WHO'S BEHIND DOOR NUMBER ONE?: PROBLEMS WITH USING CONFIDENTIAL SOURCES IN SECURITIES LITIGATION

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This Note analyzes the use of confidential sources in securities litigation cases. The fraud at issue in securities cases generally takes place behind the closed doors of the corporate boardroom, and an inside, anonymous source is often needed to substantiate these allegations of fraud. However, in response to what it perceived as an unacceptably high number of securities litigation cases, Congress adopted the Private Securities Litigation Reform Act (PSLRA), which frustrated the common practice of relying on confidential sources. The purpose of this act was twofold: reduce the number of vexatious securities cases but nonetheless encourage valid claims, thus promoting the proper regulation of the securities markets. In order to accomplish these goals, Congress raised the pleading requirements. The PSLRA now requires that plaintiffs pleading a securities action plead their claims with greater particularity. In response, courts have struggled with how to evaluate the use of these crucial sources within the new standard.

The author discusses three standards that courts take in addressing this problem. Some courts completely discount allegations made by a confidential source. Other courts allow the complaint to proceed, provided that the plaintiff has described the source in adequate detail. Finally, some courts take a middle approach and remain highly skeptical of confidential sources but nonetheless refuse to discount their allegations. The author suggests that courts should apply a middle-ground approach. A middle-ground approach is sufficiently lenient, promoting the regulatory effect offered by securities complaints, and appropriately skeptical, thus discouraging vexatious litigation.

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"Knowledge of the enemy's dispositions can only be obtained from other men."
-Sun Tzu, circa 500 B.C.[1]

I. INTRODUCTION

Twenty-five hundred years after *The Art of War*, Sun Tzu's words still ring true. Although Sun Tzu was concerned primarily with warring feudal states,[2] the principles he articulated are useful in the context of the modern-day securities complaint.

Securities complaints rely heavily on modern day "spies"—confidential sources—to establish actionable securities fraud.[3] An action for securities fraud lies when a party has engaged in insider trading, has made a materially misleading statement, or has neglected to give a statement required to make a material statement not misleading.[4] The common thread in all these actions is their inside nature. These fraudulent acts are often committed behind closed doors; for example, in a meeting or over the telephone.[5] Often only through the use of a "spy" and his or her ability to capture inside information, does an injured party have any chance of seeking relief.

The relief available in securities cases is big and attractive—so attractive, in fact, that Congress thought there were too many securities cases and expressed its opinion through its rule-making power. To stem the flood of litigation, Congress enacted legislation to create pleading barriers.[6]

This legislation has proven effective; securities cases rarely proceed to trial.[7] Therefore, the pleading stage is generally the only time that a court will examine the allegations raised by a confidential informant. For this reason, addressing the issue of confidential sources at the pleading stage is critical. The analysis is a serious one and ultimately involves a careful balancing of the plaintiff's interest in having the opportunity to plead, the defendant's interest in appropriately defending herself, and the source's interest in retaining his or her confidentiality.[8] Moreover, the judiciary must maintain an incentive for bringing valid cases while excluding frivolous and malicious strike suits.

1. SUN TZU, THE ART OF WAR 48 (Lionel Giles trans., Wilder Publications 2008).
2. MARK MCNEILLY, SUN TZU AND THE ART OF MODERN WARFARE 5 (2001).
3. Ethan D. Wohl, *Confidential Informants in Private Litigation: Balancing Interests in Anonymity and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 551, 556 (2007).
4. *See* Chiarella v. United States, 445 U.S. 222, 226 (1980); 17 C.F.R. § 240.10b-5 (2010).
5. *See, e.g.*, Wohl, *supra* note 3, at 560–61.
6. *See* Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4 (2006).
7. *See* Jane Bryant Quinn, *Madoff Victims Face Grim Prospects in Court: Jane Bryant Quinn*, BLOOMBERG.COM (Feb. 11, 2009, 12:02 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=axkhffRnncpI.
8. *See* Wohl, *supra* note 3, at 553–54.

In light of recent legislation and securities case law, plaintiffs have increasingly relied on confidential sources in drafting their complaints.[9] In response, courts have re-evaluated how these sources are used. Some courts significantly discount the allegations made by these sources.[10] Other courts allow the complaints to proceed, provided that the plaintiff has included sufficient detail to establish that the source would have the information that he or she claims to possess.[11] Still, other courts have approached the anonymous witnesses with great skepticism but appear to only slightly discount the claims provided by these sources.[12]

This Note examines the competing approaches that federal courts follow when dealing with confidential sources in securities litigation. Part II provides helpful background information regarding securities law, pleading standards, and the use of confidential sources in general. Part III identifies three standards that federal courts employ when confronted with a confidential source in a securities pleading. Finally, Part IV recommends that federal courts adopt a standard that approaches these sources with a heightened degree of skepticism.

II. BACKGROUND

Although this Note is primarily concerned with the use of confidential sources in securities class actions, a basic understanding of the legislation that governs the securities markets is imperative. Accordingly, this Part introduces initial efforts to regulate the securities markets through legislation, explains the consequences of expanded liability through private actions, addresses more recent efforts to regulate securities class actions, and introduces policy concerns behind the use of confidential sources.

A. Initial Legislation

Any conversation addressing the regulation of the securities markets must begin with a discussion of two regulatory giants: the Securities Act and the Exchange Act. Designed to remedy the crash caused by post-World War I speculation, the Securities Act of 1933[13] (Securities Act) and the Securities Exchange Act of 1934[14] (Exchange Act) have regulated the securities markets in the United States since their enactments in the wake of the Great Depression.[15] Whereas the Securities Act institutes registration requirements for certain issuers who make initial public offerings (IPOs) of stock, the Exchange Act focuses on the secondary

9. *See id.* at 554–56.
10. *See, e.g.*, Higginbotham v. Baxter Int'l Inc., 495 F.3d 753, 757 (7th Cir. 2007).
11. *See, e.g.*, Inst. Investors Grp. v. Avaya, Inc., 564 F.3d 242, 261 (3d Cir. 2009).
12. *See, e.g.*, Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1240 (11th Cir. 2008).
13. *See generally* Securities Act of 1933, 15 U.S.C. § 77a (2006).
14. *See generally* Securities Exchange Act of 1934, 15 U.S.C. § 78a (2006).
15. *See, e.g.*, Merrill Lynch v. Dabit, 547 U.S. 71, 78 (2006).

trading market.[16] Most significantly, the Exchange Act contains Section 10(b), which makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance . . . ."[17] Rule 10b-5, drafted under the authority granted to the Securities and Exchange Commission (SEC) by Section 10(b), makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or . . . [t]o engage in any act. . . which . . . would operate as a fraud or deceit upon any person . . . "[18]

Both the Securities Act and the Exchange Act were drafted with the interests of the markets in mind and are remedial in nature.[19] Because the stability of the securities markets ultimately depends on public confidence, Congress sought to instill trust by combating fraud and requiring greater disclosure.[20] Disclosure is now the chief method by which Congress assures "a high standard of business ethics in the securities industry."[21]

B. An Implied Private Right of Action

Although Congress originally intended for the Securities Act and the Exchange Act to be enforced by only the SEC and the Department of Justice, courts soon came to recognize an implied private right of action under Section 10(b) and Rule 10b-5 of the Exchange Act.[22] Indeed, the implied private rights of action under Rule 10b-5 is now routinely exercised.[23] As Justice Rehnquist memorably remarked, "[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."[24] The regulatory function of private actions under Rule 10b-5 is now well recognized.[25]

16. Kent Oz, *Independent Fund Administrators As a Solution for Hedge Fund Fraud*, 15 FORDHAM J. CORP. & FIN. L. 329, 346 (2009).

17. 15 U.S.C. § 78j(b) (2006).

18. 17 C.F.R. § 240.10b-5(b)–(c) (2010).

19. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

20. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 658 (1997).

21. Affiliated Ute v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)).

22. DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT, CASES AND MATERIALS 6 (2003); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983). There is, in fact, no sign that Congress ever intended to create a private remedy. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976).

