Fighting False Statements with Fabricated Sources: Applying the Appropriate Standard of Judicial Skepticism to Confidential Sources Used to Plead Falsity in Securities Fraud Litigation

Trumon Phillips
123@123.com

Follow this and additional works at: https://ir.law.fsu.edu/lr

Recommended Citation
https://ir.law.fsu.edu/lr/vol37/iss3/6

This Note is brought to you for free and open access by Scholarship Repository. It has been accepted for inclusion in Florida State University Law Review by an authorized editor of Scholarship Repository. For more information, please contact efarrell@law.fsu.edu.
Fighting False Statements with Fabricated Sources: Applying the Appropriate Standard of Judicial Skepticism to Confidential Sources Used to Plead Falsity in Securities Fraud Litigation

Truman Phillips

Volume 37 Spring 2010 Number 3

I. INTRODUCTION

Confidential sources serve a key role in private securities fraud litigation, meritorious and otherwise. Allowing plaintiffs to withhold a source’s identity at the pleading stage allows insiders to expose securities fraud without fear of reprisal.¹ At the same time, a fabricated confidential source stands as a tempting shortcut for the plaintiff who hopes to bypass the heightened pleading requirements of the Private Securities Litigation Reform Act (PSLRA)² and “use discovery merely as a fishing expedition in the hope that something will turn up.”³

Congress enacted PSLRA in 1995 with the stated legislative aim of combating frivolous securities litigation. Toward this end, PSLRA included a range of changes to the process of pursuing securities litigation, not the least of which was a heightening of applicable pleading standards. PSLRA consequently did not provide identical standards for pleading the various aspects of securities fraud. Rather, it provided one standard for pleading the required state of mind (scienter) and another for pleading falsity. This Note will focus on the latter of those two standards. Congress raised the standard for pleading falsity by adding the following provisions to the Securities Exchange Act of 1934:

(b) Requirements for securities fraud actions
   (1) Misleading statements and omissions
       In any private action arising under [the Securities Exchange Act of 1934] in which the plaintiff alleges that the defendant—
       (A) made an untrue statement of a material fact; or
       (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;
       the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

It further provides that “the court shall, on the motion of any defendant, dismiss the complaint if the [pleading] requirements . . . are not met” and that “all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss.”

As a practical matter, PSLRA’s requirements for pleading falsity along with the still applicable requirements of Federal Rule of Civil Procedure 9(b) create a unique set of limitations and opportunities that make the use of confidential sources simultaneously more

6. See id. § 78u-4(b)(1)-(2).
7. See id. § 78u-4(b)(2). In the context of a securities fraud case, the requisite state of mind is intention to deceive. Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc., 532 U.S. 588, 593 (2001); 7 AM. JUR. 2D Securities Regulation—Federal § 1194 (2008).
8. § 78u-4(b)(1).
9. § 78u-4(b)(1).
10. § 78u-4(b)(1) (emphasis added).
11. Id. § 78u-4(b)(3)(A)-(B).
12. FED. R. CIV. P. 9(b) (providing that when “alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake”).
appealing and more complicated. While the recent Supreme Court
decision *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* provides some
insight on the use of confidential sources in the pleading of scienter,\(^\text{13}\) there remains considerably less consensus on their use in pleading falsity. This Note explores the evolution of courts’ approaches to the use of confidential sources to plead falsity, special concerns regarding fabricated sources, and the potential pitfalls of the existing analysis. In the end, this Note proposes a revised process for evaluating confidential sources.

Part I examines PSLRA’s legislative background as well as its early judicial interpretation as it relates to the use of confidential sources to show falsity. Part II begins with an overview of *Novak v. Kasaks*,\(^\text{14}\) the landmark case that rejected the notion that PSLRA summarily precludes the use of unnamed sources in securities fraud cases. It continues with an exploration of the adoption of *Novak* throughout the circuits and the three approaches that have emerged: the original *Novak* approach, the holistic approach, and a more permissive version of the holistic approach. Part III examines the fabrication concerns inherent in the assessment of confidential sources. It then looks at the potential evaluative pitfalls that stem from those concerns including impermissible judicial evaluations of source reliability and credibility at the pleading stage. Finally, Part III argues for a two-step process where courts would look first for adequate assurances that unnamed sources are not fabricated. If adequate assurances are found, only then would a court evaluate the sufficiency of the facts pled with the level of judicial skepticism prescribed by the Federal Rules of Civil Procedure.

**II. BACKGROUND**

**A. Legislative Background**

In contrast to the atmosphere in which Congress passed the Securities Exchange Act of 1934,\(^\text{15}\) PSLRA was enacted amidst outspoken congressional concern that securities litigation had become excessive and harmful.

---

13. See 551 U.S. 308, 314 (2007) (holding that to survive the pleadings stage, an inference of scienter must not only be plausible but also at least as strong as competing inferences); see also infra Part IV.B.1 discussing the implications of *Tellabs*.


