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Second Circuit Takes Position on "Confidential Witnesses" in Securities Class Actions, Approves Depositions for Purposes of Motion to Dismiss

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In 2000, the Second Circuit Court of Appeals found that plaintiffs relying on "confidential witnesses" and other factual allegations in securities class action complaints did not need to identify such witnesses in order to defeat a motion to dismiss. *Novak v. Kasaks*, 216 F. 3d 300 (2d Cir. 2000). Ten years later, in light of intervening Supreme Court decisions on pleading standards, the Second Circuit reversed course and affirmed the dismissal of a securities class action where the lower court had ordered depositions of purported confidential witnesses and had considered the deposition testimony in deciding the motion.[1]

In reviewing the dismissal *de novo*, the Second Circuit assessed whether the confidential witness deposition testimony, taken in connection with the other allegations in the complaint, supported a claim of scienter. The Second Circuit's consideration of this deposition testimony is significant because of the Court's prior precedent on the subject, and because the discoverability and identification of such anonymous witnesses referenced in pleadings historically has been hotly contested by plaintiffs' counsel as protected work product. The decision is consistent with a recent trend where other courts have rejected the work product argument by plaintiffs and ordered identification of confidential witnesses relied upon in securities class action complaints.

Also, under the Private Securities Litigation Reform Act ("PSLRA"), discovery is typically stayed entirely in these cases until any pleading challenges are completed. The ordering of the depositions of the anonymous witnesses by the district court during the discovery stay, and the judicial evaluation of plaintiffs' allegations against the testimony of those same witnesses by that court and the Second Circuit in connection with a motion to dismiss, further confirms the courts' rigorous approach to analyzing such complaints under the heightened pleadings standards of the PSLRA. It suggests that, in relying upon such witnesses in order to meet the PSLRA's standards, and placing them before the court as persons vouching for the complaint's contents, plaintiffs' counsel may no longer conceal the identity of these confidential witnesses.

***Campo v. Sears Holding Corp.*, 2010 WL 1292329, No. 09-3589-cv (2d Cir. Apr. 6, 2010)**

The plaintiffs in *Campo v. Sears Holding Corporation* appealed from a district court order dismissing their securities class action complaint. The district court initially denied defendants' motion to dismiss without prejudice but ordered depositions of the confidential witnesses relied upon in the

complaint. The case was subsequently reassigned to another judge who considered the confidential witnesses' deposition testimony "for the limited purpose of determining whether the confidential witnesses acknowledged the statements attributed to them in the complaint."[2] The newly assigned judge then granted defendants' motion to dismiss basing its order on the allegations contained in the complaint, but limited its consideration of the confidential witness statements to those that were corroborated by their subsequent deposition testimony.[3]

On appeal, the Second Circuit reasoned that consideration of such deposition testimony is permissible in a court's determination of the sufficiency of the allegations of scienter pursuant to the United States Supreme Court's decision in *Tellabs v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314, 127 S. Ct. 2499 (2007), and under Rule 11 of the Federal Rules of Civil Procedure, which places certain good faith requirements upon litigants and their counsel. The PSLRA imposes heightened pleading requirements on plaintiffs, including that a complaint "state with particularity facts giving rise to a strong inference that the defendant acted with" scienter.[4] Courts must weigh competing inferences at the pleadings stage to determine whether "a complaint gives rise to an inference of scienter that is 'cogent and at least as compelling as any opposing inference of nonfraudulent intent.'" [5]

The use of such deposition testimony clearly assists in validating the allegations in the complaint. As the Second Circuit reasoned, Rule 11 requires that parties have a "good faith basis" for their pleadings, and such use of deposition testimony "to test the good faith basis of plaintiffs' compliance with *Tellabs* was permissible."[6]

In its *de novo* review of the district court's dismissal order, the Second Circuit considered even more deposition testimony than had the district court. It not only considered those statements in the complaint corroborated by deposition testimony, but it also considered additional testimony that *contradicted* the statements attributed to the confidential witnesses in the complaint.

