Resolving the Continuing Controversy Regarding Confidential Informants in Private Securities Fraud Litigation.

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RESOLVING THE CONTINUING CONTROVERSY REGARDING CONFIDENTIAL INFORMANTS IN PRIVATE SECURITIES FRAUD LITIGATION

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Tellabs Inc. v. Makor Issues & Rights, Ltd. has injected considerable uncertainty into the securities fraud pleading game, particularly with respect to the law of confidential informants. Before Tellabs, the circuits correctly addressed whether confidential sources satisfied the Private Securities Litigation Reform Act's particularity requirement. The essential inquiry was whether there was a probability that the source had the information pleaded. However, as we wrote in our prior article, Congress, the Supreme Court, and the Proper Role of Confidential Informants in Securities Fraud Litigation, some federal circuit courts, after Tellabs, reassessed this well-settled and well-founded assessment of confidential sources, requiring instead that allegations deriving from confidential sources be steeply discounted based on the PSLRA's scienter requirement. This approach has been gaining ground as of late.

This emerging trend, however, is based on a fundamental misunderstanding of how allegations based on information provided by confidential informants relate to the PSLRA: confidential sources speak to the particularity of the allegation. These allegations are governed by the particularity aspect of the PSLRA and not the Tellabs decision or the "strong inference" requirement. Rather, a proper assessment of allegations by confidential informants involves only an inquiry into whether the plaintiff has established a probability that the confidential source contains the information claimed—and not an assessment of whether the allegations give rise to a strong inference of scienter. This Article shows that assessing confidential source allegations only under the particularity prong of the PSLRA is consistent with the text of PSLRA, Supreme Court precedent, and the underlying purposes of the securities laws. Yet this Article acknowledges that should courts continue to reassess the

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proper role of confidential informants under the scienter prong, this re-
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INTRODUCTION

The Private Securities Litigation Reform Act ("PSLRA") requires that a plaintiff’s securities fraud complaint “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind” in defrauding investors,1 a significant modification of Federal Rule of Civil Procedure 9(b).2 Quite often, to meet the PSLRA’s heightened pleading requirements, plaintiffs rely on statements

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2 “In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.” Fed. R. Civ. P. 9(b).
from confidential sources. Confidential sources can serve to "bridge the gap" between vague allegations of a defendant's access to information and an inference of knowledge. Confidential sources have become a critical component of preventing financial fraud and deterring corporate misconduct.

Yet the Supreme Court's most recent securities fraud pleading decision, *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, has injected considerable uncertainty into the pleading game. Since *Tellabs*, the federal circuit courts have developed divergent approaches regarding the pleading requirement, particularly with the law of confidential informants. Before *Tellabs*, the circuits correctly addressed whether confidential sources were proper under the PSLRA's particularity requirement. However, as we wrote in our prior article, *Congress, the Supreme Court, and the Proper Role of Confidential Informants in Securities Fraud Litigation*, after *Tellabs*—which was completely silent on the matter—some federal circuit courts reassessed this well-settled and well-founded assessment of confidential sources under the scienter requirement and required instead that allegations deriving from confidential sources be steeply discounted. This approach, we demonstrated, incorrectly applied the *Tellabs* decision. We suggested that requiring disclosure of witnesses' identities at the 12(b)(6) stage relies on the faulty premise that disclosure will in effect aid the weighing of inferences. Additionally, we maintained that requiring a steep discount rested on drawing irrational inferences, as opposed to plausible ones, against the plaintiff at the pleading


4 Throughout this article, "confidential source," "corporate source," "confidential informant," and "whistleblower" are used interchangeably.


9 See infra Part IV.

10 See infra Part III.


12 Kaufman & Wunderlich, *Securities Fraud Litigation*, supra note 11, at 354.
stage. Finally, we demonstrated that Tellabs, if it applied at all to confidential informants, required a different balancing at the 12(b)(6) stage than that employed by those courts discounting confidential informant allegations.

This Article further elaborates on the emerging jurisprudence involving confidential informants. Currently, some federal appellate courts hold that Tellabs left the law regarding confidential informants largely unchanged. Others however have adopted the “steep discounting” approach set forth in Higginbotham v. Baxter International. One circuit has taken a different track altogether, requiring courts to be “skeptical” of allegations from confidential informants. This emerging split, we submit, is based on a fundamental misunderstanding of how allegations based on information provided by confidential sources relate to the PSLRA: confidential sources are an issue of particularity, and not scienter. As such, these allegations are governed by the particularity requirement that there be a probability that the source have the information pleaded and not the Tellabs decision and the “strong inference of scienter” requirement.

Part I of this Article first discusses the PSLRA and how it altered the traditional pleading regime. This Part also discusses the holding from Tellabs. Part II briefly reviews the state of the law regarding confidential informant allegations before the Tellabs decision. Specifically, this Part illustrates that while the federal appellate courts differed in degree, they uniformly assessed allegations from confidential informants under the PSLRA’s particularity requirement, and not the scienter aspect. Part III then illustrates the current jurisprudence surrounding confidential informants. This Part demonstrates that several circuit courts have reassessed the proper role of confidential informants in securities fraud pleading by applying the Tellabs decision and the strong inference fraud pleading.

Part IV then demonstrates that the proper assessment of allegations by confidential informants involves only an inquiry into whether the plaintiff has established a probability that the confidential source contains the information claimed and not an assessment of whether the allegations give rise to a strong inference of scienter. This Part shows that assessing confidential source allegations only under the particularity prong of the PSLRA is consistent with the text of PSLRA, Supreme Court precedent, and the underlying purposes of the securities laws. Part V concedes that even if the role of confidential informants should be

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13 See, e.g., New Jersey Carpenters Pension & Annuity Funds v. Biogen IDEC, Inc., 537 F.3d 35, 51 (1st Cir. 2008); infra Part IV.A.
14 495 F.3d 753 (7th Cir. 2007). See infra Part IV.B.
15 See infra Part IV.C.
reassessed under the strong inference portion of the PSLRA, this reassessment does not require a steep discount of these allegations out of hand.

I. THE PSLRA, TELLABS, AND CONFIDENTIAL INFORMANTS

The PSLRA altered how a plaintiff pleads securities fraud. This Part explores how allegations from confidential sources fit in with the PSLRA’s heightened pleading requirement. This Part also discusses the Supreme Court’s recent Tellabs decision regarding the strong inference of scienter.

A. The PSLRA Alters the Pleading of Securities Fraud

To establish a securities fraud claim under Section 10(b) of the Securities Exchange Act of 193416 and Rule 10b-517 a plaintiff must allege and prove the following: (1) that the defendant made a material misrepresentation or omission (materiality), (2) that the defendant acted with scienter or a wrongful state of mind (scienter), (3) that the material misrepresentation or omission was made in connection with the purchase or sale of a security (in connection with), (4) that the plaintiff relied on the material misrepresentation (reliance), (5) that the plaintiff suffered an economic loss as a result (economic loss), and (6) that the material misrepresentation actually caused the loss (loss causation).18 Originally, securities fraud cases were assessed under Federal Rule of Civil Procedure 9(b), which governed all civil allegations of fraud.19 Under Rule 9(b) a plaintiff was required to plead with particularity the circumstances constituting fraud or mistake; in other words the who, what, when, where, and how.20 Rule 9(b), however, specifically permitted malice, intent, knowledge, and other conditions of a person’s state of mind to be alleged generally.21 Then in 1995, Congress enacted the PSLRA22 which altered

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20 See, e.g., DiLeo v. Ernst & Young, 901 F.2d 624, 627 (2d Cir. 1990).
21 FED. R. CIV. P. 9(b).
RESOLVING THE CONTINUING CONTROVERSY

the pleading, discovery, and liability rules for cases brought under the federal securities laws. First, the PSLRA enhanced Rule 9(b) by requiring that state of mind be pleaded with particularity. The PSLRA states:

1. Misleading Statements and Omissions.

   In any private action arising under this chapter 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.

   This aspect of the PSLRA is known as the particularity requirement. Second, the PSLRA heightened the pleading requirement for scienter or state of mind:

2. Required State of Mind.

   In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

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23 § 78u-4(b)(1)–(2) (requiring a plaintiff to specify each statement alleged to have been misleading, the reason why each is misleading, and that the misleading statements must give rise to a strong inference that the defendant acted with scienter).
24 § 78u-4(b)(3)(B) (staying discovery until after a court rules on a 12(b)(6) motion).
26 Novak v. Kasaks, 216 F.3d 301 (2d Cir. 2000).
28 Novak, 216 F.3d at 301.
Thus, the PSLRA’s pleading requirement has two components: (1) a specificity and particularity requirement; and (2) a strong inference of scienter requirement. Both components address the pleading requirement, but in different and significant respects. The statutory language and the legislative history of the PSLRA alone make it unclear whether Congress intended to abrogate the use of confidential sources in securities fraud complaints through the PSLRA. Yet in 2002, Congress enacted the Sarbanes-Oxley Act ("SOX") without prohibiting the use of confidential informants in private securities fraud litigation.

B. Tellabs Inc. v. Makor Issues & Rights, Ltd.

The Supreme Court in Tellabs addressed the scienter aspect of the PSLRA’s pleading regime and examined what constitutes a "strong inference." The Supreme Court in Tellabs set out "to prescribe a workable construction of the 'strong inference' standard." In Tellabs, the plaintiffs alleged that the defendant falsely reassured investors that the defendant was continuing to enjoy strong demand for its products when, (2d Cir. 1994) ("The requisite 'strong inference' of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."). But the legislative history suggests that Congress explicitly rejected the Second Circuit’s requirement that a plaintiff must allege motive and opportunity or reckless or conscious behavior. Congress aimed for a standard similar to Rule 9(b), but above the Second Circuit’s interpretation. H.R. REP. No. 104-369, at 41 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 740. Congress specifically refrained from including motive, opportunity, or recklessness in the language of the statute. Id. at 49 n.23.

30 The Third Circuit explained:

The PSLRA provides two distinct pleading requirements... First, under 15 U.S.C. § 78u-4(b)(1), the complaint “must specify each allegedly misleading statement, why the statement was misleading, and, if an allegation is made on information and belief, all facts supporting that belief with particularity.” . . . Second, the complaint must, “with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”


31 Kathryn B. McKenna, Note, Pleading Securities Fraud Using Confidential Sources Under the Private Securities Litigation Reform Act of 1995: It’s All in the Details, 55 RUTGERS L.J. 205, 208 (2002) (discussing how Congressmen Ed Bryant and John Dingell argued that a plaintiff would be required to submit a witness list with his complaint, but noting that Congress did not address concerns relating to confidential sources).


33 Id. Justice Ginsburg delivered the opinion of the Court in an 8-1 decision; Chief Justice Roberts, Justice Kennedy, Justice Souter, Justice Thomas, and Justice Breyer joined; Justices Scalia and Alito concurred in the judgment; and Justice Stevens dissented. Id. at 311.
in fact, the defendant knew the opposite to be true.\textsuperscript{34} The plaintiffs based their allegations on information provided by twenty-seven different confidential sources.\textsuperscript{35}

The Supreme Court, without addressing the merits of the case, set forth a three-step analysis for pleading scienter. First, in ruling on a 12(b)(6) motion to dismiss a Rule 10b-5 action, a court must accept all factual allegations in the complaint as true.\textsuperscript{36} Second, a court must ask whether all the facts alleged, taken collectively, give rise to a strong inference of scienter, rather than whether any individual allegation, scrutinized in isolation, meets that standard.\textsuperscript{37} Third, a court must weigh opposing inferences and find that a reasonable person would deem the inference of scienter at least as likely as any opposing inference.\textsuperscript{38} The Supreme Court did not address the fact that the plaintiff rested its allegations on information from confidential informants. The majority mentioned that the allegations stemmed from confidential sources only in its statement of facts.\textsuperscript{39}

To illustrate its new scienter standard, the Court responded to a scenario posed by Justice Scalia in his concurrence.\textsuperscript{40} Justice Scalia posed the following problem: "If a jade falcon were stolen from a room to which only A and B had access, could it possibly be said there was a "strong inference" that B was the thief?"\textsuperscript{41} The majority opinion, relying on tort principles, stated that, "law enforcement officials as well as the owner of the precious falcon would find the inference of guilt as to B

\textsuperscript{34} Id. at 315.
\textsuperscript{35} Makor Issues & Rights v. Tellabs, Inc. (Tellabs I), 437 F.3d 588, 591 (7th Cir. 2006), vacated by Tellabs, 551 U.S. 308 (2007).
\textsuperscript{36} Tellabs, 551 U.S. at 322.
\textsuperscript{37} Id. at 322–23. This step adopts the approach taken by the Ninth Circuit in Gompper v. VISX, Inc., 298 F.3d 893, 897 (9th Cir. 2002), which required courts to consider and weigh inferences.
\textsuperscript{39} The Tellabs majority stated:

The Shareholders then amended their complaint, adding references to 27 confidential sources and making further, more specific, allegations concerning Notebaert's mental state. The District Court again dismissed, this time with prejudice. The Shareholders had sufficiently pleaded that Notebaert's statements were misleading, the court determined, but they had insufficiently alleged that he acted with scienter. Tellabs, 551 U.S. at 316–17 (emphasis added).
\textsuperscript{40} Id. at 324 n.5.
\textsuperscript{41} Id. at 329 (Scalia, J., concurring).
quite strong—certainly strong enough to warrant further investigation. Indeed, an inference, at least as likely as competing inferences can, in some cases, warrant recovery.42

II. FEDERAL CIRCUIT TREATMENT BEFORE TELLABS AND EVALUATIONS BASED ON PARTICULARITY

As this Part demonstrates, before Tellabs, the circuits addressed the propriety of confidential sources in securities fraud litigation by assessing whether these allegations satisfied the PSLRA's particularity requirement. In general, the courts agreed that allegations by a confidential source would be permitted so long as the sources were identified with a sufficient degree of particularity such that it was indicative of a probability of knowledge. But the federal circuits disagreed over the requisite degree of particularity required.

A. The Second and Fifth Circuits: The Reference Test for Particularity

Before Tellabs, the Second and Fifth Circuits assessed only whether allegations by confidential sources satisfied the PSLRA's particularity requirement.43 For example, the Second Circuit's leading case addressing the propriety of confidential informants, Novak v. Kasaks,44 did so in the portion of its opinion labeled "Particularity of the Facts Pledged," clearly indicating an assessment based on the particularity prong rather than the substantive strong inference prong.45 The Second Circuit allowed the use of confidential informants so long as they were described with sufficient particularity.46 In Novak, the plaintiffs alleged that the defendant, a mega-retailer, made materially false and misleading statements and omissions concerning its financial performance.47 The plaintiffs, relying on confidential sources, claimed that the defendant engaged in "box and hold" inventory practices.48 The district court dismissed the complaint because the plaintiffs failed to reveal their confidential sources.49


44 216 F.3d 300 (2d Cir. 2000).

45 Id. at 312.

46 Id. at 314.

47 Id. at 304.

48 Id. A "box and hold" inventory practice is a practice whereby the defendant would warehouse a large quantity of obsolete inventory without marking it down. Id.