15. Congress passed the Securities Exchange Act of 1934 with an eye toward curbing harms caused by market manipulation. See 15 U.S.C. § 78b(4) (2006) (“National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets . . . .”).
There is broad agreement on the need for reform. Shareholders’ groups, corporate America, the SEC, and many lawyers want to curb these abusive practices.

Lawyers who bring meritorious suits do not benefit when strikesuit artists wreak havoc on the Nation’s boardrooms and courthouses.

Our economy does not benefit when the threat of litigation deters capital formation.¹⁶

Specifically, congressional supporters of the Act pointed to harm caused by meritless lawsuits filed against corporations and others with “deep pocket[s]” in response to any significant decline in stock price, irrespective of the defendants’ culpability.¹⁷ These suits, the Conference Committee Report posited, abused the potentially costly discovery process with minimal hope of uncovering facts to support a cause of action and forced defendants into coerced settlements.¹⁸ It further noted the harms arising from discovery being used as a “fishing expedition” during which the target company’s documents are scoured for statements or actions which can be tenuously assembled into a claim.¹⁹

Congress intended PSLRA “to establish a uniform and stringent pleading requirement.”²⁰ Even before PSLRA’s enactment, Federal Rule of Civil Procedure 9(b) already established a more onerous pleading standard for fraud by requiring that allegations of fraud “state with particularity the circumstances constituting fraud.”²¹ Although PSLRA is broader in scope than the explicit requirements of Rule 9(b), its provisions represent a clarification and codification of existing case law in some federal circuits. PSLRA’s requirement that a complaint specify why allegedly false or misleading statements are false or misleading closely parallels Rule 9(b)’s insistence on stating with particularity the circumstances constituting fraud.²² Similarly,

¹⁶. Sec. Litig. Reform Proposals S. 240, S. 667, and H.R. 1058: Hearings Before the Subcomm. on Sec. of the Comm. on Banking, Hous., and Urban Affairs, 104th Cong. 8-9 (1995) (statement of Sen. Alfonse M. D’Amato, Member, S. Comm. on Banking, Hous., and Urban Affairs); see also id. at 3 (statement of Sen. Christopher J. Dodd, Member, S. Comm. on Banking, Hous., and Urban Affairs) (“The flaws in the current private securities litigation system are simply too obvious to deny. The record is replete with examples of how the system is being abused and misused.”). While a great deal of legislative sentiment had coalesced around this principle, a majority of support for PSLRA came from the newly elected Republican majority. See 141 Cong. Rec. 37,807, 38,354 (1995). Notable critics of the Act include former president Bill Clinton, see 141 Cong. Rec. 37,797-98 (1995), over whose veto PSLRA was ultimately enacted. See 141 Cong. Rec. 37,807, 38,354.
¹⁸. Id.
¹⁹. Id. at 37, as reprinted in 1995 U.S.C.C.A.N. 730, 730.
²². Prior to PSLRA’s passage, Rule 9(b)’s broad requirement of “the circumstances constituting fraud” had been interpreted along the lines explicitly spelled out in PSLRA.
PSLRA’s requirement that a statement of all particularized facts accompany allegations made on information and belief largely codifies the pre-PSLRA application of Rule 9(b) to information and belief pleading.\textsuperscript{23} Prior to the Act, courts held that plaintiffs could not satisfy Rule 9(b)’s particularity requirement as to fraud with allegations based on information and belief.\textsuperscript{24} The exception was the situation in which the matters in question were uniquely within the defendant’s knowledge and of which a plaintiff would not be expected to have personal knowledge.\textsuperscript{25} Even when this exception applied, a plaintiff had to put forth facts that supported his or her belief.\textsuperscript{26} Congress designed these areas of overlap to eliminate inconsistencies arising from different interpretations of Rule 9(b) across the various circuits.\textsuperscript{27}

B. Early Application of PSLRA to Pleading Falsity with Confidential Sources

Not surprisingly, PSLRA’s requirement that a plaintiff plead “all facts” on which they based information and belief claims gave rise to a knotty problem when complaints relied on confidential sources in their allegations of falsity. Courts initially wrestled with how far “all facts” should extend and the degree to which it encompasses the identity of confidential sources at the pleading stage, finally settling on a literal reading.\textsuperscript{28} In support of this interpretation, some courts

\begin{flushleft}
See, e.g., Cohen v. Koenig, 25 F.3d 1168, 1173 (2d Cir. 1994) (holding that Plaintiffs satisfied the particularity requirement of Rule 9(b) by “set[ting] out the representations on which they relied, stating both what financial figures they were given and what they alleged the true financial figures were[,] . . . specif[ying] who was alleged to have made the false statements; and . . . stat[ing] the precise dates and places of the meetings at which they alleged the fraudulent statements were made”); Cosmas v. Hassett, 886 F.2d 8, 11 (2d Cir. 1989) (“To satisfy the particularity requirement of Rule 9(b), a complaint must adequately specify the statements it claims were false or misleading, give particulars as to the respect in which plaintiff contends the statements were fraudulent, state when and where the statements were made, and identify those responsible for the statements.”).

