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Dealing With Confidential Witness Recantation Statements

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Grappling with the credibility of witnesses has been a focal point of legal systems for thousands of years.[1] Despite all this practice, however, our legal system has not yet established a uniform approach to dealing with a witness credibility issue in a somewhat new context — a securities class action complaint governed by the Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737, codified at 15 U.S.C. § 78u-4. This article explores why this issue has arisen since the passage of the PSLRA, enumerates the different approaches taken by a number of courts and defense counsel grappling with this issue, and explains why the approach taken recently in Union Asset Management Holding AG v. SanDisk LLC, Civ. No. 15-01455, 2017 U.S. Dist. LEXIS 977 (N.D. Cal. Jan. 4, 2017) makes sense.

The PSLRA simultaneously raised the pleading standards for surviving a motion to dismiss to a very high level and forbids discovery in most cases until and unless a complaint survives a motion to dismiss.[2] As courts have recognized, the "combined effect of the high scienter standard in securities fraud litigation and the strict PSLRA discovery stay is to place great weight at the pleading stage on the statements of confidential witnesses." Union Asset, 2017 U.S. Dist. LEXIS 977, at *6. In the absence of discovery, these confidential witnesses or whistleblowers, often former employees of the defendant companies, are often the only sources of information as to what the defendants knew and when they knew it — normally key pieces of information for a securities fraud complaint to move past the motion to dismiss. Plaintiffs counsel, working with investigators or otherwise, locate and interview these witnesses and then include allegations based on the information gleaned from the interviews in their complaints. Generally, in an attempt to protect the witness from retaliation, unwanted publicity, and other potential negative repercussions stemming from whistleblowing on their former employees, these whistleblower witnesses are listed as confidential witnesses along with descriptions (usually of title, dates of employment, and scope of responsibilities) of the past employment that gave them access to the information that is being used as the basis for allegations in the complaint.

As Newton's third law (for every action, there is an equal and opposite reaction) applies to litigation as well as to the physical world, plaintiffs' increasing use of confidential witnesses to buttress the strength of their complaint has led to increasing efforts by defendants to attack those confidential witnesses. Powerful evidence of the increasing ubiquity of these efforts can be found in the fact that, in March of 2016, attorneys from Seyfarth Shaw LLP, Cadwalader Wickersham & Taft LLP and Paul Weiss Rifkind Wharton & Garrison LLP (Gregory A. Markel, Gillian Groarke Burns and Jared S. Sunshine, respectively) gave an American Law Institute Continuing Legal Education course on "Defending Against Confidential Witnesses in Securities Fraud Class Actions." In the course materials for this CLE, these defense counsel explain,

> If a confidential witness supports the plaintiff as an evidentiary witness beyond the pleading stage, the defendant should seek discovery to undermine the witness's credibility and substantive testimony. By contrast, a confidential witness who disclaims or recants the allegations attributed to him in the complaint may provide the defendant with compelling evidence for a court considering the merits of the plaintiff's claims.

Gregory A. Markel, Gillian Groarke Burns and Jared S. Sunshine, Defending Against Confidential Witnesses in Securities Fraud Class Actions, CX023 ALI-CLE 1, The American Law Institute Continuing Legal Education (March 31, 2016).

In the second scenario, where defense counsel has secured, through whatever means,[3] a confidential witness disclaiming or recanting allegations attributed to them in the complaint, the course materials outline various techniques to put the "confidential witness' position" "before the court" through motion practice, suggesting options including moving to "strike before moving to dismiss," moving to "reconsider a denial of a motion to dismiss," for "summary judgment," or for "sanctions."

While it is a matter of dispute as to how often defense counsel present a recanting confidential witness, with some commentators calling accuracy issues with confidential witness allegations a "recurring and pervasive problem,"[4] and others concluding that "incidences of actual recanting may be lower than is often asserted,"[5] there have been enough litigated motions connected to them to create a confusing mass of case law — a perhaps unsurprising result given the variety of motions that defendants bring to address this single issue. The case law is most muddied on two issues: (1) Are reconsiderations of motions to dismiss proper in light of confidential witness recantations, and (2) when and in what circumstances do sanctions come into play? On both of these issues, Union Asset, 2017 U.S. Dist. LEXIS 977, provides much-needed clarity.