23. *Ernst & Ernst*, 425 U.S. at 196; *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); *Affiliated Ute*, 406 U.S. at 150–54.

24. *Blue Chip Stamps*, 421 U.S. at 737.

25. *See, e.g.*, Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 396 (1970) (indicating that plaintiffs who sued to enforce a violation of Section 14(a) of the Exchange Act had "rendered a substantial service to the corporation and its shareholders"). *Cf.* S. REP. NO. 104-98, at 6–7 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 685–86 ("[The PSLRA] is intended to encourage plaintiffs' lawyers to pursue valid claims . . . .").

To prove liability under Section 10(b) and Rule 10b-5, private plaintiffs must satisfy a minimum of six requirements.[26] This Note is concerned with only one of these: the scienter requirement. Scienter, the "degree of knowledge that makes a person legally responsible for" his or her acts, has a specific meaning in securities cases.[27] In these cases, scienter refers to that particular mental state wherein a person has some "intent to deceive, manipulate, or defraud."[28]

C. Problems with Expanding Liability

Although courts construe remedial statutes liberally,[29] they are nonetheless cautious to expand liability in securities cases.[30] Courts are hesitant because of the special risks "different in degree and in kind" implicated in securities litigation.[31] Securities fraud cases always proceed as class actions and generate large damages.[32] Somewhat paradoxically, although the investor (and the market in general) is harmed when there has been fraud, the individual shareholder in a defrauded company is further harmed when a securities claim proceeds against the company.[33] To illustrate, although the monetary liability that is imposed on the issuer is borne by the issuer, it is vicariously imposed on the shareholder.[34] In other words, when the issuer is fined, it is the shareholder who pays, through his or her devalued investment.[35]

Beyond the concern for shareholders, securities cases present a tempting tool for lawyers. As noted above, securities actions cause damage, both monetary and reputational.[36] When an issuer's reputation is harmed, the value of the stock will surely decline.[37] This gives plaintiffs

26. "In such an action, the plaintiff must establish that: (1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied (6) and that the false statement proximately caused the plaintiff's damages." Caremark, Inc. v. Coram Healthcare Corp., 113 F.3d 645, 648 (7th Cir. 1997).

27. BLACK'S LAW DICTIONARY 1463 (9th ed. 2009).

28. *Ernst & Ernst*, 425 U.S. at 193 (holding that negligence does not satisfy the scienter requirement under Section 10(b) and Rule 10b-5).

29. *E.g.*, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

30. *E.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring) (noting that expanding liability too far might ultimately frustrate the goals of the securities laws); *see also* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159–60 (2008) (holding that "scheme liability" is not actionable); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994) (holding that there can be no liability for aiding and abetting under Section 10(b) and Rule 10b-5); Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) (noting that silence is not deceptive absent a duty to speak).

31. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975).

32. S. REP. NO. 104-98, at 9–10 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688–89.

33. Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1370 (1966).

34. *See id.*

35. *Id.*

36. *See* James C. Sargent, *The SEC and the Individual Investor: Restoring His Confidence in the Market*, 60 VA. L. REV. 553, 563 (1974) (discussing the impact of adverse publicity on a company).

37. *See id.* (indicating that adverse publicity is tantamount to a sanction in the securities industry because adverse publicity will undermine confidence in the company, as well as the willingness of in-

an added incentive to bring blackmail suits: plaintiffs can force settlements by bringing a suit that would, if made public, damage the issuer's reputation and lower its stock price further.[38]

For this reason, securities cases rarely proceed to trial.[39] Indeed, even a complaint that may have essentially no chance of succeeding at trial may have a settlement value that is far above any amount of money that such a case could extract through litigation.[40] Because securities actions generally settle,[41] the critical moment in these cases is at the pleadings stage. Accordingly, the importance of the pleading standard cannot be overstated.

D. New Legislation: Heightened Pleading Standards

The pleading standard in securities complaints differs from the standard in general civil litigation.[42] Normal civil complaints require only that a plaintiff give notice.[43] For instance, Federal Rule of Civil Procedure 8(a)(2) requires "a short and plain statement of the claim showing that the pleader is entitled to relief."[44] This burden is quite low, existing simply to "give the defendant fair notice of what the . . . claim is and the grounds upon which it rests."[45] Accordingly, the court will accept all allegations in the complaint as true.[46] In fact, a properly plead complaint may proceed even if its potential success rate is remote.[47]

Reflecting concerns for the special nature of securities fraud cases,[48] such cases must abide by a more stringent pleading standard.[49] In contrast to their civil counterparts, securities fraud complaints must satisfy the provisions of Federal Rule of Civil Procedure 9(b).[50] Federal Rule of Civil Procedure 9(b), which applies to plaintiffs who plead fraud, requires more than just notice; these complaints must particularize the circumstances of the fraud they allege.[51] The purpose of this heightened

vestors to invest in the company, which will in turn negatively affect the value of a company's securities).

38. *See id.*

39. S. REP. NO. 104-98, at 9 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688.

40. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975).

41. S. REP. NO. 104-98, at 9 ("Most defendants in securities class action lawsuits choose to settle rather than face the enormous expense of discovery and trial. Of the approximately 300 securities lawsuits filed each year, almost 93% settle at an average settlement cost of $8.6 million." (footnotes omitted)).

42. *Compare* FED. R. CIV. P. 8(a)(2), *with* FED. R. CIV. P. 9(b).

43. FED. R. CIV. P. 8(a)(2); *see also* Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555 (2007).

44. FED. R. CIV. P. 8(a)(2).

45. *Twombly*, 550 U.S. at 555 (citing Conley v. Gibson, 355 U.S. 41, 47 (1957)).

46. *Id.*

47. *Id.* at 556. Additionally, the facts asserted in the pleading must articulate a "plausible" claim. Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009).

48. *See supra* text accompanying notes 26–40.

49. *Compare* FED. R. CIV. P. 8(a)(2), *with* FED. R. CIV. P. 9(b).

50. FED. R. CIV. P. 9(b).

51. *Id.* Federal Rule of Civil Procedure Rule 9(b) "merely require[s] the plaintiff to state in his complaint 'the identity of the person making the misrepresentation, the time, place, and content of the

standard is threefold: to protect the defendant's reputation from harm, to minimize "strike suits" and "fishing expeditions," and to provide notice of the claim to the other party.[52] In 1995, however, Congress decided that Rule 9(b) alone was insufficient for securities fraud cases.[53]

In 1995, the Republican-controlled Congress, over President Clinton's veto, passed the Private Securities Litigation Reform Act (PSLRA).[54] This Act was designed to remedy perceived abuses in the system and encourage meritorious actions to proceed.[55]

In effect, the PSLRA makes securities fraud actions much more difficult for parties to bring. Plaintiffs must now overcome four obstacles to successfully plead a securities complaint. These include a discovery stay once the defendant has filed a motion to dismiss, a "safe harbor" provision for forward-looking statements, a loss causation requirement, and a requirement that the complaint establish a strong inference of scienter.[56] Taken together, these hurdles have turned the traditional pleading rules into a quasi-summary judgment procedure.[57]

Of principal concern in this Note is the PSLRA's heightened scienter requirement, which goes beyond what is required by Rule 9(b). The PSLRA 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."[58]

Congress failed to define what constituted a "strong inference," and courts were left to their own devices to decide what would constitute a "strong inference" of scienter.[59] The Supreme Court of the United States resolved this conflict in 2007 when it granted certiorari to a case from the U.S. Court of Appeals for the Seventh Circuit.[60] In *Tellabs, Inc. v. Makor*

misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff.'" Bankers Trust Co. v. Old Republic Ins. Co., 959 F.2d 677, 683 (7th Cir. 1992) (quoting Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990)).

52. *E.g.*, Vicom, Inc. v. Harbridge Merch. Servs., Inc., 20 F.3d 771, 777 (7th Cir. 1994).

53. *E.g.*, S. REP. NO. 104-98, at 9–10 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688–89.