23. Plaintiffs plead facts on information and belief when they do not have direct knowledge, but have been informed of the facts in question and believe them to be true. See In re Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 763 (N.D. Cal. 1997); United States v. Twenty-Five Barrels of Alcohol, 18 F. Cas. 252, 256 (E.D. Mo. 1868).


25. See, e.g., Neubronner, 6 F.3d at 672.

26. See, e.g., id.


\end{flushleft}
cited congressional rejection of an amendment to PSLRA that would have lowered plaintiffs’ pleading burden as an indication that Congress intended for plaintiffs to name their confidential sources.29

III. ACCEPTANCE OF CONFIDENTIAL SOURCES

A. Novak v. Kasaks

The interpretation of “all facts” as precluding confidential sources was ultimately not widely adopted. The Second Circuit in Novak v. Kasaks30 applied a more flexible approach to PSLRA’s particularity requirement and established a mechanism by which a complaint could survive a motion to dismiss without naming confidential sources.31 Initially, the district court dismissed the plaintiff’s complaint for insufficient particularity, citing PSLRA’s “all facts” requirement for allegations based on information and belief.32 On appeal, the Second Circuit characterized the policy reasoning that underpinned the district court’s ruling, as well as that relied upon by the defense,33 as a “misreading” of PSLRA’s legislative history based on merely “hyperbolic statements of legislators attempting (unsuccessfully) to amend the proposed [a]ct . . . .”34 It further reasoned that, from a practical standpoint, Congress must not have intended PSLRA’s “all facts” to be applied literally.35 The court rationalized,

Reading “all” literally would produce illogical results . . . . [I]t would allow complaints to survive dismissal where “all” the facts

30. 216 F.3d 300 (2d Cir. 2000).
31. Id. at 314. In Novak, the plaintiffs alleged that the defendants’ statements regarding Ann Taylor Stores Corporation’s ongoing financial health were false in light of the company’s “Box and Hold” practice. Id. at 304. This practice allowed the company to enhance its appearance of profitability by warehousing obsolete, unsold merchandise rather than marking it down for sale and recording the loss. Id. In pleading facts related to the warehousing practices, the plaintiffs relied on confidential sources familiar with the operation. See id. at 304-05.
32. Novak v. Kasaks, 997 F. Supp. 425, 431 (S.D.N.Y. 1998) (noting that the plaintiff’s complaint “provides none of the required facts underlying the complaint’s allegations . . . nor does it direct the Court to where those facts might be found,” and further that “[i]f, in fact, these unnamed ‘consultants’ provided information forming the basis for these allegations, then the consultants should have been named in the complaint”).
33. On appeal, the defendants cited Silicon Graphics and several similarly reasoned out-of-circuit opinions to support their contention that plaintiffs must identify confidential sources in PSLRA pleadings. Novak, 216 F.3d at 313.
34. Id. (noting that despite attempts to include such an amendment, the ultimate enactment does not require plaintiffs to name sources).
35. Id. at 314 n.1.
supporting the plaintiff’s information and belief were pled, but those facts were patently insufficient to support that belief. Equally peculiarly, it would require dismissal where the complaint pled facts fully sufficient to support a convincing inference if any known facts were omitted.36

Most significantly, while noting PSLRA’s legislative objective of reducing frivolous and abusive strike suits,37 the Second Circuit posited that a per se rule requiring plaintiffs to name sources could deter informants from cooperating with investigators in meritorious securities fraud cases.38 Accordingly, the court held that the most reasonable interpretation of “all facts” is that plaintiffs need only plead “sufficient facts” to support the beliefs upon which they base their allegations and need not always reveal confidential sources.39

Having abstractly held that plaintiffs need not always identify their confidential sources, the Second Circuit outlined two distinct paths by which a complaint that includes confidential sources can overcome a motion to dismiss. The first path allows sources to remain unnamed when “other facts . . . provide an adequate basis for believing that the defendants’ statements were false.”40 That is, if the complaint would otherwise survive a motion to dismiss based exclusively on other facts pled, the court will not require the plaintiff to name confidential sources. The alternative path requires identification of the source “with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.”41

The Second Circuit’s analysis did not expressly indicate whether the two avenues for satisfying PSLRA’s heightened pleading standards with confidential sources were to be examined separately or together.42 Novak did not indicate that the test is always disjunctive, nor did it specifically foreclose a holistic analysis which allows for satisfaction of pleading requirements through a combination of the two options.43

36. Id.
37. Id. at 306-07.
38. Id. at 314 (“Imposing a general requirement of disclosure of confidential sources serves no legitimate pleading purpose while it could deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them.”).
39. Id. at 313-14 (emphasis omitted).
40. Id. at 314.
41. Id.
42. See id.
43. Nevertheless, the language of Novak suggests that the court established a disjunctive test which could be satisfied only by one path or the other and not by a holistic combination of the two. First, it is significant that the court left the phrase “other facts” undefined. See id. Had its analysis envisioned a holistic approach, the court could have easily clarified that “other facts” may include a description of the sources along the lines of the second path. Such an instruction would have effectively merged the two options.
B. Application of Novak

