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## **Congress, the Supreme Court and the Proper Role of Confidential Informants in Securities Fraud Litigation**

By Michael J. Kaufman and John M. Wunderlich[\*]

### I. INTRODUCTION

Confidential sources are critical to preventing financial harm and prosecuting corporate misconduct.[1] In order to overcome the Private Securities Litigation Act's heightened pleading requirements, victims of securities fraud often have to rely on confidential sources for particularized facts regarding fraud.[2] In its most recent decision[3] regarding those pleading requirements, the United States Supreme Court held that plaintiffs must allege a strong inference of scienter; meaning the inference of culpability must be at least as likely as nonculpable competing inferences. The question left unanswered by the Court in *Tellabs*, however, is whether securities fraud victims can satisfy this pleading standard through the use of confidential sources.

This article will show that *Tellabs* cannot fairly be construed to preclude plaintiffs from relying on confidential sources to satisfy the PSLRA's securities fraud pleading requirements.[4] Section II of this article will examine the federal courts' pre-*Tellabs* treatment of confidential sources for securities fraud cases based on the particularity provision of the PSLRA.[5] This section also will discuss the *Tellabs* decision and its emergent rule.[6] Section III of this article will analyze the circuits' post-*Tellabs* treatment of confidential sources.[7] The lower federal courts thus far are split on the place of confidential sources in securities fraud pleading. A recent Seventh Circuit decision invoking *Tellabs* requires courts to discount allegations from confidential witnesses.[8] This Section will show that the *Tellabs* rule does not justify such a discounting of confidential sources.[9] Finally, this article will conclude that, while the federal courts previously assessed confidential informants from a particularity viewpoint, some federal courts after *Tellabs* are beginning to treat confidential sources under an erroneous strong inference standard.[10] The continuation of that trend will disserve the Supreme Court's precedents, the will of Congress and the victims of securities fraud.

### II. CONFIDENTIAL SOURCES IN CONTEXT

Confidential sources are important in securities fraud actions.[11] This Section will provide an overview of the circuit treatment of confidential sources prior to *Tellabs* based on the Private Securities Litigation Reform Act's (PSLRA[12]) particularity requirement.[13] Next, this Section will examine how confidential sources relate to the PSLRA's "strong inference" requirement.[14] Finally, this Section will discuss the *Tellabs* ruling, expounding on the meaning of "strong inference." [15]

#### *A. Confidential Sources as they Relate to Securities Fraud Claims in Pleadings*

Plaintiffs in securities fraud actions often rely on confidential sources, such as former employees, for the basis of their allegations.[16] However, the use of confidential sources in securities litigation faces the procedural impediments imposed by the PSLRA. Through the enactment of the PSLRA Congress sought to encourage plaintiffs' lawyers to pursue valid claims and for defendants to fight abusive ones.[17] To stop the perceived abuses of the 10b-5 cause of action,[18] Congress imposed procedural barriers, including a heightened pleading re-

quirement.[19] The PSLRA's pleading requirement has three components: (1) a specificity requirement, (2) a particularity requirement for complaints pled on information and belief, and (3) a strong inference requirement.[20] The PSLRA states:

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.[21]

Before *Tellabs*, the circuits addressed the propriety of confidential sources as they relate to the PSLRA's "particularity" requirement.[22] However, post *Tellabs*, the circuits are using the PSLRA's "strong inference" requirement to reassess the appropriateness of confidential sources.[23]

#### *B. Circuit Treatment of Confidential Sources before Tellabs*

Before *Tellabs*, the circuits addressed the propriety of confidential sources in securities fraud litigation by assessing whether such allegations satisfied the PSLRA's particularity requirement.[24] The leading case on the use of confidential sources in private securities fraud litigation is *Novak v. Kasaks* from the Second Circuit.[25]

The Second Circuit allows the use of confidential informants so long as they are described with sufficient particularity.[26] The Second Circuit addressed the propriety of confidential informants in relation to the PSLRA's requirement that plaintiffs "state with particularity" all facts on which information and belief is formed.[27] The Second Circuit overruled the district court below, calling its conclusion that plaintiffs' cannot rest its allegations with anonymous former employees, "flawed in several respects." [28] First, the Second Circuit said the actual language of the PSLRA as enacted does not require the revelation of sources.[29] "[U]ltimately [the Act] requires plaintiffs to plead only facts and makes no mention of the sources of these facts." [30] Moreover, the Second Circuit noted that even if sources must be identified, there is no requirement that they be *named* so long as they are described with sufficient particularity.[31] From a policy perspective, the Second Circuit also opined that imposing a requirement of disclosure would "deter informants from providing critical information in meritorious cases or invite retaliation against them." [32] However, the Second Circuit required a plaintiff to allege facts from either people or documentary evidence and that the complaint must refer to at least one of these sources with specificity.[33]

The Ninth Circuit generally discounts information provided from confidential sources as failing to state claims with particularity unless they are described with a large degree of specificity.[34] The Ninth Circuit's position is that anonymous sources must be named at the pleading stage to satisfy the heightened pleading standard.[35]

The Third Circuit rejected the contention that the PSLRA's particularity requirement necessitates disclosure of all confidential sources at the pleading stage.[36] The Third Circuit echoed the Second Circuit when it said the PSLRA stops short of the Ninth Circuit's interpretation.[37] The Third Circuit noted that the PSLRA is silent regarding the sources of plaintiffs' facts.[38] The court said that there is no legitimate purpose to be served in requiring that confidential sources be named.[39] In so doing, the Third Circuit repeated the Second Circuit's concern that such a requirement would deter informants from providing necessary information.[40] Nevertheless, the Third Circuit requires that confidential sources be described with sufficient particularity to support the probability that such sources actually have the knowledge claimed.[41]

The Fifth Circuit likewise does not require confidential sources to be named so long as other documentary

evidence provides an adequate basis for believing the defendant's statements or omissions were false or misleading.[42] Less stringently however, if there is no documentary evidence, the Fifth Circuit does not require that confidential sources be named.[43] Instead, the sources must only be identified with general descriptions which provide sufficient probability for the veracity of their allegations.[44]

The Tenth Circuit on the other hand, rejected a *per se* rule concerning confidential informants altogether.[45] The Tenth Circuit, much like the Second, acknowledged that the particularity requirement of the PLSRA only requires the plaintiff to allege facts, and not the source of those facts.[46] However, the Tenth Circuit rejected the Second Circuit's requirement—that if personal sources are not specified, then they must refer to documentary evidence in the alternative—stating it was “too restrictive” of an approach.[47] The Tenth Circuit likewise argued that a *per se* rule rejecting confidential informants 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, however, it does not require pleading all of the evidence and proof thereunder supporting a plaintiff's claim.[48]

The Tenth Circuit stated that all that is required in the pleading is *sufficient particularity* to put the defendant on notice of the plaintiffs' claim.[49] In sum, the Tenth Circuit described its approach as a “common-sense, case-by-case approach.”[50]

Thus pre-Tellabs, the majority of the circuits seem to take a moderate approach toward confidential sources: finding them to satisfy the PSLRA where they are alleged with sufficient particularity.[51] Only the Ninth Circuit requires the disclosure of the sources.[52]

#### C. The Tellabs Decision

Congress did not define “strong inference,” and thus, the lower courts were left to interpret its meaning.[53] Before Tellabs the circuits split as to whether courts were to consider and weigh culpable and nonculpable inferences to assess a “strong inference” of scienter when ruling on 12(b)(6) motion to dismiss in a 10b-5 fraud action.[54] In June 2007, the Supreme Court heard Tellabs v. Makor Issues & Rights.[55] The issue before the Court was whether, in a 10b-5 claim on a 12(b)(6) motion to dismiss, a court must consider and weigh culpable and nonculpable inferences in determining if a plaintiff has pled a “strong inference” of scienter as required by the PSLRA.[56] Tellabs concluded that courts must consider culpable and nonculpable inferences.[57] The Court said courts must find the inference of scienter to be at least as likely as nonculpable inferences for a plaintiff to survive a 12(b)(6) motion to dismiss.[58]