54. Private Securities Litigation Act of 1995 Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

55. As noted in the Senate Report:

> [T]he "Private Securities Litigation Reform Act of 1995," is intended to lower the cost of raising capital by combatting these abuses, while maintaining the incentive for bringing meritorious actions. Specifically, [the PSLRA] intends: (1) to encourage the voluntary disclosure of information by corporate issuers; (2) to empower investors so that they—not their lawyers—exercise primary control over private securities litigation; and (3) to encourage plaintiffs' lawyers to pursue valid claims and defendants to fight abusive claims.

S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683; *see also* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 914 (stating that the PSLRA creates "procedural hurdles" that plaintiffs must overcome).

56. *See generally* MANUAL FOR COMPLEX LITIGATION (FOURTH) §§ 31.32–.33 (2004) (describing pleading requirements under Rule 9(b) and the PSLRA).

57. Geoffrey P. Miller, *Pleading After* Tellabs, 2009 WIS. L. REV. 507, 534.

58. 15 U.S.C. § 78u-4(b)(2) (2006) (emphasis added).

59. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 601 (7th Cir. 2006) ("Congress did not . . . throw much light on what facts will suffice to create such an inference."), *rev'd*, 551 U.S. 308 (2007).

60. 551 U.S. 308, 317–18 (2007).

Issues & Rights, Ltd., the Supreme Court held that lower courts must conduct a comparative analysis based on the pleadings.[61] Beyond the inferences that the plaintiff asserts, a court must also attempt to account for any "plausible opposing inferences" that would tilt the scale in favor of the defendant.[62] The Court held that, although the inference of scienter need not be irrefutable, it must be more than reasonable.[63] "[I]t must be *cogent and compelling*, thus strong in light of other explanations. A complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[64] Although commentators differ, this holding was generally considered prodefendant.[65] In order to overcome the additional burden of the PSLRA, and now *Tellabs*, plaintiffs increasingly rely on confidential sources to illustrate facts that will lead a court to find a "strong inference" of scienter.[66]

E. Confidential Sources and Their Value

A confidential source, witness, or informant is someone who provides information to another party, generally a law enforcement agency or journalist, in exchange for a guarantee of anonymity.[67] These sources are routinely used in both the journalism and law enforcement fields.[68] Confidential informants are imperative for many investigations—espionage, police work, and war are just a few examples.[69] In the world of securities, where fraud may take place behind closed doors, confidential sources may be the only way to learn about the potential existence of fraud.[70]

In law enforcement, journalism, and securities actions, confidential sources are valuable to the plaintiff but present harrowing possibilities for the defendant. As such, the use of these sources presents several competing policy concerns that must be balanced.

Because of their importance, confidential sources require a certain amount of protection.[71] Requiring disclosure, however, may effectively

61. *Id.* at 323.
62. *Id.*
63. *Id.* at 323–24.
64. *Id.* at 324 (emphasis added).
65. *See, e.g.*, Scott Balber, *Recent Pro-Defendant Trends in Securities Class Action Litigation*, AM. LAW. MEDIA'S LAW.COM (May 16, 2008), http://www.law.com/jsp/law/index.jsp (search "Recent Pro-Defendant Trends in Securities Class Action Litigation"; then follow first hyperlinked result).
66. Samuel H. Rudman, *Back to 'Novak': Confidential Witnesses in Fraud Actions*, N.Y. L.J., Oct. 20, 2008, http://rgrdlaw.com/pdf/news/Novak.pdf.
67. *See, e.g.*, BLACK'S LAW DICTIONARY 340 (9th ed. 2009).
68. *In re* Cigna Corp. Sec. Litig., No. Civ.A. 02-8088, 2006 WL 263631, at *1 (E.D. Pa. Jan. 31, 2006).
69. *Id.*
70. Wohl, *supra* note 3, at 560–61.
71. In cases of law enforcement, a source's confidentiality is protected by the Federal Freedom of Information Act. BLACK'S LAW DICTIONARY 340 (9th ed. 2009). Confidential sources in journalism are protected by the First Amendment. *Id.*

chill informants from offering information that is critical to securities cases.[72] Informants have a reason to be fearful of disclosure: disclosing their identities subjects them to the very real possibility of retaliation.[73] Retaliation against informants may come in many forms. Employees surely risk losing their jobs and, because potential employers might reasonably be hesitant to hire a snitch, even jeopardize future employment.[74]

The confidential source's need to remain confidential must be balanced against the defendant's need to prepare her case, and a failure to disclose the existence of informants will have a number of disadvantages.[75] Beyond the obvious tactical disadvantage that the defendant suffers, failure to disclose "may impair the value of litigation as a truth-seeking exercise."[76] This result is only sensible because it is impossible to assess the truthfulness of a statement that is made anonymously.[77]

Furthermore, the defendant needs information that will allow him or her to prepare a defense.[78] The defendant has a right to engage in effective discovery, and if he or she is denied access to these informants, the defendant's ability to adequately defend one's self may be impeded. Many (if not most) courts that have weighed in on the issue have found that during the discovery period the plaintiff must disclose his or her confidential sources.[79] The vast majority of these cases, however, will settle well before trial.[80] Although plaintiffs may attempt to shield their sources' identities from discovery by claiming that the work-product privilege protects them, many courts have found that this privilege is inapplicable for two main reasons.[81] First, it is unlikely that naming a witness will "reveal 'mental impressions, conclusions, opinions, or legal theories of' the plaintiff's counsel," as the work product doctrine would require.[82] Second, in balancing the relative difficulties the parties face,

72. *In re Cigna Corp.*, 2006 WL 263631, at *3.

73. N.J. Carpenters Pension & Annuity Funds v. Biogen Idec Inc., 537 F.3d 35, 52 (1st Cir. 2008).

74. For proof that this fear is well grounded, one need only look to legislation that attempts to protect confidential sources from retaliation. The most recent enactment of this legislation is the Sarbanes-Oxley Act, which includes antiretaliation provisions. Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C. § 1514A (2006).

75. Stephen M. Sinaiko & Matan A. Koch, *Using Confidential Informants to Meet the PSLRA's Pleading Standards: Their Identities Are Likely Discoverable*, N.Y. L.J., July 7, 2008, http://www.law.com/jsp/nylj/index.jsp (search "Using Confidential Informants to Meet the PSLRA's Pleading Standards"; then follow first hyperlinked result).

76. *Id.*

77. *Id.*; *see also* Higginbotham v. Baxter Int'l Inc., 495 F.3d 753, 757 (7th Cir. 2007) (remarking that because plaintiff refused to identify its five confidential witnesses, the court could not verify their allegations).

78. *See, e.g.*, Gregory Markel et al., *Complex Litigation: Sometimes, the Witness Is a Cipher*, NAT'L L.J., Apr. 21, 2008, http://www.cadwalader.com/assets/article/042108MarkelSettonNLJ.pdf.

79. Sinaiko & Koch, *supra* note 75.

80. *See* discussion *supra* Part II.C.

81. *E.g.*, *In re* Harmonic, Inc. Sec. Litig., 245 F.R.D. 424, 427 (N.D. Cal. 2007).

82. Sinaiko & Koch, *supra* note 75 (quoting FED. R. CIV. P. 26(b)(3)(B)); *see In re Harmonic*, 245 F.R.D. at 427 ("The issue here, like that in *Ventro*, is not *if* the confidential sources' identities will ever be discovered, but rather *when* they will be discovered." (citing Miller v. Ventro Corp., No. C01-01287 SBA (EDL), 2004 WL 868202, at *2 (N.D. Cal. Apr. 21, 2004))).

defendants are often sufficiently harmed by nondisclosure of confidential sources, and courts are able to find that their need for disclosure outweighs plaintiffs' need for concealment.[83] Notwithstanding the view of some commentators, the simple fact of the matter is that, ultimately, defendants may discover the identities of confidential sources.[84]

III. ANALYSIS

When plaintiffs seek to prove securities fraud by using confidential sources, federal courts have responded in a variety of ways. This Note identifies three varying standards. The following Sections illustrate and analyze the three standards, drawing appropriate comparisons from other areas of law and discussing the advantages and disadvantages of each. Section A frames the issue and discusses why confidential sources in securities complaints are problematic. Section B discusses the "detail standard." Section C analyzes the "discount standard." Finally, Section D evaluates the "skepticism standard."

