March 7, 2005

IN RE WORLDCOM, INC. SECURITIES LITIGATION

DUE DILIGENCE FOR UNDERWRITERS AND DIRECTORS

Late last year, the Southern District of New York decided a significant case regarding the due diligence defense for underwriters and directors under Section 11 of the Securities Act of 1933.[1] The decision is already seen as a landmark in this area.

THE FACTS

The case arises from two series of debt securities issued by WorldCom, Inc. under two shelf registration statements - a $5 billion offering in May 2000 and a $11.9 billion offering in May 2001. Salomon Smith Barney (now Citigroup Global Markets) and J.P. Morgan Securities led the underwriting syndicates in both offerings. On June 25, 2002, WorldCom announced a massive restatement of its financial statements (which were audited by Arthur Andersen LLP), and on July 21, 2002 WorldCom filed for protection under the federal bankruptcy laws.

Securities actions addressing the accuracy of the WorldCom financial statements that were incorporated by reference into these registration statements commenced in 2002 and were consolidated in the Southern District of New York later in that year. Citigroup Global Markets settled the class action lawsuit in late 2004. The remaining underwriter defendants moved for summary judgment on the grounds that they conducted reasonable due diligence with respect to the WorldCom financial statements.[2]

THE DECISION

The plaintiffs in the consolidated actions allege that the underwriters violated Sections 11 and 12(a)(2) of the Securities Act in that the WorldCom financial statements included in the registration statements and prospectuses for the debt

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[1] *In re WorldCom, Inc. Securities Litigation,* (S.D.N.Y. 2004) (02 Civ.3288 (DLC)) (opinion dated Dec.15, 2004).

[2] On March 3, 2005, Bank of America, another of the underwriter defendants, announced that it had reached a settlement with the class action plaintiffs, and on March 7, 2005, Lehman Brothers, Credit Suisse First Boston, Goldman, Sachs and UBS, additional underwriter defendants, announced settlements. These settlements remain subject to court approval.

offerings contained misstatements of material facts. The underwriters argued in their summary judgment motion that they were entitled to rely upon WorldCom's audited financial statements without further investigation, as there was no reasonable basis for them to believe that the audited financial statements were not accurate. The underwriters also argued that they were entitled to rely in the same manner upon Andersen's comfort letters for the interim unaudited financial statements included in the registration statements.

Judge Denise Cote, who authored the court's opinion, denied the underwriters' summary judgment motions with respect to the financial statements. As to the audited financial statements, even though these were covered by audit reports and thus were expertised, Judge Cote held that genuine issues of material fact existed as to whether there were "red flags" raised on the face of the audited financial statements sufficient to require the underwriters to inquire further. These factual issues required resolution in a jury trial. As to the unaudited financial statements, Judge Cote noted that these do not constitute "expertised" information for purposes of Section 11 liability, and thus could not be relied upon by the underwriters in the same manner as expertised audited financial statements.

The Due Diligence and Reliance Defenses. Section 11 of the Securities Act provides that underwriters are liable for material misstatements or omissions in registration statements covering securities they underwrite. Underwriters can avoid Section 11 liability in one of two ways. Under the due diligence defense, an underwriter will not be liable if, after reasonable investigation, the underwriter had reasonable ground to believe and did believe that the statements in the registration statement were true and did not omit any material facts. Under the reliance defense, if any portion of the disclosure in the registration statement is included on the basis of the authority of an expert other than the underwriter, the underwriter will not be liable for that expertised disclosure if the underwriter had no reasonable ground to believe and did not believe that the expertised statements were untrue or omitted any material facts.

Note that the diligence defense requires the performance of a "reasonable investigation," whereas the reliance defense does not. Note also that under the diligence defense, the underwriter must affirmatively believe that the disclosure is materially accurate, whereas under the reliance defense the underwriter is subject to the lesser requirement that it conclude that the disclosure is not materially inaccurate. Both determinations must be reasonable.

Manipulation of WorldCom's Financial Statements. WorldCom's largest operating expense was its line costs - costs incurred to gain access to other carriers' networks so that WorldCom could complete customers' calls. WorldCom reported in its SEC filings its ratio of line cost expense to revenues, which was called the E/R ratio. The lower the ratio, which is a commonly used metric to measure the performance of telecommunication carriers, the better the performance.

Starting in 2000, WorldCom's business results began to deteriorate such that its actual E/R ratio and reported income were unacceptable to management. Several strategies were engaged in to reduce line costs, including improperly releasing reserves or accruals to offset line costs. As it became impracticable to continue to reduce line costs through these manipulations, during the first quarter of 2001, WorldCom management began capitalizing a portion of line costs, which reduced line costs and thus the E/R ratio to levels that were largely consistent with prior period levels. These manipulations caused WorldCom's financial statements to contain materially false information. These fraudulent entries continued until the first quarter of 2002 and were uncovered in May 2002.

