

**U.S. Court of Appeals Endorses Scrutiny  
of Confidential Witnesses Used to Support  
Securities Fraud Complaint**

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It has become routine for plaintiffs' lawyers to make allegations purportedly obtained from confidential witnesses to meet the stringent pleading requirements applicable to federal securities fraud complaints, and the weight that courts should give such allegations in deciding motions to dismiss has been hotly contested. In affirming the dismissal of a federal securities fraud class action, the United States Court of Appeals for the Second Circuit has questioned the use of anonymous sources in securities complaints and endorsed the examination of those sources in determining whether such complaints should be dismissed. *Campo v. Sears Holdings Corp.*, No. 09-3589, 2010 WL 1292329 (2d Cir. Apr. 6, 2010).

Citing information purportedly obtained from several confidential witnesses, the complaint in *Campo* alleged that Kmart Holding Corporation, now part of Sears Holdings Corporation, and certain of its officers had intentionally understated the value of Kmart's real estate in the company's SEC filings. When the defendants moved to dismiss the complaint, the district court allowed the defendants to depose these confidential witnesses to determine if they had made the statements attributed to them in the complaint. Upon being deposed, the witnesses disowned and contradicted many of those statements.

On appeal following dismissal of the complaint, the Second Circuit rejected the plaintiffs' challenge to the deposition procedure ordered by the district court:

The anonymity of the sources of plaintiffs' factual allegations concerning scienter frustrates the requirement, announced in *Tellabs, [Inc. v. Makor Issues and Rights, Ltd.]*, 551 U.S. 308, 314 (2007), that a court weigh competing inferences to determine whether a complaint gives rise to an inference of scienter that is "cogent and at least as compelling as any opposing inference of nonfraudulent intent." . . . Because Fed. R. Civ. P. 11 requires that there

be a good faith basis for the factual and legal contentions contained in a pleading, the district court's use of the confidential witnesses' testimony to test the good faith basis of plaintiffs' compliance with *Tellabs* was permissible.

The Second Circuit's *Campo* decision was by summary order, which under the court's rules does not have precedential effect but may be cited. The decision accordingly can be cited for the Second Circuit's reservation about the weight that should be given on motions to dismiss to allegations based on anonymous sources and its endorsement in appropriate cases of the examination of such sources to test the veracity of the complaint's allegations.

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