In Tellabs, the plaintiffs alleged Tellabs, CEO Richard Notebaert, and a Tellabs officer, Michael Birck, engaged in a scheme to defraud investors of the true value of Tellabs' stock in violation of Rule 10b-5.[59] The Supreme Court summarized the complaint into four main allegations: (1) Tellabs and Notebaert made statements that demand for a Tellabs product, the Titan 5500, was growing, when in fact demand was dropping, (2) Notebaert made statements that another Tellabs product, the Titan 6500, was in strong demand and ready for delivery when the product was in fact failing lab trials, not available, and in weak demand, (3) that Tellabs engaged in channel stuffing[60] to falsely represent financial results, and (4) that revenue projections were overstated.[61]

The plaintiffs' allegations in the complaint rested on information provided by twenty-seven confidential sources.

i. The Northern District Court of Illinois Assesses Confidential Informants

The District Court for the Northern District of Illinois, in addressing whether the plaintiffs had pled facts sufficient to give rise to a strong inference of scienter, dismissed the plaintiffs' second amended complaint for failure to state a claim.[62] The district court assessed the complaint holistically and determined a strong inference of scienter could not be drawn from the pleadings.[63] As an initial matter, the district court addressed the propriety of the plaintiffs' pleading on information and belief by using confidential sources.[64] The district court cited *Novak v. Kasaks* for the proposition that where plaintiffs rely on confidential sources, but also on other facts, the plaintiffs need not name their sources so long as the facts provide an adequate basis for believing the statements were false.[65] The district court said the sources' information is assessed for reliability by examining the sources' positions at Tellabs, the time period the sources held the positions, their ability to access the information, and whether the allegations are based on the sources' personal knowledge.[66] Nonetheless, the district court did acknowledge that the disclosure of confidential sources would be "helpful" to distinguish whether the allegations are based on rumors or speculations as opposed to concrete information.[67] Ultimately, the district court dismissed the entirety of the plaintiffs' complaint for failure to adequately allege scienter.[68]

ii. The Seventh Circuit's Pre-*Tellabs* Standard for Assessing Confidential Informants

The plaintiffs appealed to the Seventh Circuit Court of Appeals.[69] The Seventh Circuit framed the issue as: "[H]ow much, in the way of factual detail in the pleadings, is sufficient to create this "strong inference" of the requisite scienter?"[70] The Seventh Circuit reversed the district court, finding that the plaintiffs had alleged facts sufficient to support a strong inference of scienter against some of the defendants.[71] According to the Seventh Circuit, a plaintiff demonstrates a strong inference of scienter if a *reasonable person* could infer that the defendant acted with required intent.[72]

The Seventh Circuit, like the district court, approved the use of confidential sources at the pleading stage as satisfying the particularity requirement.[73] The Seventh Circuit said to require plaintiffs to provide "name, rank, and serial number" for each of the sources would be too much.[74] The Seventh Circuit allowed the use of confidential sources so long as the descriptions supported the probability that the person in the position occupied by the source would possess the information alleged.[75] The Seventh Circuit rejected adopting a bright line rule requiring plaintiffs to reveal their sources, as it was concerned that revealing confidential sources may have a chilling effect on persons' willingness to expose corporate fraud.[76] Moreover, the Seventh Circuit noted that exposing confidential sources would expose them to retaliation by their corporate employer.[77]

iii. The Supreme Court Clarifies "Strong Inference" but does Not Address Confidential Informants

The Supreme Court granted certiorari in the case to resolve the circuit split concerning whether courts should consider and weigh competing culpable and nonculpable inferences when ruling on a 12(b)(6) motion to dismiss in a 10b-5 fraud action.[78] The Supreme Court did not directly address the merits of the case. Instead, the Court announced its new rule for pleading scienter and left the Seventh Circuit to apply it on remand.[79] The Supreme Court set out "to proscribe a workable construction of the "strong inference" standard, a reading geared toward the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims." [80] The Court's true concern was whether the complaint alleged a claim that is "not trial worthy, but rather discovery worthy." [81]

In discussing the PSLRA's pleading requirement,[82] the Court emphasized that through the PSLRA, Congress was trying to establish a uniform pleading standard designed to curb "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers." [83] With this aim in mind, the Supreme Court set forth the new pleading test. While the test is summarized as requiring an allegation

to be “cogent and compelling,”<sup>[84]</sup> the Supreme Court in actuality set forth a much more precise framework. First, in ruling on a 12(b)(6) motion to dismiss a 10b-5 action, a court must accept all factual allegations in the complaint as true.<sup>[85]</sup> Second, a court must ask whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.<sup>[86]</sup> Third, a court must weigh opposing inferences and a reasonable person must deem the inference of scienter *at least as likely* as any opposing inference.<sup>[87]</sup>

While the Court reasoned that plausible, opposing, nonculpable inferences must be considered because the inquiry of whether something is “strong” is inherently comparative,<sup>[88]</sup> the Court explicitly rejected the notion that the inference that the defendant acted with scienter needs to be irrefutable.<sup>[89]</sup> The Court clarified that the plaintiff does not need the “smoking gun” to prevail.<sup>[90]</sup>

The Supreme Court rejected the Seventh Circuit's standard however, because it failed to screen out frivolous strike suits, one of Congress's primary goals in enacting the PSLRA.<sup>[91]</sup> Thus, the Supreme Court held the inference must be more than “reasonable”—it must be cogent and compelling when compared to other plausible inferences.<sup>[92]</sup> Justice Scalia in his concurring opinion, on the other hand, proposed an even more stringent standard.<sup>[93]</sup> He advocated that on the balance, the inference of scienter must be *more plausible* than the inference of innocence.<sup>[94]</sup>

Justice Scalia challenged the Court with the following 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?”<sup>[95]</sup> The majority opinion relied on the tort case of *Summers v. Tice* to say, “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.”<sup>[96]</sup>

After announcing the standard however, the Supreme Court did not apply it. Instead, the Supreme Court vacated the Seventh Circuit's decision, rejecting the reasonable person standard, and remanded the case so that the Seventh Circuit could consider the case in accord with the Court's new rule.<sup>[97]</sup> The Supreme Court made no mention of the fact that such allegations rested on information provided by twenty-seven confidential sources.<sup>[98]</sup> The closest the Court came to addressing the issue was Justice Stevens' dissent where he argues that had the Court adopted a probable cause approach, the allegations from the confidential sources would have generated a strong inference.<sup>[99]</sup> Nevertheless, the Seventh Circuit has invoked *Tellabs* to suggest that confidential sources may no longer make the grade.<sup>[100]</sup>

### III. TREATMENT OF CONFIDENTIAL SOURCES POST-TELLABS

Before discussing the recent circuit treatment of confidential sources post *Tellabs* this Section will first further explore *Tellabs*' rule.<sup>[101]</sup> Next, this Section will discuss the circuit's recent use of *Tellabs* in assessing confidential informants.<sup>[102]</sup> Following this, this Section will discuss a recent circuit decision which calls for a discount of allegations based on information from confidential sources.<sup>[103]</sup> This Section will then show that this interpretation of *Tellabs* is inconsistent with the *Tellabs* rule for a variety of reasons.<sup>[104]</sup>

#### A. The *Tellabs* Rule: Competing Inferences Need only be at Least as Likely<sup>[105]</sup>

Before examining the post-*Tellabs* treatment of confidential sources, it is important to clarify the actual rule emergent from *Tellabs*. *Tellabs*' standard is not entirely clear as the Supreme Court did not apply the test. Nonetheless *Tellabs* does supply some indicators as to what a court is to consider in weighing the competing inferences.<sup>[106]</sup> As an initial matter, the standard does not require the most plausible of inferences; they need not be “of the smoking gun genre.”<sup>[107]</sup> The Court also tells us that omissions and ambiguities in the complaint count



against inferring scienter.[108] Even though a plaintiff is not required to have the “smoking gun,” a complaint that is too vague or ambiguous may not survive a 12(b)(6) motion.[109] In addition, the Court says motive, such as personal financial gain, weighs in favor of finding scienter, but the absence of such an allegation is not fatal.[110]