By considering deposition testimony of confidential witnesses at the pleadings stage, the Second Circuit in *Campo* effectively authorizes courts to look past the allegations in the complaint with regard to statements from confidential witnesses, as part of its determination of plaintiffs' good faith basis for their pleadings. Securities litigation defendants have on occasion utilized contradictory statements that were later obtained from confidential witnesses in post-trial sanctions motions.[7] *Campo* allows defendants to advance such a strategy to the beginning stages of a case, and to challenge the plaintiffs' use of confidential witness statements in testing the viability of a complaint.

Historical Confidentiality of Witnesses Relied Upon in Securities Complaints

The ability to depose confidential witnesses at the pleadings stage of securities litigation reinforces the notion that the plaintiffs should not be able to cloak the supposed sources of their allegations in anonymity.

Although not directly addressed in *Campo*, generally the plaintiff securities bar argues that such confidential sources constitute work product, and resists discovery targeting the witnesses' identity. The plaintiff bar frequently invokes policy arguments about protecting such individuals from potential retaliation from defendants as a rationale for maintaining confidentiality, even during merits stage discovery. Recent decisions, however, have increasingly favored defendants asserting that the identity of confidential witnesses is in fact discoverable and not shielded work product.[8]

Campo is entirely consistent with this more recent trend and effectively takes these decisions a substantial step further, by identifying and sanctioning discovery from these witnesses at the earliest stage of the lawsuit, prior to the commencement of merits discovery.

Conclusion

Campo could significantly impact the use and treatment of confidential witnesses in future securities litigation. Plaintiffs' counsel now may exercise greater care in the selection of such witnesses and in attributing information to them in a pleading. Defendants will likely invoke *Campo*, not only in an effort to identify such witnesses in the course of such litigation, but in order to depose them during the discovery stay in order to test the sufficiency and veracity of the complaint.

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[1] *Campo v. Sears Holding Corp.*, 2010 WL 1292329, No. 09-3589-cv, at *3, n.4 (2d Cir. Apr. 6, 2010) (slip copy).

[2] *Id.*

[3] *Campo v. Sears Holding Corp.*, 635 F. Supp. 2d 323, 330 (S.D.N.Y. 2009).

[4] 15 U.S.C. § 74u-4(b)(2).

[5] *Campo*, 2010 WL 1292329, at *3, n.4 (quoting *Tellabs*, 551 U.S. at 314).

[6] *Id.*

[7] *See*, *e.g.*, *In re JDS Uniphase Sec. Litig.*, 2008 WL 753758, Case No. NO. C 02-1486 CW (N.D. Cal. Mar. 19, 2008); *The WU Group, Inc. v. Synopsis, Inc.*, 2005 WL 1926626, Case No. C 04-3580 MJJ (N.D. Cal. Aug. 10, 2005).

[8] *See, e.g.*, *In re Harmonic, Inc. Sec. Litig.*, 245 F.R.D. 424, 427-28 (N.D. Cal. 2007); *In re Connetics Corp. Sec. Litig.*, 2009 WL 1126508, at *1 (N.D. Cal. Apr. 27, 2009); *Miller v. Ventro Corp.*, 2004 WL 868202, at *2 (N.D. Cal. Apr. 21, 2004); *Hubbard v. BankAtlantic Bancorp, Inc.*, 2009 WL 3856458, at *3 (S.D. Fla. Nov. 17, 2009); *Marsh & McLennan Cos., Inc. Sec. Litig.*, 2008 WL 2941215, *3 (S.D.N.Y. Jul. 30, 2008); *Netbank, Inc. Sec. Litig.*, 259 F.R.D. 656, 676-77 (N.D. Ga. 2009); *Lefkoe v. Jos. A. Bank Clothiers*, 2008 WL 7275126 (D. Md. May 13, 2008); *In re Faro Tech. Sec. Litig.*, 2008 WL 205318, at *2 (M.D. Fla. Jan. 23, 2008); *Brody v. Zix Corp.*, 2007 WL 1544638, at *1 (N.D. Tex. May 25, 2007).