On the first issue, a number of courts have actually dismissed cases with prejudice after granting for reconsideration of motions to dismiss based on recantation of witness statements. For example, in Belmont Holdings Corp. v. SunTrust Banks Inc., 896 F. Supp. 2d 1210, 1220 (N.D. Ga. 2012) a motion for reconsideration was granted and the case dismissed with prejudice because of recantation of witness statement — with the same being done in City of Livonia Employees' Ret. Sys. v. Boeing Co., Civ. No. 09-7143, 2011 U.S. Dist. LEXIS 22347, at *5-8 (N.D. Ill. Mar. 7, 2011). In Union Asset, the court explains clearly, succinctly and correctly why this approach — reconsidering a motion to dismiss based on a witness recantation affidavit or other evidence — is procedurally improper. "[A]t bottom, the defendants are introducing extrinsic material in an effort to sow doubt at a stage when the plaintiffs' factual allegations are presumed true. That is not appropriate." Union Asset Mgmt. Holding AG, 2017 U.S. Dist. LEXIS 977, at *7. This seems obvious given that the law is well settled that on "a motion to dismiss, all factual allegations in the complaint are accepted as true" and that a "motion to dismiss for failure to state a claim considers the face of the pleadings without reference to extrinsic evidence."[6] Moreover, in making this holding, Union Asset is actually further developing and solidifying a line of cases that recognizes that recantation affidavits from confidential witnesses are no different than any other extrinsic evidence and cannot be considered on a motion to dismiss when every allegation must be taken as true.[7] Union Asset Mgmt. Holding AG, 2017 U.S. Dist. LEXIS 977. Finally, it prevents the unfairness of having plaintiffs litigate a merits issue while their ability to conduct discovery is still blocked by the strictures of the PSLRA discovery stay — a situation that is akin to permitting a boxing match when one side has his arms bound.[8]

One explanation as to why certain courts have not followed this clear rule is that they are so outraged by the carelessness (or worse) of the attorneys who cited the confidential witnesses who later recanted their complaints that they feel those attorneys should not be rewarded for bad behavior by considering those allegations in the complaint. This is wrong. As the court in Union Asset recognized, how to treat the allegations in the complaint in light of the extrinsic evidence of recanting affidavits is an entirely separate issue as to whether the attorneys who included those allegations did so in good faith. Union

Asset Mgmt. Holding AG, 2017 U.S. Dist. LEXIS 977. This second issue — when and in what circumstances do sanctions come into play — is also dealt with well by the court in Union Asset. In Union Asset, the court recognized that a witness recanting testimony does not "necessarily mean that the allegations in the complaint were made in bad faith or that a sanctions motion would be justified." Id. at *8. It also recognized that if the defense counsel believed that the plaintiffs' counsel may have behaved unethically, that there is a whole system in place to regulate (and, if necessary, punish) bad behavior by attorneys. Specifically,

> [I]f a defendant truly believes a plaintiff is violating Rule 11 by including inaccurate statements from a confidential witness, the defendant can notify opposing counsel and inquire into the situation. See Fed. R. Civ. Pro. 11(b). If, following that process, the defendant still believes that the plaintiff's allegations about the confidential witness are made frivolously or in bad faith, the defendant can move for sanctions after the motion to dismiss has been adjudicated. If the motion is granted, that will almost certainly result in dismissal of the complaint, not to mention monetary sanctions.

Id at *8.

This well-established system, governed by the Rules of Civil Procedure and which provides for notice to and explanation by plaintiffs counsel prior to bringing disputes before the court, is both more efficient and fairer than the approach taken by some defense counsel, which move straight into sanctions based on the inherent powers of the district court.[9] Union Asset's approach is not novel — it is mainstream and sensible in that it uses the appropriate and well-established procedures of Rule 11 to deal with confidential witness recanting allegations.