The most important guideline Tellabs sets forth however is what happens in the event of tying inferences.[111] The Court sets up a baseball scenario whereby “the tie goes to the runner.”[112] For example, returning to the Court's jade falcon hypothetical: a jade falcon is stolen from a room to which only *A* and *B* have access.[113] According to the Court's standard, we can draw a strong inference that *A* or *B* took the jade falcon.[114] The Court only requires that the inference be at least as compelling as opposing inferences, not more so.[115] Most importantly, the Supreme Court made no mention of the confidential sources used in pleading.[116] The most relevant guideline the Court establishes as relating to confidential sources is that ambiguities count against an inference of scienter.[117]

*B. Confidential Sources still only Require Specificity for Probability*

Post Tellabs, the circuits are reassessing the validity of confidential sources from a strong inference, rather than a particularity, standpoint.[118] One circuit however seems to be abiding by its pre-Tellabs standard concerning whether confidential informants suffice to plead a “strong inference.”[119] In *Central Laborers' Pension Fund v. Integrated Electrical Services, Inc.*, the Fifth Circuit used the Tellabs decision to dismiss a complaint, finding GAAP allegations and allegations of insider trading resting on information provided by confidential sources did not collectively give rise to a strong inference of scienter.[120]

Specifically, the plaintiffs in *Central* relied on confidential sources to attribute knowledge of an accounting error and insider trading onto management.[121] The Fifth Circuit began by saying rather matter-of-factly that confidential source statements are a permissible basis on which to make an inference of scienter.[122] Nevertheless, while the Fifth Circuit weighed GAAP violations in favor of finding scienter, as “books do not cook themselves,” the balance tipped the other way because the confidential source descriptions lacked specific job details, particular job descriptions, individual responsibilities, and specific employment dates.[123] This absence of information, the Fifth Circuit said, cannot amount to a strong inference of scienter.[124] The court, in reading the complaint holistically, said as a matter of law there was no strong inference.[125]

Similarly, the Tellabs case recently decided on remand provides some insight on the propriety of confidential sources in the circuits.[126] On remand, the Seventh Circuit addressed the fact that the Tellabs allegations rested on confidential sources.[127] The Seventh Circuit dismissed the plaintiff's argument that without the assurance of confidentiality for employee informants, plaintiffs will not, “be able to get to first base.”[128] With whistleblower laws preventing employer retaliation, the Seventh Circuit saw no reason for employees to be fearful.[129] Moreover, the Seventh Circuit said informants have no evidentiary privilege and ultimately their identity will be revealed in pretrial discovery.[130] 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.[131]

Nonetheless, the Seventh Circuit found the allegations deriving from these confidential sources to be sufficient.[132] In so doing, the Seventh Circuit listed a number of factors that justified reliance on these confidential sources.[133] Among the factors were the numerosity 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 such specificity as to make them convincing, and whether the information was corroborated with multiple sources.[134] Because these factors all weighed in favor of the plaintiff, the Seventh Circuit concluded that the

absence of proper names does not invalidate the drawing of a strong inference from the informants' assertions.[ 135]

Thus, post *Tellabs*, two circuit cases have said the anonymity of the confidential sources will not affect the strong inference evaluation. However, the Seventh Circuit set forth some rather vigorous factors before such an inference will be drawn in favor of the plaintiffs.

*C. Confidential Sources Must be Steeply Discounted*

In *Higginbotham*, one of the first circuit cases to illustrate the *Tellabs* rule at length, the plaintiffs' complaint was struck down as it relied primarily on confidential informants.[136] The *Higginbotham* court assessed the sufficiency of allegations based on confidential informants from a “strong inference” standpoint, rather than a particularity standpoint.[137]

In *Higginbotham v. Baxter* the defendant company announced it would restate the preceding three years' earnings to correct fraudulent statements by its subsidiary.[138] The court applied the *Tellabs* rule requiring courts to weigh culpable and nonculpable inferences.[139] The *Higginbotham* court said all allegations attributable to confidential witnesses must be discounted, as there is no way to engage in an evaluative comparison; there is no way to consider opposing inferences in such a situation.[140]

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.[141] However, the *Higginbotham* court argued that “[o]ne upshot of the approach that *Tellabs* announced is that we must discount allegations that the complaint attributes to five confidential witnesses.”[142] Specifically, the court stated that “Perhaps 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.”[143] 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.”[ 144]

Even still, the *Higginbotham* court provided for a limited role for confidential sources when it said, “It is possible to imagine situations in which statements by anonymous sources may corroborate or disambiguate evidence from disclosed sources.”[145] The court left open the possibility that perhaps confidential sources can be used to bolster claims.[146] In the end, however, the allegations stemming from confidential informants were all “discounted” and the complaint dismissed.[147]

*D. Tellabs does Not Require the Steep Discounting of Confidential Sources*

The impact of *Higginbotham* is already being acknowledged as significant.[148] While it quite possible that *Higginbotham* will turn out to be the exception rather than the rule,[149] *Higginbotham* makes compelling arguments for the discounting of confidential sources in their entirety post *Tellabs*. [150] However, there are several reasons the *Higginbotham* approach is inconsistent with *Tellabs*. [151] As this Section will discuss, it is based on the false premise that full disclosure will aid in assessing the strength of any inferences to be drawn from the allegations. [152] Also it considers irrational inferences, not plausible nonculpable inferences. [153] Finally, the actual weighing of inferences is inconsistent with the *Tellabs* mandate. [154]

i. Requiring Disclosure of Confidential Sources at the Pleading Stage Relies on a False Premise

The *Higginbotham* court discounted confidential sources at the pleading stage because they were confiden-



tial and thus could not contribute to a strong inference.[155] The court did not criticize the specificity of the descriptions or the degree to which the sources' stories corroborate. The court focused only on the concealment of the sources' identity.[156]

Underlying the approach adopted in *Higginbotham* however is the faulty premise that such disclosure will in effect aid in the weighing of inferences at the pleading stage. Of course, while disclosure of the source would evidence the existence of an actual person, without more however, a name means nothing.[157] More important than the identity of the source is an explanation of how the employee came to have the information pleaded.[158] Even allegations of job titles and job duties merely serve as a means to suggesting this probability, rather than an end in of themselves.[159] The focus of the court's inquiry at the pleading stage should be how the employee came to have the information pleaded, rather than the name of the employee, job title, or duties.[160]

The *Higginbotham* approach also claims that where the source is not disclosed, an evaluative comparison cannot be made.[161] However, *Tellabs* addresses just such a circumstance.[162] *Tellabs* requires that vagueness or ambiguity in the complaint simply weighs against inferring scienter.[163] *Tellabs* does not require a discount of such allegations.[164]

ii. The Inferences Drawn in Discounting Confidential Sources are Irrational, not Plausible

Another reason the *Higginbotham* approach is inconsistent with *Tellabs* is because it considers irrational, not plausible, inferences.[165] To illustrate, consider what the *Higginbotham* court said regarding confidential informants: "Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist." [166] Despite the court's worry that these confidential sources are complete fabrications, the Rules of Civil Procedure, as well as the PSLRA, have already addressed such a concern.[167] Namely, [Rule 11](#) safeguards the process.[168] Plaintiffs' counsel are required by the [Rule 11\(b\)](#) to conduct reasonable inquiry and to believe the allegations have factual support.[169] In addition, the PSLRA requires courts to include in their findings whether the attorneys complied with the requirements of [Rule 11\(b\)](#). [170] Thus, if counsel were to base allegations on non-existent sources, this would run afoul of [Rule 11](#) and sanctions would be appropriate.[171] Because the *Higginbotham* court is inferring an outcome which would have detrimental effects for the plaintiff and his attorney, to draw such an inference is irrational and the inference itself is implausible. According to *Tellabs* therefore, the inference should not be drawn.[172]

