PROSKAUER ROSE LLP®

Client
Alert

A report
for clients
and friends
of the firm

April 2005

# In re WorldCom, Inc. Securities Litigation

Underwriters and outside directors should pay particular attention to two decisions of the United States Court for the Southern District of New York in the WorldCom securities litigation.[1]

In its December 2004 decision that closely examines the due diligence responsibilities of underwriters, the court set the stage for what would amount to a multi-billion dollar settlement with the underwriters of two WorldCom registered offerings of debt totaling $16.9 billion. In denying the defendant underwriters' motion for summary judgment, the decision highlights the limits of the so-called "due diligence" and "reliance" defenses with respect to audited financial statements and auditors' comfort letters covering unaudited interim statements.

Separately, in February 2005, the court rejected the January 2005 settlement stipulation entered into by the lead plaintiff and most of the director defendants and their insurance companies. Focusing on the condition of the stipulation that would have limited the amount by which the settlement would be creditable toward the discharge of the overall liability of the non-settling defendants, the court declined to approve the judgment reduction formula, and, as a consequence, the lead plaintiff withdrew from the settlement. This decision may make it more difficult for outside directors to settle with plaintiffs in circumstances where other transaction participants have not settled.

## Background

The WorldCom class action suit, currently being tried against the remaining defendant, WorldCom's former auditors, Arthur Andersen LLP, was brought against WorldCom's former CEO, Bernie Ebbers; its former CFO, Scott Sullivan; its former board members; Arthur Andersen; and the investment banks that underwrote WorldCom's $5 billion debt offering in 2000 and its $11.9 billion debt offering in 2001. The plaintiffs sued on a variety of strict liability and fraud theories under the Securities Act of 1933 and the Securities Exchange Act of 1934, or the Exchange Act, alleging material misrepresentations in and omissions from the offerings' registration statements and the financial statements that they incorporated. The inaccuracies in the offering documents related primarily to WorldCom's accounting for its 'line costs'—its single largest operating cost—in its audited 1999 financial statements that were incorporated in the 2000 offering document and in its first quarter 2001 earnings release filed on Form 8-K and incorporated in WorldCom's May 2001 offering document. Although the parties disputed whether the pre-2001 financial statements included false statements, it was conceded by the underwriter defendants that the first quarter 2001 data was fraudulent. The defendant underwriters' motion for summary judgment, however, was based on their assertion that they were entitled to avoid the strict liability imposed on underwriters by Section 11 of the Securities Act for prospectus misstatements, because they were entitled, under the circumstances, to invoke the affirmative defenses of "due diligence" and "reliance." These defenses, in turn, depended on whether the underwriters were entitled to rely on Arthur Andersen's audit of the 1999 financial statements and its comfort letter regarding the 2001 first quarter data.

## The Reliance Defense and "Red Flags"

Under Section 11 of the Securities Act, an underwriter will not be liable for misstatements in any part of a registration statement that purports to be made on the authority of an expert, if the underwriter had no reasonable ground to believe and did not believe that

[1] *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004) and *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2005 U.S. Dist. LEXIS 1805 (Feb. 9, 2005)

the statements were untrue. Pointing to the well established law that views auditors as experts and an audited financial statement as an expertised part of a registration statement, the defendant underwriters asserted that they were entitled to rely on the audited WorldCom financial statements. The *WorldCom* court, however, noted that "underwriters' reliance on audited financial statements may not be blind" and "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." The court observed that

> *"[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements is a red flag."*

Denying the underwriters' motion for summary judgment on their reliance defense, the court held that the plaintiff had demonstrated the presence of at least one "red flag" that should have led the defendants to question the accuracy of WorldCom's audited financial statements. Rejecting the defendants' argument that an audited figure can never constitute a "red flag" and impose a duty of investigation, the court accepted the plaintiff's assertion that because WorldCom's reported 1999 ratio of 'line costs' to revenue, or E/R Ratio, was significantly lower than the E/R Ratios of its two closest competitors, Sprint and AT&T, the underwriters may have had a duty not to accept the audited financial statements at face value. In the words of the court,

> *"if a 'prudent man in the management of his own property,' 15 U.S.C. §77k(c), upon reading the 1999 Form 10-K and being familiar with the other relevant information about the issuer's competitors would have questioned the accuracy of the figures, then those figures constituted a red flag and imposed a duty of investigation on the underwriter defendants."*

## The Due Diligence Defense

Although the defendant underwriters did not argue that the comfort letters they received from Arthur Andersen concerning the unaudited 2001 first quarter data expertised that data, thereby entitling the underwriters to the reliance defense, they did argue that by obtaining the comfort letters they had discharged their obligation under Section 11 to conduct an investigation. They asserted that the shift away from traditional registration statements—the preparation of which involved weeks of effort and the opportunity to conduct more extensive due diligence investigations—and toward a short-form registration regime that permits registrants to incorporate prior disclosures by reference, sharply reduced the time available to conduct due diligence. They contended that, as a consequence, from the point of view of the underwriter, at least with respect to seasoned issuers utilizing the integrated disclosure system, there is no difference between audited and unaudited financial statements so long as the underwriter receives an auditor's comfort letter with respect to the latter.