49 Id. at 304–05.
The Second Circuit overruled the district court though, calling its conclusion that plaintiffs cannot rest their allegations on anonymous former employees, "flawed in several respects." First, the Second Circuit reasoned that the actual language of the PSLRA as enacted does not require the revelation of sources. Instead, the Act "requires plaintiffs to plead only facts and makes no mention of the sources of these facts." The Second Circuit then stated that even if sources must be identified, there is no requirement that they be named so long as they were described with sufficient particularity. From a policy perspective, the Second Circuit opined that imposing a requirement of disclosure would "deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them." The Second Circuit, however, required plaintiffs to allege facts from either people or documentary evidence and that the complaint refer to at least one of these sources with specificity.

The Fifth Circuit, in *ABC Arbitrage Plaintiffs Group v. Tchuruk*, likewise assessed the propriety of confidential informants under the PSLRA’s particularity requirement as opposed to the strong inference prong. The Fifth Circuit stated that the PSLRA does not require plaintiffs to name confidential sources so long as other documentary evidence provides an adequate basis for believing the defendant’s statements or omissions were false or misleading. In a later decision, *Barrie v. Intervoice-Brite, Inc.*, the Fifth Circuit laid out its three-step approach to assessing allegations stemming from confidential informants:

1. If plaintiffs rely on confidential personal sources and other facts, their sources need not be named in the complaint so long as the other facts, i.e., documentary evidence, provide an adequate basis for believing that

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50 Id. at 312.
51 Id. at 313 ("In fact, the applicable provisions of the law as ultimately enacted requires plaintiffs to plead only facts and makes no mention of the sources of these facts.").
52 Id.
53 Id. at 314.
54 Id.
55 Id. This standard was also adopted by the First Circuit in *In re Cabletron Sys., Inc.*, 311 F.3d 11, 29 (1st Cir. 2002), the Third Circuit in *California Public Employee’s Retirement Sys. v. The Chubb Corp.*, 394 F.3d 126, 146 (3d Cir. 2004), the Fourth Circuit in *Teachers’ Retirement Sys. of La. v. Hunter*, 477 F.3d 167, 173–74 (4th Cir. 2007) and the Fifth Circuit in *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 351–52 (5th Cir. 2002).
56 291 F.3d 336 (5th Cir. 2002).
57 Id. at 351–52.
58 Barrie v. Intervoice-Brite, Inc., 397 F.3d 249, 259 (5th Cir. 2005). See also *ABC Arbitrage*, 291 F.3d at 353.
59 397 F.3d at 259.
the defendants’ statements or omissions were false or misleading.60

In other words, if the allegation is supported by a confidential source and documentary evidence, it satisfies the PSLRA’s particularity requirement.

(2) If the other facts, i.e., documentary evidence, do not provide an adequate basis for believing that the defendants’ statements or omissions were false, the complaint need not name the personal sources so long as they are identified through general descriptions in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source as described would possess the information pleaded to support the allegations of false or misleading statements made on information and belief.61

According to the Fifth Circuit, if the allegation is supported by only a confidential source, the plaintiff must provide a general description of the source such that it shows that there is a probability that the source possessed the information pleaded.

(3) If the other facts, i.e., documentary evidence, do not provide an adequate basis for believing that the defendants’ statements or omissions were false and the descriptions of the personal sources are not sufficiently particular to support the probability that a person in the position occupied by the source would possess the information pleaded to support the allegations of false or misleading statements made on information and belief, the complaint must name the personal sources.62

Last, if the plaintiff fails to satisfy the particularity requirement through either documentary evidence or a confidential source, the PSLRA requires that the source be named.63 Thus, the Fifth Circuit did not require that confidential sources be named, only that the sources are identified with general descriptions that provide a probability for the veracity of their allegations.64 Both the Second and the Fifth Circuits recognized that the PSLRA’s particularity requirement permits confidential

60 Id.
61 Id. (italics added).
62 ABC Arbitrage, 291 F.3d at 353.
63 See Barrie, 397 F.3d at 259; ABC Arbitrage, 291 F.3d at 353.
64 Barrie, 397 F.3d at 259.
source allegations;\textsuperscript{65} the Circuits did not assess the use of confidential sources under the PSLRA’s scintar standard.\textsuperscript{66} Moreover, the Second and Fifth Circuits recognized that the essential inquiry for confidential informants was whether there was a probability that the source had the information pleaded.\textsuperscript{67}

B. The Ninth Circuit: Confidential Informants Must be Named

Before Tellabs, the Ninth Circuit likewise addressed the propriety of confidential sources in a securities fraud pleading under the particularity requirement of the PSLRA.\textsuperscript{68} In \textit{In re Silicon Graphics},\textsuperscript{69} the Ninth Circuit stated that confidential sources would fail the PSLRA’s particularity requirement where the plaintiff fails to include adequate corroborating details.\textsuperscript{70} In \textit{In re Silicon Graphics}, the plaintiffs brought a securities fraud class action suit against the defendant corporation, a manufacturer of software.\textsuperscript{71} The plaintiffs alleged that the defendant made misleading statements that artificially inflated the company’s stock price.\textsuperscript{72} The plaintiffs based their allegations on anonymous internal reports allegedly read and received by the corporation’s officers.\textsuperscript{73} The district court dismissed the complaint because the plaintiffs failed to “provide a list of all relevant circumstances in great detail.”\textsuperscript{74} The district court ruled that the PSLRA required plaintiffs to reveal the names of confidential sources.\textsuperscript{75}

The Ninth Circuit affirmed the district court’s dismissal because the plaintiffs did not list the contents of the reports, who prepared them, which officers reviewed them, and from whom the source of the report obtained the information.\textsuperscript{76} In other words, the “adequate corroborating

\begin{footnotesize}
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\item[65] See Barrie, 397 F.3d at 259; ABC Arbitrage, 291 F.3d at 351–52; Novak v. Kasaks, 216 F.3d 300, 312 (2d Cir. 2000).
\item[66] See Barrie, 397 F.3d at 259; ABC Arbitrage, 291 F.3d at 353; Novak, 216 F.3d at 312.
\item[67] Barrie, 397 F.3d at 259 (quoting ABC Arbitrage, 291 F.3d at 353); Novak, 216 F.3d at 314.
\item[68] In re Silicon Graphics Sec. Litig. (Silicon II), 183 F.3d 970, 984–85 (9th Cir. 1999). The dissent likewise addressed the propriety of confidential sources under the particularity prong. \textit{Id.} at 998–99 (Browning, J., dissenting).
\item[69] 183 F.3d 970 (9th Cir. 1999).
\item[70] \textit{Id.} at 985.
\item[71] \textit{Id.} at 979–80.
\item[72] \textit{Id.} at 980.
\item[73] \textit{Id.} at 984.
\item[74] \textit{Id.} at 985.
\item[75] In re Silicon Graphics Sec. Litig. (Silicon I), 970 F. Supp. 746, 764 (N.D. Cal. 1997).
\item[76] Silicon II, 183 F.3d at 984. The dissent strongly disagreed with the majority and noted that the plaintiffs had pleaded the requisite “who, what, when, where, and how” kind of facts: [The plaintiffs] alleged that daily and monthly reports: (1) were prepared by “SGI's financial department” (who); (2) informed “SGI's top managers, such as [the individual defendants]” of production problems with the Indigo2, as well as sluggish sales in North America and Europe which resulted in SGI’s inability to meet its financial goals (what); (3) were distributed at specific times during the class period
\end{itemize}
\end{footnotesize}
details” suggested by the Ninth Circuit included disclosure of some form. The Ninth Circuit was primarily concerned with Congress’s perceived intent in creating procedural hurdles in private securities litigation through the PSLRA. The Ninth Circuit’s In re Silicon Graphics decision has been interpreted to impose a blanket requirement that confidential sources must be named.

C. The Tenth Circuit: Particularity Case-by-Case

The Tenth Circuit, while taking a different approach to the required specificity, likewise assessed whether confidential sources were appropriate under the particularity requirement for plaintiffs’ allegations before Tellabs. The Tenth Circuit rejected a per se rule concerning confidential informants altogether. The Tenth Circuit, much like the Second, acknowledged that the particularity requirement of the PSLRA only requires plaintiffs to allege facts, and not the source of those facts. The Tenth Circuit, however, rejected the Second Circuit’s requirement—that if personal sources were not specified, then the complaint must refer to documentary evidence in the alternative—stating it was “too restrictive.” The Tenth Circuit rejected a per se rule discounting confidential informants because it would force plaintiffs to plead their evidence in their complaint:

The PSLRA did not, however, purport to move up the trial to the pleadings stage. While the PSLRA certainly heightened pleading standards for securities fraud lawsuits, we believe that if Congress had intended in securities fraud lawsuits to abolish the concept of notice pleading that underlies the Federal Rules of Civil Procedure, Congress would have done so explicitly. Clearly, the Reform Act requires some precision in alleging facts,

(when); (4) were presented in the form of daily reports . . . (where); and (5) were suppressed by the named defendants in an alleged cover-up. . . (how).

Id. at 998 (Browning, J., dissenting).

77 Id. at 985.

78 Id. at 988. The dismissal of the plaintiff’s complaint was not due solely to the plaintiff’s failure to name confidential sources, but also because of the plaintiff’s broader failure to create a sufficient strong inference of scienter. Id. at 980.

79 See, e.g., Higginbotham v. Baxter Int’l, Inc., 495 F.3d 753, 757 (7th Cir. 2007); In re Party City Sec. Litig., 147 F. Supp. 2d 282, 305–06 (D.N.J. 2001); In re Nice Sys. Ltd. Sec. Litig., 135 F. Supp. 2d 551, 571 (D.N.J. 2001); but see In re Daou Sys. Sec. Litig., 411 F.3d 1006 (9th Cir. 2005).


81 Id. at 1101.

82 See Novak v. Kasaks, 216 F.3d 300, 314 (2d Cir. 2000).

83 Adams, 340 F.3d at 1101.

84 Novak, 216 F.3d at 314.

85 Adams, 340 F.3d at 1101.
however, it does not require pleading all of the evidence and proof thereunder supporting a plaintiff’s claim.\(^6\)

The Tenth Circuit stated that all that is required in the pleading is \textit{sufficient particularity} to put the defendant on notice of the plaintiff’s claim.\(^7\) But the Tenth Circuit cautioned that this was a “common-sense, case-by-case approach.”\(^8\) Again, the focus was on the particularity requirement and whether there was a likelihood that the confidential source had the information alleged.\(^9\)

### III. \textbf{Federal Circuit Court Treatment of Confidential Informants After Tellabs and Reevaluations Based on Sciente}

In 2007, the Supreme Court’s \textit{Tellabs} decision changed much about the pleading game and securities litigation in general. For example, \textit{Tellabs} has altered the pleading balance in some circuits\(^9\) and called into question whether plaintiffs could establish scienter by alleging \textit{either} motive and opportunity \textit{or} facts which constitute circumstantial evidence of recklessness or conscious behavior in others.\(^9\) Additionally though, it has significantly affected the role of confidential informants in securities

\(^{86}\) \textit{Id.; see also} Swierkiewicz v. Sorema N.A., 534 U.S. 506, 513 (2002) ("Just as Rule 9(b) makes no mention of municipal liability . . . neither does it refer to employment discrimination. Thus complaints in these cases, as in most others, must satisfy only the simple requirements of Rule 8(a).’"); Leeham v. Tarrant County Narcotics Intelligence & Coordination Unit, 507 U.S. 163, 168 (1993) (Rule 9(b)’s particularized pleading requirements do not extend to § 1983 claims regarding municipal actions); Makor Issues & Rights v. Tellabs, Inc. (\textit{Tellabs I}), 437 F.3d 588, 600 (7th Cir. 2006), \textit{vacated sub nom}. Tellabs, Inc. v. Makor Issues & Rights, Ltd. (\textit{Tellabs II}), 551 U.S. 308 (2007) (enactment of the PSLRA did not change the standard for pleading scienter); \textit{Black’s Law Dictionary} 620 (8th ed. 1999) ("\textit{expressio unius est exclusion alterius}. A canon of construction holding that to express or include one thing implies the exclusion of the other, or of the alternative.").\(^{87}\) Adams v. Kinder-Morgan, Inc., 340 F.3d 1083, 1102 (10th Cir. 2003). The Tenth Circuit admitted, however, that disclosing sources would strengthen a plaintiff’s claim. \textit{Id.}\(^{88}\) \textit{Id.} at 1100–03.\(^{89}\) \textit{See, e.g.}, Frank v. Dana, 547 F.3d 564, 567 (6th Cir. 2008); New Jersey Carpenters Pension & Annuity Funds v. Biogen IDEC, Inc., 537 F.3d 35, 45 (1st Cir. 2008) (stating that \textit{Tellabs} requires courts to rule for the plaintiff in the case of a tie).\(^{90}\) \textit{See, e.g.}, Inst. Invs. Group v. Avaya, Inc., 564 F.3d 242, 267–69 (3d Cir. 2009) (stating that \textit{Tellabs} does not permit a plaintiff to establish scienter through either motive and opportunity or facts which serve as circumstantial evidence of recklessness or conscious behavior, but rather requires a holistic assessment); Zucco Partners LLC v. Digimarc Corp., 552 F.3d 981 (9th Cir. 2009) (stating \textit{Tellabs} requires a two-step analysis requiring assessment of individual allegations first, and then assessment of the complaint holistically). \textit{But cf.} Dorsey v. Portfolio Equities, Inc., 540 F.3d 333, 339 (5th Cir. 2008) ("Alleged facts are sufficient to support . . . an inference [of fraud] if they either (1) show a defendant’s motive to commit securities fraud or (2) identify circumstances that indicate conscious behavior on the part of the defendant.") (quoting Hermann Holdings, Ltd. v. Lucent Technologies, Inc., 302 F.3d 552 (5th Cir. 2002)).
fraud litigation. As this Part demonstrates, because of Tellabs, almost all federal circuits have reexamined the propriety of confidential informants under the "strong inference of scienter" prong of the PSLRA's heightened pleading standard, and some circuits have begun to "steeply discount" these allegations. This Part first examines those decisions that have reassessed confidential informant allegations under the strong inference prong, but recognized that Tellabs had no effect on the law concerning confidential informants. Conversely, one line of cases has adopted the Higginbotham approach, steeply discounting confidential informants under the strong inference prong. Similarly, the Eleventh Circuit has announced a different, more moderate standard, calling for skepticism of confidential sources. There can be no doubt however, that because of Tellabs, the federal circuits have reevaluated the law on confidential sources under the scienter standard.

A. The First and Second Circuits: Reevaluating but Staying the Course

The First Circuit and several lower courts in the Second Circuit have suggested that Tellabs did not alter the law on confidential informants.92 For instance, in New Jersey Carpenters Pension & Annuity Funds v. Biogen IDEC, Inc.,93 the First Circuit held that Tellabs did not alter its law on confidential informants.94 In Biogen, the plaintiffs brought a federal securities class action against a drug company, alleging that its executives intentionally misrepresented the safety and the market for a particular drug developed by the company.95 As part of their complaint, based on information provided by confidential sources, the plaintiffs alleged that the company hid data regarding the safety of the drug from the Food and Drug Administration.96 The lower court dismissed the action for failing to allege a strong inference of scienter as required by the PSLRA.97

93 537 F.3d 35 (1st Cir. 2008).
94 Id. at 51.
95 Id. at 37.
96 Id. at 49–50.
On appeal however, the First Circuit rejected the defendant's invitation to revise the law on confidential sources in light of *Tellabs*. The First Circuit stated:

*Tellabs* requires that all information in plaintiffs' complaint be evaluated. We think that includes confidential source information, subject to the restrictions stated in our case law. 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.