In addition, the *Higginbotham* court's concern that perhaps these confidential sources do not exist, would result in the discountance of all confidential sources, regardless of the number, degree of specificity with which they are described, or degree to which they corroborate other allegations.[173] If the sources themselves are fabrications, then all aspects of these sources, including the job title or degree of corroboration, could just as easily be fabricated. If plaintiffs can make-up a source, plaintiffs are capable of crafting a corroborating set of facts. This same logic dispenses with the number of confidential sources.[174] If five could be inferred to not exist, there is no more justification to believe six exist, seven exist, twenty-seven exist, or even one-hundred confidential sources exist.

iii. *Tellabs* Requires a Different Balancing of Inferences

The weighing in *Higginbotham* is inconsistent with *Tellabs*' mandate that the inferences need only be "at least as likely" to be strong.[175] Judge Posner said at oral argument, "[H]aving a confidential witness doesn't strengthen the allegation ... Such a person can be any kind of snitch, any kind of liar ... [making] anonymous accusations against a company." [176] In the opinion, the court wrote, "Perhaps they have axes to grind." [177] The problem here, as opposed to the irrational inference that these sources merely do not exist, is that the inference of a dilutory motive is only half of the balance.[178]

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.<sup>[179]</sup> 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 to be weighed in such a scenario would seem to be as follows: (1) a culpable inference that the confidential source is accurate and thus there was corporate fraud versus (2) a nonculpable inference that the source is confidential because he has an axe to grind or other dillutory motive. Thus, even in a case such as this, Tellabs requires that the tie goes to the plaintiff and therefore, the claim should survive.<sup>[180]</sup>

However, even assuming the confidential source does have an axe to grind, this does not entirely negate the inference that even despite this grudge, the informant's allegation is not still true. Perhaps this informant bears ill will toward the corporation precisely because of the veracity of his allegations. The Higginbotham approach does not consider this. Also, it equates anonymity with the masking of an evil motive on the part of the source.<sup>[181]</sup> Even with these exonerating inferences in favor of the defendant, there are equally plausible inferences to be drawn in favor of plaintiff. For instance, perhaps the source is confidential because he does not want to lose his job, does not want to be harassed at work, shunned from fellow employees, or have difficulty securing a reference for a future job.<sup>[182]</sup> Indeed, even the Seventh Circuit itself previously acknowledged this concern.<sup>[183]</sup>

Instead of Tellabs' rule, the Higginbotham approach applies Justice Scalia's concurring standard requiring the inference to be *more* likely to be "strong."<sup>[184]</sup> Justice Scalia, in his concurring opinion, proposed a more stringent standard.<sup>[185]</sup> 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.<sup>[186]</sup> 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 on this balance, tips the scale in favor of the defendant.<sup>[187]</sup> However, Tellabs gave the tie to the plaintiff; the inferences must only be equal to be strong, not more so.<sup>[188]</sup>

#### IV. CONCLUSION

Prior to Tellabs, the circuits nearly all agreed that confidential sources were a permissible method of pleading in securities fraud under the PLSRA's particularity requirement. However, lower courts have begun to use Tellabs's interpretation of the PSLRA's strong inference requirement to reassess the propriety of confidential informants in securities fraud litigation. Post Tellabs, Tellabs has been invoked as an excuse to steeply discount allegations from confidential sources. Such a rule is inconsistent with the holding in Tellabs, the language and intent of Congress and the objective of preventing and prosecuting securities fraud.

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J.D. Loyola University Chicago School of Law, expected May 2009.

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[FN1] Ethan D. Wohl, *Confidential Informants in Private Litigation: Balancing Interests in Anonymity and Disclosure* XII Fordham J. Corp. & Fin. L. 551, 555 (2007) [hereinafter Wohl].

[FN2] Wohl, *supra* note 1, at 553, 556 (arguing that due to a heightened pleading standard imposed by the PSLRA, treatment of private confidential informants is increasingly important).

[FN3] [Tellabs, Inc., v. Makor Issues & Rights, Inc.](#), 127 S. Ct. 2499 (2007).

[FN4] *See infra* Part III. D (arguing the Seventh Circuit's use of Tellabs to steeply discount allegations from confidential informants is not supported by the Supreme Court's Tellabs opinion).

[FN5] *See infra* Part II.B (discussing the circuit's treatment of confidential sources prior to the Tellabs decision).

[FN6] *See infra* Part II.C and Part III.A (exploring the Tellabs decision and rules garnered from the ruling).

[FN7] *See infra* Part III. B and Part III.C (discussing [Cent. Laborers' Pension Fund v. Integrated Elec. Serv. Inc.](#), 497 F.3d 546 (5th Cir. 2007) and).

[FN8] [Higginbotham](#), 495 F.3d 753 (7th Cir. 2007). *See infra* Part III.C and Part III.D (discussing the Higginbotham decision and arguing it is inconsistent with Tellabs).

[FN9] *See infra* Part III.D (saying the discounting confidential sources relies on the false premise that identification is necessary for evaluation, the Seventh Circuit is considering irrational inferences covered by [Fed. R. Civ. P. 11](#), and the Seventh Circuit is applying the concurrence standard rather than the Supreme Court's holding).

[FN10] *See infra* Part IV. (concluding Tellabs does not change the assessment of confidential sources).

[FN11] *See supra* notes 1—2 and accompanying text (discussing the importance of confidential sources).

[FN12] [15 U.S.C.A. § 78u-4\(b\)\(2\)](#); *See also* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?* 4 U. Ill. L. Rev. 2003 914, 925 (2004) (noting that the pleading requirement actually has three components: (1) a specificity requirement, (2) a particularity requirement for complaints pled on information and belief, and (3) the strong inference requirement) [hereinafter Perino].

[FN13] *See infra* Part II.B.

[FN14] *See infra* Part II.A (discussing how the PSLRA requires plaintiffs' allegations to give rise to a strong inference of scienter).

[FN15] *See infra* Part II.C (discussing the Tellabs case at the district court, Seventh Circuit, and Supreme Court levels).

[FN16] Harold S. Bloomenthal & Samuel Wolff, *Novak Applied, Sec. & Corp. L.* § 16:102:10 (Thomson/West 2007) [hereinafter Bloomenthal & Wolff].

[FN17] [S. Rep. No. 104-98, at \\*4](#) (1995) as reprinted in 1995 U.S.C.A.C.A.N. 679, 683. *See HR Conf. Rep. 105-803* (Congressional finding that securities regulation has a dual aim of protecting investors and promoting growth of financial markets); *see also HR. Conf. Rep. No. 104-369, at 31* (1995), as reprinted in 1995 U.S.C.A.C.A.N. 730, 731 (saying the overriding purpose of the Nation's securities laws is to protect investors and maintain confidence in the market so national savings and investments may

grow for the benefit of all).

[FN18] *Tellabs*, 127 S. Ct. at 2508; see Michael J. Kaufman, The Private Securities Litigation Reform Act: Generally, 26 *Sec. Lit. Damages* § 3:1 (Thomson/West 2007) (noting that the Private Securities Litigation Reform Act had parallel effects on both the Securities Act of 1934 and the Securities Act of 1933 impacting areas such as class action litigation, forward-looking statements, pleading requirements, RICO liability, and auditor disclosures); see also H.R. Conf. Rep. No. 104-369, at 37 (1995), as reprinted in 1995 U.S.C.A.C.A.N. 730, 736 (“[T]he cost of discovery often forces innocent parties to settle frivolous securities class actions.”); See also Perino, *supra* note 13, at 915 (saying the three goals of the PSLRA are: (1) to reduce the costs that securities actions impose on the capital markets by discouraging the filing of non-meritorious suits, (2) reducing litigation risk for high technology issuers, and (3) reducing the race to the courthouse door whereby class actions are filed soon after a significant stock price declines). *But see Tellabs*, 127 S. Ct. at 2515 (Scalia, J., concurring) (arguing the report of a single committee of a single House does not express the will of Congress).

