements will be included in a complaint prior to filing that complaint (*Id.* at *2)—also have the potential to prevent disputes over confidential witness allegations. Witnesses who fully understand how their comments will be used and that their identities may later be revealed may be more likely to confine their comments to those that will withstand scrutiny, and less likely to later seek to ''disavow having made incriminating statements against [their employers].'' *In re Dynex Capital, Inc. Sec. Litig.*, No. 05 CIV. 1897 (HB), 2011 BL 441243, at *5 (S.D.N.Y. Apr. 29, 2011), report and recommendation adopted, No. 05 CIV. 1897 (HB), 2011 BL 162671 (S.D.N.Y. June 20, 2011).

Of course, it is far from certain that plaintiffs' lawyers will begin following the procedures set forth in *Millennial Media* in all cases simply as a result of this decision. Therefore, defense counsel may wish to rely on it and other recent case law in this area to draw the court's attention to potential inaccuracies in confidential witness allegations at an early stage of the litigation. *Millennial Media* stands for the proposition that, if a defendant has information calling into question the veracity of the statements of confidential witnesses in the complaint, the defendant may be able to obtain limited discovery into the confidential witness allegations even before a motion to dismiss is made.[4] And, under

in confidentiality and the interest of the parties and the truth-seeking process in fulsome discovery. There is, thus, a meaningful possibility that a court will order counsel to reveal the names of CWs, so as to enable these presumably knowledgeable fact witnesses to be deposed.'').

[4] Courts may be reluctant to grant discovery into the veracity of statements made by confidential witnesses prior to a motion to dismiss due to the PSLRA discovery stay. For example,

Campo, a defendant may be able to argue that a court that denies a motion to dismiss solely in reliance on the allegations of a confidential witness should only do so without prejudice and should grant limited discovery into the veracity of the statements of the confidential witnesses immediately following the disposition of the motion.

Millennial Media also suggests that it is best practice for defense counsel to assist their clients in conducting an investigation into confidential witness allegations as soon as a complaint is filed, and provides guidance for the type of evidence that defense counsel should look for in that investigation. In each case discussed herein where a court has granted a motion or discovery regarding confidential witness allegations, the common thread is that the court was first presented with some evidence of potential inaccuracies in the confidential witness allegations. While the particular circumstances of any case will dictate what actions along these lines are appropriate, in many cases it will be helpful to work with not only the general counsel's office, but also the managers of business units within the client company, to identify the confidential witness. Because plaintiffs are required to plead facts regarding how the confidential witness is in a position to know the information alleged, a client will frequently be able to identify the confidential witness with relative ease.

Once the confidential witness has been identified, an employee of the company with a good relationship with the confidential witness may be able to discuss the allegations in the complaint with that witness, using *Millennial Media* as a guide for that conversation. For example, the confidential witnesses should be asked whether it was counsel or an investigator who interviewed them, if they knew that they would be quoted in a complaint, if they objected to being quoted in the complaint and whether the statements attributed to them in the complaint were altered or mischaracterized in any way.[5] Following *Millennial Media*, if plaintiffs' counsel failed to comply with any of Judge Engelmayer's procedures in obtaining the confidential witness statement, a court may be more likely to grant a motion for discovery into the confidential witness allegations pre-motion to dismiss, or at least to be sensitive to these issues in considering a motion to dismiss.

Thus, *Millennial Media* provides important support, both procedurally and substantively, for securities fraud defendants seeking to dismiss complaints containing confidential witness statements of dubious merit. It also contributes to a growing body of case law on this topic that provides significant support for motions for discovery into confidential witness statements even at a very early stage in the litigation, notwithstanding the PSLRA discovery stay. Securities fraud defendants and their counsel should take note of these developments and incorporate this precedent into their practice.

---

in *In re Cell Therapeutics*, defendants, relying on *Campo*, moved for the court to permit depositions of the confidential witnesses after obtaining, prior to a motion to dismiss, statements from three people thought to be amongst the confidential witnesses ''assert[ing] that their statements to Plaintiffs' investigators . . . [were] taken out of context, misrepresented or (in some cases) fabricated.'' *In re Cell Therapeutics, Inc.*, No. C10-414MJP, 2010 BL 434057, at *1 (W.D. Wash. Nov. 18, 2010). There, the court denied defendants' motion, relying in part on the PSLRA's stay of discovery during the pendency of a motion to dismiss. *Id*. at *2-3. However, it is worth noting that if a plaintiff is able to survive the motion to dismiss stage solely on fabricated or hyperbolic confidential witness allegations, the intention of Congress in enacting the PSLRA discovery stay is thwarted. *See* H.R. Rep. No. 104–369, at 31 (1995) (Conf. Rep.) (The discovery stay is intended to deter lawsuits that would be filed ''without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action.''); *see also In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 129, 129–30 (S.D.N.Y. 2003) (same). Such an argument could be persuasive to a court, particularly in light of the Second Circuit's decision in *Campo*, which rested in part on the idea that discovery into the identity of the confidential witness furthered the aims of the PSLRA as interpreted by the Supreme Court in *Tellabs*. *See Campo* v. *Sears Holdings Corp.*, 371 F. App'x at 216 n.4.

[5] Of course, it is important to instruct the client carefully regarding this conversation, and its investigation in general, to avoid any behavior that might be construed as retaliation against a whistleblower.

   ISSN 0037-0665