Nevertheless, the First Circuit further observed there was an important policy in allowing confidential source allegations:

Scienter involves wrongdoing by high-level company officials; low-level employees or consultants may well know of the wrongdoing and wish to disclose it but fear retaliation if their names appear among the accusers. Legislatures, both federal and state, have recognized similar fears in enacting anti-retaliation statutes and in encouraging whistleblowers. Some allowance at the motion to dismiss stage for consideration of confidential sources in litigation is consistent with those policies.

In this case, the substance of the confidential sources' allegations failed to give rise to a strong inference of scienter because, the court reasoned, the confidential sources' allegations were not corroborated with any other evidence. The court was concerned with the fact that the allegations based on a confidential source failed to state when the defendant knew its statement was materially misleading. Additionally, the court rejected other allegations based on information from confidential sources because the allegations were too vague to give rise to a strong inference of scienter. Thus, the First Circuit reevaluated the use of confidential sources under the scienter standard, but held that *Tellabs* left the law regarding confidential informants largely unchanged: confidential sources still require a probability that they had the information pleaded.

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98 *Id.* at 51.
99 Id. (internal citations omitted).
100 Id. at 52.
101 Id.
102 Id. at 52–53 (emphasis added).
103 Id. at 53 (rejecting a confidential source allegation because an allegation of a “serious” adverse event report provides no information regarding whether these reports were confirmed or connected with the conduct at issue).
104 Id. at 52.
B. The Fifth, Sixth, and Seventh Circuits: Discounting Allegations from Confidential Informants


The leading case post-Tellabs on confidential sources that requires a “steep discount” of their allegations and assessed the adequacy of an allegation from confidential sources from a strong inference standpoint is Higginbotham v. Baxter International.105 In Higginbotham, the Seventh Circuit held that all allegations attributed to confidential witnesses must be steeply discounted at the motion to dismiss stage because there is no way to consider opposing inferences.106 It was the first appellate court to illustrate the Tellabs rule at length as applied to confidential informants and it struck down the plaintiffs’ complaint as it relied primarily on confidential informants.107 The Higginbotham court assessed the sufficiency of allegations based on confidential informants from a “strong inference” standpoint, rather than a particularity standpoint.108

In Higginbotham the defendant company, Baxter International, announced it would restate the preceding three years’ earnings to correct fraudulent statements by its Brazilian subsidiary.109 The court applied the Tellabs rule requiring courts to weigh both culpable and nonculpable inferences at the motion to dismiss stage.110 The Higginbotham court stated that all allegations attributed to confidential witnesses must be discounted, as there was no way to engage in an evaluative comparison; there was no way to consider opposing inferences in this situation.111 The Higginbotham court noted that before the Supreme Court decided Tellabs, the Seventh Circuit abided by the standard it laid out in Makor Issues & Rights v. Tellabs, which rejected a bright line rule and allowed confidential sources so long as the descriptions supported the probability that the sources had the information alleged.112 The Higginbotham court argued, however, that “[o]ne upshot of the approach that Tellabs announced is that we must discount allegations that the complaint attributes

105 495 F.3d 753 (7th Cir. 2007).
106 See id. at 756–57.
107 See id. at 761.
108 See id. at 756–57.
109 See id. at 755–56. The Brazilian subsidiary reported sales made earlier than their actual dates to accelerate revenue. Id. When revenue could no longer be accelerated, they simply made up sales data. Id.
111 See Higginbotham, 495 F.3d at 757.
112 See id. at 756.
to five confidential witnesses."¹¹³ Specifically, the court stated that, "[p]erhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don’t even exist. . . . Tellabs requires judges to weigh the strength of plaintiffs’ favored inference in comparison to other possible inferences; anonymity frustrates that process."¹¹⁴ The court seemed particularly concerned that confidential sources would never be revealed: "At oral argument, we asked when the identity of these five persons would be revealed. . . . The answer we received was that the sources’ identity would never be revealed, which means their stories can’t be checked. . . . There is no “informer’s privilege” in civil litigation."¹¹⁵

Nonetheless, the Higginbotham court provided for a limited role for confidential sources when it stated that "[i]t is possible to imagine situations in which statements by anonymous sources may corroborate or disambiguate evidence from disclosed sources."¹¹⁶ Thus, the court left open the possibility that perhaps confidential sources could be used to bolster claims.¹¹⁷ But the court provided no further guidance as to when this limited situation would arise. In the end however, the allegations stemming from confidential informants were all "discounted" and the complaint dismissed.¹¹⁸

2. Higginbotham’s Increasing Acceptance Among the Circuit Courts

The Higginbotham decision called into question the validity of confidential sources in securities litigation and it has been gaining ground among the circuit courts. The Fifth and Sixth Circuits, for instance, have adopted this "steep discount," scienter-based approach to confidential sources.¹¹⁹ Previously, the Fifth Circuit refrained from reassessing allegations from confidential sources from a "strong inference" standpoint and held that these allegations were a permissible basis on which to infer scienter.¹²⁰ However, a recent Fifth Circuit decision, Indiana Electric Workers’ Pension Trust Fund IBEW v. Shaw Group,¹²¹ has cited the Seventh Circuit’s Higginbotham decision with approval and stated that

¹¹³ Id. at 757 (internal quotes omitted).
¹¹⁴ Id.
¹¹⁵ Id.
¹¹⁶ Id.
¹¹⁷ See id.
¹¹⁸ Id. at 757, 761.
¹¹⁹ See Ley v. Visteon Corp., 543 F.3d 801, 811 (6th Cir. 2008); Cent. Laborers’ Pension Fund v. Integrated Elec. Servs., Inc., 497 F.3d 546, 553 (5th Cir. 2007).
¹²⁰ See Cent. Laborers’ Pension Fund, 497 F.3d at 552; see also Kaufman & Wunderlich, Securities Fraud Litigation, supra note 11, at 352—53 (analyzing the Cent. Laborers’ decision).
¹²¹ 537 F.3d 527, 535 (5th Cir. 2008).
“courts must discount allegations from confidential sources.” The Fifth Circuit even echoed the reasoning of the *Higginbotham* court and stated that “[s]uch sources afford no basis for drawing the plausible competing inferences required by *Tellabs.*” Similarly, a district court in the Fifth Circuit held in *In re Dell Securities Litigation* that resting allegations on information provided from confidential sources “detracts from their weight in the scienter analysis.”

The Sixth Circuit has likewise reformed its jurisprudence regarding confidential informants, requiring that they satisfy both the particularity and the “strong inference” prongs. For example, in *Ley v. Visteon Corp.*, the Sixth Circuit cited the *Higginbotham* standard with approval in denying allegations by confidential informants. In *Ley*, the plaintiffs sued the defendant corporation, a Ford spin-off and global supplier of automotive systems and components. As part of the spin-off, the defendant-corporation and Ford filed a prospectus and registration statement with the SEC. The plaintiffs alleged that the defendant’s prospectus was misleading and inaccurate in violation of Section 11 of the Securities Act of 1933 and that when the defendant reported its fourth quarter and full year financial results and other filings with the SEC, it violated Section 10 of the Securities Exchange Act and Rule 10b-

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125 *In re Dell Sec. Litig.*, 591 F. Supp. 2d 877, 895 (W.D. Tex. 2008). The *In re Dell* court stated that for allegations from confidential sources to be given any weight they must (1) be described with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information pleaded; and (2) allege with particularity when a comment was made to a confidential source. See also *Indiana Elec. Workers’ Pension Trust Fund IBEW*, 537 F.3d at 538 (confidential statements capable of many interpretations cannot contribute to a strong inference of scienter); *Cent. Laborers’ Pension Fund*, 497 F.3d at 552 (violations of Generally Accepted Accounting Principles do not on their own establish scienter); *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 382 (5th Cir. 2004) (strong inference of scienter not found when allegations were not pleaded with sufficient particularity to attach to a particular individual); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 353 (5th Cir. 2002) (adopting the Second Circuit’s particularized pleading requirements).
126 543 F.3d 801 (6th Cir. 2008).
127 Id. at 811; see also *In re Proquest Sec. Litig.*, 527 F. Supp. 2d 728, 739–40 (E.D. Mich. 2007) (information from confidential sources cannot be the sole basis of information, but nevertheless cannot be wholly discounted). *But see In re Huffy Corp. Sec. Litig.*, 577 F. Supp. 2d 968, 993 (S.D. Ohio 2008) (information from confidential sources must be discounted, but not ignored).
128 See *Ley*, 543 F.3d at 804.
129 See id. at 804.
As part of their allegations, the plaintiffs, relying on an anonymous source, alleged that the defendant acted with a strong inference of scienter because the defendant intentionally violated Generally Accepted Accounting Principles ("GAAP").

The plaintiffs claimed that according to a senior finance director at the defendant-corporation, the defendant booked customer rebates obtained from suppliers in the year the contract was entered into, as opposed to the year the rebates had actually been received. This same senior finance director also claimed that the defendant's suppliers would pass along increases in the price of materials for the goods sold to the defendant, but rather than book these surcharges, the defendant would defer them. The district court granted the defendant's motion to dismiss and the Sixth Circuit affirmed. The Sixth Circuit acknowledged that anonymous sources "are not altogether irrelevant to the scienter analysis," but dismissed the allegations because the plaintiffs failed to allege not only who knew, but further what, where, when, and how they knew (the particularity aspect of the PSLRA). The Sixth Circuit ultimately dismissed the allegations based on the confidential source, citing the Seventh Circuit's Higginbotham decision steeply discounting allegations from confidential sources.

3. Tempering the Higginbotham Approach

But the federal courts are far from resolute in their adherence to the Higginbotham "steep discount," scienter approach. Indeed, the Seventh Circuit, the originator of the "steep discount," scienter approach, appears to have tempered the Higginbotham decision. When Tellabs went back to the Seventh Circuit on remand in Tellabs II, the court impliedly accepted Higginbotham's reevaluation of confidential sources based on scienter, but tempered Higginbotham's ruling on confidential sources, allowing the sources to persist so long as there was a sufficient probability

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131 See Ley, 543 F.3d at 805; 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.
133 See Ley v. Visteon Corp., 543 F.3d 801, 811 (6th Cir. 2008).
134 See id.
135 See id. at 804.
136 See id. at 811.
137 See id.
138 See Makor Issues & Rights, Ltd. v. Tellabs (Tellabs II), 513 F.3d 702, 711-12 (7th Cir. 2008).
that they had the information pleaded.\textsuperscript{139} In \textit{Tellabs II}, the Seventh Circuit dismissed the plaintiffs’ argument that without the assurance of confidentiality for employee informants, plaintiffs would not “be able to get to first base . . . .”\textsuperscript{140} With whistleblower laws preventing employer retaliation, the Seventh Circuit saw no reason for employees to be fearful.\textsuperscript{141} Moreover, the Seventh Circuit noted that informants have no evidentiary privilege and ultimately their identity would be revealed in pretrial discovery.\textsuperscript{142} In addition, the Seventh Circuit acknowledged that allegations based on anonymous informants are difficult to assess and it would have been better had the sources been named.\textsuperscript{143}

Nonetheless, the Seventh Circuit found that the allegations deriving from these confidential sources were sufficient.\textsuperscript{144} In so doing, the Seventh Circuit departed from \textit{Higginbotham}’s steep discount approach and listed a number of factors reminiscent of \textit{Novak v. Kasaks} and \textit{ABC Arbitrage v. Tchuruk}, that justified reliance on these confidential sources.\textsuperscript{145} Among the factors were the numerosness of the sources, whether they were in a position to know the information first-hand, whether they were prepared to testify, whether the allegations were described with enough specificity as to make them convincing, and whether the information was corroborated with multiple sources.\textsuperscript{146} Because these factors all weighed in favor of the plaintiffs, the Seventh Circuit concluded that the absence of proper names did not invalidate the drawing of a strong inference from the informants’ assertions.\textsuperscript{147}

\textsuperscript{139} \textit{Tellabs II}, 513 F.3d at 711. In \textit{Higginbotham}, the Seventh Circuit panel consisted of Chief Judge Easterbrook writing for the court, Judge Posner, and Judge Ripple. \textit{Higginbotham v. Baxter Int’l, Inc.}, 495 F.3d 753, 755 (7th Cir. 2007). In \textit{Tellabs II}, the panel consisted of Judge Posner writing for the court, Judge Wood, and Judge Sykes. \textit{Tellabs II}, 513 F.3d at 704. This moderated approach has been recognized by \textit{Silverman v. Motorola, Inc.}, No. 07-C-4507, 2008 WL 4360648, at *14 (N.D. Ill. Sept. 23, 2008).

\textsuperscript{140} \textit{Tellabs II}, 513 F.3d at 711.

\textsuperscript{141} \textit{Id.} (citing 18 U.S.C. § 1514A (2006)). The statute also provides for a remedy for injured persons. § 1514A(c) (providing for any relief necessary to make the employee whole and a variety of compensatory damages).

\textsuperscript{142} \textit{Tellabs II}, 513 F.3d at 711.

\textsuperscript{143} \textit{Id.}

\textsuperscript{144} \textit{Id.} at 712.

\textsuperscript{145} \textit{Tellabs II}, 513 F.3d at 711–12 (citing \textit{Novak v. Kasaks}, 216 F.3d 300, 312–14 (2d Cir. 2000) and \textit{ABC Arbitrage Plaintiffs Group v. Tchuruk}, 291 F.3d 336, 353–54 (5th Cir. 2002)).

\textsuperscript{146} \textit{Tellabs II}, 513 F.3d at 712 (“The confidential sources listed in the complaint . . . are numerous and consist of persons who from the description of their jobs were in a position to know at first hand the facts to which they are prepared to testify . . . . The information that the confidential informants are reported to have obtained is set forth in convincing detail, with some of the information, moreover, corroborated by multiple sources.”).

\textsuperscript{147} \textit{Id.}
C. The Eleventh Circuit: A General Skepticism

Post-Tellabs, the Eleventh Circuit in *Mizzaro v. Home Depot, Inc.* entered the fray on confidential sources and stated that courts must be skeptical of confidential sources. Suggestive of the Tenth Circuit’s pre-Tellabs approach, the Eleventh Circuit does not require a per se rejection of confidential sources. In *Mizzaro*, the Eleventh Circuit addressed the status of confidential informants post-Tellabs at length. As part of its analysis, the Eleventh Circuit compared its assessment of confidential sources to a court’s assessment of affidavits used to establish probable cause for search warrants:

Courts are often called upon to evaluate confidential sources to determine whether an affidavit establishes probable cause to issue a search warrant. In that area of law, it is well-settled that a confidential, indeed even an anonymous source may support a finding of probable cause where the tipster provides the specific basis for his knowledge. . . . Applying the same logic here, we see no reason to adopt a per se rule that always requires a securities-fraud complaint to name the confidential source, so long as the complaint unambiguously provides in a cognizable and detailed way the basis of the whistleblower’s knowledge.

