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Courts Continue to Express Skepticism over Confidential Witnesses

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One of the more questionable techniques of modern civil litigation, the reliance on so-called "confidential witnesses" in securities fraud complaints, is attracting even more judicial scrutiny. Unlike most civil plaintiffs, securities fraud plaintiffs are subject to the heightened pleading requirements of the Private Securities Litigation Reform Act. This requires them to not only plead fraud with particularity, but also to plead a "strong inference" of scienter. That means that the inference of scienter must be "at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007).

This pleading burden as set by Congress and the Supreme Court is intentionally high. To survive dismissal, a securities plaintiff should choose her cases carefully, and only where she can present robust, specific allegations. In reality, however, many securities plaintiffs do the opposite: they file a great number of complaints hoping that one of them will stick and knowing that many will not. One technique often used to attempt to increase a complaint's stickiness is the attribution of factual allegations to "confidential witnesses," usually presented as ex-employees of an organization who were present during key moments in an allegedly fraudulent scheme. The plaintiff will then insist that the complaint's allegations must be taken as true, even if the defense has no way of discerning whether the alleged informants could plausibly be in possession of whatever information they claim to possess.

When confidential witnesses' supposed statements are simply taken at face value, the potential for abuse is high. As I wrote about in 2018, past cases have involved: misstatements or exaggerations about the witnesses' supposed job titles and access to information; witnesses whose supposed statements were distorted by plaintiffs' lawyers and who disclaimed those statements in sworn affidavits; and the use of a supposed confidential witness to launder allegations known by counsel to be false or unreliable. My 2018 article discussed a number of cases in which courts evaluated "confidential witness" statements with an increased level of skepticism.

In the years since, that trend has continued. Courts across the country continue to pressure-test vague or exaggerated claims attributed to confidential sources, often resulting in case dismissal at the pleading stage.

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Last year in *Altimeo Asset Management v. Qihoo 360 Technology*, for example, the Southern District of New York dismissed a complaint where the confidential witness's access to information was unexplained and implausible. There, the plaintiff brought securities fraud claims against an internet security company based on supposed false or misleading statements to depress the company's share value in the lead-up to a take-private merger. No. 19-cv-10067 (PAE), 2020 WL 4734989 (S.D.N.Y. Aug. 14, 2020). The complaint relied heavily on a supposed confidential witness within the company's public relations department, who claimed to have known that the take-private transaction was part of a secret plot to later re-list in China. In dismissing the complaint, the court noted that the supposed witness's "position and job responsibilities are not described at a sufficient level of particularity" and that it was "dubious that he or she would be entrusted by corporate management with an explosive secret capable, if revealed, of derailing Qihoo's plan to go private." The court then took plaintiff's counsel to task as they "appear[ed] to have done nothing whatsoever to confirm the veracity of [the witness]." An appeal is pending.

In other recent cases, courts dismissed securities fraud claims where the supposed confidential witnesses added only vague or conclusory information that was of no probative value. For example, in *Ortiz v. Canopy Growth Corporation*, the District of New Jersey dismissed securities fraud claims against a cannabis company based on confidential witness statements. No. 2:19-CV-20543-KM-ESK, 2021 WL 1967714, at *1 (D.N.J. May 17, 2021). In holding that the plaintiff failed to establish a strong inference of scienter, the court noted that the confidential witness could only report "secondhand the gist of a statement" allegedly made by a vice president during a conversation for which the witness was not present. Likewise, in *In re Adient PLC Securities Litigation*, the Southern District of New York dismissed securities fraud claims alleging that the automotive seating company misled investors about the growth prospects its metals division. No. 18-CV-9116 (RA), 2020 WL 1644018 (S.D.N.Y. Apr. 2, 2020). Confidential witnesses alleged in vague terms that problems within the metals division were "common knowledge" and that problems within the metals division were regularly discussed at meetings with top executives. The court found that "[e]ven assuming that all of the [confidential witnesses'] statements are true … the fact that Adient experienced various challenges in Metals does not demonstrate how the Company's projected margin expansion was 'unreasonable,' 'unrealistic,' or 'reckless' at the time it was announced or subsequently discussed." An appeal is pending.

Similar issues were present in *In re Micro Focus International Securities Litigation*. There, the plaintiff claimed that the software and information technology company misled investors as to the risk of customer attrition following a merger. No. 1:18-cv-6763, 2020 WL 5817275 (S.D.N.Y. Sept. 29, 2020). The plaintiff relied on the supposed statements of a number of former salespeople who alleged in vague terms that the merger made it more difficult for them to sign up new customers and to renew existing contracts, that they were given "talk tracks" to use in answering customer questions about the merger, and that executives asked salespeople to alert them when an account was a flight risk. In dismissing the complaint, the court noted that these allegations were "consistent with unremarkable circumstances short of fraud." An appeal is pending.

The most extreme cases involve situations where a confidential witness's supposed testimony is exaggerated or made up entirely. In *Nguyen v. Endologix, Inc.*, the Ninth Circuit affirmed dismissal

of a securities fraud case in which a medical device company was accused of misleading investors about the likelihood of receiving a specific FDA approval. 962 F.3d 405 (9th Cir. 2020). The complaint relied heavily on the supposed statements of a confidential witness within the company's R&D team. After the complaint was filed, the witness submitted a declaration disavowing the complaint and stating that "most of the factual assertions attributed to me ... are contrary to my understandings of fact and my opinions." Neither the district nor the appellate court needed to rely on that declaration in granting dismissal, however. As the Ninth Circuit noted, the supposed statements attributed to the witness in the complaint were "high on alarming adjectives" but "short on the facts."

Whether this trend of skepticism towards confidential witnesses continues is up for debate. In a pending case that will be worth watching, *Moshell v. Sasol Ltd.*, the Southern District of New York has been asked to reconsider an earlier denial of dismissal and to grant sanctions against the plaintiff. There, according to the defendants, a number of confidential witnesses relied on in the complaint later gave deposition testimony unequivocally disclaiming key statements attributed to them. The motion to reconsider dismissal and grant sanctions is pending.