

2005 Seminar Series

# The Perils of Capital Formation After *WorldCom*

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# What A Wonderful *World[Com]*

“Don’t know much about history,

Don’t know much biology,

Don’t know much about science books...”

Herman’s Hermits

*Wonderful World*

## Quotation of the Day

“I don’t know anything about technology and I don’t know [much] about finance and accounting.”

*The New York Times*  
March 1, 2005

# *WorldCom* Headlines

- Two key opinions with similar themes:
  - Duties of Underwriters
  - Duties of Directors
- Director settlement required personal contributions

## Headlines (cont'd)

Reliance on management is not sufficient.

## Headlines (cont'd)

Reliance on audited financial statements is not sufficient.

## Headlines (cont'd)

Underwriters get no breaks in fast transactions.



## Headlines (cont'd)

Not all directors are created equal.

## Headlines (cont'd)

It doesn't matter that the fraud would not have been discovered.

## Headlines (cont'd)

Joint and several liability puts non-settling defendants at great risk.

# *WorldCom* Facts

- Two SEC-registered offerings
  - May 2000: \$5.0 billion
  - May 2001: \$12.0 billion  
(largest in history)
  
- Investment grade debt; shelf take-downs
  
- Bert Roberts (Chairman of the Board) and other directors signed Exchange Act reports incorporated by reference into registration statement

## *WorldCom Facts* (cont'd)

- Beginning in early 2001 management moved line cost expenses aggregating \$3.8 billion from income statement to capital accounts — conceded to be fraudulent and criminal
- June 2002: WorldCom announces massive accounting restatement (ultimately \$76 billion in adjustments to 2000 and 2001 financial statements)
- July 2002: WorldCom files for bankruptcy

## *WorldCom Facts* (cont'd)

- WorldCom financial metrics were better than industry peers (superior line-cost-to-revenue ratio)
- By early 2001, credit sides of several underwriters were downgrading WorldCom debt and actively reducing loan exposures

## *WorldCom Facts* (cont'd)

- Ebbers and Banks had unusual tie-ins:
  - Ebbers had substantial personal debt to affiliates of the underwriters, principally margin loans.
  - Beginning in September 2000, Ebbers was subject to numerous margin calls as WorldCom's stock price declined.

## *WorldCom Facts* (cont'd)

- Bondholders brought claims against Ebbers & Sullivan; Board of Directors; Underwriters; and Arthur Andersen
- Claims against underwriters and directors centered on violations of Section 11 of the Securities Act — no 'scienter' required
- Class actions consolidated in S.D.N.Y. — assigned to Judge Cote



## Section 11 – Affirmative Due Diligence Defense

- Section 11 provides an affirmative defense if the director or underwriter has “after reasonable investigation, reasonable grounds to believe and did believe....that the statements [in the registration statement] were true....”
- With respect to “expertised” information (e.g., audited financials), Section 11 provides a less demanding defense that exonerates the director or underwriter if he “had no reasonable ground to believe and did not believe...that the statements [in the registration statement] were untrue....”

# Decisions

- December 2004: Judge Cote denies underwriters' motion for summary judgment. Lengthy discussion of due diligence obligations of underwriters.
- March 2005: Judge Cote denies Roberts' motion for summary judgment. Discussion of directors' due diligence defense; parallels drawn between duties of directors and duties of underwriters, particularly where "red flags" exist.

# Key Findings — Underwriters Decision

- Financial statements covered by audit opinions qualify as expertised information; unaudited financial information covered by comfort letters does not.
- However, reliance on audit opinions may not be blind. Where “red flags” exist, mere reliance on an audit opinion is not sufficient to ward off liability.

## Underwriters Decision (cont'd)

- Red flags existed:
  - WorldCom's line costs as a % of revenue were out of line with those of Sprint and AT&T.
  - WorldCom's long-distance business was deteriorating.
  - Ebbers' personal financial situation was precarious and depended hugely on WorldCom's stock price performance.

## Underwriters Decision (cont'd)

- Competitive timing pressures do not modify underwriters' diligence obligations.
- Underwriters are never compelled to do an offering before they have finished their due diligence.
- Rule 176 does not list time schedule as a factor to be considered.
- Nothing from Congress or the SEC, since 1933, has suggested that the speed of an offering mitigates the need for a thorough diligence.

## Key Findings – Director Case

- Directors may not fend off liability by claiming reliance on audit “where ‘red flags ‘ regarding the reliability of an audited financial statement emerge....”
- Because of “red flags”, Roberts needed to demonstrate a “more active dialogue with management and perhaps even with the company’s auditors *and underwriters*” to avail himself of the Section 11 affirmative defense.

## Findings – Director Case (cont'd)

- The court: Roberts has “not shown that he conducted any sort of investigation, much less a reasonable investigation in light of all relevant circumstances.”
- What constitutes a reasonable investigation and a reasonable ground to believe will vary with the degree of involvement of the individual, his expertise and his access to the pertinent information and data.

# Director Settlement

- \$40 billion in claimed damages
- 18 months of negotiations amongst 12 directors, 7 insurers, the company, Breeden and plaintiffs
- Roberts initially opted out of settlement



# Director Settlement

- First settlement rejected by court – determined that judgment reduction feature of settlement violated PSLRA
- Second settlement: WorldCom directors agreed to pay an aggregate of \$24.75 million out of their own pockets
- Following Judge Cote’s decision, Roberts joined settlement, but at a higher level

# Lessons

- Underwriters must ...
  - Attempt to independently verify management's representations.
  - Play devil's advocate.
  - Interview suppliers, customers and distributors.
  - Review all company documents, financial data, operating plans and forecasts.
  - Extensively interrogate management and auditors.

## Lessons (cont'd)

- Underwriters must ...
  - Explore in detail the audited and interim financial statements with management and the auditors.
  - Consult with lending side of the investment banking organization.
- In the face of red flags, due diligence efforts must go into overdrive.

## Lessons (cont'd)

- Directors must ...
  - Pay attention to fundamentals.
  - Carefully review and comment on Exchange Act filings.
  - Be active and attentive.
  - Avoid appearance of impropriety.
  - Demand rapid, corrective action regarding all regulatory/accounting deficiencies.

## Lessons (cont'd)

- Fulfilling state law “duty of care” applicable to directors will go a long-way toward Securities Act “reasonable investigation”.
- What is reasonable for one director may not be reasonable for another.

# Unresolved Issues

- Can due diligence ever be thorough enough in an “expedited” shelf take-down?
- Should “strict” underwriter (or director) liability be the law in this type of transaction? Should Congress amend Securities Act Section 11?

## Unresolved Issues (cont'd)

- Does ongoing or periodic diligence before a specific offering satisfy the requirement in respect of that offering?
- What are the duties of syndicate members who are not managers of an offering?
- Can directors rely on work done by board committees, such as the audit committee?
- Can solvent issuers contribute more to settlements to obtain releases of directors from personal contributions?

## For Discussion

1. Who does issuer's counsel represent? Is it ever appropriate for boards to have separate counsel in connection with a securities offering?
2. How should directors document their efforts? Should corporate secretaries take long-form minutes?
3. Should directors be required to spend dedicated time to due diligence procedures (e.g., five days/year)?



## For Discussion

4. How should underwriters' due diligence be documented?
5. Should all underwriters be “tethered” to the diligence performed by the manager?
6. Should investment banking firms or industry associations impose time restraints/speed bumps?

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