But this approach was advocated by Justice Stevens in his dissent in *Tellabs*. Justice Stevens argued that the scienter standard should be similar to the probable cause standard in criminal proceedings. And he reasoned that just as citizens suspected of criminal activity can be subject to search only after a finding of probable cause, so too should

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149 *Id.* at 1239.
152 *Mizzaro*, 544 F.3d at 1239-40 (emphasis omitted).
153 Justice Stevens remarked:

[Congress] implicitly delegated significant lawmaking authority to the Judiciary in determining how that standard should operate in practice. . . . In addition to the benefit of its grounding in an already familiar legal concept, using a probable-cause standard would avoid . . . [forcing a court to] ‘take into account plausible opposing inferences.’

154 “There are times when an inference can easily be deemed strong without any need to weigh competing inferences. . . . [I]f a known drug dealer exits a building . . . carrying a suspicious package, a judge could draw a strong inference that the individual was involved in the . . . drug transaction.” *Id.* at 336–37 (Stevens, J., dissenting).
defendants in a securities fraud action be forced to produce documents for discovery only after a finding of probable cause.\textsuperscript{155} He further observed that the probable cause standard has the added benefit of being a concept familiar to judges and thus easier to administer.\textsuperscript{156} Indeed, Justice Stevens' approach would have alleviated many of the Seventh Amendment concerns that plagued the Court by refraining from requiring judges to weigh inferences at the 12(b)(6) stage.\textsuperscript{157} Nevertheless, the Supreme Court did \textit{not} adopt Justice Stevens' approach. The Eleventh Circuit recognized this however, and observed:

We are, however, careful not to carry the search-warrant analogy too far. For one thing, the probable-cause standard for issuing search warrants is less stringent than the "cogent and compelling" standard imposed on plaintiffs under the PSLRA. For another, lying to the police or to law enforcement in general will likely lead to much harsher consequences than lying to a plaintiff's attorney, so statements by confidential police informants may be more reliable than conversations between plaintiffs' attorneys and whistleblowers. These are just two reasons why courts may be skeptical of confidential sources cited in securities fraud complaints; there are likely others. We conclude that the weight to be afforded to allegations based on statements proffered by a confidential source depends on the particularity of the allegations made in each case, and confidentiality is one factor that courts may consider. Confidentiality, however, should not eviscerate the weight given if the complaint otherwise fully describes the foundation or basis of the confidential witness's knowledge, including the position(s) held, the proximity to the offending conduct, and the relevant time frame.\textsuperscript{158}

Thus, according to the Eleventh Circuit, courts should not discount confidential sources, but rather must assess the basis for their knowledge and give weight accordingly.\textsuperscript{159} Nevertheless, later decisions by the fed-

\textsuperscript{155} Id. at 336–37 (Stevens, J., dissenting).
\textsuperscript{156} Id.
\textsuperscript{157} Wunderlich, supra note 38, at 681.
\textsuperscript{158} Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1240 (11th Cir. 2008).
\textsuperscript{159} Id.
eral courts have interpreted the *Mizzaro* decision as requiring a general skepticism of allegations from confidential sources.  

IV. THE PROPER ROLE OF CONFIDENTIAL INFORMANTS IN PRIVATE SECURITIES LITIGATION

This Part shows that the propriety of confidential informants as sources of allegations in a securities fraud complaint is properly assessed under the PSLRA’s particularity prong. The PSLRA requires a dual and distinct inquiry: one assessing whether the plaintiffs’ allegations are particularized, and one assessing whether the allegations amount to a strong inference of scienter. As this Part shows, this dual and distinct inquiry is implicitly endorsed by the Supreme Court in *Tellabs*. Moreover, an inquiry that focuses only on whether there is a probability that the confidential source has the information pleaded is consistent with the underlying purposes of the securities laws in that it promotes and protects confidential sources.

A. The Statutory Text: Conducting the Appropriate Dual Inquiry of Particularity and Scienter

The proper assessment of allegations from confidential informants involves a dual and distinct inquiry. The Ninth Circuit, in *Zucco Partners LLC v. Digimarc Corp.*, 161 and the Third Circuit in *Institutional Investors Group v. Avaya, Inc.*, 162 clarified the text of the PSLRA and delineated two distinct pleading hurdles: (1) the particularity hurdle, whereby plaintiffs must describe their allegations with sufficient particularity to establish reliability and, in the case of confidential informants, personal knowledge; and (2) the scienter hurdle, whereby the statements reported by confidential informants themselves are indicative of a culpable state of mind. 163 Each requirement on its own is a basis for dismis-
To determine whether plaintiffs have satisfied the first hurdle, the Ninth Circuit considers certain indicia of reliability, such as the level of detail provided by the confidential sources, the corroborative nature of other facts alleged, the coherence and plausibility of the allegations, the number of sources, and the reliability of the sources. The primary inquiry at this stage is whether there is a probability that the confidential source had the information the source claims to have. Once a court determines that the source has the information claimed, the court moves onto the second inquiry, the scienter hurdle. To illustrate, consider the following allegation: according to Confidential Source 1 ("CS-1"), a senior manager of the defendant company’s operations during the class period and one of those responsible for negotiating storage contracts, the defendant, leased extra storage space from Company A, B, and C, during the time of the misstatements (June 2009 to May 2010) to store returned products because the defendant company was engaging in channel stuffing to enhance revenue.

Applying the Ninth and Third Circuits’ standard to the allegation above, CS-1 is a reliable source. The first inquiry is whether the allegation is sufficiently particularized. Here, the allegation contains the means by which the source came to possess the information ("one of those responsible for negotiating storage contracts during the class period") and a specific level of detail (naming specific companies and the

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Gregory Markel et al., Complex Litigation: Sometimes, the Witness is a Cipher, NAT’L L.J., Apr. 21, 2008, at C2 (analyzing the evolution of the requirements to demonstrate scienter).

164 See 15 U.S.C. § 78u-4(b)(3) ("In any private action arising under this chapter, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.").

165 This is a common indicia of reliability invoked by the courts. It is important to note, however, that the Madoff scandal involved only one whistleblower, and the Enron scandal, by most accounts, involved no conventional whistleblowers.

166 Zucco Partners, 552 F.3d at 995 (quoting In re Cabletron Sys., Inc., 311 F.3d 11, 29 (1st Cir. 2002)).

167 See Kaufman & Wunderlich, Securities Fraud Litigation, supra note 11, at 355; see also In re Dura Pharm. Inc. Sec. Litig., 548 F. Supp. 2d 1126, 1134 (S.D. Cal. 2008) (categorizing a confidential source as unreliable when that source lacked sufficient knowledge of facts underlying relevant information); In re Elan Corp. Sec. Litig., 543 F. Supp. 2d 187, 207 (S.D.N.Y. 2008) (requiring confidential sources to describe facts with such particularity to ensure the sources possess the relevant information); Weiss v. Amkor Tech., Inc., 527 F. Supp. 2d 938, 951 (D. Ariz. 2007) (acknowledging that use of a confidential informant requires a description of the informant that sufficiently supports the “probability a person in the position occupied by the confidential witness would possess the information alleged”); In re Trex Co., Inc. Sec. Litig., 454 F. Supp. 2d 560, 573 (W.D. Va. 2006) (holding that allegations from confidential sources would not be considered because they were not personally in a position to know the information they conveyed to the plaintiff).

168 See, e.g., Zucco Partners, 552 F.3d at 1000 (demonstrating the court’s treatment of the scienter prong following extensive treatment regarding the knowledge of the confidential informant).

169 See Zucco Partners, 552 F.3d at 995.
timeline of the events). The second inquiry involves a scienter determination.\textsuperscript{170} It is important to note that solely because the allegation comes from CS-1 does not necessarily demonstrate that the defendant did not act with scienter or a culpable state of mind.\textsuperscript{171} Under the scienter analysis the court should focus on only whether the substance of the allegation gives rise to a strong inference that the defendant acted with scienter.\textsuperscript{172} Therefore, after finding the particularity requirement satisfied, the court looks to whether the substance of the allegation gives rise to a strong inference.

As indicative of scienter, in this case, the allegation involves channel stuffing, a practice whereby a supplier induces its customers to substantially increase their purchases of particular products above what they would otherwise buy from the company in the normal course of business, thus giving the company the immediate appearance of rising revenue.\textsuperscript{173} Channel stuffing creates the short-term illusion that demand is rising between the time a company sends an extra product to distributors and the time when the distributors return it.\textsuperscript{174} Channel stuffing practices can be both good and bad however.\textsuperscript{175} Good channel stuffing occurs where a distributor was discounting and offering other incentives for persons to buy.\textsuperscript{176} Bad channel stuffing occurs where a distributor floods customers with unwanted products and fabricates orders for purposes of inflating revenue projections.\textsuperscript{177} Thus, here it is unclear whether the defendant engaged in good or bad channel stuffing; it is also unclear whether the defendant acted with scienter.\textsuperscript{178} It is important to recognize however, that the allegation does not fail because it was based on information from a confidential source; rather it may fail because the substance of the allegation may not be indicative of the requisite state of mind of the defendant.

\textsuperscript{170} See id.
\textsuperscript{171} The Ninth Circuit failed to specifically address whether allegations from confidential informants must be "discounted" under the PSLRA's strong inference requirement. Id. at 995 n.2.
\textsuperscript{174} \textit{Tellabs I}, 437 F.3d at 598.
\textsuperscript{175} Transcript of Oral Argument at 37-38, \textit{Tellabs}, 551 U.S. 308 (No. 06-484).
\textsuperscript{176} Id. at 38.
\textsuperscript{177} Id.
\textsuperscript{178} See id. at 37-38.
1. The Supreme Court’s Indirect Assent to the Dual Inquiry Approach

The Tellabs decision indirectly recognized the dual inquiry approach articulated by the Ninth and Third Circuits. In his concurring opinion, Justice Alito addressed an issue largely ignored by the majority by maintaining that only facts alleged with particularity should be considered when balancing inferences of scienter.\(^{179}\) He reasoned that because the statute requires facts to be stated with particularity,\(^{180}\) a strong inference must arise from those facts.\(^{181}\) According to Justice Alito, to determine whether a strong inference exists without facts stated with particularity circumvents the entire purpose of the particularity requirement—to prevent plaintiffs from using vague or general allegations.\(^{182}\) Thus, Justice Alito in his concurring opinion meshed the PSLRA’s two pleading requirements of particularity and scienter into a single inquiry. But the majority did not endorse Justice Alito’s approach. Rather, the only consideration the majority gave to Justice Alito’s concurring point was to note that certain omissions and ambiguities can create inferences opposing the plaintiff’s allegations.\(^{183}\) Justice Alito maintained, however, that they should not enter the balance altogether.\(^{184}\) By rejecting Justice Alito’s proposal, the majority impliedly held fast to the dual inquiry required by the PSLRA.

2. Reassessing Confidential Informants Under the Strong Inference Standard Erroneously Conflates the Particularity and Scienter Requirements

Reassessing the role of confidential informants under the strong inference standard erroneously conflates issues of particularity with issues of scienter. For example, the Higginbotham court discounted confidential sources at the pleading stage because they were confidential and thus could not contribute to a strong inference of scienter.\(^{185}\) Underlying the


\(^{180}\) 15 U.S.C. § 78u–4(b)(1) (2006) ("[i]f 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.").

\(^{181}\) Tellabs, 551 U.S. at 334 (Alito, J., concurring).

\(^{182}\) Id. Justice Alito noted that "the particularity requirement is thus stripped of all meaning" under the majority’s opinion. Id.

\(^{183}\) Id. at 325.

\(^{184}\) Id. at 334.

\(^{185}\) Higginbotham v. Baxter Int’l, Inc., 495 F.3d 753, 757 (7th Cir. 2007). "Higginbotham, however, is a classic case of bad facts making bad law and ... is an opinion noteworthy for its intemperate language—which a different Seventh Circuit panel effectively abandoned a short time later ... ." John P. Coffey & Boaz A. Weinstein, The Use of Confidential Sources in Securities Fraud Complaints, Bernstein Litowitz Berger & Grossmann LLP, Publication 8
approach adopted in *Higginbotham*, however, is the faulty premise that disclosure will in effect aid in the weighing of inferences at the pleading stage. Yet most important to the role of confidential informants in securities fraud pleading is an explanation of how the employee came to have the information pleaded.\footnote{See Teachers' Ret. Sys. of La. v. Hunter, 477 F.3d 162, 193 (4th Cir. 2007) (Shed, J., dissenting) ("For example, a personal aide or administrative assistant to the CEO could plausibly overhear a pertinent piece of information that may later form the basis for a securities fraud action, notwithstanding his job title."); Samuel H. Rudman, *Back to 'Novak': Confidential Witnesses in Fraud Actions*, 240 N.Y. L.J 79 (Oct. 22, 2008), available at http://www.csgrr.com/pdf/news/Novak.pdf ("[T]he real issue . . . [is] whether confidential witness accounts need to be pleaded at all or whether a plaintiff may simply allege the facts derived from plaintiff's investigation which may come from the accounts of confidential witnesses."); Wohl, \textit{supra} note 6, at 561.} Even allegations of job titles and job duties merely serve as a means to suggest this probability, rather than as ends in and of themselves.\footnote{Wohl, \textit{supra} note 6, at 561 ("[J]ob titles may convey little about actual job duties, and formal job duties may say little about whether an employee would have been privy to senior-level communications evidencing actionable misconduct.").} The focus of the court's inquiry at the pleading stage should be how the source came to have the information pleaded, rather than the source's name, job title, or duties.\footnote{See \textit{id}.} The Third Circuit recognized this in \textit{Avaya} when it stated that a confidential witness allegation may score highly on the particularity requirement, but fail to give rise to a strong inference of scienter: "[F]or analytical purposes, it is important to distinguish deficiencies relating to the content of allegations from those relating to their form."\footnote{Inst. Inv. Group v. Avaya, Inc., 564 F.3d 242, 263 n.33 (3d Cir. 2009).}

B. An Assessment Based on Particularity is Consistent with the Purposes of the Securities Laws

As shown, the dual inquiry approach is consistent with the text of the PSLRA and the Supreme Court's \textit{Tellabs} decision. Additionally, it is consistent with the underlying purposes of the securities laws because it facilitates disclosure of corporate fraud. The dual inquiry approach appropriately balances the competing interests involved with confidential sources to afford these sources needed protection, but to weed out frivolous and meritless claims. As this Part demonstrates, there is significant value in permitting confidential sources in private securities litigation and in maintaining their confidentiality at the motion to dismiss stage.
1. The Significant Value of Confidential Informants in Preventing Financial Harm

Confidential sources promote the underlying purposes of the securities laws by protecting against corporate misconduct and ensuring the integrity of our financial markets. As this Part shows, the structure of the PSLRA necessitates confidential sources for private securities litigation. Moreover, these sources serve important disclosure and deterrence functions.