While their analyses take different forms and encompass different factors, most circuits that have addressed the issue have adopted the fundamental aspects of Novak.\(^4^4\) Even where courts apply Novak differently, several key aspects are in harmony throughout the circuits. More specifically, courts in most circuits have universally accepted Novak’s central premise that PSLRA’s “all facts” requirement does not per se require that plaintiffs name confidential sources.\(^4^5\) Similarly, there has been broad recognition of PSLRA’s dual, competing policy objectives of combating frivolous strike suits while encouraging meritorious securities fraud claims.\(^4^6\)

Despite broad acceptance of Novak’s fundamental underpinnings, three different applications of Novak have emerged throughout the circuits—the original Novak approach, the holistic approach, and the permissive holistic approach. The approaches primarily differ in the extent to which they consider the two paths available for a complaint to meet PSLRA’s pleading requirement without naming confidential sources holistically or separately.

1. The Original Novak Approach

The original Novak approach, developed in the Second Circuit,\(^3^7\) has been adopted by the Fourth,\(^4^8\) Fifth,\(^4^9\) and Seventh\(^5^0\) Circuits.

Additionally, the court introduces the second option with the transition “[m]oreover, even if personal sources must be identified . . . .” Id. (emphasis added). This if/then structure suggests that the description of sources path should only be considered once the “other facts” avenue has proven unsatisfactory. Further, because the case was remanded to the district court for reconsideration in light of the appellate court’s instructions, the lack of guidance on how to weigh each path suggests that the court of appeals intended the two to be considered separately. See id.

44. Wohl, supra note 1, at 559-60 (noting that the First, Third, Seventh, Eighth, Ninth, and Tenth Circuits endorse Novak).


48. Teachers’ Ret. Sys., 477 F.3d at 174 (proposing a “case-by-case assessment” of all facts or, “[w]hen the complaint chooses to rely on facts provided by confidential sources,” a separate assessment mirroring the second suggested path of Novak).
This approach simply applies the analysis used in Novak without analytical embellishment or structural adjustments. Although Novak did not specifically call for the analysis to be separate, courts purporting to adhere directly to its approach have interpreted it as such. Unlike the more holistic approach discussed in the next Section, the original Novak approach does not consider a totality of facts encompassing both Novak paths together. Rather, it looks at each option separately and independently of the other. Under this approach, a plaintiff cannot meet the pleading standard by combining facts from nonconfidential sources with a description of his or her confidential source suggesting that the source would have access to the information in question—the plaintiff must satisfy one path or the other. In Tellabs, for example, the Seventh Circuit made it clear that it considers the two paths separately by holding that plaintiffs must “describe their sources with sufficient particularity ‘to support the probability that a person in the position occupied by the source would possess the information alleged,’ or in the alternative provide other evidence to support their allegations.”

Although courts in this first group have not elaborated on the basic Novak analysis, they have provided some guidance on when a plaintiff has or has not sufficiently described his or her confidential sources. Courts in this camp have rejected complaints which fail to provide any description or provide only nominal, boilerplate descriptions such as an indication that the confidential sources were discovered through “plaintiffs’ investigation.” Generic job descriptions such as “director” and even specific titles such as “Supervisor of Insurance Accounting” or “Executive of Pricing” have also been found insufficient to satisfy the pleading standard. Courts in this group have been more willing to accept descriptions that provide dates of employment, job responsibilities, and the manner in which the source came to know the information.


51. Tellabs, Inc., 437 F.3d at 596 (emphasis added) (citation omitted).


55. See Selbst v. McDonald’s Corp., 432 F. Supp. 2d 777, 781-85 (N.D. Ill. 2006) (noting that an amended complaint’s failure to include the specific scope of the source’s responsibilities and the manner in which he came to know the information pled made the description insufficient); In re Fleming Cos. Sec. & Derivative Litig., 2004 U.S. Dist. LEXIS 26488, at *68-69 (holding that a complaint’s description of its confidential sources was
2. The Holistic Approach

The second application of Novak that has emerged among the circuits adjusts the structure of the first approach and widens the analysis. This holistic approach, adopted by the First, 56 Third, 57 and to a lesser extent, the Ninth 58 Circuits, looks at a totality of the facts pled to determine whether or not they “provide an adequate basis for believing that the defendants’ statements were false.” 59 In making this determination, the court will look to, among other things, "the level of detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia." 60 This analysis examines both paths used in the original Novak approach but does not consider them separately; rather, it considers them to be components of the totality of facts pled in determining whether or not those facts are sufficient to support a belief in the allegations pled on information and belief. 61

In applying this second approach, courts have provided some guidance as to what circumstances will and will not satisfy the holistic analysis. One factor that has proven crucial in establishing sufficiency is the degree of specificity present in information provided by confidential sources. In Sekuk Global Enterprises v. KVH Industries, the court concluded that statements by confidential informants (whose job titles were included in the pleadings) met PSLRA's pleading requirement, in part, because of the level of specificity and corroboration provided. 62 The confidential sources named a specific executive as making the orders in question as well

sufficient because it included dates of employment, descriptions of job responsibilities, and a description of how each came to know the information pled).