The Underwriters' Summary Judgment Motion. The underwriter defendants sought summary judgment with respect to the WorldCom financial statements that were incorporated by reference into the two registration statements covering the 2000 and 2001 bond offerings. The underwriters asserted that they acted reasonably in relying upon Arthur Andersen's reports with respect to WorldCom's audited financial statements and had no duty to investigate further as they had no reasonable ground to believe that these financial statements contained false statements. The underwriters also asserted that they were entitled to rely in the same manner on Andersen's comfort letters for the unaudited quarterly financial statements incorporated into the registration statements.

> *Unaudited Financial Statements* - The court denied the underwriter defendants' summary judgment motion as it related to their assertion of the reliance defense and the Andersen comfort letters. The SEC has previously stated that auditors are not experts with respect to unaudited financial statements. The court held that a comfort letter relating to unaudited financials does not change that result - the unaudited financial statements remain unexpertised. Therefore, underwriters seeking to avoid liability for misstatements contained in unaudited financial statements must establish a due diligence defense in the same manner as for other unexpertised information contained in the registration statement. The reliance defense is not available in this situation.[3]
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> *Audited Financial Statements* - The court also denied the underwriter defendants' summary judgment motion as it related to the assertion of the reliance defense and the audited financial statements. The court held that, while in most situations it would be reasonable for underwriters to rely on audited financial statements, this reliance may not be blind. Rather, adopting a standard more commonly found in anti-fraud cases brought under Section 10(b) of the Exchange Act, the court held that

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[3] See Rule 436 under the Securities Act; Rel. No. 33-6173 (Dec. 28, 1979). *See also* Committee on Federal Regulation of Securities, *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 Bus. Law. 1185, 1210 (1993).

"where 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability."[4]

The court defined a "red flag" as "any information that strips a defendant of his confidence on the accuracy of those portions of a registration statement premised on audited financial statements." This could involve accounting fraud (in which the auditor knowingly participated in the preparation of false financial statements) or audit failure (in which the auditor failed to uncover improper actions taken by the company that it audited). The court also stated that whether a red flag exists in a particular situation is a question of fact, not law.

In denying this aspect of the underwriter defendants' summary judgment motion, the court made the following observations:

- At the time of the 2000 Registration Statement, WorldCom's reported E/R ratio of 43% was significantly lower than those of its two closest competitors - AT&T (46.8%) and Sprint (53.2%). During this period, WorldCom's revenues also fell, suggesting that WorldCom's E/R ratio should have increased unless line costs fell at a faster rate, and thus making it more unlikely that WorldCom's E/R ratio would be significantly lower than those of its closest competitors.
- The discrepancies between WorldCom's E/R ratio and those of AT&T and Sprint continued at the time of the 2001 Registration Statement.
- At the time of the 2001 Registration Statement, several of the underwriter defendants had downgraded their internal credit rating for WorldCom and taken steps to hedge or otherwise limit their credit exposure to WorldCom, due to their respective assessments of WorldCom's deteriorating financial condition.
- Underwriters' diligence sessions with WorldCom and Andersen were poorly documented and cursory in nature.
- There were two instances in which an underwriter or underwriters' counsel identified potential issues that were not raised with WorldCom for fear of eliciting a negative reaction from senior management.
- The sheer size of the two bond offerings in question, particularly in light of the general deterioration in WorldCom's financial situation

[4] The court also noted a case decided under Section 11 in which the concept of "red flags" arose. In *In re Software Toolworks Inc. Sec. Litig.,* 50 F.3d 615 (9th Cir. 1994), underwriters discovered a memorandum that revealed backdating of a sales contract for improper revenue recognition purposes. Appropriately, the underwriters then conducted an additional investigation that the court found to be reasonable as a matter of law, holding that, despite the presence of a red flag, the underwriters had established a due diligence defense. *Id.*, 50 F.3d at 623-24.

and the general downturn in the telecommunications industry, arguably heightened the scope of the investigation on the part of the underwriters that was warranted to establish a due diligence defense.

The court held that these issues raised questions of fact as to whether the underwriters had been confronted with red flags sufficient to require further investigation in order to establish the reliance defense. On this basis, the court thus denied their motion for summary judgment with respect to the audited financial statements.[5]

Observations

There are very few reported cases that provide meaningful interpretation of the due diligence and reliance defenses under Section 11. The *WorldCom* decision is one of the most important decisions in this area in many years. However, it is also an example of sub-optimal facts producing difficult decisions.