[FN19] See 15 U.S.C.A. § 78u-4(b)(1) to (2) (2000) (requiring a plaintiff to specify each statement alleged to have been misleading, the reasons why they are misleading, and that it must give rise to a strong inference that the defendant acted with scienter); 15 U.S.C.A. § 78u-4(b)(3)(B) (staying discovery until after a court rules on a 12(b)(6) motion); 15 U.S.C.A. § 78u-4 (a)(4) (changing the standard from joint and several liability to proportionate liability).

[FN20] Perino, *supra* note 13, at 925.

[FN21] 15 U.S.C.A. § 78u-4(b)(2) (emphasis added). The legislative history suggests Congress did not intend to codify the Second Circuit's strong inference standard of alleging motive and opportunity or reckless or conscious behavior to state a 10b-5 claim:

The Conference Committee language is based in part on the pleading standard of the Second Circuit. The standard also is specifically written to conform the language to Rule 9(b)'s notion of pleading with “particularity.” Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a “strong inference” of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.

H.R. Conf. Rep. No. 104-369, at 41 (1995), as reprinted in 1995 U.S.C.A.C.A.N. 730, 740. Congress specifically denied including motive, opportunity, or recklessness in the language of the statute. H.R. Conf. Rep. No. 104-369, at 49, n.23 (1995), as reprinted in 1995 U.S.C.A.C.A.N. 730, 748.

[FN22] See *infra* Part II.B (discussing circuit court decisions before the Supreme Court's *Tellabs* decision assessing the validity of confidential sources).

[FN23] See *infra* Part III (discussing circuit court decisions after *Tellabs* which assess confidential informants based on the “strong inference” requirement of the PSLRA as opposed to its “particularity” requirement).

[FN24] See *supra* notes 26–52 and accompanying text (discussing the pre-*Tellabs* approach taken by the circuits assessing confidential sources).

[FN25] *Novak v. Kasaks*, 216 F.3d 300 (2d. Cir. 2000).

[FN26] *Novak*, 216 F.3d at 313.

[FN27] *Id.*

[FN28] *Id.*

[FN29] *Id.*

[FN30] *Id.*

[FN31] *Novak*, 216 F.3d at 314.

[FN32] *Id.*

[FN33] *Id.* This standard was also adopted by the First Circuit, *In re Cabletron Sys. Inc.*, 311 F.3d 11, 29 (1st Cir. 2002), and the Fifth Circuit, *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 351–52 (3d. Cir. 2004).

[FN34] *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999).

[FN35] *Id.* (“It is not sufficient for a plaintiff’s pleadings to set forth a belief that certain unspecified sources will reveal, after appropriate discovery, facts that will validate her claim.”).

[FN36] *California Pub. Employees’ Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 146 (3d. Cir. 2004) (citing *Novak*, 216 F.3d at 314).

[FN37] *Id.*

[FN38] *Id.*

[FN39] *Id.* at 147.

[FN40] *Id.*

[FN41] *California Pub. Employees’ Ret. Sys.*, 394 F.3d at 155.

[FN42] *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 259 (5th Cir. 2005). *See also* *ABC Arbitrage Group*, 291 F.3d at 353.

[FN43] *Barrie*, 397 F.3d at 259.

[FN44] *Id.*

[FN45] *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1101 (10th Cir. 2003).

[FN46] *Id.*

[FN47] *Id.*

[FN48] *Id.* (internal quotes omitted) See also [Makor Issues & Rights v. Tellabs, Inc.](#), 437 F.3d 588, 600 (7th Cir. 2006), vacated sub nom. [Tellabs, Inc. v. Makor Issues & Rights, Ltd.](#), 127 S. Ct. 2499 (2007) [hereinafter *Makor Issues & Rights, Tellabs* Seventh Circuit decision]; [Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit](#), 507 U.S. 163, 168 (1993) (*expressio unius est exclusion alterius*); Black's Law Dictionary 620 (8th ed. 1999) (“*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.”); [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).”)

[FN49] [Adams](#), 340 F.3d at 1102. However, the Tenth Circuit did admit that disclosing sources would strengthen a plaintiffs' claim. *Id.*

[FN50] *Id.*

[FN51] See *supra* notes 27–34, 43–51 and accompanying text (describing the Second, Fifth, and Tenth circuits' approach to assessing confidential informants).

[FN52] See *supra* notes 35–36 and accompanying text (describing the Ninth Circuit's pre *Tellabs* approach to assessing confidential sources).

[FN53] See *infra* note 55 and accompanying text (discussing the circuit split on whether to weigh and consider nonculpable inferences on a 12(b)(6) motion to dismiss in a securities fraud claim).

[FN54] Compare [Brown v. Credit Suisse First Boston Corp.](#), 431 F.3d 36, 51 (1st Cir. 2005) (stating a court must consider nonculpable inferences) and [Ottoman v. Hanger](#), 353 F.3d 338, 347 (4th Cir. 2003) (weighing both culpable and nonculpable inferences) and [Pirraglia v. Novell, Inc.](#), 339 F.3d 1182, 1187–88 (10th Cir. 2003) (requiring a court to consider inferences but specifically refrain from weighing) with [Gompper v. VISX, Inc.](#), 298 F.3d 893, 898 (9th Cir. 2002) (requiring a court to consider and weigh nonculpable inferences) with [Helwig v. Vencor, Inc.](#), 251 F.3d 540, 553 (6th Cir. 2000) (limiting the plaintiff's inferences to only the most plausible inferences). The Circuits were likewise divided not only as to whether nonculpable inferences are to be considered in assessing a “strong inference,” but also as to what kind of allegations qualified to allege a strong inference of scienter. First, some circuits applied the Second Circuit's standard that required plaintiffs to plead only mere motive and opportunity or to establish an inference of recklessness. See, e.g., [Novak](#), 216 F.3d at 311. Second, some courts heightened the Second Circuit's standard by rejecting motive and opportunity as sufficient, but still allowing an inference of recklessness to suffice as a strong inference. See, e.g., [In re Comshare, Inc., Sec. Litig.](#), 183 F.3d 542, 549–51 (6th Cir. 1999) (holding that under the PSLRA, plaintiffs may plead scienter by alleging facts giving rise to strong inference of recklessness, but not by alleging facts merely establishing that defendant had motive and opportunity to commit securities fraud). Third, the harshest standard, as set forth by the Ninth Circuit, would allow only an inference of conscious conduct to suffice to allege a strong inference. See, e.g., [In re Silicon Graphics Sec. Litig.](#), 970 F.Supp. at 757.

[FN55] [Tellabs, Inc.](#), 127 S. Ct. 2499.

[FN56] *Id.* at 2506.



[FN57] *Id.* at 2509–10.

[FN58] *Id.*

[FN59] *Id.* at 2505–06.

[FN60] Channel stuffing is a practice whereby a supplier induces customers to substantially increase their purchases before they would otherwise buy products from the company in the normal course of business, thus giving the immediate appearance of rising revenue. *Johnson v. Tellabs, Inc.*, 303 F.Supp.2d 941, 959 (N.D. Ill. 2004), rev'd sub nom. *Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), vacated sub nom. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007) [*Johnson v. Tellabs*, District Court Decision]. 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. *Id.* At oral argument in *Tellabs*, Justice Ginsburg likened channel stuffing practices to good and bad cholesterol. Transcript of Oral Argument, at 37–38, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (Mar. 28, 2007) [hereinafter *Tellabs*, Oral Argument]. Justice Ginsburg said it was not clear here whether the plaintiffs were alleging the good or the bad kind. *Id.* Good channel stuffing would be where a distributor was discounting and offering other incentives for persons to buy. *Id.* Bad channel stuffing would be where a distributor floods customers with unwanted products and fabricated orders for purposes of inflating revenue projections. *Id.*

[FN61] *Tellabs*, 127 S. Ct. at 2505.