*A. Introduction to the Various Approaches: The Pre-*Tellabs *Standard*

Before *Tellabs*, courts were not bothered by a plaintiff's use of confidential sources to plead scienter. In analyzing complaints that relied heavily on these sources, courts used analogies to other areas of law.[85] The *Tellabs* decision, however, proved problematic for many courts. In particular, the Supreme Court in *Tellabs* defined the PSLRA's strong inference standard as requiring allegations of scienter to be "cogent and compelling," mandating a comparative approach to determine whether a complaint meets this threshold.[86] That courts must now make "plausible opposing inferences" in favor of both parties[87] begs the question: how can courts make valid inferences in favor (or against) a party when that party does not disclose the source of its allegation?

In response, courts appear to have applied three different standards in evaluating claims made by confidential sources. The following Sections attempt to succinctly divide these different standards, addressing each approach and the problems associated with it. Each Section de-

83. *See* United States v. Amerada Hess Corp., 619 F.2d 980, 988 (3d Cir. 1980).

84. *Compare In re* Cigna Corp. Sec. Litig., No. Civ.A. 02-8088, 2006 WL 263631, at *3 (E.D. Pa. Jan. 31, 2006) (stating that courts can require a plaintiff to disclose a confidential informant's identity so that the other party may engage in discovery, however, a plaintiff need not disclose that the person is a confidential informant), *with In re* Marsh & McLennan Cos., Inc. Sec. Litig., No. 04 Cv. 8144(SWK), 2008 WL 2941215, at *3 (S.D.N.Y. July 30, 2008) (pointing out that it is possible for a defendant to identify confidential witnesses "by comparing the descriptions of the [confidential sources] in the [complaint] to the list of witnesses disclosed pursuant to Rule 26(a)(1)"), *and Miller*, 2004 WL 868202, at *2 (noting that "descriptions in the complaint are sufficiently detailed to enable Defendants to identify the individuals from the list of potential witnesses").

85. *See infra* Part III.B.2.

86. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007).

87. *Id.* at 323.

scribes the mechanics of an approach, uses a case analysis to illustrate those mechanics, and then discusses the advantages and disadvantages of the approach. The detail standard is examined first.

*B. The Detail Standard and the Pre-*Tellabs *Approach*

The detail standard is the most lenient of the three standards and most clearly approximates the pre-*Tellabs* standard.[88] Courts following this approach conduct a holistic review of the plaintiff's complaint and do not per se discount statements given by confidential sources.[89] Here, courts will consider the level of detail provided by the sources, the sources' basis of knowledge of the facts (i.e., whether the source was in a position to be likely to possess that information), the sources' reliability, whether the statement could be corroborated through other facts alleged, and how plausible the allegation appears to be.[90]

1. Case Analysis

The U.S. Court of Appeals for the Second Circuit first applied this approach in *Novak v. Kasaks*.[91] In that case, the plaintiffs brought a securities fraud action against clothing retailer Ann Taylor.[92] The plaintiffs alleged that defendants had made both material misstatements and omissions concerning Ann Taylor's financial performance.[93] The district court dismissed the case, holding that the PSLRA required that the confidential sources be specifically named.[94] On appeal, the Second Circuit reversed.[95]

Turning to the plaintiffs' use of anonymous witnesses, the court held that when a plaintiff relies on confidential sources in combination with other facts, it need not name its witnesses so long as the other facts alleged provide an adequate basis for believing that the statements were untruthful.[96] Even if the other facts do not independently establish scienter, however, plaintiffs need not name their confidential sources if they can provide sufficient detail to warrant a belief that the source would have the information that they claim to possess.[97] Thus, *Novak* and its progeny rejected a bright-line rule that sources must be named. More-

88. *See* discussion *infra* Part III.B–C.
89. Inst. Investors Grp. v. Avaya, Inc., 564 F.3d 242, 263 (3d Cir. 2009).
90. *Id.*
91. 216 F.3d 300 (2d Cir. 2000).
92. *Id.* at 303–04.
93. *Id.*
94. Novak v. Kasaks, 997 F. Supp. 425, 431, 435 (S.D.N.Y. 1998).
95. *Novak*, 216 F.3d at 315.
96. *Id.* at 314; John H. Henn et al., *Tales from the Loading Dock: The Use of Anonymous Sources in Securities Fraud Class Action Complaints*, *in* SECURITIES LITIGATION: PLANNING AND STRATEGIES 2006, at 959, 963–65 (ALI-ABA Continuing Prof'l Educ., Course Handbook Ser. No. SL085, 2006).
97. *Novak*, 216 F.3d at 314.

over, the *Novak* line of cases would even allow a complaint to succeed in the absence of documentary evidence that would independently establish scienter.[98]

Although lenient, the detail standard will not always allow a complaint to get through the pleading door. When a confidential source's statements are too general and amount to no more than "bald assertions," there will be no finding of scienter.[99] Furthermore, if the descriptions of the individuals are lacking, the complaint will be dismissed unless the sources are named.[100]

Adopting the Second Circuit's reasoning, other courts have also ruled that a plaintiff need not name his or her confidential sources if the plaintiff has provided sufficient detail to warrant a belief that the sources would have the information that they claim.[101] For instance, the U.S. Court of Appeals for the First Circuit evaluated a case that relied heavily on confidential sources for the allegation that senior executives in a drug company had purposefully misrepresented their drug's safety.[102] The First Circuit found that it was able to evaluate the complaint in its totality to determine that the pleading was insufficient, the inclusion of the confidential sources notwithstanding.[103]

2. Criminal Law Comparison

In evaluating sources under the detail standard, many courts draw the intuitive comparison to criminal law, where parties routinely depend on confidential sources to obtain information.[104] Indeed, the approach applied in the detail standard is reminiscent of the approach that courts take when evaluating whether a confidential source is sufficiently reliable to establish probable cause.[105] Before the Supreme Court adopted its current approach to determining probable cause,[106] courts evaluated information derived from anonymous sources under two prongs: the veracity prong and the reliability prong.[107] This two-step process is known as the *Aguilar-Spinelli* test.[108] Substantively, this test mandates that information given by confidential sources reveal the sources' "basis of knowledge" and "veracity."[109] Under the first prong, a court would determine how the informant came to possess the information that he or she claims

98. *See, e.g.*, Inst. Investors Grp. v. Avaya, Inc., 564 F.3d 242, 261 (3d Cir. 2009).
99. N.J. Carpenters Pension & Annuity Funds v. Biogen Idec Inc., 537 F.3d 35, 47, 52 n.18 (1st Cir. 2008).
100. ABC Arbitrage Plaintiffs Grp. v. Tchuruk, 291 F.3d 336, 353–54 (5th Cir. 2002).
101. *See, e.g.*, *id.*
102. *N.J. Carpenters*, 537 F.3d at 37, 51.
103. *Id.* at 45, 52.
104. *See, e.g.*, Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1239 (11th Cir. 2008).
105. Illinois v. Gates, 462 U.S. 213, 230–31 (1983).
106. *See id.*
107. *Id.* at 228–29; Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 995 (9th Cir. 2009).
108. *Gates*, 462 U.S. at 267–68 (White, J., concurring).
109. *Id.* at 228–29 (majority opinion).

to have.[110] Under the second prong, a court would evaluate whether there were sufficient facts to establish that the information given was credible.[111] For this second prong, a court might consider the amount of detail that an informant provided to law enforcement.[112] Thus, the *Aguilar-Spinelli* test required an examination of the information contained in the informant's tip and of the informant him or herself.[113]

Similarly, under the detail standard, courts often apply a two-pronged analysis in evaluating information provided by confidential sources. First, the court will analyze whether the complaint provides enough detail about the witness to warrant a conclusion that the witness himself is reliable and would possess the kind of knowledge that he or she claims to have.[114] Second, the statements that are reported by the informant must themselves be indicative of scienter.[115]

3. Advantages and Disadvantages of a Detail Standard

The detail standard's inherent consistency with *Tellabs*, as well as its ease of application, make it an attractive option. Also, this standard is the easiest for plaintiffs to meet and still affords an honest look at the sources without barring their use entirely.[116] Its disadvantages, however, stem from the amount of detail that plaintiffs must provide and its similarity to the criminal law approach.

