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Seventh Circuit Remands for Possible Rule 11 Sanctions on Counsel That Failed To Adequately Investigate Confidential Witnesses

by

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Plaintiffs' counsel beware: to avoid Rule 11 sanctions you might actually have to talk to "confidential witnesses" yourself and corroborate their statements before citing them in a securities fraud complaint.

That is one major takeaway from the Seventh Circuit's March 26, 2013 opinion in *City of Livonia Employees' Retirement System v. The Boeing Company, et al*. In that case, Judge Posner singled out plaintiffs' counsel for making "confident assurances in their complaints about a confidential source . . . even though none of the lawyers had spoken to the source and their investigator had acknowledged that she couldn't verify what (according to her) he had told her." Slip op. at 16. Citing multiple cases in which the same firm, Robbins Geller Rudman & Dowd LLP, had "engaged in similar misconduct" and noting that "recidivism is relevant in assessing sanctions," Judge Posner remanded to the district court for further proceedings on Rule 11 sanctions.

The appeal came from the district court's grant of a renewed motion to dismiss in Boeing's favor after discovery into the CW's statement revealed significant inconsistencies with the complaint's allegations. The allegations, briefly, were that Boeing made false statements about the progress of Boeing's flagship aircraft, the Dreamliner. In April and May 2009, with the Dreamliner's maiden test flight (or "First Flight") scheduled for June 30, 2009, the Dreamliner failed several "stress tests" that raised doubts about the First Flight's timing. Boeing remained optimistic about the scheduled First Flight, though, and made disclosures to that effect in May and June. But one week before the anticipated First Flight, the Company disclosed that it had failed the tests and that the First Flight had been canceled, delaying final delivery of the plane to customers. Following the disclosure, Boeing's stock price fell 10% over two days of trading.

The district court had dismissed the first amended complaint "for failure to create a strong inference that the defendants had acted with scienter. The complaint did not indicate whether [defendants] or anyone else who had made optimistic public statements about the timing of the First Flight knew that their optimism was unfounded." Slip op. at 7. As Judge Posner explained, "the complaint was not inconsistent with the defendants having had a realistic hope that the defects in the stringers revealed by the tests could be eliminated quickly, without requiring postponement of the flight." *Id*. At bottom, the FAC failed to allege facts sufficient to create a strong inference that defendants had made any statements with scienter.

The FAC had alluded to internal emails implying that the defendants were aware of the failed tests at the time they made optimistic statements. But the second amended complaint ("SAC") did better. It cited statements from a CW identified as a "'Boeing Senior Structural Analyst Engineer and Chief Engineer' who had worked on wing-stress tests of the Dreamliner and who as part of his job 'had direct access to, as well as first-hand knowledge of the contents of, Boeing's 787 stress test files that memorialize the results of the failed 787 wing' tests of April and May 2009." *Id*. at 11. Importantly for scienter purposes, the files he had access to included "copies of internal electronic communications to defendants . . . informing them that the tests had failed and that the failure might result in a delay of the Dreamliner's First Flight." *Id*. On the basis of these new allegations, the district court denied a motion to dismiss the SAC, finding

them sufficient to allege scienter under the standard set forth in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007).

Discovery proceeded and it soon became obvious that the plaintiffs had problems. Apparently, "[n]o one had bothered to show the complaint to [the CW] . . . and investigation by Boeing soon revealed that the complaint's allegations concerning him could not be substantiated. Some clearly were false: He had never been employed by the company. He had been employed by a contractor for Boeing. And although the contractor had been involved in wing tests for the Dreamliner, [the CW's] role in or knowledge of those tests, or of any communications to the individual defendants, was and is unknown, but it is highly improbable that he either was involved in the tests or was privy to internal communications with top officials of the company." Slip op. at 12.

To make matters worse, the CW at his deposition "denied virtually everything that the investigator had reported. He denied that he had been doing work for Boeing when the tests were conducted. He denied that he had ever worked on the Dreamliner 787-8, the model in question; he had worked on the 787-9, a later model. He denied having knowledge of or access to internal Boeing communications regarding the tests on the 787-8." *Id.* On the basis of this and other discovery, defendants promptly asked the district judge to reconsider her denial of the motion to dismiss, which she did, finding there had in effect been a fraud on the court and dismissing the SAC with prejudice.

On appeal, Judge Posner took Robbins Geller to task for failing to fully investigate and follow up on clear red flags. For instance, the investigator had informed counsel that "the names the source had given her of persons to whom he reported in the Boeing chain of command were inconsistent with what she was able to learn about the chain." *Id.* at 16. "This should have been a red flag to the plaintiffs' lawyers," Judge Posner wrote. "Their failure to inquire further puts one in mind of ostrich tactics—of failing to inquire for fear that the inquiry might reveal stronger evidence of their scienter regarding the authenticity of the confidential source than the flimsy evidence of scienter they were able to marshal against Boeing." *Id.* at 16-17.

The court noted that this was not the first time the firm had failed to actually interview a confidential witness, a fact relevant to imposing sanctions. *Id.* at 17. In at least two other cases, it had relied entirely on information reported to it by investigators without corroboration. *See Belmont Holdings Corp. v. SunTrust Banks, Inc.*, 2012 WL 4096146, at *16-18 (N.D. Ga. Aug. 28, 2012) (noting that "no lawyer representing Plaintiff ever met with or interviewed [the CW] about what he knew, whether he was credible, or even how long he actually worked for SunTrust and the currency of his knowledge."); *Applestein v. Medivation, Inc.*, 861 F. Supp. 2d 1030, 1037-39 (N.D. Cal. 2012) (noting that plaintiffs' reliance on hearsay from CW and lack of corroborating information "render[s] Plaintiffs' confidential witnesses unreliable for purposes of demonstrating falsity under PSLRA").

For procedural and other reasons, the Seventh Circuit remanded to the district court to determine whether plaintiffs' counsel should be sanctioned for its conduct. The court said that even though the defendants had not moved for sanctions, the Reform Act provides for sanctions at the conclusion of litigation, enabling the court to either impose sanctions or remand for a consideration of sanctions. It chose to remand, but its discussion suggests that, had the decision been up to the court, it would have imposed sanctions. Regardless, the takeaway is clear: plaintiffs' counsel needs to talk to the witnesses it cites in a complaint, not rely exclusively on the reports of its investigators, even more so when those investigators express doubt about the accuracy of the information they have uncovered. By failing to do so, not only does the firm risk sanctions, it undermines the value of CW statements in the first place, which have become in most cases essential to successfully pleading falsity and/or scienter under the PSLRA.

The *Boeing* decision builds on Judge Easterbrook's earlier observation in *Higginbotham v. Baxter Int'l., Inc.*, 495 F.3d 753, 756 (7th Cir. 2007), that CW allegations must be steeply discounted because a purported CW may be lying, have an axe to grind, or not even exist. Judge Posner described the use of CWs as "a gimmick for obtaining discovery costly to the defendants and maybe forcing settlement or inducing more favorable settlement terms." Slip. Op. at 11. As such, *Boeing* adds

to the momentum of recent cases that support early discovery into CW allegations, even at the motion to dismiss stage. *See, e.g., Campo v. Sears Holding Corp.*, 635 F. Supp. 2d 323 (S.D.N.Y. 2009), *aff'd.*, 371 Fed. App'x 212 (2d Cir. 2010).