At bottom, what the court in Union Asset wisely determined was that, underneath the heated rhetoric and varied and exotic litigation tactics utilized by defense counsel in connection with recantation statements by confidential witnesses lay two garden-variety questions that the legal system has well-established paths for resolving: (1) Were the allegations made by the confidential witnesses in the complaint credible in light of their later recanting statements, and (2) did the plaintiffs' counsel have a good-faith basis for making those allegations when they filed their complaint? Summary judgment or trial should resolve the first question, while the procedures set out by Rule 11 should govern the second.

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[1] See, e.g., Deuteronomy 19:15 ("One witness shall not rise up against a man for any iniquity, or for any sin, in any sin that he sinneth: at the mouth of two witnesses, or at the mouth of three witnesses, shall the matter be established").

[2] See, e.g., In re ProQuest Sec. Litig., 527 F. Supp. 2d 728, 740 (E.D. Mich. 2007) ("The analysis required [by the PSLRA], particularly with respect to pleading scienter, is akin to holding a mini-trial on the merits of the case based only on the complaint."); In re Par Pharm. Sec. Litig., Civ. No. 06-3226, 2009 U.S. Dist. LEXIS 90602, at *33-37 (D.N.J. Sept. 30, 2009) ("The PSLRA requires that 'all discovery and other proceedings' be stayed pending any motion to dismiss unless a court finds that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.").

[3] A recent article opined that "Defendants as of late have been luring CWs into recanting their testimony .... The fear of retaliation by a defendant company accounts for most witness recantations." Leigh Handelman Smollar, The Importance of Conducting Thorough Investigations of Confidential Witnesses in Securities Fraud Litigation, 46 LOY. U. CHI. L.J. 503, 505, 511 (2015).

[4] Douglas W. Greene, How to Solve the Flawed Confidential Witness Issue, Law360 (Apr. 8, 2013), http://www.law360.com/articles/430766/ how-to-solve-the-flawed-confidential-witness-issue

[5] Gideon Mark, Recanting Confidential Witnesses in Securities Litigation, 45.3 Loy. U. Chi. L.J. (2014)

[6] Littlejohn v. City of New York, 795 F.3d 297, 306 (2d Cir. 2015); United States ex rel. Gage v. Davis S.R. Aviation LLC., 658 Fed. Appx. 194 (5th Cir. 2016).

[7] See Dep't of the Treasury of N.J. v. Cliffs Natural Res., Civ. No. 14-1031, 2015 U.S. Dist. LEXIS 151359, at *10-12 (N.D. Ohio Nov. 6, 2015) ("In any event, the issues of fact and credibility raised by Defendants' witness declarations cannot be determined at the pleading stage."); Halford v. AtriCure Inc., Civ. No. 08-867, 2010 U.S. Dist. LEXIS 144377, at *9-12 (S.D. Ohio Mar. 29, 2010) (granting plaintiffs' motion to strike defendants' affidavits of confidential witnesses as inappropriate prior to discovery); In re Par Pharm. Sec. Litig., Civ. No. 06-3226, 2009 U.S. Dist. LEXIS 90602, at *33-37 (D.N.J. Sept. 30, 2009) (granting plaintiffs' motion to strike recanting declaration from confidential witness at motion to dismiss stage).

[8] See, e.g., In re ProQuest Sec. Litig., 527 F. Supp. 2d 728, 738-740 (E.D. Mich. 2007) ("As to the allegations of CI 1, the Court is constrained to note that ProQuest, in seeking out and obtaining a declaration from CI 1, engaged in discovery which was wholly improper. Plaintiffs have not yet had the opportunity to respond or otherwise challenge the statements in CI 1's declaration.").

[9] See, e.g., In re Pfizer Inc. Sec. Litig., 2012 U.S. Dist. LEXIS 39449, 14-24 (S.D.N.Y. Mar. 22, 2012) (rejecting defendants' attempt to "invoke the inherent sanctioning power of the Court, arguing that Plaintiffs' counsel's alleged ethical violations and misrepresentations warrant dismissal of the putative class action on the merits," on a reconsideration of a motion to dismiss).