To begin with, the detail standard may be most consistent with the *Tellabs* opinion. The holding in *Tellabs* is extraordinarily inclusive because it requires courts to make a comparative analysis of all allegations in a complaint—plaintiff's and defendant's.[117] Logically, this holding might also require a court to give due consideration to allegations made by confidential sources.[118]

110. *See id.* at 227–28.

111. *Id.* at 228–29.

112. *See* Spinelli v. United States, 393 U.S. 410, 416–17 (1969) (citing Draper v. United States, 358 U.S. 307 (1959)), *overruled by* Illinois v. Gates, 462 U.S. 213 (1983).

113. *Gates*, 462 U.S. at 228–29 (noting that under *Aguilar-Spinelli*, a court would first determine the informant's "'basis of knowledge' . . . the particular means by which he came by the information given in his report. Second, it had to provide facts sufficiently establishing either the 'veracity' of the affiant's informant, or, alternatively, the 'reliability' of the informant's report in this particular case").

114. Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 995 (9th Cir. 2009).

115. *Id.*

116. N.J. Carpenters Pension & Annuity Funds v. Biogen Idec Inc., 537 F.3d 35, 51 (1st Cir. 2008) ("*Tellabs* requires that all information in plaintiffs' complaint be evaluated. . . . We think that includes confidential source information . . . . We have never said a complaint would survive if it were based only on confidential source allegations. Indeed, we have said there must be a hard look at such allegations to evaluate their worth." (citation omitted)).

117. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322–23 (2007) ("The inquiry, as several Courts of Appeals have recognized, is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.").

118. *E.g.*, *N.J. Carpenters*, 537 F.3d at 51.

Furthermore, refusing to discount a confidential source's allegations does not mean that those allegations are admitted.[119] Also, the detail standard is one that courts are accustomed to applying. Because courts regularly applied this approach in criminal law,[120] the move to apply it in the civil context should be straightforward.

Nonetheless, transposing an approach from one area of law to another can be problematic. Of central concern is that the standard is different. Probable cause, the standard used in evaluating warrants in criminal law,[121] is a relatively low standard; it does not require that the likelihood that an allegation is true be greater than fifty percent.[122] The standard for evaluating securities complaints, however, requires that there be a "cogent and compelling" inference of scienter.[123] Cogent and compelling is a much higher standard than probable cause.[124] Thus, to apply the same analysis when the standards are different might encourage incorrect results.

Moreover, a more substantive problem exists with applying a criminal law type standard. Namely, the consequences of lying in the two contexts differ greatly. For example, a witness who lies to the police will surely face criminal prosecution.[125] There would be no equivalent consequences, however, if a purported "witness" were to lie to a lawyer.[126] Some critics counter by arguing that Rule 11 of the Federal Rules of Civil Procedure provides incentives for lawyers to flush out untruthful claims made by witnesses.[127] In this vein, they argue that a requirement that

119. *See id.* at 52 (holding that the allegations made by confidential sources do not establish a finding of scienter).

120. Illinois v. Gates, 462 U.S. 213, 233–35 (1983).

121. *Id.* at 236.

122. *See* United States v. Funches, 327 F.3d 582, 586 (7th Cir. 2003) (en banc).

123. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007).

124. Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1240 (11th Cir. 2008). It is also worth noting that Justice Stevens argued that the proper threshold in evaluating what constitutes a "strong inference" of scienter would be "probable cause," not "cogent and compelling." *Tellabs*, 551 U.S. at 336 (Stevens, J., dissenting). In his dissent in *Tellabs,* Justice Stevens argued that establishing a higher standard in a civil case than in a criminal case was absurd. *Id.* Moreover, Justice Stevens felt that probable cause would be the most convenient standard to adopt because although it "is not capable of precise measurement, . . . it is a concept that is familiar to judges." *Id.*

125. 18 U.S.C. § 1001(a) (2006) ("[W]hoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully . . . falsifies, conceals, or covers up by any trick, scheme, or device a material fact; . . . makes any materially false, fictitious, or fraudulent statement or representation; or . . . makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry; . . . shall be fined under this title, imprisoned not more than 5 years . . . .").

126. *Mizzaro*, 544 F.3d at 1240.

127. Rule 11(b) of Federal Rules of Civil Procedure establishes that:

> By presenting to the court a pleading, written motion, or other paper—whether by signing, filing, submitting, or later advocating it—an attorney or unrepresented party certifies that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances: (1) it is not being presented for any improper purpose, such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation; . . . [and] (3) the factual contentions have evidentiary support or, if specifically so identified, will likely have evidentiary support after a reasonable opportunity for further investigation or discovery . . . .

FED. R. CIV. P. 11(b).

courts discount claims made by confidential sources is unwise; it requires a court to be overly imaginative and consider the irrational inference (and not merely plausible inferences) that an attorney is relying on a nonexistent source.[128]

Notwithstanding the above arguments, legislative history indicates that Congress considered Rule 11 when it drafted the PSLRA.[129] The Senate Report accompanying the PSLRA demonstrates Congress's concern that Rule 11 is ineffective in combating abusive litigation.[130] Consequently, relying on Rule 11 alone as a bar to nonmeritorious litigation is insufficient.

Moreover, this approach's moniker suggests a further disadvantage: If a certain degree of detail is sufficient, how much is enough and how much is too much? For instance, including a certain amount of detail could equate to actually naming the source.[131] To fully understand, one must consider the context in which this type of fraud occurs. It normally involves statements made in corporate boardrooms and executive suites, areas closed off to the public.[132] If one requirement is that the confidential source be in a "position to know," and the universe of people who would be "in the know" is forcibly small, then it might be facile to identify the confidential source.[133] In addition, defendants devote significant resources to discovering the source of "leaks."[134] Therefore, an overly stringent detail requirement might be the functional equivalent of naming a source.

4. The Detail Standard—Summary

The detail standard most closely resembles the pre-*Tellabs* approach that courts used for dealing with confidential sources in securities litigation. These courts evaluate sources under a totality test and do not per se discount statements made by anonymous witnesses. This approach is beneficial because it allows for an analysis of all aspects of a complaint. This standard is potentially problematic, however, because it borrows heavily from a criminal law standard and may not provide the effective bar to vexatious litigation that the PSLRA sought to establish.

128. Michael J. Kaufman & John M. Wunderlich, *Congress, the Supreme Court and the Proper Role of Confidential Informants in Securities Fraud Litigation*, 36 SEC. REG. L.J. 345, 355–56 (2008).

129. S. REP. NO. 104-98, at 13–14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 692–93.

130. *Id.* (noting the high cost of filing a Rule 11 motion and the hesitancy of most courts to impose sanctions on attorneys).

131. Wohl, *supra* note 3, at 561.

132. *Id.*

133. *See* Institutional Investors Grp. v. Avaya, Inc., 564 F.3d 242, 261–62 (3d Cir. 2009).

134. Wohl, *supra* note 3, at 561.

C. The Discount Standard: The Seventh Circuit and the Steep Discount of Confidential Sources

In contrast to the more lenient detail standard, some circuits are demonstratively more apprehensive about the use of confidential sources. These circuits appear to include at least the Seventh Circuit,[135] but probably also the Fifth,[136] Sixth,[137] and Third Circuits.[138] Under this standard, allegations made by confidential sources are discounted—even before the court evaluates the source or the allegations provided.[139]

1. Case Analysis

The discount standard originated in *Higginbotham v. Baxter*, a case before the Seventh Circuit.[140] In that case, plaintiffs attempted to use five confidential sources to prove fraudulent accounting practices by a parent company's Brazilian subsidiary.[141]

In its opinion, the court expressed extreme skepticism, bordering on paranoia.[142] The judges seemed surprised that they would not have the opportunity to evaluate the anonymous sources in great detail.[143] During oral arguments Judge Posner vocalized the rationale behind his strong concerns, remarking that maybe the sources "have axes to grind. Perhaps they are lying. Perhaps they don't even exist."[144]

Beyond this skepticism, the panel demonstrated a more substantive concern. In particular, the judges opined that they might be bound by precedent to exclude allegations made by confidential sources.[145] The panel gave two reasons why precedent might prevent it from giving credence to the allegations made by the confidential sources. First, the court reasoned that, under *Tellabs*, the inference of scienter must be compelling.[146] The panel members doubted that information provided by sources who would never reveal their identities could ever be compelling.[147] Second, the court noted that *Tellabs* requires courts to draw

135. Higginbotham v. Baxter Int'l Inc., 495 F.3d 753, 756–57 (7th Cir. 2007) (noting that statements by confidential witnesses must be discounted and cannot be "compelling").