[FN62] *Johnson v. Tellabs*, District Court Decision, *supra* note 61, at 944. Specifically, the district court rejected the Second Circuit's approach which required plaintiffs to allege either: (1) facts showing that the defendants had both motive and opportunity to commit fraud, or (2) facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Id.* at 961 (citing *Ottoman*, 353 F.3d at 345 (taking a holistic approach to determining scienter)). The district court did acknowledge however that such facts can be used as factors in determining whether a strong inference of scienter had been pled. *Johnson v. Tellabs*, District Court Decision, *supra* note 61, at 961.

[FN63] *Id.*

[FN64] *Id.* at 952.

[FN65] *Id.*

[FN66] *Id.*

[FN67] *Johnson v. Tellabs*, District Court Decision, *supra* note 61, at 952 (“The disclosure of information regarding confidential sources may be helpful in distinguishing whether a particular allegation is mere rumor and speculation or whether it is based on concrete information from relevant documents or people who were in a position to know the truth ...”) (internal quotes omitted).

[FN68] *Id.* at 971.

[FN69] *Makor Issues & Rights v. Tellabs*, Seventh Circuit Decision, *supra* note 49, at 594.

[FN70] *Id.* at 595.

[FN71] *Id.* at 605.

[FN72] *Id.* at 602.

[FN73] *Id.* at 596.

[FN74] *Makor Issues & Rights v. Tellabs*, Seventh Circuit Decision, *supra* note 49, at 596.

[FN75] *Id.*

[FN76] *Id.*

[FN77] *Id.*

[FN78] *Tellabs*, 127 S. Ct. at 2506.

[FN79] *Id.* at 2513.

[FN80] *Tellabs*, 127 S. Ct. at 2509. Justice Ginsburg delivered the opinion of the Court in an 8-1 decision, in which Chief Justice Roberts, Justice Kennedy, Justice Souter, Justice Thomas, and Justice Breyer joined. Justices Scalia and Alito concurred in the judgment. Justice Stevens dissented. *Id.* at 2503.

[FN81] *Tellabs*, Oral Argument, *supra* note 61, at 47; see *Tellabs*, 127 S. Ct. at 2514 (Scalia, J., concurring) (noting the pleading standard should effectively deter baseless actions); *Id.* at 2517 (Stevens, J., dissenting) (saying the basic purpose of the pleading standard is to protect defendants from the costs of discovery and trial in unmeritorious cases).

[FN82] *Tellabs*, 127 S. Ct. at 2506.

[FN83] *Id.* at 2508. The Supreme Court cited various examples of just such an objective by pointing out Congress's newly prescribed lead plaintiff and lead counsel procedures, and Congress's enactment of the 'safe harbor' provision. But see, *Brief for Amici Curiae Joseph A. Grundfest et al.* Supporting Petitioners at 12, *Tellabs v. Makor Issues & Rights*, 127 S. Ct. 2499 (2007) (No. 06-484) (arguing no formal legislative intent can be discerned, but rather the Court should look to case law for history concerning 10b-5 claims for more adequate and accurate guidance).

[FN84] See, e.g., *Higginbotham*, 495 F.3d at 757 (citing the *Tellabs* rule as cogent and at least as compelling as any opposing inference); Cent. *Laborers' Pension Fund*, 497 F.3d at 551 (citing *Tellabs* as requiring an inference to be cogent and compelling).

[FN85] *Tellabs*, 127 S. Ct. at 2509.

[FN86] *Id.* This step adopts the approach taken in *Gompper*, 298 F.3d at 897 (requiring courts to consider and weigh inferences).

[FN87] *Tellabs*, 127 S. Ct. at 2509–10.

[FN88] *Id.* at 2510 (“The strength of an inference cannot be decided in a vacuum.”). Justice Alito, at oral argument, demonstrated this point when he said, “You see somebody walking in the direction of Capitol Hill. You could draw an inference that the person is coming to the Supreme Court. If there are no other buildings in Washington, this is a strong inference. But, don't you have to consider the possibility that the person is going to the Capitol, the Library of Congress, or some other location?”

Tellabs, Oral Argument, *supra* note 61, at 36–37.

[FN89] *Tellabs*, 127 S. Ct. at 2510 (“The inference that the defendant acted with scienter need not be irrefutable, i.e., of the “smoking-gun” genre, or even the most plausible of competing inferences”).

[FN90] *Id.*

[FN91] *Id.*

[FN92] *Id.* at 2509–10. Even at oral argument, the Justices seemed adamant that a reasonable inference did not capture Congress' strong inference requirement. *See Tellabs*, Oral Argument, *supra* note 61, at 35–37.

[FN93] *Tellabs*, 127 S. Ct. at 2513 (Scalia, J., concurring).

[FN94] *Id.* at 2513 (Scalia, J., concurring).

[FN95] *Id.* (emphasis in original).

[FN96] *Id.* at 2510, n.5 (citing *Summers v. Tice*, 199 P.2d 1, 2 (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 2513 (Scalia, J., concurring). Justice Scalia also said allowing someone 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 2513, n.\* (2007). (Scalia, J., concurring). Justice Scalia also criticized the majority's reliance on a single committee report of the House of Representatives and the Court's reliance on *Summers v. Tice*.

[FN97] *Tellabs*, 127 S. Ct. at 2513. The Seventh Circuit has recently decided the *Tellabs* case on remand concluding the plaintiff's sufficiently alleged a strong inference of scienter as per its original holding. *Makor Issues & Rights v. Tellabs, Inc.*, No. 04-1687, 2008 WL 151180, \*9 (7th Cir. 2008).

[FN98] J. Robert Brown, Jr., The “*Tellabs* Excuse” and Confidential Witnesses, Sept. 28, 2007, <http://blogs.law.harvard.edu/corpgov/2007/09/28/the-tellabs-excuse-and-confidential-witnesses/> [hereinafter J. Robert Brown, Jr.].

[FN99] *Tellabs*, 127 S. Ct. at 2517 (Stevens, J., dissenting).

[FN100] *Higginbotham*, 495 F.3d at 757.

[FN101] *See infra* Part III. A (explaining the *Tellabs* rule further).

[FN102] *See infra* Part III.B (discussing Cent. Laborers' Pension Fund, 497 F.3d 546).

[FN103] *See infra* Part III.C (exploring the Seventh Circuit's holding in [Higginbotham](#), 495 F.3d 753).

[FN104] *See infra* Part III.D (arguing (1) the Seventh Circuit's steep discountenance of allegations from confidential informants rests on the false premise that identification is necessary for evaluation, (2) the Seventh Circuit considers irrational, as opposed to plausible inferences, and (3) the Seventh Circuit is applying the concurrence standard rather than the Supreme Court's holding). *See also* *In re Wet Seal, Inc.*, Sec. Litig., 51 F.Supp.2d 1148, 1170 (C.D. Cal. 2007) (refusing to adopt *Higginbotham* in the Ninth Circuit saying the Supreme Court has not enunciated a rule irreconcilable with previous Ninth Circuit precedent).

[FN105] *See generally* Michael J. Kaufman, *Mission Implausible: The Supreme Court Replaces Federal Pleading Rules with Unfounded Economic Assumptions* (Working Paper (Spring 2008)) (arguing that when *Tellabs*, 127 S. Ct. 2499, and *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955, 1965 (2007), are read together they substantially raise the traditional Rule 8(a) pleading requirement, and limits irrational economic inferences at the pleading stage).

[FN106] *See* Michael J. Kaufman, *Tellabs Decision*, 26 Sec. Lit. Damages § 3:11:80 (Thomson/West 2007) (describing the likely impact of the *Tellabs* decision).

[FN107] *Tellabs*, 127 S. Ct. at 2510 rejecting *Helwig*, 251 F.3d at 553 (allowing courts to consider only the most plausible inferences of the plaintiff).

[FN108] *Tellabs*, 127 S. Ct. at 2511.