It is fair to expect that plaintiffs will now allege as a matter of course the presence of one or more red flags in any litigation involving allegedly false audited financial statements. However, the *WorldCom* decision need not be read to hold that any such an allegation will result in a denial of summary judgment and a jury trial. As in the *Software Toolworks* decision, if underwriters identify the red flag as part of their diligence investigation and then engage in a carefully constructed, well-documented investigation of the facts giving rise to the red flag and, if appropriate, include disclosure resulting from the investigation in the registration statement, a court can, and should, hold that the underwriters remain entitled to the reliance defense.[6] If the red flag affects unaudited financial statements, the underwriters remain subject to the higher burden of the due diligence defense, but a reasonable investigation should also enable them to prevail on a summary judgment motion.

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[5] The court did find that the underwriter defendants had no obligation to disclose in either of the registration statements their internal ratings for, or hedging strategies with respect to their exposure to, WorldCom's credit.

[6] An additional example of underwriters successfully rebutting a red flag allegation can be found in the *WorldCom* decision itself. Plaintiffs alleged that the extent to which the wealth of Bernard J. Ebbers, WorldCom's chief executive officer at the time of the offerings giving rise to this litigation, was dependent on WorldCom's stock price provided a reason for him to engage in fraudulent activity and thus constituted a red flag. The court held that, absent a specific allegation that the underwriter defendants had reason to believe that Ebbers would use his access and power to commit fraud, his dependence on WorldCom's financial health, although extraordinary, was insufficient to constitute a red flag imposing on the underwriters a duty to inquire beyond the face of the audited financial statements. In so holding, the court demonstrated that plaintiffs need to do more than merely allege the existence of red flags relating to financial statements or other expertised information to be able to defeat a summary judgment motion.

The *WorldCom* decision is also an important reminder that context matters. The offerings in question were massive in size and occurred at a time that WorldCom, and the telecommunications industry in general, were known to be encountering difficulties. These facts, without more, appeared to suggest to the court that the underwriters had an obligation to review the audited financial statements with a dose of healthy skepticism rather than blindly rely.

The underwriter defendants attempted to argue that the court should evaluate the reasonableness of their actions in the context of the speed of shelf registration statements, noting that most of the seminal due diligence decisions predate the adoption of the shelf registration architecture. The court held that it did not have to address this argument in reaching its decision. The opinion notes in dicta that practitioners and academics have called for a reexamination of underwriters' liability under Sections 11 and 12(a)(2) for several years, but in so noting the court concludes that in the absence of legislative or regulatory change, the existing guidelines and decisions continue to apply. To that end, Judge Cote favorably cited a 1998 statement by the SEC to the effect that considerations of competitive timing and pressures are not to be considered when evaluating the reasonableness of an underwriter's investigation. Therefore, this decision suggests that it is for the SEC or the legislature, not the courts, to interpret underwriters' liability in light of shelf registration architecture and current market dynamics.

The underwriters also argued that further inquiry would have been futile, as WorldCom's management would have simply fabricated responses to continue to hide the fraud. The court noted that perceived futility does not relieve underwriters from conducting a reasonable investigation. While this is undoubtedly a frustrating result for the underwriter defendants in light of the recent testimony about the depth and extent of the fraud at WorldCom, this is a potentially helpful holding for underwriters in futures securities litigation. The decision makes clear that underwriters facing fraudulent activity need not uncover the fraud in order for their investigation to be sufficient to establish a due diligence defense. On the other hand, underwriters must establish futility by engaging in a reasonable investigation; they may not limit their investigation on the grounds that further inquiry would be futile.

This decision adds to the long line of cases in which liability is alleged under both Sections 11 and 12(a)(2), but the decision turns solely on Section 11 and the defenses thereto. Therefore, there is no discussion of the meaning of the "reasonable care" standard under Section 12(a)(2). While the SEC has stated that the reasonable investigation standard of Section 11 requires a more diligent investigation than the reasonable care standard of Section 12(a)(2),[7] neither the SEC nor the staff has ever expanded upon this conclusory statement, and we are not aware of a court decision that has analyzed this issue.

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[7] Rel. No. 33-7606A (Nov 13, 1998) at footnote 460 and accompanying text.

Finally, while most of the attention generated by the *WorldCom* decision has focused on its meaning for underwriters, the holdings are also very relevant for a registrant's outside directors, as they are also eligible to rely upon the due diligence and reliance defenses to Section 11 liability.[8] The need for speed in capital markets transactions is often a product of pressure imposed both by registrants and underwriters, who want to complete the transaction while potentially erratic market conditions are favorable. While there is no question that it is important for underwriters to have the opportunity to perform a due diligence investigation that will withstand the sort of scrutiny that the *WorldCom* decision evidences, well-advised registrants have an equally strong interest in protecting their outside directors from liability. Therefore, performing meaningful diligence is in both the registrant's and the underwriters' interest.

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[8] As part of the Private Securities Litigation Reform Act of 1995, Congress amended Section 11(f) of the Securities Act to increase the standards of culpability required to be established to impose liability on outside directors. Although Congress instructed the SEC to implement a definition of the term "outside director," that has yet to occur.