136. *See* Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Grp., Inc., 537 F.3d 527, 535 (5th Cir. 2008); Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc., 497 F.3d 546, 552 (5th Cir. 2007).

137. *See* Ley v. Visteon Corp., 540 F.3d 376, 386 (6th Cir. 2008).

138. *Institutional Investors Grp.*, 564 F.3d at 263 ("If anonymous source allegations are found wanting with respect to these criteria, then we must discount them steeply.").

139. The Seventh Circuit in *Higginbotham* clarified that the steep discount standard does not mean that the source's allegations will be ignored. *Higginbotham*, 495 F.3d at 757.

140. *Id.* at 755–56.

141. *Id.*

142. *See id.* at 756–57.

143. *See id.* at 757.

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

plausible competing inferences in favor of both parties.[148] Because the plaintiff was relying largely on nameless sources with unverifiable claims, however, the court was unable to weigh competing inferences in favor of the defendant.[149]

Finally, the court indicated that complete anonymity in a judicial proceeding is impossible.[150] To begin with, the protections that criminal law offers anonymous witnesses are not present in the civil law context.[151] No analogy to the "informer's privilege" exists in civil litigation.[152] Moreover, the discovery process imposes limitations, and the plaintiff will ultimately be required to reveal the identities of all parties who "have discoverable information that . . . [he or she] may use to support [his or her] claims or defenses."[153] Thus, because the source must ultimately be disclosed, a court may infer from a plaintiff's failure to divulge the source's identity that the case is entirely settlement driven and is therefore the genre of suit that Congress sought to eliminate.

In the end, the three judge panel consisting of Judges Easterbrook, Posner, and Ripple, found that *Tellabs* requires courts to discount allegations made by confidential witnesses.[154] Ultimately, this discount will be steep.[155] Such language indicates that the Seventh Circuit would give almost zero credibility to unnamed confidential sources and amounts to a blanket requirement that sources be named.

The Seventh Circuit's *Higginbotham* discount standard has been influential. Judges Posner and Easterbrook's participation—both influential jurists in their own right—surely adds to the far-reaching effect of the opinion. In any case, several circuits, including the Fifth, Sixth, and Third Circuits, have cited the *Higginbotham* decision in opinions dismissing complaints that relied on confidential sources.[156] Consequently, the discount standard may signal a decreased role for confidential sources in private securities fraud actions.[157]

148. *Id.*

149. *Id.* ("*Tellabs* requires judges to weigh the strength of plaintiffs' favored inference in comparison to other possible inferences; anonymity frustrates that process.").

150. *Id.*

151. *See id.*

152. *Id.*

153. *Id.* (quoting FED. R. CIV. P. 26(a)(1)(A)).

154. *Id.*

155. *Id.*

156. Jordan Eth & Timothy Blakely, *The Use and Abuse of Confidential Witnesses: The Battle Continues After* Tellabs, *in* SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2009, at 607, 624–28 (2009); Kaufman & Wunderlich, *supra* note 128, at 352–54; *see also* Institutional Investors Grp. v. Avaya, Inc., 564 F.3d 242, 263 (3d Cir. 2009); Ley v. Visteon Corp., 540 F.3d 376, 386 (6th Cir. 2008); Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc., 497 F.3d 546, 552 (5th Cir. 2007).

157. Paul V. Konovalov, *"Plausible Opposing Inferences": The Disappearing Role of Confidential Witnesses in Securities Fraud Class Actions*, FED. B. ASS'N ORANGE COUNTY CHAPTER, Winter 2008, at 10, 15–16, http://www.fbaoc.com/ (follow "Newsletters" hyperlink; then follow "Winter 2008 Newsletter" hyperlink).

2. *Advantages and Disadvantages of a Steep Discount*

Effectiveness and efficiency characterize the discount standard. To begin with, discounting confidential sources might be the surest method of enforcing Congress's objectives in enacting the PSLRA.[158] The need to discount allegations by these sources reflects the general concern with securities actions in general;[159] namely, these actions present a very real danger of vexatious litigation.[160] If a party were able to blackmail another into settlement by lying and issuing false, unverifiable allegations, vexatious securities litigation would increase.[161] In this light, a requirement that sources must always be named would be the surest method of guaranteeing that a plaintiff could not bring an untruthful witness before the court and would thus limit invalid actions.

Moreover, the U.S. justice system recognizes that the right to confront one's accusers is fundamental.[162] Forbidding a defendant to confront those who make allegations frustrates this principle, even in a civil setting. While the defendant can always cross-examine the witness at trial, securities complaints will settle the vast majority of the time.[163] When a case settles, the pleadings stage functions as a quasi-summary judgment proceeding. Therefore, no opportunity to cross examine the witness will be available, and denying a party the right to confront his or her accuser in this setting rings inquisitorial.

Furthermore, defendants are at an extreme tactical disadvantage when a plaintiff uses confidential sources in his complaint.[164] Although the defendant will ultimately uncover a source's identity through discovery,[165] he or she likely needs to prepare an initial response, which the defendant may be unable to do at this preliminary stage.

Also, perhaps sources *should* be named—both for the court and for the defendant. Disclosure would further add to the detail provided to the court. Greater detail would ensure greater confidence, and the plaintiff would bolster his or her chances of surviving a motion to dismiss.[166] In the alternative, if the concern is for the witness's security, Congress

158. *Higginbotham*, 495 F.3d at 757 ("Concealing names at the complaint stage . . . does not protect informers from disclosure . . . ; it does nothing but obstruct the judiciary's ability to implement the PSLRA."); *see also* Erin E. Rhinehart, *Diluting the Strong Inference Standard*, 55 FED. LAW. 20, 20 (2008) (arguing that in adopting the PSLRA Congress went beyond the strictest standard applied in any court and required plaintiffs to particularly state facts that would give rise to a strong inference of scienter).

159. *See supra* Part II.D.

160. S. REP. NO. 104-98, at 9–10 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 688–89.

161. These concerns are identical to those that Congress expressed when it drafted the PSLRA. *See id.*

162. *See* U.S. CONST. amend. VI.

163. S. REP. NO. 104-98, at 9.

164. *See supra* text accompanying notes 75–84.

165. *See, e.g.*, FED. R. CIV. P. 26(a).

166. The outrage of the *Higginbotham v. Baxter International Inc.* court was visible. 495 F.3d 753, 757 (7th Cir. 2007) ("Concealing names at the complaint stage . . . does not protect informers from disclosure . . . ; it does nothing but obstruct the judiciary's ability to implement the PSLRA.").

has repeatedly passed legislation strengthening such protection.[167] If these safeguards are inadequate, then perhaps it is not the role of the judiciary to implement further protections.

Moreover, in terms of protection, a requirement that a plaintiff plead his or her sources with a great amount of detail might be the functional equivalent to naming a source. In this light, the discount and the detail standards produce the same result. For example, in the recent case of *Mizzaro v. Home Depot, Inc.*,[168] the plaintiff attempted to persuade the court by describing his confidential source as the "Director of Home Depot's Northwest Division from 1997 through 2003."[169] That source oversaw three hundred stores in twelve states and supervised twenty-six distinct managers.[170] Although lower-level employees might not be readily identifiable through particularized descriptions, higher-level managers (who would be in a position to know about fraudulent activity) are more conspicuous.[171] Descriptions like the one given in *Mizzaro*[172] would render a confidentiality shield ineffective.