[FN109] *Id.* *See Key Equity Inv. v. Sel-Leb Mktg Inc.*, No.06-1052, 2007 WL 2510385, at \* 5(3d Cir. Sept. 6, 2007) (dismissing the plaintiffs complaint in a securities fraud action where the plaintiff relies on conclusory allegations rather than specified allegations).

[FN110] *Tellabs*, 127 S. Ct. at 2511 (“While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal.”). *See In re Bearingpoint, Inc. Sec. Litig.*, No. 1:05-cv-454,2007 WL 2713906, \*12 (E.D. Va. Sept. 12, 2007) (the court considering motive as a factor weighing against scienter). For instance, if the defendant sells all his stock immediately before the market gets wind of the bad news, this weighs in favor of a culpable scienter. *See Cent. Laborer's*, 497 F.3d at 552–53 (saying where a defendant CEO sells stock before disclosure of bad news to the market, this weighs in favor of finding scienter); *see also Ross v. Abercrombie & Fitch Co.*, No. 2:05-CV-819, 2007 WL 2284477, at \*12 (Aug. 9, 2007 S.D. Ohio) (stating an allegation that a defendant sold stock prior to a disclosure of a prior misrepresentation counts in favor of finding scienter).

[FN111] *See supra* notes 113–118 and accompanying text (discussing how a plaintiff prevails in the result of tying inferences).

[FN112] *See* Peter Lattman, *Tellabs: Securities Lawyers React*, Wall St. J. Online, June 21, 2007, <http://blogs.wsj.com/law/2007/06/21/tellabs-securities-lawyers-react/> (quoting Joe Grundfest, Securities Law Professor at Stanford Law School as saying,

“[T]he opinion unfortunately leaves room for lower courts to reason “gee, the story in support of scienter seems as cogent as the story in opposition to scienter and that's good enough.” The danger then is that the

language devolves into the equivalent of baseball's rule of" a tie goes to the runner.

(quotes in original)). See also Roger Parloff, Supreme Court Deals Blow to Securities Class Actions, 8-1, CNNMoney.com, June 21, 2007, <http://legalpad.blogs.fortune.com> (quoting Sean Coffey, a plaintiffs' class action lawyer of Bernstein Litowitz & Grossman as saying "[N]ow in the event of a tie, the plaintiff wins.").

[FN113] [Tellabs](#), 127 S. Ct. at 2514 (Scalia, J., concurring).

[FN114] *Id.* at 2510, n.5.

[FN115] *Id.* at 2509–10. Had the Court adopted Justice Scalia's approach, this would be insufficient. *Id.* at 2513 (advocating the inference must be more plausible than an innocent inference).

[FN116] J. Robert Brown, Jr., *supra* note 99. See also Steven Wolowitz & Joseph De Simone, Did 'Tellabs' Raise PSLRA Scierter Bar?: Six Months Out, the Jurisprudence Evolves, 238 N.Y.L.J. S3 (Dec. 3, 2007) (saying Tellabs did not resolve whether plaintiffs may rely upon allegations attributed to anonymous sources).

[FN117] See [Tellabs](#), 127 S. Ct. at 2511 (saying ambiguities and vagueness in the complaint counts against inferring scierter).

[FN118] See *infra* notes 119–148 and accompanying text (describing circuit's analyzing whether confidential sources are sufficient in assessing whether a strong inference of scierter has been pled).

[FN119] Compare [Barrie](#), 397 F.3d at 259 and [ABC Arbitrage Group](#), 291 F.3d at 353 (saying the PSLRA's particularity requirement does not automatically preclude the use of confidential sources in pleading) with [Cent. Laborers' Pension Fund](#), 497 F.3d at 552 (saying confidential source statements are a permissible basis to allege an "inference of scierter."). See also [In re Wet Seal, Inc., Sec. Litig.](#), 518 F.Supp.2d 1148, 1170 (C.D. Cal. 2007) (refusing to adopt the Higginbotham approach and abiding by the Ninth circuit's pre-Tellabs requirement).

[FN120] [Cent. Laborers' Pension Fund](#), 497 F.3d at 555.

[FN121] *Id.* at 552.

[FN122] *Id.*

[FN123] *Id.*

[FN124] *Id.* at 555.

[FN125] Compare [Cent. Laborers' Pension Fund](#), 497 F.3d at 552 (allowing allegations derived from confidential sources to establish a strong inference of scierter) with [Barrie](#), 397 F.3d at 259 (allowing confidential sources to satisfy the particularity requirement so long as there is sufficient probability for the veracity of the complaint even if there is no corroborating source).

[FN126] [Makor Issues & Rights, Ltd., v. Tellabs, Inc.](#), 2008 WL 151180 (7th Cir. Jan. 17, 2008).

[FN127] *Id.* at \*8.

[FN128] *Id.*

[FN129] *Id.* (citing 18 U.S.C.A. § 1514A). The statute also provides for a remedy for injured persons. 15 U.S.C.A. § 1514A(c) (providing for any relief necessary to make the employee whole and a variety of compensatory damages).

[FN130] *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 2008 WL 151180, \*8 (7th Cir. Jan. 17, 2008).

[FN131] *Id.*

[FN132] *Id.* at \*9.

[FN133] *Id.* at \*8.

[FN134] *Id.* (“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.”)

[FN135] *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 2008 WL 151180, \*8 (7th Cir. Jan. 17, 2008).

[FN136] *Higginbotham*, 495 F.3d at 761.

[FN137] *Id.* at 756–57.

[FN138] *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.*

[FN139] *Higginbotham*, at 757. Also, at oral argument, Judge Posner said “they could be any kind of snitch, any kind of liar.” *J. Robert Brown, Jr.*, *supra* note 99.

[FN140] *Higginbotham*, 495 F.3d at 757.

[FN141] *Id.* at 756. See also *supra* notes 74–78 and accompanying text (discussing the Seventh Circuit's approach before the *Tellabs* decision).

[FN142] *Higginbotham*, 495 F.3d at 757. (internal quotes omitted).

[FN143] *Id.*

[FN144] *Id.*

[FN145] *Id.*

[FN146] *Id.*



[FN147] [Higginbotham, 495 F.3d at 757.](#)

[FN148] [Bloomenthal & Wolff, supra note 17](#) (saying the decision in [Higginbotham](#) could have a significant impact on securities fraud proceedings). It is important to note that arguments were made for the Seventh Circuit to distinguish [Tellabs](#) on remand from [Higginbotham](#) because in [Tellabs](#) there are some twenty-seven confidential sources, while in [Higginbotham](#) there were only five. Supplemental Br. for Pl-Appellants, No. 04-1687, [Makor Issues & Rights, Inc. v. Tellabs Inc. at 2](#) (Sept. 19, 2007). However, only four of the twenty-seven anonymous sources discuss [Notebaert](#). Supplemental Br. for Def.—Appellees, No. 04-1687, [Makor Issues & Rights, Inc. v. Tellabs Inc. at 3, n.2](#) (Oct. 9, 2007); see also [supra note 138](#) and accompanying text (illustrating how the Seventh Circuit did distinguish [Tellabs](#) from [Higginbotham](#) on remand). But see [Frank v. Dana Corp., No. 3:05CV7393, 2007 WL 241372 \(N.D. Ohio, Aug. 21, 2007\)](#) (seeming to apply the [Higginbotham](#) approach).

[FN149] [See infra notes 127–136](#) and accompanying text (discussing the Seventh Circuit's decision in [Tellabs](#) on remand issued after [Higginbotham](#)). The [Tellabs](#) decision was decided on remand in the middle of January. [Makor Issues & Rights v. Tellabs, Inc., No. 04-1687, 2008 WL 151180 \(7th Cir. Jan. 17, 2008\)](#). The Seventh Circuit distinguished [Tellabs](#) from [Higginbotham](#) noting that [Tellabs](#) involves numerous sources, prepared to testify, whose stories corroborated with multiple sources. *Id.* See also [Bloomenthal & Wolff, supra note 17](#) (discussing the distinctions between [Tellabs](#) and [Baxter](#)).