First, Congress itself has made plaintiffs' reliance on confidential informants vital for a plaintiff to survive a motion to dismiss. As part of the PSLRA, Congress erected a stay of discovery provision which provides that courts must stay discovery pending a 12(b)(6) motion to dismiss. Discovery is put on hold unless there is a particularized showing that absent discovery, a party will suffer undue prejudice. The provision stays even mandatory disclosures. Thus, discovery does not commence until after a court rules on a 12(b)(6) motion. This stay of discovery provision coupled with the PSLRA's heightened pleading standard has forced plaintiffs to resort to confidential sources to fill the pleading gaps. Thus, "[P]laintiffs seeking to bring securities fraud actions must rely on extrajudicial means of obtaining the detailed information necessary to pass muster under the heightened pleading standard; this often involves reliance on cooperative former (and sometimes current) employees of the defendant company who have knowledge of

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190 See Makor Issues & Rights, Ltd. v. Tellabs (Tellabs II), 513 F.3d 702, 711 (7th Cir. 2008). ("Because the Reform Act requires detailed fact pleading of falsity, materiality, and scienter, the plaintiff's lawyers in securities-fraud litigation have to conduct elaborate precomplaint investigations—and without the aid of discovery, which cannot be conducted until the complaint is filed.").

191 15 U.S.C. § 78u-4(b)(3)(B). There is an exception, however, if a court finds upon motion of any party, that a particularized discovery is necessary to prevent undue prejudice to that party. See Michael J. Kaufman, Limits on Abusive Discovery, 26 SEC. LIT.: DAMAGES §3:8 n.6, available at SECLITD § 3:8 (Westlaw) ("An example of a situation involving the necessity to preserve evidence may be the terminal illness of an important witness.").

192 See 15 U.S.C. § 78u-4(b)(3)(B). Courts recognize an additional exception to the stay of discovery when there is a risk that evidence will be destroyed if discovery does not commence. See Med. Imaging Ctr. of Am., Inc. v. Lichtenstein, 917 F. Supp. 717, 720 (S.D. Cal. 1995) (stating two exceptions: (1) to preserve the evidence and (2) to prevent undue prejudice). Another additional purpose of the discovery stay is "to that it slows the race to the courthouse" by forcing plaintiffs to conduct more extensive prefiling investigations. Perino, supra note 30, at 929.

193 Medhekar v. U.S. Dist. Court, 99 F.3d 325, 328–29 (9th Cir. 1996) (holding that initial disclosure requirements are subject to the disclosure stay).


195 Coffey & Weinstein, supra note 185, at 1–2.
the misconduct at issue." Given this, securities plaintiffs cannot be expected to plead fraud with complete insight.

Apart from the practical fact that the PSLRA necessitates the use of confidential sources to make out a private securities fraud claim, confidential sources serve important corporate governance functions in that they disclose major corporate frauds. As the Supreme Court has recognized, the primary aim of the securities laws is disclosure. And this has been similarly recognized by Congress and all fifty states. The states have recognized the value of whistleblowers through various legislative enactments. Likewise, through Sarbanes-Oxley, Congress acknowledged the vital role confidential informants play in disclosing corporate securities fraud. Indeed, some federal whistleblower laws not only protect against retaliation, but also provide financial incentives to encourage this activity. For instance, the Federal False Claims Act provides financial incentives for disclosure of fraud against the government, as does the Internal Revenue Code for tax evasion. The SEC has similarly pushed Congress to expand the SEC’s reliance on confidential sources and provide these sources compensation for blowing the whistle on corporate fraud.

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196 Id.; see also Rudman, supra note 186 (explaining that PSLRA forced plaintiffs to turn to confidential witness accounts).
197 In re Silicon Graphics Sec. Litig. (Silicon II), 183 F.3d 970, 999 (9th Cir. 1999) (Browning, J., dissenting) (quoting Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1225 (1st Cir. 1996).
198 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); see also Geoffrey Christopher Rapp, Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers, 94 B.U. L. Rev. 91, 94 (2007) (“In enacting the PSLRA, Congress evinced its belief that the existing securities litigation regime was ineffective at exposing new information about ongoing corporate fraud.”).
201 Callahan & Dworkin, supra note 199, at 100. Some have argued that SOX should afford similar financial incentives to corporate fraud whistleblowers. See generally Rapp, supra note 198, at 96 (noting that the SEC rarely “shares” the fines it collects with whistleblowers, even though it is empowered to do so in some circumstances). However, financial incentives disproportionate to disincentives may corrupt corporate informants and motivate them to bring false claims. See, e.g., Neil Weinberg, The Dark Side of Whistleblowing, FORBES, Mar. 14, 2005, at 90–98.
203 26 U.S.C. § 7623 (2006). Approximately thirty-five other federal statutes also contain explicit provisions protecting public and/or private employees from retaliation for reporting violations of various laws. Wohl, supra note 6, at 557.
204 Rich Edson, SEC Gives ‘Wish List’ of 42 Changes It Wants in Securities Law, FOXBUSINESS.COM, July 16, 2009, http://www.foxbusiness.com/story/markets/industries/government/sec-gives-wish-list—changes-wants-securities-law/ (stating that the SEC wants, among other things, authorization “to pay awards to individuals who provide information to the agency leading to the successful enforcement of the federal securities laws.”). The SEC is uniquely qualified to assess “the proper balance between the need to insure adequate disclo-
nize that whistleblowers believe in, and serve, the public interest, an interest that overrides the interests of the corporation whom they serve.\textsuperscript{205} The states and the federal government acknowledge that these internal corporate sources are "uniquely qualified" to reveal misconduct because they observe the business on a daily basis.\textsuperscript{206}

Moreover, absent the use of confidential sources in private securities litigation, there is a substantial risk that corporate fraud will go undiscovered. Absent confidential sources, future incidents of massive corporate wrongdoing, along the lines of the Enron scandal or the Bernard Madoff ponzi scheme might never be revealed, or might have been revealed too late.\textsuperscript{207} Corporate sources are primed to uncover fraud because of their inside status. In particular, the issue of confidential sources in the recent wave of subprime litigation is crucial. The subprime crisis caused the collapse of the banking system and cost taxpayers trillions of dollars to place it on life support.\textsuperscript{208} Like complaints alleging corporate fraud, "[S]ubprime complaints often rely on allegations of nonpublic internal company procedures like lending practices or internal quality controls."\textsuperscript{209} And confidential sources, such as former brokerage

\begin{footnotes}
\item[206] Brown v. Texas A & M Univ., 804 F.2d 327, 337 (5th Cir.1986) (These individuals are "uniquely qualified to reveal unseemly machinations by their fellow employees because they observe them on a daily basis."); see also Rachelle Younglai & Karey Wutkowski, SEC Pummeled as Madoff Whistleblower Testifies, REUTERS UK, Feb. 5, 2009, http://uk.reuters.com/article/idUKLNE51402Q20090205 (quoting Markopolos as stating the SEC was neither willing nor able to uncover the Madoff fraud).
\item[207] See Allan Chernoff, Madoff Whistleblower Blasts SEC, CNNMONEY.COM, Feb. 4, 2009, http://money.cnn.com/2009/02/04/news/newsmakers/madoff_whistleblower/index.htm (discussing the whistleblower of the massive Madoff Ponzi scheme fraud). The very essence of a ponzi scheme is deception and concealment: "The investor thinks that the promised high return on his investment will come from the promoter's putting the investment to work, not that his investment will be used to pay other investors in order to keep the scheme going." \textit{Richard A. Posner, The Failure of Capitalism: The Crisis of '08 and the Descent into Depression} 246 (2009) [hereinafter \textit{Posner, Failure of Capitalism}].
\item[208] Posner, Failure of Capitalism, supra note 207, at vii.
\end{footnotes}
firm employees, are well-suited to expose the occurrence of naked short-selling. Further, the high attrition rate at brokerage firms suggests an abundance of these witnesses.\textsuperscript{210}

Additionally, by assessing confidential sources only on the basis of particularity, without steeply discounting these allegations or entertaining a general skepticism, confidential sources are encouraged to come forward while still receiving necessary protection from retaliation and other harms. As an initial matter, providing internal corporate sources with a "whistle" empowers the person and deters misconduct:

Employees who protest corporate wrongdoing are . . . not invoking the whistle of authority but the whistle of desperation. Their action resembles that of a person who blows a whistle to bring help when threatened with assault on the city streets. The hope is that the law will arrive and protect not only the person's rights but the peace and good order of the community. In a society where the law operates well, the hope is also that just wearing the whistle on a street, or threatening to use it in the corporate setting, may serve to ward off misconduct.\textsuperscript{211}

Yet these internal corporate sources are in need of protection. In general, confidential sources prefer confidentiality because they fear retaliation.\textsuperscript{212} A study conducted after Sarbanes-Oxley found that in eighty-two percent of cases with named employees, the whistleblower alleged that she was either "fired, quit under duress, or had significantly altered responsibilities as a result of bringing the fraud to light."\textsuperscript{213} Pro-

\begin{itemize}
  \item[212] Coffey & Weinstein, \textit{supra} note 185, at 1-2. Whistleblowers also face additional obstacles. As Professor Geoffrey Rapp notes:
  \item[-] Potential whistleblowers face tremendous obstacles beyond direct employer retaliation. They know, for example, that bringing massive, Enron-style fraud to light could potentially lead to their current employer's implosion. Moreover, whistleblowers may fear blacklisting from future employers who suspect disloyalty, as well as social ostracism from their coworkers. Additionally, the psychological burdens associated with whistleblowing, including the effects of public criticism and a lengthy stay in litigation's limelight cannot be ignored. Finally, employees may be contractually or otherwise bound in a way that deters them from blowing the whistle.
\end{itemize}
Professor Geoffrey C. Rapp catalogues the myriad of risks associated with whistleblowing. He notes that retaliation can take the form of being fired, demoted, blacklisted, denied a promotion or overtime, formally disciplined, denied various benefits, reassigned, intimidated, or suffering a reduction in pay or hours.214 In fact, according to Professor Rapp, most whistleblowers never work in their fields again.215 Some corporate sources even fear for their physical safety when making their disclosures.216 Aside from retaliation, a confidential source may lose her job indirectly because of disclosure, as in the case of Enron, where disclosure led to the employer’s demise.217 Disincentives to disclosure can appear in any combination and degree. As a result, the majority of corporate employees who witness corporate wrongdoing do not report it.218

This evidences the true danger in revealing confidential sources. As a result of their whistleblowing experience, one survey found that a full third of those who had blown the whistle “would not have [in retro-

percent of whistleblowers experienced some form of retaliation. Kim R. Sawyer et al., The Necessary Illegitimacy of the Whistleblower 4 (unnumbered working paper, on file with Social Science Research Network) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=917316. This fear of retaliation extends to former employees as well who will almost invariably be required by prospective employers to provide names of their former employers. Wohl, supra note 6, at 557–58.

214 See Rapp, supra note 198, at 118–26. Blacklisting, or social ostracism can be a considerably significant deterrent for whistleblowers. Our desire to belong—social conformity—can cause us to see shorter objects as longer, change our dinner order, or even see moving objects. See Solomon Asch, Effects of Group Pressure Upon the Modification and Distortion of Judgments, in GROUPS, LEADERSHIP AND MEN 177–90 (Harold Guetzkow ed. 1951) (describing a series of experiments in which subjects were asked to assess the length of lines and illustrating, as the participants generally erred more when others gave an incorrect answer than when they answered independently, a tendency to go along with the group majority even when the group judgment went against what their own senses perceived); DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS 232–38 (2008) (describing an experiment which found that patrons at a brewery ordering out loud in sequence chose a larger variety of types of beer per table than those that ordered in private on a write-down menu, perhaps to convey individuality or a “need for uniqueness”); RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 57–58 (2009) (describing group conformity effects in an experiment by Muzaffer Sherif which polled individuals to estimate the distance that a small pinpoint of light moved, though it was actually stationary). Even federal appellate court judges refrain from dissenting out of concerns of “collegiality.” RICHARD A. POSNER, HOW JUDGES THINK 32–34 (2008).

215 See id. at 118; see also Associated Press, Madoff Whistleblower Went Unheeded for Years, MSNBC.COM, Dec. 19, 2008, http://www.msnbc.msn.com/id/28310980/ (quoting Harry Markopolos, the whistleblower of the Bernard Madoff Ponzi scheme, as stating that he was worried about his personal safety and the safety of his family).

216 See Rapp, supra note 198, at 119–20. This is an additional problem for confidential sources where the source is an undiversified investor in his employer’s stock. Id. at 120.

217 See Rapp, supra note 198, at 119–20. This is an additional problem for confidential sources where the source is an undiversified investor in his employer’s stock. Id. at 120.
RESOLVING THE CONTINUING CONTROVERSY

spect] . . . because it wasn’t worth it.”219 Another study found that “nearly all whistleblowers say they wouldn’t do it again.”220 This provides the most important reason to shield confidential sources: absent assurances of confidentiality, “many truthful witnesses with knowledge of corporate wrongdoing would not come forward,”221 thereby leaving fraudulent behavior unmasked. Professor Rapp aptly explains the paradox of whistleblowing:

[T]he disincentives to whistleblowing are most potent when the fraud involved is a major one. In particular, the more serious the fraud, the more likely a whistleblower is to find herself out of a job and socially ostracized. Yet it is in connection with these major frauds that public policy has the greatest interest in encouraging effective whistleblowing.222

Therefore, the greater the fraud, the greater the disincentives to disclose, thereby masking the greatest frauds. Confidentiality is vital to protecting those that do disclose fraud to the market to combat serious fraud. Confidential sources are better served by concealing their identities than by relying on the deterrent effect of post hoc remedies under a statutory anti-retaliation provision.223

2. Necessary Confidentiality at the Motion to Dismiss Stage

The concerns present for revealing a confidential source are not disputed, but opponents of confidential informant protection argue that anonymity is used to shield witnesses at the 12(b)(6) stage whose claims do not stand up.224 As discussed above in Part V.A., however, the substance of the allegation is accounted for in the two-prong assessment.225 These

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220 Id. at 118–19 (quoting C. FRED ALFORD, WHISTLEBLOWERS: BROKEN LIVES AND ORGANIZATIONAL POWER 1 (2001)) (internal quotation marks omitted).
221 Coffey & Weinstein, supra note 185, at 11.
222 Rapp, supra note 198, at 119; cf. Alexander Dyck et al., Who Blows the Whistle on Corporate Fraud? 4–5 (Univ. of Chicago Booth Sch. of Bus., Working Paper No. 08-22, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=891482 (surveying the parties that reveal corporate fraud and concluding that employees are more likely to reveal fraud when they have financial incentives to do so).
223 Post-hoc remedies can raise a number of issues, such as the power of the judiciary to enforce them. See, e.g., Mitchell v. Robert De Mario Jewelry, Inc., 361 U.S. 288, 296 (1960) (holding, in a 6-3 decision, that the district court had jurisdiction under the Fair Labor Standards Act to order employers to compensate wrongfully discharged employees for wages lost).
224 Justin Scheck, Securities Lawyers Spar over Use of Confidential Sources; Identities Disclosed, RECORDER, Apr. 11, 2005, as reprinted in 233 N.Y. L.J. 76 (2005) (quoting, among other attorneys, Jordan Eth, partner with Morrison and Foerster).
225 See infra Part V.A.
concerns do not go unaddressed, rather they are issues for a different inquiry: the scienter inquiry. The essential inquiry for the propriety of confidential sources is whether there is a probability that the source has the information pleaded.