Also, such a per se rule might be advantageous for the degree of clarity and predictability it would offer.[173] Plaintiffs could save valuable time and money if they could better determine their chances of pleading a successful complaint. Moreover, stricter, clearer guidelines would lessen the burden on courts because parties would be discouraged from filing complaints that have little chance of success.

On the other hand, the broad nature of the discount standard is the hallmark of its inadequacy. Specifically, this standard suffers from the same disadvantages always present with per se rules: "it may sweep too broadly."[174] Clearly a steep discount against the claims of confidential sources would present a formidable barrier for plaintiffs who already face a significant hurdle with the PSLRA.

Additionally, establishing a blanket rule that sources must be named might contradict the PSLRA. A central tenet behind the PSLRA was "to encourage plaintiffs' lawyers to pursue valid claims."[175] These valid claims serve a regulatory effect by disincentivizing fraudulent behavior.[176] But given that the number of securities complaints relying on confidential sources is increasing, a per se rule that allegations from these sources will be steeply discounted would likely filter out many valid

167. *See supra* note 74.

168. 544 F.3d 1230 (11th Cir. 2008).

169. *Id.* at 1241.

170. *Id.*

171. This result is logical: on the employment pyramid there will be fewer employees at the top than there are at the bottom.

172. *Mizzaro*, 544 F.3d at 1241.

173. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988).

174. *Id.*

175. S. REP. NO. 104-98, at 6 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 685.

176. Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 396 (1970) (indicating that plaintiffs who sued to enforce a violation of Section 14(a) of the Exchange Act had "rendered a substantial service to the corporation and its shareholders").

claims. When fewer complaints are allowed in the door, the ability to prevent fraud is lessened. Hence, enacting a far-reaching barrier that would keep out a great number of complaints would be detrimental to one of the PSLRA's most fundamental purposes.

Furthermore, the extreme, automatic discount standard that the Seventh Circuit applied may be unnecessary. In fact, the *Tellabs* decision itself may have mandated a different kind of approach.[177] Under *Tellabs*, when a plaintiff pleads fraud through a material omission, or when a plaintiff's complaint contains ambiguous facts, courts must treat those omissions or ambiguities as inferences in favor of the defendant.[178] Under this logic, if a source is left unnamed and if that source did not occupy a position in the company that would afford them access to the information which they claim to possess, the court may appropriately treat that source as ambiguous. Consequently, this ambiguity would count as a "plausible opposing inference" in favor of the defendant.

On a further note, legislative research reveals that Congress may have foreseen that parties would rely on confidential sources in their pleadings but purposely excluded language in the PSLRA that would limit this practice.[179] In fact, this point came up during congressional debates,[180] yet Congress neglected to include any such provision in the PSLRA.[181] In this case, to read in a requirement that sources must be discounted, because they are not specifically named, might be an unfounded act of judicial activism.[182]

3. The Discount Standard—Summary

The discount standard mandates a steep discount of statements made by confidential sources. This approach is the strictest of all approaches courts have taken in dealing with these sources. Although this approach will certainly guard against malicious strike suits, one must question whether this standard is, in fact, overly strict and unwarranted by the language and intent of the PSLRA.

177. Kaufman & Wunderlich, *supra* note 128, at 355–57.

178. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314, 326 (2007).

179. *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 763–64 (N.D. Cal. 1997); *see also* 141 CONG. REC. H2848 (daily ed. Mar. 8, 1995) (statement of Rep. Bryant). Representative Dingell argued that Congress drafted the PSLRA to require parties to "literally . . . include the names of confidential informants . . . who have provided information leading to the filing of the case." *Id.* at H2849 (statement of Rep. Dingell).

180. 141 CONG. REC. H2849 (daily ed. Mar. 8, 1995) (statement of Rep. Dingell).

181. *See* 15 U.S.C. § 78u-4 (2006).

182. *See* Nachman Corp. v. Pension Benefit Guar. Corp., 446 U.S. 359, 392–93 (1980) (Stewart, J., dissenting) ("Few principles of statutory construction are more compelling than the proposition that Congress does not intend *sub silentio* to enact statutory language that it has earlier discarded in favor of other language.").

D. The Skepticism Standard

The skepticism standard lies somewhere between the steep discount standard formulated by the Seventh Circuit in *Higginbotham* and the detail standard formulated by the Second Circuit in *Novak*.[183] Under the skepticism standard, a court may reject the bright-line deep discount that the Seventh Circuit applies but nonetheless remain ostensibly skeptical of claims by confidential sources.[184] As with the detail standard, a court will initially evaluate the strength of the complaint based on a totality of the circumstances, paying particular attention to the basis of the source's knowledge and the probability that the source would have the information that he or she claims to possess.[185] Under the skepticism standard, however, a court might explicitly take into account the fact that the witness has chosen to remain confidential.[186] At least one court has indicated that confidentiality "should not eviscerate the weight given if the complaint otherwise fully describes the foundation or basis of the confidential witness's knowledge,"[187] but even that court took a skeptical tone. Such skepticism suggests that courts will sometimes slightly discount statements offered by confidential sources.

1. Case Analysis

The U.S. Court of Appeals for the Eleventh Circuit case of *Mizzaro v. Home Depot, Inc.* illustrates this skepticism.[188] In that case, the plaintiffs brought a class action suit against Home Depot alleging that the company had falsely inflated its earnings through a complicated purchase-and-return scheme.[189] In so pleading, the plaintiffs named the company's corporate officers as defendants.[190] The complaint relied heavily on testimony from six confidential sources to support its allegations.[191] Each witness supplied a detailed account of the mechanics involved in the alleged scheme.[192]

Although the complaint detailed the roles of the six confidential sources,[193] the court ultimately dismissed the action.[194] In its opinion, the court evinced skepticism and noted several deficiencies in the complaint.[195] In particular, although the plaintiff's confidential sources re-

183. *See* discussion *supra* Part III.B–C.
184. Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1239–40 (11th Cir. 2008).
185. *Id.*
186. *Id.* at 1240.
187. *Id.*
188. *See id.*
189. *Id.* at 1240–41.
190. *Id.* at 1246–47.
191. *Id.* at 1241–42.
192. *Id.*
193. *Id.* These witnesses occupied positions from clerks, to store management, to Regional Managers. *Id.*
194. *Mizzaro*, 544 F.3d at 1257.
195. *Id.* at 1255–57.

peatedly referred to a "plan" (the alleged purchase-and-return scheme), the plaintiffs had neglected to cite the actual "plan" itself.[196]

A protracted discussion in dicta illustrates the skepticism that the court felt in evaluating these sources.[197] The court began by noting that the use of confidential sources was a well-established practice, and that courts were accustomed to dealing with them.[198] Nonetheless, it was quick to distinguish between the use of confidential sources in securities complaints and the use of these sources in other areas of law.[199] At the outset, the court indicated that the repercussions for lying in civil cases are less serious than the repercussions for lying in criminal investigations.[200] The court further noted that the probable cause standard used in criminal law is less stringent than the cogent and compelling standard used in securities fraud complaints.[201] In light of these differences, the court stated that it would explicitly take into account the fact that the witnesses remained confidential.[202]

Although in context it is difficult to isolate the confidentiality factor from other potential deficiencies in the complaint, the court's language implies that it treated confidentiality itself as an inference against the plaintiff.[203]

The Eleventh Circuit's skepticism is reminiscent of the inference against scienter that *Tellabs* mandates when a plaintiff alleges a material omission or when plaintiff's complaint contains ambiguities—in other words, when plaintiffs have insufficiently particularized the scienter allegation.[204] In fact, another court that cited *Mizzaro* expressed concern that confidential witnesses are often ambiguously described and courts are unable to determine whether the source would have the knowledge that he or she claims to possess.[205]

2. Advantages and Disadvantages of a Skepticism Standard

In light of the requirement that ambiguities in a complaint count as an inference against scienter, it might be logical to slightly discount (as the skepticism standard would suggest) statements made by confidential sources. This kind of inference is easy to make. Moreover, even if they do not vocalize their thought processes, courts might make this inference naturally as part of a totality of the circumstances test. In this context, a

196. *Id.* at 1242.
197. *Id.* at 1248.
198. *Id.* at 1239.
199. *Id.* at 1240.
200. *Id.*
201. *Id.*
202. *Id.*
203. *See id.*
204. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314, 323 (2007).
205. Hubbard v. BankAtlantic Bancorp, Inc., 625 F. Supp. 2d 1267, 1284 (S.D. Fla. 2008) (citing *Mizzaro*, 554 F.3d at 1239–40).

formal announcement that the use of confidential sources will count as an inference against the plaintiff might add a certain degree of predictability and certainty to securities fraud complaints.[206] A logical step would be to then allow the plaintiff to rebut this inference with additional detail. Such an approach may strike a happy medium between an automatic steep discount and an approach that relies solely on the level of detail that is plead along with the confidential source.

