# THE WORLDCOM SCANDAL'S LESSONS FOR THE CURRENT SEC

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Over two decades ago, the WorldCom scandal became one of the largest accounting frauds in U.S. history, and its importance lives on to this day. We spearheaded the case as a co-lead counsel representing the lead plaintiff, the New York State Common Retirement Fund, through its sole Trustee, the Comptroller of the State of New York, and the class.

While WorldCom went into bankruptcy, by bringing and extensively litigating a class action in the U.S. District Court for the Southern District of New York on behalf of investors in WorldCom stock and bonds, we were able to recover a landmark $6.19 billion recovery for the investor class through a series of settlements that required payments from WorldCom's former senior executives, its board members, its outside auditor (following five weeks of trial until just before closing arguments were to be presented to a jury), and the underwriters for two massive bond offerings issued within the two years preceding WorldCom's implosion.

However, under the SEC's recent policy change, these disputes might have been required to be brought in private arbitration rather than publicly in court, and the historic class-wide recoveries for defrauded shareholders would likely not have been achieved at all. Indeed,

we are now seeing in SpaceX's registration statement for its massive IPO a very strict proposed forum provision requiring that any securities cases be brought in a Texas State Business Court (even though state courts do not have jurisdiction over securities fraud claims brought under the Securities Exchange Act of 1934), an equally strict forced arbitration provision that would not have been allowed absent the SEC's recent policy change, and a prohibition on SpaceX shareholders bringing investor class actions.

In addition to the monetary recoveries, the WorldCom class action provided critical rulings on summary judgment that set important precedents that are still cited today for the duties and actions required of directors, outside auditors, and underwriters for stock and debt offerings. Among other things, it developed much needed law concerning an underwriter's obligations of due diligence when bringing a security to market. But with the SEC's new permissive policy on mandatory arbitration in place, this case law that has directly benefited investors and markets could never have been established in the first place.

The WorldCom case's effect on corporate law and culture cannot be overstated. According to Alan Murray, founding president of the WSJ Leadership Institute, the WorldCom case changed everything about the way corporations are governed. He wrote: "Corporate boards of directors have been around for centuries, but for most of that time they were inert — rubber-stamping CEO proposals with minimal oversight. ... I trace their animation to Jan. 7, 2005, when 10 former directors of WorldCom agreed to pay investors $18 million out of their own pockets as part of a settlement in the giant accounting-fraud case."

Murray explains that post-WorldCom, the new laws and standards forced corporate boards to take greater oversight roles, because the legal stakes were raised if they failed. Boards responded by taking more responsibility, fundamentally changing the governance equation of America's big businesses for the better.

**Directors**

The WorldCom litigation spawned a number of significant rulings concerning the liability of directors for securities claims. Collectively, the rulings reject the "see no evil, hear no evil" defense historically used by directors of corporations accused of securities law violations. The court's ruling on one particular summary judgment motion provides significant guidance concerning the potential liability and defenses of corporate directors.

The motion was filed by Bert C. Roberts, Jr., the former chairman of the WorldCom board, who had refused to join in the settlement reached with the other eleven board members and sought summary judgment dismissing all claims against him. In rejecting Roberts' motion, the court clarified the standards governing corporate directors and others charged with culpability.

The court first addressed the standard governing the affirmative defenses to liability, which concerns registration statements filed with the SEC in connection with public offerings of stocks and bonds, imposing strict liability upon the issuing company along with potential liability for others, including directors, who sign, or are otherwise connected to, registration statements that contain a material false statement or material omission. The liability standard for directors is tempered by an affirmative defense of "due diligence." However, the court stressed that directors are not excused from performing meaningful due diligence investigations simply because there are other professionals involved with the public offerings, such as underwriters or auditors. Even when dealing with an audited financial statement, the court held that the due diligence defense does not immunize directors who blindly accept statements of these experts. Instead, directors who disregard "red flags" regarding the reliability of audited financial statements or any other expertised statement may be liable.

The court explained that there are two distinct affirmative defenses that are traditionally referred to as the due diligence defense. The nature of these affirmative defenses depends upon which portion of the registration statement contained the misleading statement. If the allegedly false statements were made on the authority of an "expert" such as an outside auditor, then the defendant asserting this affirmative defense has the burden to prove that, at the time the registration statement became effective, they (1) had no reasonable ground to believe, and (2) did not, in fact, believe, that the statements were false or contained material omissions. If the misleading statement in the registration statement was not made in reliance upon the authority of an expert, the standard is stated in the opposite way: the defendant asserting this affirmative defense has the burden to prove that, after reasonable investigation, they (1) affirmatively had reasonable ground to believe, and (2) did, in fact, believe that the statements in it were true and contained no material omissions. The standard of reasonableness to be applied under either test is that of a prudent person in the management of their own property.

The court additionally explained that even though the same statutory language governs the due diligence obligations of directors and others (such as experts who contribute to the preparation of those statements and underwriters), the court's evaluation of the thoroughness of a defendant's investigation will vary depending, in part, upon the importance of their role in the distribution of the securities and their involvement in the company's activities. A director who, for example, is a corporate officer and has expertise, knowledge or responsibility about the subject matter of the misstatement or omission is held to a higher standard of liability than an outside director with no special knowledge or responsibility. The court found that what constitutes a "reasonable investigation" and "reasonable ground to believe" varies with the involvement of the individual, their expertise, and their access to the pertinent information and data. However, even an outside director has a duty to conduct a reasonable investigation of the non-expertised portions of a registration statement and is not permitted to accept the representations of management or a company's outside auditors at face value.