Moreover, a confidential source’s anonymity is most important at the motion to dismiss stage rather than at later stages of the litigation. Even though confidential sources must be revealed at the discovery stage, confidentiality at the 12(b)(6) stage is necessary to vindicate the source’s claims and mitigate the consequences to the source of disclosure. On a 12(b)(6) motion to dismiss, discovery is stayed before a plaintiff’s complaint is tested. If a source blows the whistle on unproven corporate fraud, the source can easily be labeled a liar without any recourse to prove otherwise. Once in the discovery stage, however, a plaintiff need no longer rely solely on allegations from the confidential source. The confidential witness’s claims can be proven with evidence obtained in discovery apart from the confidential source’s own word. This is why some commentators have remarked that, “[t]ypically in a securities case, the case is won or lost on the documents produced in discovery.” It is often key for a confidential source or corporate whistleblower to enlist the government—or in this case, private plain-

226 Rule 26 explains the timing and scope of this disclosure:

Except as exempted by Rule 26(a)(1)(B) or as otherwise stipulated or ordered by the court, a party must, without awaiting a discovery request, provide to the other parties the name and, if known, the address and telephone number of each individual likely to have discoverable information—along with the subjects of that information—that the disclosing party may use to support its claims or defenses, unless the use would be solely for impeachment.


227 15 U.S.C. § 78u-4(b)(3)(B) (2006). However, an exception to this rule exists where “the court finds upon motion of any party that a particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.” Id. See Michael J. Kaufman, Limits on Abusive Discovery, 26 SEC. LIT.: DAMAGES §§ 3:8 n.6, available at SECLITD § 3:8 (Westlaw) (“An example of a situation involving the necessity to preserve evidence may be the terminal illness of an important witness.”) (citation omitted).

228 Judge Posner, at oral argument in Higginbotham, noted that confidential sources “could be any kind of snitch, any kind of liar.” Posting of J. Robert Brown, Jr., supra note 110, at 2.

229 Some worry that if confidential informants remain anonymous at the 12(b)(6) stage and are not revealed until after discovery, the unidentified confidential informants might try to change their stories based on evidence developed through discovery. Stephen M. Sinaiko & Matan A. Koch, Using Confidential Informants to Meet the PSLRA’s Pleading Standards, 240 N.Y. L.J. 11 (2008). But, this would require the plaintiffs to amend their complaint at a minimum. Additionally, even if confidential sources change their story, if the source serves to uncover corporate fraud, it still serves a valuable end.

230 Scheck, supra note 224 (quoting Solomon Cera, Managing Partner of the firm Gold Bennett Cera & Sidener) (internal quotation marks omitted).
tiffs—who have power to obtain the necessary information. Thus, if the plaintiff can find evidence to win the case at the discovery stage, the confidential source will be vindicated.

3. Confidential Informants Are Appropriate in Private Enforcement

There is no doubt that there is continuing judicial hostility to private securities litigation. The Fifth Circuit, with former Justice O'Connor sitting by designation, remarked that “[i]t is to be successful, a securities class-action plaintiff must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action.” In the realm of confidential sources, opponents of the private right of action have questioned the use of confidential sources in private litigation as

231 See Weinberg, supra note 201, at 96 (“For whistleblowers the key is to enlist the government—with its power to subpoena defendants ...”); see also Macey, supra note 207, at 178 (stating that because “whistle-blowing is not self-effectuating,” whistleblowers must rely on a “corporate governance intermediary” such as a regulator or financial analyst to validate their claims).

232 This judicial hostility has been well-documented. See, e.g., Michael J. Kaufman & John M. Wunderlich, Regressing: The Troubling Dispositive Role of Event Studies in Securities Fraud Litigation, 15 STAN. J.L. BUS. & FIN. (forthcoming 2010) (showing how the federal courts require an event study to establish essential elements of a securities fraud claim in contravention to the Seventh Amendment and the securities laws); Michael J. Kaufman & John M. Wunderlich, The Unjustified Judicial Creation of Rule 23 Trials in Securities Fraud Litigation, 43 U. MICH. J. REFORM 323, 330–43 (2010) (arguing that the federal appellate courts have recently, unjustifiably created Rule 23 trials on the merits that significantly impair meritorious private actions); Charles W. Murdock, Sarbanes-Oxley, Corporate Corruption, and the Complicity of Courts and Legislatures, 6 BERKELEY BUS. L.J. (forthcoming 2010) (arguing Congress and the Supreme Court have been complicit in fraud from the late 1970s by gradually rescinding investor protections or outright enacting investor-hostile procedures); Joanne Doroshow, Gordon Gekko Justice Makes a Comeback, RECORDER (Mar. 21, 2008) (arguing the Supreme Court in Stoneridge Investment Partners LLC v. Scientific Atlanta, Inc., 552 U.S. 148 (2008) ushered in an era of “Gordon Gekko justice” whereby shareholders are more vulnerable and the integrity of American markets more exposed than in decades). See also Carl W. Hittinger & Jarod M. Bona, The Diminishing Role of the Private Attorney General in Antitrust and Securities Class Action Cases Aided by the Supreme Court, 4 J. BUS. & TECH. L. 167, 167–68 (2009) (arguing that the Supreme Court has diminished the role of private attorneys in securities litigation as of late); Brett Deforest Maxfield, Ethics, Politics and Securities Law: How Unethical People are Using Politics to Undermine the Integrity of Our Courts and Financial Markets, 35 OHIO N.U. L. REV. 243, 274–93 (2009) (briefly surveying the legislative history of securities regulation before suggesting that some courts have unduly restricted the scope of 10b-5 as per the secondary actors who act in concert with the perpetrators of corporate fraud); Matthew L. Mustokoff, Fraud Not on the Market: Rebutting the Presumption of Classwide Reliance Twenty Years After Basic Inc. v. Levinson, 4 HASTINGS BUS. L.J. 225, 226 (2008) (“In a wave of recent decisions, the courts have made it tougher for plaintiffs to demonstrate that a particular security trades in an efficient market for purposes of triggering the classwide presumption of reliance. [A principal reason for this is that] the courts have interpreted Federal Rule of Civil Procedure 23 ... more stringently in recent years.”). 233 Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 235 (5th Cir. 2009) (per curiam).
distinct from government enforcement efforts by the SEC. But the
aim of the securities laws is disclosure, plain and simple. Whistleblowing has a strong potential for effectively uncovering
fraud. Thus, not only should the securities laws encourage this disclosure to public officials, but to those able to instigate private actions as well. The use of confidential sources in private securities litigation is consistent with the historical role of whistleblowers and it supplements SEC enforcement efforts, providing for holistic regulation of the securities markets. Moreover, as this Part demonstrates, the recent Madoff scandal evidences the need for courts to keep alternative avenues of disclosure, such as private attorneys general, open to inside corporate sources in order to facilitate disclosure of corporate fraud. Additionally, this Part shows that private economic actors, such as plaintiff’s attorneys, can serve as efficient corporate governance mechanisms.

a. The Historical Role of Confidential Informants Was to Alert the General Public of Wrongdoing

Historically a whistleblower served as an alert to both law enforcement and the general public within the zone of danger. Justice Doggett, supra note 6, at 572–73. The private attorney general model in general has come under serious attack by the Supreme Court as of late. Hittinger & Bona, supra note 232, at 167–68.


Moreover, it would be perverse indeed to hold that an indicted corporate officer facing years in prison and loss of reputation was barred by the privilege from obtaining the identities of informants located by prosecutors, while her former employer, facing the loss of a few basis points of quarterly earnings in a class action,
gett of the Texas Supreme Court surmised the historical purpose of whistleblowers, stating:

The term is derived from the act of an English bobby blowing his whistle upon becoming aware of the commission of a crime to alert other law enforcement officers and the public within the zone of danger. . . . Like this corner law enforcement official, the whistleblower sounds the alarm when wrongdoing occurs on his or her "beat," which is usually within a large organization.238

Thus, those who "blow the whistle" on wrongdoing serve not only to alert appropriate public officials, but the public at large so they can take the necessary defensive actions.

b. Confidential Informant Allegations in Private Litigation Are Necessary to Supplement SEC Enforcement Efforts

Aside from this historical purpose, whistleblowing to private attorneys general serves to supplement otherwise deficient SEC enforcement efforts.239 Indeed, "the very act of whistleblowing indicates that governmental regulation has been inadequate to protect the public; it 'represents a breakdown of systems whose very goal is to make sure that misconduct does not occur in the first place.'"240 In general, because of the sheer massiveness of the market, the SEC cannot monitor market activity and corporate conduct alone.241 Congress has recognized this through its en-

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238 Winters, 795 S.W.2d. at 727 (Doggett, J., concurring).
239 Barbara Black, Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: Reliance on Deceptive Conduct and the Future of Securities Fraud Class Actions, 36 SEC. REG. L.J. 330, 338 (2008) ("[E]mpirical studies make clear that the SEC cannot investigate and bring enforcement actions against all corporate wrongdoers; the concept of the private plaintiffs acting as a 'private attorney general' [sic] as a necessary supplement to the SEC's enforcement powers maintains its vitality.").
240 Winters, 795 S.W.2d. at 728 (Doggett, J., concurring).
actment of the PSLRA. Moreover, consider that from 1996 to 2004, the SEC was able to detect only six percent of fraud cases. Journalists, industry regulators, and employees made up the majority of the rest of the sources responsible for detecting fraud. Additionally, Professor Jonathan R. Macey notes that corporate governance mechanisms, such as SEC officials, benefit little from validating a corporate source's whistleblowing. Revelations by confidential sources can be embarrassing to regulators who are on the lookout for fraud. Government bureaucrats in particular benefit little in comparison to the cost they incur if the corporate source is wrong. Additionally, according to Professor Macey,

[A]nalysts and other corporate governance intermediaries have incentives to bias their recommendations and analyses in favor of companies and to ignore fraud. . . . Investment banks pressure the analysts they employ to give positive ratings on companies tracked by issuers, because positive ratings boost stock prices and generate capital for their investment banking clients. Thus gatekeepers such as stock market analysts and bureaucrats have much to lose and little to gain from crediting whistle-blowers' accusations.

Thus, confidential corporate sources may be least effective when these other methods of corporate governance—the SEC and market analysts, to name a few—fail.

c. The Madoff Scandal As Evidence of the Need for Alternative Forms of Corporate Governance

This point is further illustrated by the recently exposed Madoff Ponzi scheme. The Madoff whistleblower, Harry Markopolos, claimed

860815 (stating that a steep decline in restatements and material weaknesses in 2008 was more to do with a sleepier securities watchdog than with compliance with the Sarbanes-Oxley Act).

242 See Rapp, supra note 198, at 105 ("Congress could have simply eliminated private rights of action with the PSLRA, but chose not to. Congress found that private securities litigation amounted to an indispensable tool that promotes public and global confidence in our capital markets and helps deter wrongdoing.") (quotations omitted).

243 Johnson, supra note 213.

244 Id.

245 MACEY, supra note 207, at 180.

246 Id. at 166.

247 Id. at 180.

248 Id.; see also POSNER, FAILURE OF CAPITALISM, supra note 207, at 259 (describing a similar relationship with finance professors and the finance industry). The plaintiffs alleged exactly this in Lentell v. Merrill Lynch & Co., Inc., 396 F.3d 161, 165–67 (2d Cir. 2005). Additionally, a post-SOX study finds that analysts, young analysts in particular, lack incentives to disclose corporate fraud. Dyck et al., supra note 222, at 19–21.
that his warnings to the SEC about Bernard Madoff’s fifty billion dollar fraud “went nowhere.” In fact, Markopolos sounded the warning for fraud for almost a decade prior to the SEC’s decision to investigate, but the SEC took no action and eventually investors lost billions. In 1992, the SEC began receiving detailed and substantive complaints warranting a thorough investigation of Madoff. Even “[a] minimally energetic investigation of Markopolos’s accusations would have revealed that Madoff’s volume of trading was too small to generate the profits that he was reporting to his investors or to execute the hedge he claimed kept those profits steady.” The SEC investigators, however, discovered suspicious information, caught Madoff in contradictions and inconsistencies, but nevertheless accepted Madoff’s implausible explanations at face value. This occurred despite the massive SEC budget increases in 2002 and 2003 in reaction to the SEC’s failure to detect Enron, Worldcom, and other frauds.

The Madoff scandal is also a prime example of where not only the SEC, but other corporate governance mechanisms, failed. Along with the SEC, Markopolos went to a reporter at the Wall Street Journal with his information, but the editors never approved an investigative piece. Additionally, the Financial Industry Regulatory Authority (FINRA) was likewise ineffective in Madoff’s case. Markopolos claimed he never went to FINRA out of fear for his safety because Madoff was chairman of its predecessor organization and his brother was its former vice chairman. Similarly, the National Association of Securities Dealers (NASD) was asked by examiners from the SEC to independently examine data relating to suspected fraud by Madoff. NASD failed to

249 See Chemoff, supra note 207. Even though Harry Markopolos was not an employee, or former employee of Madoff’s, his predicament is not unique; rather, inside confidential sources are in an even more precarious position and in need of further protection. See id.

250 Associated Press, supra note 216; see also Posner, Failure of Capitalism, supra note 207, at 244–47.


252 Posner, Failure of Capitalism, supra note 207, at 247.

253 See Kotz, Failure of the SEC, supra note 251, at 4.

254 Posner, Failure of Capitalism, supra note 207, at 247.


256 FINRA is the largest independent regulator for all securities firms doing business in the U.S. For general information regarding the institution, see http://www.finra.org/AboutFINRA/index.htm (last visited Nov. 6, 2009).

257 Chew, supra note 255.

258 Kotz, Failure of the SEC, supra note 251, at 4.
analyze the data "claiming that it would have been too time-consuming."\(^\text{259}\)

Markopolos' efforts provide one example of how private actions can supplement SEC enforcement efforts and other failed corporate governance mechanisms.\(^\text{260}\) The most important lesson for corporate governance is that putting more reliance on any particular corporate governance mechanism increases investors' vulnerability to any failure of that mechanism.\(^\text{261}\) Private enforcement also protects against agency capture, an additional element that may have been present in the Madoff scandal.\(^\text{262}\) Both securities plaintiffs' attorneys and the SEC serve simi-

\(^\text{259}\) Id.

\(^\text{260}\) See In re Seagate Tech. II Sec. Litig., 843 F. Supp. 1341, 1350 (N.D. Cal. 1994) ("[T]he class action device is viewed as a necessary and desirable supplement to the enforcement efforts of the Securities and Exchange Commission."); D. Brian Hufford, Deterring Fraud vs. Avoiding the "Strike Suit": Reaching an Appropriate Balance, 61 BROOK. L. REV. 593, 638 (1995) ("The risk of restricting shareholders’ ability to combat fraud through private litigation becomes especially critical in light of the heavy burden already placed on regulators who are not in a position to replace the efforts of private attorneys general."). Moreover,

There is little dispute about the centrality of private actions in enforcing the complex web of securities law. Indeed, the most sophisticated critical assessments of securities laws turn not on the lack of public enforcement, but on the insufficiency of private enforcement to deter misconduct as a result of complicated incentive structures that make it easier to collect from the firm itself or its insurers than it is to collect from corporate malefactors.