58. Sparling v. Daou, 397 F.3d 704, 711-12 (9th Cir. 2005) (adopting the analysis from Novak and indicating that it would use the factors listed in Cabletron to assess the reliability of confidential sources).
59. Cabletron, 311 F.3d at 29 (quoting Novak v. Kasaks, 216 F.3d 300, 314 (2d Cir. 2000)).
60. Id. at 29-30.
61. See id. at 32 (“Each securities fraud complaint must be analyzed on its own facts; there is no one-size-fits-all template. Sufficient evidence of one type might reduce or eliminate the need for evidence in other categories . . . .”).
as the shipping company involved in the scheme. Similarly, corroboration of facts by other confidential or documentary sources has proven effective at overcoming PSLRA’s pleading requirements in these circuits. In *Cabletron*, the case most closely associated with the broader approach to *Novak*, the court noted the consistency of information provided by the plaintiff’s numerous confidential sources as a factor in satisfying the pleading standard.

3. The Permissive Holistic Approach

A third approach to the general *Novak* analysis adopted by the Tenth Circuit is a more permissive version of the holistic approach adopted by courts in cases like *Cabletron*. As in *Cabletron* and cases like it, this approach examines the facts in the pleading in their totality to determine whether a sufficient basis has been established to believe that the statements in question are false or misleading. This analysis makes that determination by considering the level of detail, the number and aggregate coherence of facts, and other factors suggesting that a reasonable person would find the statements in question false or misleading.

Whereas the other two approaches adopted by the circuits look for sufficient descriptions of confidential or documentary sources or some combination of the two, the Tenth Circuit approach, as illustrated in *Adams v. Kinder-Morgan, Inc.*, does not strictly require that a plaintiff always reveal the source of the facts he or she pleads on information and belief. The court advanced three justifications for this position. First, the text of PSLRA does not expressly require plaintiffs to identify sources, but rather only requires supporting facts. Secondly, a requirement that plaintiffs always divulge their sources amounts to an evidentiary pleading requirement. Finally, the court reasoned that there would be circumstances in which the

---

63. *Id.*; see also *Cabletron*, 311 F.3d at 30 (describing statements from confidential sources as sufficient because they were “not conclusory allegations of fraud, but specific descriptions of the precise means through which it occurred”).

64. *Cabletron*, 311 F.3d at 30; see also Pathfinder Mgmt., Inc. v. Mayne Pharma PTY, No. 06-CV-2204 (WJM), 2008 U.S. Dist. LEXIS 61081, at *31-32 (D.N.J. Aug. 5, 2008) (holding that a complaint pled sufficient particularity because the report of the company’s new comptroller corroborated allegations from a confidential informant).


66. *Id.* at 1099.

67. *Id.*

68. *Id.* at 1101.

69. *See id.*

allegations would be sufficiently verifiable, making personal or documentary sources simply unnecessary.71

While Adams did not recognize a per se requirement that sources be identified, it did indicate that identification would strengthen the extent to which a complaint met the PSLRA pleading standard.72 The Tenth Circuit further cautioned that when an information and belief allegation does not identify the sources of its facts, “the facts alleged . . . will usually have to be particularly detailed, numerous, plausible, or objectively verifiable by the defendant before they will support a reasonable belief that the defendant’s statements were false or misleading.”73

IV. ANALYSIS

A. Special Considerations with Fabricated Sources

While the extent or even existence of fabricated sources unsurprisingly evades statistical capture, several factors unique to securities fraud litigation necessitate some level of assurance that confidential sources exist. The rush to file an initial complaint and serve as lead counsel for a securities class action suit encourages hastily crafted pleadings.74 Working against this objective is PSLRA’s requirement that plaintiffs plead their claims with particularity. Making this task even more onerous is the stay of discovery prompted by any pending motion to dismiss.75 For an unethical plaintiff, the acceptance of Novak’s premise that confidential sources must not always be named makes the fabrication of a confidential source a tempting shortcut through PSLRA’s potentially burdensome pleading standards. Though courts have been hesitant to directly accuse a plaintiff of this tactic, judges have raised the issue.76

B. Potential Evaluative Pitfalls Stemming from Fabrication Concerns

Concern that complaints are relying on fabricated confidential sources gives rise to judicial demand for assurances that confidential

71. Adams, 340 F.3d at 1102.
72. See id.
73. Id. at 1103.
74. HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 16:101 (2d ed. 2009).
76. See Higginbotham v. Baxter Int'l, Inc., 495 F.3d 753, 757 (7th Cir. 2007) (listing among the court’s potential concerns with regard to a set of confidential sources the possibility that “they don’t even exist”); Teachers’ Ret. Sys. v. Hunter, 477 F.3d 162, 193 (4th Cir. 2007) (Shedd, J., dissenting) (proposing a less rigorous pleading standard by which plaintiffs simply plead “facts sufficient to support a reasonable belief that [they] did not merely invent sources”).
sources represent actual persons. Thus, as a practical matter, the presence of these concerns means the existing analysis for satisfying PSLRA’s pleading standards must answer two questions:

1) Does the complaint sufficiently support a belief that the confidential sources in question actually exist?; and

2) Do the facts alleged by those confidential sources, if taken to be true, support a belief that the statements or omissions in questions were false or misleading?