In its conclusion, the court ruled that Roberts' due diligence defense required "an exquisitely fact-intensive inquiry into all of the circumstances surrounding the facts upon which the Section 11 claim is premised" and that such inquiries did not easily lend themselves to resolution as a matter of law. Even if Roberts were properly considered an outside director, despite his position as chairman of WorldCom's board (and the former CEO and chairman of the board of WorldCom's predecessor MCI), he had to show that he conducted some investigation to qualify for the due diligence defense. Notably, on the eve of trial and immediately after his motion was denied, Roberts agreed to pay $4.5 million from his personal assets to settle the class claims against him.

**Underwriters**

In the early 2000s, the area of law concerning the standard by which an underwriter is judged to be liable for the statements made in a registration statement was surprisingly undeveloped. Thus, the court's decision, which denied the underwriters' summary judgment motion in all significant respects, was groundbreaking.

Plaintiffs brought claims against the underwriters of WorldCom's massive May 2000 and May 2001 bond offerings for the damages that resulted from the company's issuance of allegedly false and misleading prospectuses and registration statements for those offerings.

The May 2000 offering was for $5 billion in new bonds issued by WorldCom and sold by nine underwriters. The May 2001 offering was for $11.8 billion of new bonds – the largest bond offering in United States history – which were brought to market by more than a dozen underwriters.

The losses suffered by investors who purchased the bonds were staggering as the value of the bonds sunk to as low as 14 cents on the dollar after WorldCom admitted its fraud in late June 2002 and entered bankruptcy proceedings in July 2002.

In the New York State Comptroller's consolidated complaint, plaintiffs alleged that the underwriters could not rely blindly on audit opinions issued by WorldCom's outside auditor, Arthur Andersen, or WorldCom's management representations for their due diligence, and that they had an affirmative obligation to disclose various facts, including the many conflicts that allegedly existed between the underwriters and their affiliates, on the one hand, and WorldCom, its CEO Bernie Ebbers and its CFO Scott Sullivan, on the other hand. Nonetheless, in their summary judgment motion, the underwriters argued that the court should find that they could not be liable as a matter of law for the alleged misstatements and omissions in the registration statements for the offerings.

In denying the underwriters' motion for summary judgment as to their due diligence defense, the court distinguished between the two affirmative defenses available to claims brought under the Securities Act of 1933: the due diligence defense and the reliance defense. While the court agreed with the underwriters that they were entitled to rely on Andersen's audit opinions for the year-end financial statements, it found that the underwriters were not entitled to rely on Andersen's "comfort" letters, which comment on interim financial statements but do not rise to the level of audit opinions, regarding the interim financial statements, since comfort letters do not "expertise" any portion of the registration statement. Moreover, the court ruled that even reliance on audit opinions may not be blind: "[r]ather, 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."

Citing facts from the record, plaintiffs argued that there were numerous red flags that should have led the underwriters to investigate further and perform additional due diligence, including: (1) WorldCom's earnings-to-revenue ratio, an important profitability standard, was significantly higher than its competitors, Sprint and AT&T, and that in the extremely

competitive telecommunications market, that discrepancy should have triggered a duty to investigate with respect to both bond offerings (as one competitor had testified, they could never figure out WorldCom's "secret sauce"); and (2) the deterioration of WorldCom's MCI long-distance business should have led the underwriters to question the accuracy of WorldCom's reported asset values in connection with the 2001 offering.

The court's opinion thus established that where red flags exist concerning the accuracy of statements in a registration statement, which require further investigation of the statements, mere acceptance of management's representations and even a clean audit opinion letter will not satisfy an underwriter's due diligence obligations.

**Current SEC**

What does it say about the current SEC that its new policy regime could prevent historic cases like WorldCom from being litigated in the first place? Why would we want to return to Alan Murray's pre-WorldCom world of far less corporate responsibility, oversight and accountability?

Under Chairman Paul Atkins, the SEC's abrupt policy change allowing companies to adopt forced arbitration provisions with class action waivers threatens to do just that. In private arbitration, not only would the landmark WorldCom recoveries not have been possible, but the case law that has proved critical for protecting investors would never have been established. Such necessary case law similarly will not be further developed by judicial analyses and decisions should companies be allowed to force their shareholders to arbitrate their claims – on an individual rather than a collective basis – in a private setting rather than litigate alleged violations of the federal securities laws in a public forum and on behalf of similarly situated classes of investors.

Arbitration proceedings are private and arbitration awards are generally non-appealable except under very narrow circumstances. The details of arbitration proceedings are thus hidden from the public. Moreover, whereas judicial proceedings and decisions create legal "rules of the road," arbitration awards are not precedential and carry no legal weight for future cases.

Further, while the specter of a public trial and written summary judgment decisions that bring into the public domain key facts and arguments underlying a federal securities law

case serve as great disinfectants and deterrents of future fraudulent acts, the exact opposite is true of arbitration. In this light, the types of forced arbitration provisions now being allowed by the SEC – and being adopted in SpaceX's governing corporate documents – should be seen as just another way for companies to conceal from their own shareholders and other investors the companies' and their affiliates' wrongdoing, while also seeking to minimize the rightful compensation to be paid to the investors they misled.

Over and above these considerations, another "value" of mandatory arbitration for companies is likely to be avoiding class actions altogether because there may be no securities claim an individual could bring that is economically viable absent the class action vehicle. Moreover, if individual shareholders – even assuming some are institutional investors with large stakes in the outcome – are forced to bring multiple arbitrations to vindicate their rights, the possibility of multiple conflicting arbitration awards will create chaos in the markets and uncertainty in the law.

The SEC's new policy stance runs counter to its mission of protecting investors and threatens the security of our markets. The SEC is on a dangerous new path, and given the stakes, the sooner it corrects course the better.

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