\(^\text{261}\) See Macey, supra note 207, at 56–57.

\(^\text{262}\) See Faiza Virani, SEC Probes Its Own Chummy Ties to Madoff, CBSNEWS.COM, June 3, 2009, http://www.cbsnews.com/stories/2009/06/03/cbsnews_investigates/main5060022.shtml (reporting SEC Inspector General David Kotz investigation of former SEC official who had personal relationship with Madoff relative); see also Chew, supra note 255 (describing how Madoff’s brother was former vice chairman of the FINRA, making it “unsafe” for Markopolos to report the allegations to FINRA); Younglai & Wutkowski, supra note 206 (citing Markopolos as stating the SEC was beholden to the financial industry). The SEC Office of the Inspector General, however, has released a report maintaining that the failure to detect the Madoff scheme was not the product of agency capture. Kotz, Failure of the SEC, supra note 251, at 1.

Additionally, there now exists some support for the tentative hypothesis that SEC officials may not engage in truly impartial enforcement; in other words, there is evidence of agency capture. See Stavros Gadinis, Is Investor Protection the Top Priority of SEC Enforcement? Evidence from Actions Against Broker-Dealers 5 (Harvard John M. Ctr. for Law, Econ. & Bus. Fellows, Working Discussion Paper No. 27, 2009), available at http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Gadinis_27.pdf; see also Lucian Arye Bebchuk & Zvika Neeman, Investor Protection and Interest Group Politics 23 REV. FIN. STUD. 28–33 (forthcoming 2010) (Harvard John M. Ctr. for Law, Econ. & Bus. Fellows, Working Discussion Paper No. 603, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=103035 (discussing how lobbying by interest groups can affect the level of investor protection). For example, a recent study concludes that the SEC pursues broker-dealer violations by initiating administrative proceedings as opposed to civil lawsuits to avoid courts, as they are a worse forum for finance professionals. See Gadinis, supra at 4–5. In addition, in administrative cases, the study concludes that for the same violation and comparable levels of harm to investors, big firms and their employees are less likely to receive a ban from the securities industry when compared to small firms and their employees. Id. The study
lar purposes and seek to recover damages on behalf of injured investors for violations of the securities laws. The Markopolos ordeal illustrates the need for alternative methods of disclosure; permitting confidential sources, at least preliminarily, for private attorneys' general provides another powerful avenue of disclosure.

d. Private Economic Actors Facilitate Disclosure of Corporate Fraud

The use of confidential informants in private securities litigation is beneficial because private economic actors facilitate the disclosure of corporate fraud. Although Professor Macey does not specifically advocate for the use of confidential informants in securities fraud actions, he makes a compelling and analogous argument for the legitimacy of certain inside traders as methods of corporate governance. Professor Macey argues that a limited and tightly regulated ability to sell short can credibly signal to the market that the trader has negative information about the company. Insider trading on the basis of information about an ongoing fraud necessarily leads to the exposure of that fraud because it is not profitable for an inside trader to simply sell or sell short without revealing the underlying information.

Professor Macey discusses how inside traders revealed corporate fraud in Dirks v. SEC. According to Professor Macey, "In Dirks, the Supreme Court evaluated the insider trading liability of Raymond Dirks, who received valuable information from a disgruntled employee of

\[\text{then discredits the possibility that such enforcement disparities can be explained by the arguably better compliance systems larger firms have in place by finding that small and big firm violations for failing to supervise subordinates were virtually indistinguishable. Id. Last, the study connects the enforcement disparity with post-SEC career trajectories of agency officials. Id. As a result, the study concludes that SEC officials may be responding to future employment prospects by giving prospective employers favorably treatment. Id.}\]

\[263 \text{ Hufford, supra note 260, at 595--96; Luis A. Aguilar, Comm'r, U.S. Sec. & Exchange Comm'n, Speech by SEC Commissioner: Empowering the Markets Watchdog to Effect Real Results (Jan. 10, 2009), available at http://www.sec.gov/news/speech/2009/spch011009laa.htm ("The SEC's mission is very clear. It is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.").}\]

\[264 \text{ See Macey, supra note 207, at 179--81. Professor Macey concludes though that insider trading provides a more credible signal of the veracity of the information, and that whistleblowers are less credible. Id. at 175. But Macey does observe that a combination of whistleblowing and insider trading appears to be the norm, and that whistleblowing can be used to expose fraud, it is just less effective than inside trading appears to be. Id. at 177.}\]

\[265 \text{ See id. at 167. One of the regulations Professor Macey states is necessary is limiting such short selling to employees who have no power to affect the strategic decisions of the company to prevent perverse incentives to cause harm to their firm for private gains. Id. at 173.}\]

\[266 \text{ See id. at 173.}\]

\[267 \text{ See Dirks v. SEC, 463 U.S. 646 (1983); Macey, supra note 207, at 180;}\]
fraud-ridden Equity Funding of America." In Dirks, a securities analyst, Dirks, received a tip from Ronald Secrist, a disgruntled former employee of Equity Funding. Secrist alleged that Equity Funding was vastly overstating its assets and was engaged in a series of frauds. Secrist told Dirks that he tried to convey this information to the SEC, the California state securities commissioner, and the Illinois state securities commissioner, but none followed up on the accusations. Dirks then visited Equity Funding and interviewed several employees and officers; some corroborated the charges of fraud. Dirks similarly urged a contact at the Wall Street Journal to write a story on the fraud allegations, but the contact would not write the story because he refused to believe that such a massive fraud could go undetected. During Dirks' investigation, Dirks disclosed the information he received from the inside corporate source to investors who traded on the basis of that information. The SEC then charged Dirks with aiding and abetting violations of the securities laws. The Supreme Court held that Dirks did not violate the insider trading laws however.

Professor Macey correctly notes that if the insider trading restrictions had been successful in deterring Dirks from trading, it would have prolonged a massive ongoing fraud. According to the appellate court in Dirks, "Largely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding."

Dirks v. SEC demonstrates how whistleblowing to private economic actors—in this case, private attorneys general—can similarly facilitate disclosure of corporate fraud. In Dirks, the whistleblower, Secrist, disclosed fraud occurring at Equity Funding to stock market analysts, the SEC, outside auditors, and journalists, but all of these corporate govern-

268 Macey, supra note 207, at 174.
269 See Dirks, 463 U.S. at 649.
270 Id.
271 See Macey, supra note 207, at 175; see also Dirks, 463 U.S. at 668 n.2 (Blackmun, J., dissenting) (noting that Secrist did not tell Dirks that he had also disclosed the fraud to New York insurance regulators).
272 Dirks, 463 U.S. at 649.
273 Id. at 649–50.
274 See id. at 649.
275 See id. at 650. Dirks was charged with violation Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. Section 17(a) of the 1933 Act prohibited fraud and misstatements in the sale of securities. 15 U.S.C. § 77q(a); Dirks, 463 U.S. at 650–51.
276 Dirks, 463 U.S. at 666–67. The Supreme Court held that because neither Secrist nor the other Equity Funding employees breached a duty owed to Equity Funding, there was no derivative breach by Dirks. Id.
277 Macey, supra note 207, at 175.
278 Dirks, 681 F.2d at 829.
ance mechanisms failed to expose the corporate fraud. Only, the inside trader (or private economic actor) disclosed the fraud because he had a sufficient financial incentive to do so. Inside traders may be an effective corporate governance mechanism because they have: (1) a private incentive to reveal corporate fraud through trading on inside information; and (2) an incentive to ensure the accuracy of the fraudulent allegation (if the fraud never comes to fruition, the inside trader will not make any profit). This is analogous to private attorneys general. Plaintiffs’ attorneys have a private incentive to reveal corporate fraud from the lawyer fees they may generate from the suit. Similarly, they have substantial incentive to ensure the accuracy of their allegations. As will be elaborated on in Part VI.A, plaintiffs’ attorneys are sufficiently motivated to verify the accuracy of their confidential source by the Federal Rules of Civil Procedure, the PSLRA, the Model Rules of Professional Conduct, the possibility of a vacated judgment, and concerns about reputational costs. Moreover, absent a reliable source of fraud, the plaintiffs’ hope of judgment or settlement, and the attorney’s hope of a fee, is slim to none. Thus, just as private economic actors in Dirks serve to illuminate corporate fraud, so too can private economic actors, such as plaintiffs’ attorneys, serve such a corporate governance role.

Nevertheless, the use of confidential sources in any context comes with a certain degree of risk. As Professor Macey notes, “[t]o gauge the efficiency of ignoring whistle-blowing, one must compare the costs of ignoring the information with the benefits, which come in the form of conserving resources that would otherwise be wasted in pursuing false charges of disgruntled employees and other malcontents.” This question however, “remains an empirical issue for which data are scarce if nonexistent.” But, the point remains: the federal courts should at least leave another avenue open for corporate sources to alert the market of corporate fraud, such as the form of a confidential source allegation in a private securities fraud complaint. Steeply discounting these allegations as the court does in Higginbotham or calling for a general skepticism as the court does in Mizzaro unnecessarily hinders the use of confidential sources in securities litigation.

279 See MACEY, supra note 207, at 178-79.
280 See id. at 173.
282 See supra Part VI.A.
283 MACEY, supra note 207, at 180.
284 Id.
V. Assessing Confidential Informants Under the Strong Inference Requirement Does Not Require a Steep Discount or General Skepticism

The authors of this Article recognize that some courts may find the distinction between the “particularity” requirement and the “strong inference of scienter” requirement overly formalistic. Some may point to the Tellabs court’s suggestion that the vagueness of allegations weighs against scienter, as indicating a single holistic assessment. Tellabs focused on scienter, however, and not the particularity requirement. Nevertheless, even if courts evaluate confidential sources under the scienter standard, Tellabs does not require a steep discount, or even skepticism for that matter, of allegations by confidential informants.

A. Steep Discounts and Skepticism Rest on Inappropriately Drawn Inferences

As we wrote previously, discounting confidential sources is inconsistent with Tellabs because it considers irrational, not plausible, inferences. The Higginbotham court’s concern was that “[p]erhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don’t even exist.” Despite these concerns, however, several safeguards already in the judicial system prevent plaintiffs’ attorneys from fabricating a source or conducting a shoddy inquiry into the allegations of the claim. The Federal Rules of Civil Procedure, the Model Rules of Professional Conduct, the possibility of a vacated judgment, and reputational costs obviate the credibility problems raised by Higginbotham.

First, the Federal Rules of Civil Procedure, as well as the PSLRA, require a reasonable inquiry and factual support for all allegations in a complaint. Plaintiffs’ counsel is required by Rule 11 to conduct a rea-

286 Id at 321. (“Our task is to prescribe a workable construction of the ‘strong inference’ standard.”).
287 See Kaufman & Wunderlich, Securities Fraud Litigation, supra note 11, at 355; see also Tellabs, 551 U.S. at 321 (“[I]n determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.”) (emphasis added).
288 Higginbotham v. Baxter Int’l, Inc., 495 F.3d 753, 757 (7th Cir. 2007); see also Markel et al., supra note 163, at C2 (“[A] complaint theoretically could survive a motion to dismiss—and a defendant could be forced to engage in expensive and protracted discovery and be subjected to economic and reputational risk—even if the confidential witnesses’ information was untrue or based on rumor or misunderstanding.”); Weinberg, supra note 201, at 90 (explaining how whistleblowers can receive a portion of money recouped by the government under a 1986 law). See generally Kurt Eichenwald, The Informant 524 (2000) (describing the famous FBI informant Marc Whiteacre’s bizarre behavior, lies, and flat-out deception in blowing the whistle on one of the largest price fixing cases in history).
289 See FED. R. CVR. P. 11(b) (requiring attorneys’ filings not to have an improper purpose, be warranted by law, and the based on evidentiary support after a reasonable inquiry); 15
sonable inquiry and to believe that the allegations have factual support. In addition, the PSLRA requires courts to include in their findings whether the attorneys complied with the requirements of Rule 11. Thus, if counsel were to base allegations on non-existent sources, this would run afoul of Rule 11 and sanctions would be appropriate. In particular, in the securities fraud context, Congress enacted a provision in the PSLRA relating to Rule 11. This provision requires courts to issue findings that the attorneys and parties have complied with Rule 11’s requirement that there be no improper purpose for pleadings and that the allegations contain existing evidentiary support. But this provision is not currently utilized to its full capacity. Thus, if courts are overly concerned with meritless claims, this concern can be addressed by strengthening the application of Rule 11 and without hindering the ability of legitimate victims of fraud to pursue legitimate claims. As one author of this Article previously explained,

U.S.C. § 78u-4(c)(2) (2006) (requiring courts to make findings regarding the compliance by each party with Rule 11(b)).


15 U.S.C. § 78u-4(c)(1), (2) (2006) (stating that at the close of adjudication, the court shall include in the record specific findings regarding compliance by each party with each requirement of Rule 11(b) and that if the court makes a finding that a party violated any requirement of Rule 11(b) the court shall impose sanctions on such party).


Perino, supra note 30, at 938 (finding that courts impose small sanctions and in only a handful of cases).


The true “strike suit” nuisance action, filed only because it was too expensive to defend, is, in this author’s judgment, a beast like the unicorn, more discussed than directly observed. Although small settlements may have been impelled in part by the high cost of defense, the corresponding observation is that the small damages in these cases also do not justify much effort on the plaintiff’s side. Neither side wanted to invest much effort in them—but this does not make them inherently frivolous. Similarly, the economic evidence that strike suits predominate also seems unpersuasive.

John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation, 106 Colum. L. Rev. 1534, 1536 & n.5 (2006). Professor Charles M. Yablon has stated similarly that:

There is little conceptual or empirical support . . . for the far more radical assertion that these cases lack “merit” in the sense that plaintiff’s lawyers do not even consider their chances of success when deciding whether to bring them. That contention is dubious as a matter of theory. If entrepreneurial plaintiff’s lawyers do not have the
To actually effectuate change, courts should not only engage in a sanctions review but also impose sanctions or fee shifting if the action is dismissed. Plaintiffs’ attorneys would thus have less of an economic incentive to initiate strike suits to begin with. Consequently, Rule 11 can work to impose direct costs on plaintiffs’ attorneys themselves.297

Additionally, the Model Rules of Professional Conduct require that a lawyer not bring any proceeding unless there is a basis in fact for doing so.298 A lawyer must also be candid with the court and refrain from offering evidence that the lawyer knows is false.299 Moreover, in the event the lawyer later discovers that this evidence is false, the lawyer is obligated to take certain remedial measures, which may include disclosure to the court if necessary.300

Aside from Rule 11 and ethical constraints, should the plaintiff eventually win a lawsuit based on a made-up confidential source, this may constitute fraud on the court, giving the defendant grounds for vacating that verdict.301 Fraud on the court is a species of fraud which attempts to subvert the integrity of the court.302 Fraud on the court may also include improperly influencing the court’s decision and an interference with the judicial system’s ability to impartially adjudicate a matter.303 Making up witnesses would present false evidence to the court; it is beyond mere non-disclosure, and constitutes a deliberate and intentional fabrication.304 If the court finds fraud on the court, the judgment is vacated, the offending party is denied all relief,305 and the entire costs of proceedings can be assessed against the offending party.306

Additionally, attorneys that fabricate allegations would incur substantial reputation costs.307 It is intuitive that reputation—the opinion or capacity to bring an infinite number of claims (and they don’t), it would seem to be in their interest to distinguish the cases that pose a stronger litigation threat from the weaker ones.