The first step in this process makes investigations of confidential sources’ reliability intuitively appropriate. Such inquiries into truthfulness and accuracy are not uncommon. The Cabletron court included “reliability of the sources,” in its inexhaustive list of factors to consider in determining whether a complaint relying on confidential sources had met its pleading burden.77 It further listed consistency of information from confidential sources as a factor in favor of sufficiency because it “undermine[s] any argument that the complaint relies unduly on the stories of just one or two former employees, possibly disgruntled.”78 Although, based on the facts of Cabletron, reliability of the sources was a positive factor in satisfying the particularity requirement, the court’s language suggests that it would have granted the motion to dismiss had it been suspicious of the sources’ inclination for mendacity. The court in Sekulk was even bolder in its exploration of source credibility, indicating that corroboration of confidential sources’ statements is significant because it “reinforces the potential veracity of their allegations.”79

1. Is Source Reliability an Acceptable Inquiry at the Pleading Stage?

Determining whether inquiries into source reliability are permissible requires a more precise interpretation of PSLRA’s “all facts” pleading requirement for allegations made on information and belief. As discussed, the broad acceptance of Novak means that courts have interpreted “all facts” as all facts necessary to support a belief in allegations made on information and belief. The operative question then becomes whether the facts necessary to support such a belief are those which logically support the allegation, or if “all facts” also encompasses facts which make the plaintiff trust the confidential

77. Mesko v. Cabletron Sys., Inc., 311 F.3d 11, 29-30 (1st Cir. 2002).
78. Id. at 30 (emphasis added).
source’s accuracy and honesty. Only if the latter is correct may a court appropriately engage in source reliability inquiries. Absent statutory guidance to the contrary, the standard level of judicial skepticism should be applied; that is, when considering a Rule 12(b)(6) motion to dismiss for failure to state a claim upon which relief may be granted, the court must apply a suspended level of skepticism and construe all pled facts as true.

Neither the text of PSLRA nor its legislative history suggests that any such contrary guidance or intent to depart from the standard approach is present. The Act provides that any defendant may move for dismissal of a complaint that fails to meet the pleading standards set forth in § 78u-4(b)(1) or (2). Since the mechanism for dismissal will still be a Rule 12(b)(6) motion, the aforementioned suspended level of judicial skepticism must be applied to facts pled whether their source is confidential or otherwise.

PSLRA’s legislative history similarly suggests that Congress intended to raise pleading standards only with regard to the amount of facts required and not as to their credibility. Representative Christopher Cox clarified that the underlying facts which support an allegation need not be proven at the pleading stage: “First of all, we are talking today about allegations, so we do not need to know that they are true.” He went on to characterize the appropriate application of judicial scrutiny of the allegations: “[F]or purposes of judging the pleading, all the court does is assume all of the allegations are true even before you have actually proved them, and if added together, assuming their truthfulness, they would state a cause of action and you get by judgment on the pleadings . . . .”

Unlike the provisions covering the pleading of falsity, the applicable language governing the pleading of scienter requires that the facts “giv[e] rise to a strong inference that the defendant acted with the required state of mind.” In *Tellabs*, the Supreme Court interpreted this language as requiring courts to consider “competing inferences” that can be drawn from the facts pled when determining whether scienter has been sufficiently shown. In a relatively recent
decision, the Seventh Circuit interpreted Tellabs as requiring discounting information in pleadings attributed to confidential sources. The Seventh Circuit reasoned that competing inferences as to the reliability of the facts could not be made without knowledge of the source and his or her tendency to tell the truth. If this interpretation is correct, and the “strong inference” language of PSLRA’s scienter requirement provides for inquiries into source reliability, its absence from sections dealing with falsity further suggest that no such inquiry should be made when determining the sufficiency of facts supporting information and belief falsity allegations. Even if the Seventh Circuit’s interpretation is incorrect and competing inferences are only to be made with regard to whether the facts presumed true sufficiently show the appropriate state of mind, it is clear that Congress intended courts to apply a lower level of scrutiny to the pleading of falsity than that of scienter.