Rejecting the assertion that serious due diligence efforts are not feasible within the time constraints of a takedown from a shelf registration statement, the *WorldCom* court declined to conclude that the integrated disclosure system had effected a fundamental change in the nature of the underwriter's due diligence obligations. Again, the court viewed the presence of "red flags" as a determinative factor regarding the extent of the required investigation. Noting that the underwriter defendants had internally downgraded WorldCom's credit rating and had sought to minimize their exposure with respect to their participation in WorldCom's credit facility, the court concluded that the question of whether a reasonable investigation would have required more than obtaining comfort letters from the auditors was one for the jury to determine. The court stated,

> *"In assessing the reasonableness of the investigation, [the underwriters'] receipt of the comfort letters will be important evidence, but it is insufficient by itself to establish the defense."*

Responding to the defendants' argument that if they are not entitled to rely on a comfort letter, the costs of capital formation in the United States will be substantially increased since underwriters will have to hire their own accounting firms to rehash the work of the issuer's auditors, the court cautioned against reading its opinion as imposing that burden. The court observed that there were many modes of inquiry available to underwriters that fell short of a re-audit but that went further than simply obtaining a comfort letter and doing little more. The court suggested, for example, that if a reasonable investigation brings to light aggressive or unusual accounting methods, a prudent underwriter may choose to consult with accounting experts to confirm that the accounting treatment is appropriate and that no additional disclosure is required.

## The Directors' Settlement

The January, 2005 settlement reached by the lead plaintiff and most of the director defendants and their insurance companies provided for a settlement amount of $54 million to be paid by the directors themselves ($18 million) and their insurers ($36 million). The settlement stipulation provided, among other things, that the amount of any judgment obtained by the plaintiff against the non-settling defendants would be reduced by no more than the greater of (i) the actual settlement amount, (ii) the amount of insurance coverage available and (iii) the portion of the judgment allocable to the settling directors had they not settled, *reduced to the amount those individuals would actually be capable of paying*.

The non-settling defendants objected to the reduction formula on the basis that it conflicted with Paragraph (7)(B) of Section 21D(f) of the Exchange Act, which provides for a reduction of the judgment by either the actual amount paid in settlement or, if greater, "the amount that corresponds to the percentage of responsibility" of the settling party, without adjustment to reflect any limitation on the financial capability of the settling defendants to pay their share of the defendants' total liability.

> *"… taking the Settling Director Defendants' financial ability into account in the Contribution Credit could make an enormous difference in the amount collectible from a non-settling jointly and severally liable defendant."*

The court gave an example of the jury allocating thirty percent of the responsibility for the Section 11 violations (for which all the defendants were at least potentially liable, jointly and severally). Under the statutory provision, the reduction amount would be thirty percent. Referring to the requested Section 11 damages for the 2000 and 2001 offerings of approximately $17 billion, the court observed that if total damages were $10 billion, the defendants found liable at trial would be responsible for seventy percent, or $7 billion. Under the settlement stipulation, the reduction amount would have been the greater of the settlement amount ($54 million), the insurance coverage ($85 million), and the settling directors' share of the judgment ($3 billion), reduced to the amount those directors would actually be capable of paying. If the total amount the settling directors were capable of paying was $100 million, the non-settling defendants would be responsible for $9.9 billion of the judgment rather than $7 billion.

As the court noted, the effect of Paragraph 7(B) of Section 21D(f) of the Exchange Act is to provide a powerful disincentive for plaintiffs to enter into partial settlements with outside directors in any case where the stakes are high, if the deep pocket defendants like investment banking firms and auditors have not settled. Ironically, this provision, which was enacted under the Private Securities Litigation Reform Act, may make it more difficult for outside directors to settle and reduce their risk of potentially catastrophic personal liability.

You can also visit our Website at **www.proskauer.com**

**NEW YORK • LOS ANGELES • WASHINGTON**

**BOSTON • BOCA RATON • NEWARK**

**NEW ORLEANS • PARIS**

## Client Alert

**Proskauer's Capital Markets Group has extensive experience in all types of capital markets transactions, including both registered and exempt transactions. We represent domestic and foreign private issuers and underwriters in registered transactions and exempt Rule 144A, Regulation S and Regulation D transactions. We provide the full range of services required by our domestic and international clients to facilitate initial public offerings, follow-on offerings, investment-grade, convertible and high-yield debt offerings and real estate securities transactions.**

**For more information about this practice area, contact:**

**Julie M. Allen**
212.969.3155 – jallen@proskauer.com

**Richard H. Rowe**
202.416.6820 – rrowe@proskauer.com

**Allan R. Williams**
212.969.3220 – awilliams@proskauer.com

**Robert A. Cantone**
212.969.3235 – rcantone@proskauer.com

Proskauer Rose is an international law firm that handles a full spectrum of legal issues worldwide.

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice or render a legal opinion.

© 2005 PROSKAUER ROSE LLP. All rights reserved.