297 Wunderlich, supra note 38, at 668–69.
298 MODEL RULES OF PROF’L CONDUCT R. 3.1.
299 Id. at 3.3(a)(3).
300 In re Intermagnetics Am., Inc, 926 F.2d 912, 916 (9th Cir. 1991).
301 Id.
303 See Greiner v. City of Champlin, 152 F.3d 787, 789 (8th Cir. 1998) (stating fabrication of evidence as an example of fraud on the court).
305 Universal Oil Prods. Co. v. Root Refining Co., 328 U.S. 575, 580 (1946). This includes attorney fees. Id.
306 See HERBERT M. KRITZER, RISKS, REPUTATIONS, AND REWARDS: CONTINGENCY FEE LEGAL PRACTICE IN THE UNITED STATES 219–53 (2004) (discussing the role of reputation in contingency fee practice such as large class actions).

evaluation of a person or group of people—can be extremely influential in molding a person’s behavior. Indeed, corporations recognize the intrinsic value of reputation as evidenced from the presence of in-house public relations departments.\textsuperscript{308} A plaintiffs’ attorney that fabricates a claim would quickly develop an unflattering reputation among other attorneys, potential plaintiffs and recurrent institutional investors, and the courts.\textsuperscript{309} For example, Professor Fred C. Zacharias notes that “adversaries will respond differently to settlement offers and statements made in negotiations, depending on their opponents’ reputations for candor and for taking reasonable positions.”\textsuperscript{310} Thus, a plaintiffs’ attorney that develops a reputation for fabricating allegations can have little hope at settlement. Similarly, Professor Zacharias notes that a firm or lawyer must maintain a reputation for taking moderate and reasonable positions before specialized agencies or tribunals.\textsuperscript{311} A plaintiffs’ attorney and his firm that routinely files securities class action complaints in certain districts and before certain judges has a significant reputation at stake in ensuring the accuracy of its allegations.\textsuperscript{312} Additionally, fabricating a source risks incurring substantial reputational costs among institutional investors. The PSLRA all but requires that sophisticated institutional investors serve as the lead plaintiff in a securities fraud class action.\textsuperscript{313} Professor Zacharias notes that “[w]ealthy, experienced, and sophisticated clients are likelier to know how to identify earned reputation and to make the effort to identify the reputations of potential counsel.”\textsuperscript{314} Thus, in

\textsuperscript{308} Public Relations Consultants Association, http://www.prca.org.uk/Whatispr (last visited Nov. 20, 2009) (“Public relations is all about reputation.”).

\textsuperscript{309} KRITZER, supra note 307, at 220 (discussing the role of reputation in contingency fee practice such as large class actions).


\textsuperscript{311} Zacharias, supra note 310, at 11.

\textsuperscript{312} See id.


\textsuperscript{314} Zacharias, supra note 310, at 16.
private securities litigation, these large institutional investors are likely to discover the reputation of certain plaintiffs’ attorneys.

Thus, a plaintiffs’ attorney risks violating Rule 11, ethical rules, committing fraud on the court, and incurring substantial reputational costs. Each possibility imposes considerable costs on plaintiffs’ attorneys. Drawing an inference that plaintiffs’ attorneys would expose themselves to these substantial consequences is irrational and implausible. Therefore, the inferences drawn under Higginbotham that result in a steep discount and the inferences drawn in Mizzaro that cause courts to view these allegations with a general skepticism should not be drawn according to Tellabs.

B. A Steep Discount and Skepticism Erroneously Applies Tellabs by Tipping Scales in Favor of Defendants

The weighing in Higginbotham and Mizzaro is inconsistent with Tellabs’ mandate that the inferences need only be “at least as likely” to be strong. At oral argument, the Higginbotham court stated that, “[H]aving a confidential witness doesn’t strengthen an allegation. . . . Such a person could be any kind of snitch, any kind of liar . . . [making] anonymous accusations against a company.” In the opinion, the Higginbotham court wrote, “Perhaps they have axes to grind.” Other commentators have similarly hypothesized that disgruntled employees were more likely to engage in whistleblowing than other employees. The problem here, as opposed to the irrational inference that these sources merely do not exist, is that the inference of a dilatory motive is only half of the balance.

Tellabs requires that courts consider both culpable and nonculpable inferences, and that on the balance, the culpable inference be only as likely as the competing nonculpable inference to be strong. Recall the

315 Kaufman & Wunderlich, Securities Fraud Litigation, supra note 11, at 356.
316 See id.; see also Tellabs, Inc. v. Makor Issues & Rights, Ltd. (Tellabs), 551 U.S. 308, 323 (2007) (“[I]n determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.”) (emphasis added).
317 See Posting of J. Robert Brown, Jr., supra note 110 (saying the judges in the Seventh Circuit used Tellabs I merely as an excuse to get rid of anonymous accusations against a company).
318 Id. (quoting Judge Posner at oral argument in Higginbotham).
319 Higginbotham v. Baxter Int’l, Inc., 495 F.3d 753, 757 (7th Cir. 2007).
320 MACEY, supra note 207, at 170. Professor Macey provides other accounts of tippers of inside information turned whistleblower because they were either upset over the size of their bonus or passed over for a promotion. Id. at 180.
321 See Tellabs, 551 U.S. at 323–24 (2007) (“To determine whether the plaintiff has alleged facts that give rise to the requisite ‘strong inference’ of scienter, a court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.”) (emphasis added).
322 Id. at 324.
jade falcon hypothetical: "If a jade falcon were stolen from a room to which only A and B had access, could it possibly be said there was a 'strong inference' that B was the thief?" The majority stated yes and that "law enforcement officials as well as the owner of the precious falcon would find the inference of guilt as to B quite strong—certainly strong enough to warrant further investigation. Indeed, an inference at least as likely as competing inferences can, in some cases, warrant recovery."

To put this in a different perspective: Assume a plaintiff makes an allegation of corporate fraud based on a confidential source. The plaintiff describes the confidential source by position and rough estimates of employment time with the company. The inferences weighed in this scenario would seem as follows: (1) a culpable inference that the confidential source is accurate and thus there was corporate fraud versus (2) a non-culpable inference that the source is confidential because she has an axe to grind or other dilatory motive. Even in a case such as this, Tellabs requires that the tie goes to the plaintiff and therefore, the claim should survive.

Instead of Tellabs' rule, the Higginbotham approach applies Justice Scalia's concurring standard requiring the inference to be more likely to be "strong." Justice Scalia, in his concurring opinion, proposed a more stringent standard. He argued that the inference of culpability must be more plausible than the inference of innocence, thereby giving full effect to the meaning of "strong," in a comparative context. The Seventh Circuit takes an inference that perhaps the sources do not exist, balanced with the plaintiff's allegation that these are actual sources, and

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323 Id. at 329 (Scalia, J., concurring).
324 Id. at 324 n.5 (citing Summers v. Tice, 199 P.2d 1, 3–5 (Cal. 1948)). Yet, the concurring Justice Scalia replied that even a strong possibility is still merely a possibility and does not amount to the "strong inference" required by the PSLRA. Id. at 329 (Scalia, J., concurring). Justice Scalia also said allowing the falcon owner to draw such an inference would contravene the wisdom of the old maxim, "no man ought to be a judge of his own cause." Id. at 329 n.1 (2007). (Scalia, J., concurring).
325 Id. at 324 ("A complaint will survive we hold, 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."). (emphasis added).
326 Compare Higginbotham v. Baxter Int'l, Inc., 495 F.3d 753, 757 (7th Cir. 2007) (discounting allegations from confidential sources because the inference that such sources do not exist and the inference that such sources do, do not weigh in favor of the plaintiff), with Tellabs, 551 U.S. at 329 (Scalia, J. concurring) (advocating in his concurrence that the inference of culpability needs to be more than plausible than opposing inferences for the complaint to succeed).
327 Tellabs, 551 U.S. at 329 (Scalia, J., concurring).
328 Id. (Scalia, J., concurring). But see Murdock, supra note 232 at 51 (arguing the courts and legislatures have been complicit in the culture of corporate corruption and that Justice Scalia's standard would require plaintiffs to prevail by a preponderance of the evidence at the pleading stage where the plaintiff's lack the benefit of discovery).
on this balance, tips the scale in favor of the defendant.\textsuperscript{329} But, \textit{Tellabs} gave the tie to the plaintiff; the inferences must only be equal to be strong, not more so.\textsuperscript{330}

And even assuming the confidential source has an axe to grind, this does not negate the inference that, despite this grudge, the informant’s allegation is still true. Perhaps this informant bears ill toward the corporation precisely \textit{because} of the veracity of her allegations. Consider \textit{Dirks v. SEC} in which a tipper who blew the whistle on Equity Funding’s fraud: the tipper tipped information “because he was upset over his small Christmas bonus.”\textsuperscript{331} His allegations were no less true, however. Thus, this adds a third possible inference: (1) an inference that the confidential source is reliable and thus there was corporate fraud; versus (2) a inference that the source is unreliable because she has an axe to grind or other dilatory motive; versus (3) an inference that the source has a grudge against the defendant, but is nurturing this grudge because the company is committing fraud. The \textit{Higginbotham} approach does not consider this, and neither does \textit{Tellabs}.

Also, steeply discounting confidential sources because of anonymity unnecessarily equates anonymity with the masking of an evil motive on the part of the confidential source.\textsuperscript{332} Even with this inference weighing against the plaintiff because of the source’s anonymity, equally plausible inferences weigh in favor of the plaintiff. For instance, perhaps the source is confidential because she does not want to lose her job, does not want to be harassed at work, shunned from fellow employees, or have difficulty securing a reference for a future job opportunity.\textsuperscript{334} As dis-

\textsuperscript{329} \textit{Higginbotham}, 495 F.3d at 757 (discounting allegations from confidential sources, because balancing the competing inferences that such sources do not exist and that such sources do, does not weigh in favor of the plaintiff).

\textsuperscript{330} \textit{Tellabs}, 551 U.S. at 324.

\textsuperscript{331} \textit{Macey}, \textit{supra} note 207, at 180. Moreover, consider the case of Mark Whitacre, the infamous whistleblower who disclosed the massive antitrust conspiracy involving Archer Daniels Midland Company, and several other industry participants. Whitacre was wrought with double-crossing, dirty dealing, lying, and conniving behavior, but his allegations concerning the antitrust conspiracy were no less true. \textit{See generally} \textit{Kurt Eichenwald}, \textit{supra} note 288.


\textsuperscript{333} \textit{See Higginbotham}, 495 F.3d at 757 (“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 sources have axes to grind. Perhaps they are lying.”).

\textsuperscript{334} Wohl, \textit{supra} note 6, at 553, 556–57 (“Threats of retaliation and harm to reputation serve, however, as strong disincentives to corporate employees who consider stepping forward” as evidenced by (1) government recognition of the threat of corporate retaliation against employees through the enactment of over thirty-five federal statutes prohibiting retaliation, (2) state recognition of likely retaliation through the enactment of forty-seven state laws protecting whistleblowers and seventeen private sector whistleblower protection laws, and (3) Supreme Court recognition of the likelihood of retaliation in \textit{Mitchell v. Robert DeMario Jewelry, Inc.},
cussed above in Part V.B.1., those that blow the whistle on corporate fraud expose themselves to a serious risk of retaliation and ostracism.\textsuperscript{335} In fact, the confidential source must overcome numerous disincentives to disclosure, including job loss, psychological strain, and industry blacklisting.\textsuperscript{336} Discounting confidential sources because they “have an axe to grind” draws an unreasonable inference that the corporate whistleblower’s emotional satisfaction from harming her superiors outweighs the myriad of other disincentives to disclosure.\textsuperscript{337}

Furthermore, the “steep discount” approach neglects a significant inference weighing in favor of the validity of confidential informants’ allegations in private securities fraud complaints: there is an absence of financial motive for confidential sources in private securities litigation. Those that blow the whistle to government agencies are tainted with the prospect of receiving a “bounty.”\textsuperscript{338} Even Markopolos admitted he was motivated partly by the opportunity to receive a bounty.\textsuperscript{339} These bounties can run into the millions, thereby giving confidential informants significant monetary incentive to falsify information in hopes of striking oil in the form of a false allegation that turns out to be true. There is no

\begin{quote}
\textsuperscript{335} See infra Part V.B.1.
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\textsuperscript{336} Cf. Rapp, supra note 198, at 123–24 (noting that while some whistleblowers may derive satisfaction from reporting the misdeeds of their superiors, it is more likely that psychological factors inhibit whistleblowing, as it involves deviating from established group behavior, and subjecting oneself to the nagging suspicion that suspicions of wrongdoing were misplaced).
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\textsuperscript{338} Weinberg, supra note 201 ("The government makes whistleblowers filthy rich for ferreting out fraud on the job.").
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evidence, however, that private attorneys generals offer any kind of monetary incentive (nor should they). Confidential sources in private securities litigation lack this significant strike against their credibility. They have less of an incentive to fabricate information.

CONCLUSION

Tellabs Inc. v. Makor Issues & Rights, Ltd., has injected considerable uncertainty into the law of confidential informants. Ironically, Tellabs was completely silent on the matter, making no mention of the use of confidential informants in securities fraud pleading. Tellabs altered the circuit’s well-settled and unanimous assessment of confidential informants based on the PSLRA’s particularity requirement, even though the circuits disagreed over the degree of particularity required. The circuits correctly recognized that the essential inquiry was whether there was a probability that the source had the information pleaded. After Tellabs, however, some federal circuit courts reassessed this well-settled and well-founded assessment of confidential sources, instead steeply discounting these allegations based on the PSLRA’s scienter requirement. This approach has been gaining ground as of late.

Yet this emerging trend is based on a fundamental misunderstanding of how allegations based on information provided by confidential informant relate to the PSLRA: confidential sources are an issue of particularity. A proper assessment of allegations by confidential informants involves only an inquiry whether the plaintiff has established a probability that the confidential source contains the information claimed, not an assessment whether the allegations give rise to a strong inference of scienter merely because it takes the form of a confidential source. Assessing confidential source allegations only under the particularity prong of the PSLRA is consistent with its text, Supreme Court precedent, and the underlying purposes of the securities laws.

Should courts continue to reassess the proper role of confidential informants under the scienter prong, however, this reassessment does not require a steep discount or general skepticism out of hand. Tellabs gave the tie to the plaintiff. A steep discount or general skepticism rests on irrational inferences and fails to consider the plausible inferences that weigh in the plaintiffs’ favor.