Such an approach, however, also suffers disadvantages. One major disadvantage is shared with the detail standard. If a plaintiff can rebut an inference by supplying additional details, at what point does enough detail become too much detail? In other words, at what point does a detail requirement rob the source of his or her confidentiality?[207]

Furthermore, maintaining a skepticism standard might present an unsatisfying option for those who would prefer a more conservative approach. Whereas the discount standard is simple and straightforward in its application,[208] the skepticism standard is nebulous and may lead to further questions to be fleshed out by case law. For example, exactly how skeptical must courts be of confidential sources? Also, how much detail is required to rebut that degree of skepticism?

3. Skepticism Standard—Summary

The skepticism standard is a midpoint between the detail standard and the discount standard. Under this approach, a court might explicitly take into account the fact that a witness has chosen to remain confidential. In cases where a confidential source's base of knowledge cannot be unambiguously established, courts may treat confidentiality as an inference in favor of the defendant.[209]

IV. RECOMMENDATION

This Note recommends that courts adopt the skepticism standard when evaluating claims made by confidential sources in securities litigation. This approach is more consistent with the twin goals of the PSLRA than the other two aforementioned standards: it effectuates congressional intent behind the PSLRA because it is sufficiently lenient so as to encourage the regulatory effect of valid claims, and it more successfully discourages malicious litigation than does the detail standard. The skepticism standard strikes a middle ground and represents a happy compromise between the various circuits.

206. "While we recognize that a case-by-case approach may provide less concrete guidance to district courts, the tension inherent in balancing the two congressional goals cannot be evaded by adopting an unnecessarily broad per se rule which may prevent pursuit of legitimate cases." *In re* Cabletron Sys., Inc., 311 F.3d 11, 30 (1st Cir. 2002).

207. *See* discussion *supra* Part III.B.3.

208. *See supra* Part III.C.

209. *See supra* notes 186, 205–206 and accompanying text.

A. The Skepticism Standard Better Effectuates Congress's Intent Than Does the Discount Standard

The skepticism standard best effectuates Congress's goal of encouraging valid securities claims and is most consistent with statutory language, goals of the PSLRA, and prior case law. First, the skepticism standard is consistent with the plain language of the PSLRA. Examining the statutory language of the PSLRA, there is no requirement that sources be named.[210] In enacting the PSLRA, Congress did little more than raise the pleadings bar. Under these circumstances, a skeptical look—rather than a steep discount—would be more appropriate. The Seventh Circuit, in ruling that confidential sources would be steeply discounted, went beyond this statutory language.[211]

Second, the skepticism standard is most appropriate because it furthers the PSLRA's goal of disincentivizing fraud.[212] The implied private action under Rule 10b-5 has been consistently recognized in the U.S. judicial system[213] and is now an important part of our system, serving a crucial role in securities regulation.[214] A blanket requirement that confidential sources be named, however, would keep out many cases that would serve this important regulatory effect.[215] Firstly, many confidential sources will only agree to testify if they are guaranteed that their identities will be kept confidential.[216] Secondly, because the actionable fraud involved in securities complaints generally takes place in the context of closed meetings,[217] confidential sources are often the only means that a plaintiff would have of establishing fraud.[218] By enacting a requirement that would eviscerate sources' confidentiality, courts would prevent valid claims from proceeding and would curtail the impact of implied private rights of action under Rule 10b-5.

Third, the skepticism standard is more consistent with *Tellabs* than is the discount standard. *Tellabs* does not require courts to disregard claims made by confidential sources.[219] To the contrary, *Tellabs* is remarkably inclusive; its holding mandates that courts take all allegations into account.[220] All allegations should also include those made by confidential sources.

210. Teachers' Ret. Sys. of La. v. Hunter, 477 F.3d 162, 193 (4th Cir. 2007) (Shedd, J., dissenting).
211. *See* Higginbotham v. Baxter Int'l Inc., 495 F.3d 753, 757 (7th Cir. 2007).
212. *See supra* text accompanying notes 175–176.
213. *Cf.* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 396 (1970) (indicating that plaintiffs who sued to enforce a violation of Section 14(a) of the Exchange Act had "rendered a substantial service to the corporation and its shareholders").
214. *See id.*
215. *See id.*
216. Wohl, *supra* note 3, at 558.
217. *Id.* at 560–61.
218. *Id.* at 556.
219. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314–23 (2007).
220. *See id.* at 322–23.

B. The Skepticism Standard Offers Greater Protection Against Strike Suits and Vexatious Litigation Than Does the Detail Standard

The skepticism standard is more advantageous than the detail standard because it better addresses Congress's concern for the risks of securities cases. For instance, the skepticism standard compensates for the court's inability to distinguish truth from falsities, offers protection beyond the limits of Rule 11, and is commensurate with the heightened pleadings standards of the PSLRA.

To begin with, the skepticism standard is appropriate because it is consistent with the high pleadings standards of the PSLRA. In selecting the "strong inference" requirement, Congress went beyond the strictest standard that was applied in any court at that time.[221] This threshold, which, in turn, must be "cogent and compelling," is even higher than the standard required to deprive an individual of his freedom.[222] Consequently, the approach that courts use to determine whether the facts are sufficient to meet this benchmark should be equally high. A more critical approach to dealing with confidential source—a key part of many plaintiffs' claims—is appropriate because the pleadings threshold has been heightened.

Also, a skeptical approach would help compensate for the court's inability to examine and question the witness. Securities fraud cases are attractive to plaintiffs' lawyers because the damages in these types of cases are large.[223] Moreover, because securities fraud cases almost always settle, plaintiffs' lawyers are spared the effort and expense of litigating at the trial stage; settlement is their ultimate goal.[224] For this reason, plaintiffs can handicap a court by playing on its inability to ferret out lies. Essentially, it is impossible to assess the truthfulness of these statements in the front end. Therefore, courts need additional protection from those that would provide false information. A heightened degree of skepticism—but one that does not rise to the level of a complete discount—would provide this protection.

Moreover, as discussed on the Senate floor during debates over the PSLRA, Rule 11 is an ineffective barrier for witnesses who would knowingly provide false information.[225] Because criminal-law repercussions for knowingly providing false information are unavailable in civil laws,[226] reliance on Rule 11 alone is misplaced. A skeptical approach to dealing with claims made by confidential sources would compensate for the Rule's deficiencies.

221. Rhinehart, *supra* note 158, at 20.
222. *See Tellabs*, 551 U.S. at 336 (Stevens, J., dissenting).
223. S. REP. NO. 104-98, at 6 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 685.
224. *Id.* at 9.
225. *Id.* at 13.
226. *See supra* text accompanying notes 125–127.

V. CONCLUSION

The damages at stake in securities fraud cases are sizeable, and a healthy economy relies on market stability. Lawsuits that would drag down the securities markets are a cause for concern. It is in this context that the modern-day spy—the confidential source—plays a small but meaningful role.

Although some of these spies serve a helpful function by flushing out fraud that would harm the securities markets, there is a great risk that others will help promulgate vexatious, settlement-driven lawsuits. These vexatious lawsuits were Congress's principal concern in drafting the PSLRA. As such, courts should adopt an approach that would best effectuate Congress's intentions. The skepticism standard identified by this Note serves that purpose. Accordingly, courts should apply this standard when evaluating claims made by confidential sources in securities complaints.