Loyola University Chicago Law Journal

Volume 45
Issue 3 *2014 Spring*

Article 4

2014

Confidential Informants and Securities Class Actions: Mixed Messages and Motives

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Confidential Informants and Securities Class Actions: Mixed Messages and Motives

Remarks of Judge Jed S. Rakoff*

I want to take a step back and offer a broader perspective of federal securities class action litigation. There are certain distinct aspects of this kind of litigation that cannot be overlooked and that really provide the backdrop to all these more nitty-gritty issues that we have been grappling with.

The first is that it is lawyer-driven litigation. I don't say that pejoratively. There are those who think that is a terrible thing; I think there are arguments both ways about it. There's a social function, a sort of private Attorney General function, that is being served by many of these cases that is socially beneficial. On the other hand, these are lucrative litigations and there is a danger of champerty.

But, for good or ill, the reality is that these cases tend to be initiated by the law firms who specialize in this area. Before the Private Securities Litigation Reform Act ("PSLRA"),[1] this was done through individual plaintiffs, "professional plaintiffs" if you will, who had ongoing relationships with certain law firms. Now you have more often union and state pension funds, which enter into agreements with law firms whereby the law firms, free of charge, will "monitor" the funds' investments and tell the trustees of the funds when they think a class action lawsuit should be brought. I'm not necessarily criticizing any of this; I'm just saying that a clear-eyed view of it is that this is lawyer-driven litigation.

The second thing that is worth noting is that, as was already mentioned today, these cases almost always settle. Now, to some degree that is true of civil litigation in general in this country. Given our system's preference for expensive and time-consuming discovery, for slow

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* Honorable Jed S. Rakoff serves as a federal judge for the United States District Court for the Southern District of New York. Judge Rakoff delivered these remarks at the Third Annual Institute for Investor Protection Conference, "Strategies for Investigating and Pleading Securities Fraud Claims," held at Loyola University Chicago School of Law on October 25, 2013, and cosponsored by the Institute for Investor Protection and the Institute for Law and Economic Policy. Judge Rakoff spoke on a panel titled, "The Effective and Ethical Use of Confidential Witnesses."

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

decision making by trial judges who are themselves anxious to promote settlement, for multiple opportunities for appeals, and so forth, in many cases parties that file their lawsuits intent on going to trial come around after awhile to realizing that they might as well settle.

But I think there are special features about class action securities litigation that create even a greater pressure to settle. First, the stakes are very high in monetary terms because it is a class action. And, second, I think most corporations fear juries: fear them greatly. They fear, if you will, the increasing hostility that many everyday people feel towards corporate America. We had that chart earlier about how much more CEOs are paid than anywhere else in the world.[2] This may be rational, it may be irrational, but it invites anger and suspicion, which, in turn, makes corporate lawyers very reluctant to put a case before a jury.

What is the result of all this pressure to settle? The result is that, in real terms, a judge is deciding these cases when he or she decides early motions, such as a motion to dismiss or a motion for class certification. In other words, a corporate defendant will take, at most, two shots to get rid of the case: a motion to dismiss and, if that fails, an opposition to class certification. If the corporation wins either of these motions, the case will either disappear or be settled cheaply. If the corporation loses both motions, the corporation will settle for a big number.

A corollary to this is that, increasingly, courts will take a "peek" at the merits in deciding these motions. To some extent, moreover, this has been in effect embodied in statutory and case law through the heightened pleading requirements imposed by Congress under the PSLRA and by the Supreme Court in cases like *Twombly*[3] and *Iqbal*.[4] From a plaintiffs' perspective, however, this creates a dilemma: how can you meet these pleading requirements before you have had any discovery? This has driven plaintiffs' lawyers to try to overcome these pleading hurdles through, among other things, increasing use of confidential informants.[5] This is an unintended, but natural result of the PSLRA, and as has already been pointed out, this means mostly contacting former employees and getting information from them. In that regard, we've heard a lot about the dangers of retaliation, which I think is a genuine problem, even for

2. *See CEO-to-Worker Pay Ratios Around the World*, EXECUTIVE PAYWATCH, http://www.aflcio.org/Corporate-Watch/CEO-Pay-and-You/CEO-to-Worker-Pay-Gap-in-the-United-States/Pay-Gaps-in-the-World (last visited Mar. 30, 2014) ("On average, U.S. CEOs . . . make far more than CEOs of comparably sized companies in other developed countries.").

3. Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007).

4. Ashcroft v. Iqbal, 556 U.S. 662 (2009).

5. *See* Gideon Mark, *Recanting Confidential Witnesses in Securities Litigation*, 45 LOY. U. CHI. L.J. 575, 576 (2014).

former employees; but we need to balance that with the danger that a former employee often has a strong motive to gripe, and to exaggerate, and to say nasty things that may or may not be true about his or her former employer. It's a two-edged sword. So how does a judge deal with that?

I give as a modest example the *City of Pontiac* case that was referred to earlier, a case in my court, where I wrote the relevant opinion this past July.[6] The plaintiff was a municipal pension fund that had invested in Lockheed stock and claimed it had been defrauded; and the complaint, in order to meet the requirements of the PSLRA, relied heavily on the statements of six unidentified confidential informants.[7] Incidentally, I totally agree with Professor Mark: I see no reason why such statements should be inherently discounted at the pleading stage just because the informants are unidentified.[8] And in this case, I denied a motion to dismiss and upheld the complaint largely on the basis of the allegations attributed to the confidential informants.[9]

In due course, the identities of the informants were disclosed, so that their depositions could be taken, which I do not think is a bad thing either: they need to be tested like any other witnesses.[10] But, perhaps because of the special pressures that may be brought to bear when a former (let alone present) employee is involved, five of the six either denied the statements attributed to them in the complaint or recanted their accuracy.[11] I do not agree with those courts that say that that mere fact should kill the lawsuit, because again, these witnesses have motivations going in both directions. They have motivations to overstate misconduct by the companies, but they also have motivations to recant: you cannot have a bright-line rule, in my view, in these situations.

So, what I did was hold a hearing, an evidentiary hearing, and five of the six, the five who had denied ever making the statements or had recanted, were required to testify in my court, subject to examination and cross-examination—exactly the way our system posits that the truth will come out.[12] In the end, the plaintiffs had the better of it. For example, several of the informants who had said things at their depositions like "we never even spoke to the investigator for the plaintiff for more than two or

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6. City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp., 952 F. Supp. 2d 633 (S.D.N.Y. 2013).

7. *Id.* at 635.

8. Mark, *supra* note 5, at 601.

9. City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp., 875 F. Supp. 2d 359, 375 (S.D.N.Y. 2012).

10. *City of Pontiac Gen. Emps' Ret. Sys.*, 952 F. Supp. 2d at 636.

11. *Id.*

12. *Id.*

three minutes," were confronted with phone records that showed that they had had conversations for fifty, sixty, or more minutes with the plaintiffs' investigator.[13] They had lied at their deposition because they feared retaliation, and I had a certain sympathy for the plight that they were placed in; nevertheless, they had lied.

The plaintiffs' investigator, on the whole, had pretty good notes about everything that was said. In my written decision following the hearing, I faulted him for some of his methods; it would have been much better, for example, as Professor Mark just suggested, if there had been a written statement taken from the witnesses.[14] Some of the statements used by the investigator were clearly out of context.[15] And there were other problems: he had no one else with him when he did the interviews, they were telephone interviews, and he was making his notes at the very same time he was talking to the witnesses.[16] Nevertheless, on the whole, what he had said and reported to plaintiffs' counsel as the witnesses having said was far more accurate than the recantations that they had given in their depositions.

Of course, in other cases, it might be the statements to the investigator that are the lies. My point is simply that issues involving confidential informants should not be decided by legal presumptions or paper wars: you need to have an evidentiary hearing if you are going to decide whether in any given case the confidential informants are sufficiently reliable to enable the case based on their statements to continue.

13. *Id.* at 637.
14. *Id.*
15. *Id.* at 637–38.
16. *Id.* at 637.