Given the absence of contrary legislative instruction, courts must consider the motion to dismiss as they would any other—by taking facts pled as true and refraining from inquiries into their credibility or reliability. While reliability would be an important issue at trial, it is not an appropriate consideration when deciding a Rule 12(b)(6) motion to dismiss. A court’s judgment at the pleading stage as to the reliability of a confidential source must not substitute the judgment of the finder of fact and should not be included in an appropriate PSLRA analysis. Rather, in applying the appropriate standard to a determination of PSLRA’s pleading standards for allegations of falsity based on information and belief, the court must simply determine whether the facts pled, if true, support a belief in the allegation in question. In making this determination, courts

89. Id. at 756-57 (“It is hard to see how information from anonymous sources could be deemed ‘compelling’ or how we could take account of plausible opposing inferences. Perhaps these confidential sources have axes to grind. Perhaps they are lying.”).
90. See Bell Atl. Corp. v. Twombly, 550 U.S. 544, 564 n.8 (2007) (“[W]hen a complaint adequately states a claim, it may not be dismissed based on a . . . court’s assessment that the plaintiff will fail to . . . prove his claim to the satisfaction of the factfinder.”).
91. Although much has been made of the impact of Twombly on the factual requirements of pleadings, it has little impact on the determination of factual sufficiency here. Prior to Twombly, a complaint subject to Federal Rule of Civil Procedure 8(a) was dismissed for failure to state a claim only when no conceivable set of facts could be proven that would support the plaintiff’s claim. Conley v. Gibson, 355 U.S. 41, 45-46 (1957). Twombly now requires plaintiffs provide facts that “raise a right to relief above the speculative level.” Twombly, 550 U.S. at 555. Because complaints subject to PSLRA and Rule 9(b) are already required to provide all facts upon which their allegations are based, and courts are charged with determining whether or not those facts support the claim, the shift in Twombly does not impact the analysis. See also Teachers’ Ret. Sys. v. Hunter, 477 F.3d 162, 173 (4th Cir. 2007) (clarifying that the pre-Twombly standard did not apply to PSLRA claims in that “[t]he ‘all facts’ requirement is imposed . . . to determine the legal sufficiency of the complaint . . . . [A] complaint is legally sufficient if it ‘state[s] a claim upon which relief can be granted.’ . . . [U]nder the generally applicable notice pleading
should look to whether the facts alleged amount to specific allegations of fraud or whether they rise only to the level of formulaic boilerplate allegations (e.g., “they were lying”) or vague rumors. For example, an overly broad allegation from a confidential source of rumors relating to the falsity of a statement, even if taken to be 100% accurate, would only amount to the existence of that rumor and would not be sufficient to overcome a motion to dismiss. Such an assessment is in line with the standard of review discussed above as it does not purport to assess the credibility or accuracy of the facts.

2. May Courts Look for Assurances that Sources Actually Exist?

Given the aforementioned limitations on a court’s ability to inquire as to the reliability of confidential sources, the issue arises as to whether the court may seek assurances that confidential sources exist and are not fabricated. While courts must suspend their skepticism with regard to the accuracy of facts at the pleading stage, they may not do so in determining whether the facts pled amount to a cognizable claim. At the heart of an allegation pled on information and belief is the idea that the plaintiff does not have direct knowledge of the facts in question but has been informed of them by a source and believes that information. Thus, the fundamental issue of how a plaintiff generally came to be informed of the information pled is a crucial fact in support of a belief in the allegation in question. Here, the court is not determining whether the confidential source has given reason to justify the plaintiff’s belief in the information provided, but rather whether the plaintiff is, in fact, pleading an allegation on information and belief. To the extent that there is not a sufficient basis to believe that the plaintiff is informed and believes the allegations in question, the complaint is not factually sufficient as to that allegation. A court's seeking of assurances that a confidential source is not fabricated does not constitute a reliability analysis as to that source—rather, it is a factual sufficiency determination as to the pleading itself.

rules, this standard requires the court to ask whether any conceivable set of facts could be proved consistent with the complaint’s allegations that would permit relief to be granted. The PSLRA’s ‘all facts’ standard, however, changes the relevant set of facts for alleging misrepresentations and omissions to those alleged in the complaint. Under the PSLRA, therefore, our inquiry becomes whether, if those facts alleged in the complaint are true, relief could be granted on the plaintiffs’ claim.” (internal citations omitted); see also Jonathan M. Hoff & Martin L. Seidel, Impact of ‘Twombly’ on Notice Pleading, N.Y.L.J., Sept. 13, 2007, at 4 (discussing the impact of Twombly on pleading the elements of securities fraud that are not already subject to heightened factual pleading standards on account of Rule 9(b) or PSLRA).

92. See supra note 23.
C. A Two-Step Evaluation of Confidential Sources and Their Facts

The natural inclination to assuage concerns about source fabrication with impermissible evaluations of credibility and reliability would be significantly reduced by a two-step approach. Under such an analysis a court would look first for adequate assurances that the sources do in fact exist. After finding such assurances the court's analysis would move to the second step to determinate whether the facts provided by the sources support a belief in the allegations in question.