[FN150] [See J. Robert Brown, Jr., supra note 99](#) (quoting Judge Posner at oral argument expressing surprise that confidential witnesses were ever used in securities suits as saying, “What are they? ... Are they like police informants? ... [H]aving a confidential witness doesn't strengthen an allegation.” ... [In our legal system] we don't have anonymous lawsuits.”).

[FN151] [See infra notes 156–190](#) and accompanying text (discussing how [Higginbotham](#) is inconsistent with [Tellabs](#)).

[FN152] [See infra Part III.D.i.](#)

[FN153] [See infra Part III.D.ii.](#)

[FN154] [See infra Part III.D.iii.](#)

[FN155] [Higginbotham, 495 F.3d at 757.](#)

[FN156] *Id.* (“It is hard to see how informant from anonymous sources could be deemed compelling ... [W]e asked when the identity of these five persons would be revealed and who their stores could be tested ... [A]nonymity frustrates that process.”).

[FN157] [See, e.g., Novak, 216 F.3d at 313; California Pub. Employees' Ret. Sys., 394 F.3d at 155; Barrie, 397 F.3d at 259; Adams, 340 F.3d at 1102](#) (all acknowledging that the name of the source is not important but rather the probability that the source has the information alleged). [See also Shakespeare, Romeo & Juliet, Act II, Sc. ii](#) (“What's in a name? A rose by any other name would smell as sweet.”).

[FN158] [Wohl, supra note 1, at 561.](#)

[FN159] [Wohl, supra note 1, 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.”)

[FN160] *Wohl*, *supra* note 1, at 551.

[FN161] *Higginbotham*, 495 F.3d at 757.

[FN162] *Tellabs*, 127 S. Ct. at 2511 (saying ambiguities weigh against inferring scienter).

[FN163] *Id.*

[FN164] *Id.* See J. Robert Brown, Jr., *supra* note 99 (suggesting the Seventh Circuit is merely using *Tellabs* as an excuse to vent “considerable hostility toward securities class actions ... to force plaintiffs to name their confidential witnesses in the complaint, which in turn will make it harder to obtain information that can help bring securities fraud to light. *Tellabs* is no excuse for making meritorious causes of action more difficult to bring.”).

[FN165] See *Tellabs*, 127 S. Ct. at 2509 (“[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).

[FN166] *Higginbotham*, 495 F.3d at 757.

[FN167] See Fed. R. Civ. P. 11(b) (requiring attorneys' filings not to have an improper purpose, be warranted by law, and be based on evidentiary support after a reasonable inquiry) and 15 U.S.C.A. § 78u-4(c)(2) (requiring courts to make findings regarding the compliance by each party with Rule 11(b)).

[FN168] Fed. R. Civ. P. 11(b).

[FN169] Fed. R. Civ. P. 11(b) to (c).

[FN170] 15 U.S.C.A. § 78u-4(c)(2) (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). Yet, this provision is not currently utilized to its full capacity. *Perino*, *supra* note 13, at 938 (finding small sanctions are imposed in only a handful of cases). A 2002 study suggests that procedural barriers do not affect the filing of nonmeritorious suits. *Id.* To actually effectuate a change, courts should not only engage in a sanctions review, but also impose sanctions or fee shifting if the action is dismissed. *Id.* at 971. *Perino* also argues Congress should alter current damage calculation methods and attorney fee models. *Id.* at 973–74. Thereby, plaintiffs' attorneys will have less of an economic incentive to bring strike suits to begin with. *Id.* at 971.

[FN171] See *Bloomenthal & Wolff*, *supra* note 17.

[FN172] See *Tellabs*, 127 S. Ct. at 2509 (“[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).

[FN173] Compare [Higginbotham](#), 495 F.3d at 757 and [Makor Issues & Rights v. Tellabs, Inc.](#), No. 04-1687, 2008 WL 151180, \*8 (7th Cir. Jan. 17, 2008) (allowing the plaintiffs to rely on confidential informants as the informants were numerous, corroborated with multiple sources, provided convincing allegations, and were in positions to know first-hand the information).

[FN174] See [California Pub. Employees' Ret. Sys.](#), 394 F.3d at 155 (“Cobbling together a litany of inadequate allegations does not render those allegations particularized in accordance with Rule 9(b) or the PSLRA.”).

[FN175] See J. Robert Brown, Jr., *supra* note 99 (saying the judges in the Seventh Circuit used Tellabs merely as an excuse to get rid of anonymous accusations against a company).

[FN176] J. Robert Brown, Jr., *supra* note 99 (quoting Judge Posner at oral argument in [Higginbotham](#)).

[FN177] [Higginbotham](#), 495 F.3d at 757.

[FN178] See [Tellabs](#), 127 S. Ct. at 2510 (“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).

[FN179] *Id.*

[FN180] *Id.* (“A complaint will survive ... 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.”).

[FN181] See [Higginbotham](#), 495 F.3d at 757 (“It is hard to see how information from anonymous sources could be deemed “compelling” ... Perhaps these sources have axes to grind. Perhaps they are lying.”).

[FN182] [Wohl](#), *supra* note 1, at 553 (“Threats of retaliation and harm to reputation serve, however, as strong disincentives to corporate employees who consider stepping forward.”). See *id.* at 556 (discussing (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 47 state laws protecting whistleblowers and seventeen private sector whistleblower protection laws, and (3) Supreme Court recognition of the likelihood of retaliation in [Mitchell v. Robert DeMario Jewelry, Inc.](#), 361 U.S. 288, 292 (1960)). See also [Novak](#), 216 F.3d at 314; [California Pub. Employees' Ret. Sys.](#), 394 F.3d at 147; [Adams](#), 340 F.3d at 1101. However, Judge Posner of the Seventh Circuit suggested in [Makor Issues & Rights, Ltd. v. Tellabs, Inc.](#), 2008 WL 151180, \*8, that such a concern is “flimsy” because it is unlawful for employers to retaliate against an employee who blows the whistle on securities fraud. [Makor Issues & Rights, Ltd. v. Tellabs, Inc.](#), 2008 WL 151180, \*8 (citing 17 U.S.C.A. § 1514A, the Sarbanes-Oxley Act providing for whistleblower protection). However, the sheer volume of whistleblower laws may suggest that employer retaliation is a very real threat. See, e.g., 42 U.S.C. § 7622 (the Clean Air Act); 42 U.S.C.A. § 9610 (the Comprehensive, Environmental Response, Compensation and Liability Act); 42 U.S.C.A. § 5851 (the Energy Reorganization Act); 49 U.S.C.A. § 20109 (the Federal Rail Safety Act); 42 U.S.C.A. § 300j-9 (the Safe Drinking Water Act); 42 U.S.C.A. § 6971 (the Solid Waste Disposal Act); 15 U.S.C.A. § 2622 (the Toxic Substances Control Act).

[FN183] *Makor Issues & Rights v. Tellabs*, Seventh Circuit Decision, *supra* note 49, at 596.

[FN184] Compare *Higginbotham*, 495 F.3d at 757 (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*, 127 S. Ct. at 2513 (Scalia, J. concurring) (advocating in his concurrence that the inference of culpability needs to be more than likely than opposing inferences for the complaint to succeed).

[FN185] *Tellabs*, 127 S. Ct. at 2513 (Scalia, J., concurring). See also *Wohl*, *supra* note 1, at 558.

[FN186] *Id.* But see Charles W. Murdock, *Sarbanes-Oxley, Corporate Corruption, and the Complicity of Courts and Legislatures*, at 38 (Working Paper (2007) (arguing the courts and legislatures have been complicit in the culture of corporate corruption)) (arguing 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). Charles W. Murdock, professor at Loyola University Chicago School of Law, likewise argues Scalia's approach fails to consider the three degrees of adjectives: positive, comparative, and superlative, which would translate into strong, stronger, and strongest. *Id.* at 48.

[FN187] *Higginbotham*, 495 F.3d at 757 (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).

[FN188] *Tellabs*, 127 S. Ct. at 2510.

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