1. Adequate Assurances

The first part in this two-step analysis can be satisfied so long as the court's analysis does not shift from a factual evaluation of whether the source exists to a reliability analysis of whether the source is to be believed. Thus, a range of possibilities exists. The positional aspect of the original Novak approach (evaluation of whether the confidential source is sufficiently described to support a belief that a person similarly situated would have access to the information pled) is one option so long as it is applied with limitations. A plaintiff could provide a sufficiently detailed description of how its confidential source came to know the information in question. Here, the court would not look at whether these details suggest the source was reasonably well informed. Rather, it would determine if the description was sufficiently detailed to render discovery ineffective for finding and producing a witness with the described back story if the case made it through pleading and the source was in fact fabricated. Details beyond how the source came to know the information could also be pled to achieve the same effect of narrowing the possible field of sources. Such details could assuage concerns about source fabrication without a need for the court to indulge in overreaching assessments of the information's credibility.

Consideration of the level of detail provided by the confidential source may also be of use in this phase of the analysis. As with a unique description of the source, this factor may only be considered for its tendency to suggest a nonfictional source. That is to say, a

---

93. Though not provided for by PSLRA, an in-camera presentation of the source's identity is one judicial tool that could be considered in addition to the pleading of additional facts to assure the court that confidential sources have not been fabricated.

94. For instance, a description of a confidential source which states that the individual was employed by the defendant during a specific time, was involved at a management level, attended the University of Florida, and has green eyes might not be enough information to expose the source to reprisal, but it would likely narrow the pool enough to dash the plans of a plaintiff who hopes to find a source in discovery who can provide the information attributed to a fabricated source at the pleading stage.
high level of factual detail is likely to come from an actual source and not be a product of fabrication. Further, if the information was the product of source fabrication, discovery would be unlikely to produce a source that could speak to the details at trial. To be clear, the level of detail provided should not be considered for its tendency to show that, by virtue of lack of details, the confidential source is mistaken or is being dishonest. The inference, for example, that a confidential source’s lack of details on a particular matter suggests that she is ill-informed, exaggerating her knowledge of the issue, or is otherwise mistaken would amount to an impermissible assessment of source reliability at the pleading stage.

2. Sufficiency of Facts

In the next stage of the analysis, courts would determine whether the facts pled, if true, support a belief in the allegation in question. This second step should only be undertaken once the court determines that the plaintiff has pled facts which provide sufficient assurance that its confidential sources are not fictitious. Having made this determination, courts may evaluate the facts pled with the appropriate level of suspended skepticism and without lingering intuitive concern over the potential nonexistence of confidential sources. Having culled dubious sources and their attendant facts in the first stage of the analysis, the court may proceed with a straightforward assessment of the facts. The appropriate analysis would be the same as that applied to any motion to dismiss except that the court would look to the facts pled rather than contemplating the complaint in terms of any plausible set of facts.95 This analysis should examine the level of specificity provided by the facts to determine whether or not they support a belief in the allegation made on information and belief. The application of this standard is not only in line with the Federal Rules of Civil Procedure, it is also consistent with Congress’s aim of reforming private securities litigation law without placing undue burden on meritorious cases.96

V. Conclusion

Demand for assurances that confidential sources are real and the potential for overstepping, inherent in the existing approaches to Novak, increase the appeal of such a two-step analysis. Further, an independent step which focuses on culling fabricated sources serves

95. See supra note 91 and accompanying text.
PSLRA’s policy objective of combating strike suits that seek to use discovery as a “fishing expedition.”

This Note has argued that inquiries into the reliability or credibility of confidential sources used to plead falsity in federal securities litigation are prohibited by the Federal Rules of Civil Procedure and counter to the legislative intent of PSLRA. To address the very real concern of fabricated sources in such actions, this Note has also proposed a two-step process for use in determining whether a complaint subject to PSLRA which relies on confidential sources for its allegations of falsity may survive a motion to dismiss for failure to plead with sufficient particularity. This process looks first for sufficient assurances that the confidential sources are, in fact, real and then determines whether the facts stated by those sources support a sufficient basis for believing the allegations made on information and belief. Such a two-step approach is consistent with PSLRA’s twin legislative objectives of combating strike suits while preserving the deterrence and enforcement function provided by private securities litigation. It does so by separately addressing the unique potential for fabrication presented by complaints relying on confidential witnesses such that courts may review the pled facts of the case without a level of skepticism beyond that permitted by the Federal Rules of Civil Procedure. This proposed analysis is not fundamentally at odds with existing approaches applied throughout the circuits. Rather, it restructures the analysis in the hope of keeping separate two decidedly disparate considerations: (1) the existence of the confidential sources and (2) the facts’ tendency to support a belief in the allegations made on information and belief. By deconstructing and separating the existing analysis, this approach enables courts to determine the sufficiency of the pled facts, free from otherwise very reasonable concerns regarding fabricated sources. An analysis that rigorously keeps out fictitious confidential sources, without inappropriately raising the level of scrutiny for facts pled, achieves a balance between combating strike suits and encouraging meritorious claims. In doing so, this approach threads the policy needle and achieves a result in line with PSLRA’s objectives.
