

The Due Diligence and Reliance Defenses in *WorldCom*: Retrospect and Prospect

By Gideon A. Schor¹

In the *WorldCom* securities litigation, the Court denied the underwriter defendants' motion for summary judgment on their two affirmative defenses to liability. In a formidably long opinion filed on December 15, 2004, Judge Denise Cote of the United States District Court for the Southern District of New York held that the underwriter defendants' mere reliance on comfort letters and unaudited financial statements, absent reasonable investigation of the statements' accuracy, would not establish a due diligence defense. Judge Cote further held that the underwriter defendants' mere reliance on audited financial statements – at least where the underwriter faces a red flag concerning the accuracy of those statements – would not establish a reliance defense and that the red flag triggered a duty to investigate.²

The *WorldCom* decision hit the underwriter community with seismic force. Over time, however, the decision's frailties have become evident, and the effects that the decision will have on securities underwriting are better understood. This analysis of the *WorldCom* decision begins with a review of the statutory provisions concerning underwriter liability and affirmative defenses, continues with an examination of the decision's significant gloss on the statutory language – particularly the injection of an investigation requirement into the reliance defense – and concludes with a discussion of the decision's practical consequences for underwriters. Depending on the particular case, those consequences may include vigilance for red flags, limitations on the availability of summary judgment, retention by underwriters of their own accounting experts, and the necessity of all members of underwriting syndicates to participate in aggressive and well-documented due diligence sessions.

A. Section 11: Liability and Defenses

Section 11(a) of the Securities Act of 1933 renders underwriters liable if “any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading”³

¹ Gideon A. Schor is a litigation partner in the New York office of Wilson Sonsini Goodrich & Rosati, P.C. From 2003 to 2005, he was Director of Litigation for the Americas at Credit Suisse First Boston (“CSFB”), where he specialized in securities underwriting, investment banking, and internal investigations. Prior to CSFB, he spent 13 years in the civil division of the U.S. Attorney's Office for the Southern District of New York, where he was appointed Chief Appellate Attorney in 1999.

² See generally *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

³ 15 U.S.C. § 77k(a).

As relevant here, section 11(b) gives underwriters two affirmative defenses. Under the “due diligence” defense, the underwriter, insofar as the registration statement was *not* made on the authority of an expert (*e.g.*, an auditor), is not liable if “he had, *after reasonable investigation*, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading”⁴ Under the “reliance” defense, the underwriter, insofar as the registration *was* made on the authority of an expert (other than the underwriter himself), is not liable if “he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading”⁵ Audited financial statements included or incorporated by reference into the registration statement are considered to be made on the authority of an expert (“expertised”), though Rule 436 provides that reports on unaudited interim financial information are not expertised.⁶

Thus, on the face of section 11(b), the defense available to an underwriter depends on whether the relevant part of the registration statement was expertised. If that part was expertised, the underwriter need not have investigated its accuracy and was thus entitled to rely on the preparing expert; the only requirement is that the underwriter have had no reasonable ground to believe that part false or misleading. If that part was not expertised, the underwriter must have conducted a reasonable investigation into its accuracy and must have had reasonable ground to believe that part true and not misleading.

WorldCom, however, held that an underwriter’s reliance on audited financial statements “may not be blind,” and that “red flags” concerning the reliability of audited financial statements or unaudited financial information impose on the underwriter certain investigative obligations.⁷

B. Looking Back: The *WorldCom* Holding Concerning Underwriters’ Defenses

On June 25, 2002, WorldCom announced that it had improperly treated billions of dollars in ordinary expenses as capital expenditures and that it would restate its public financial statements.⁸ On July 21, 2002, WorldCom filed for bankruptcy.⁹ In the securities litigation resulting from WorldCom’s decline and fall, a class of WorldCom bondholders sued the underwriters of two public debt offerings by WorldCom – the \$5 billion offering of May 2000, and the \$11.9 billion offering of

⁴ *Id.* § 77k(b)(3)(A) (emphasis added).

⁵ *Id.* § 77k(b)(3)(C).

⁶ *See* 17 C.F.R. § 230.436(c).

⁷ 346 F. Supp. 2d at 672, 677.

⁸ *Id.* at 635.

⁹ *Id.*

May 2001.¹⁰ Bringing claims under sections 11 and 12(a)(2),¹¹ the plaintiffs alleged that financial statements incorporated into WorldCom's registration statements contained material misstatements and omissions. On August 20, 2004, the defendant underwriters moved for summary judgment on their due diligence and reliance defenses.¹²

The May 2000 Offering

WorldCom filed a shelf registration statement six weeks before the first offering, and a prospectus supplement five days before the first offering.¹³ The registration statement incorporated by reference WorldCom's Form 10-K for 1999, which included Arthur Andersen's unqualified audit opinion (*i.e.*, the most favorable report an auditor can give).¹⁴ The registration statement also incorporated by reference WorldCom's Form 10-Q for the first quarter of 2000, which included WorldCom's unaudited financial statement for that quarter.¹⁵ On the same day the prospectus supplement was issued, Andersen issued a "comfort letter" stating that, after reviewing the unaudited statement and further inquiring of WorldCom, Andersen found no basis for materially modifying the unaudited statement.¹⁶ The day before the offering, Andersen issued a letter reaffirming the comfort letter.¹⁷

The principal written record of due diligence performed by the underwriters was a memorandum (prepared by underwriters' counsel) concerning a nine-day period ending the day before the offering.¹⁸ The memorandum describes one phone call, in which Scott Sullivan, WorldCom's CFO, was asked general questions about WorldCom's merger with Sprint, whether WorldCom had had difficulty integrating two other acquired companies, and whether there were any other material issues.¹⁹ According to the memorandum, Sullivan gave a growth prediction for 2000, and represented that the proceeds of the offering would be used to pay commercial debt, that the environment was competitive, and that there were no other material issues.²⁰ The memorandum

¹⁰ *Id.* at 636.

¹¹ Section 12(a)(2) of the Securities Act of 1933 renders underwriters liable for any material misstatement or omission in a prospectus. 15 U.S.C. § 77l(a)(2). The underwriter establishes an affirmative defense to a claim under section 12(a)(2) if "he did not know, and in the exercise of reasonable care could not have known, of" the misstatement or omission. *Id.*

¹² 346 F. Supp. 2d at 637.

¹³ *Id.* at 645-46.

¹⁴ *Id.* at 643 & n.17, 645.

¹⁵ *Id.* at 645, 649, 664, 682, 683 n.52.

¹⁶ *Id.* at 645, 649.

¹⁷ *Id.* at 649.

¹⁸ *Id.* at 647-48.

¹⁹ *Id.*

²⁰ *Id.* at 648.

neither identified the participants in the call (besides Sullivan) nor mentioned any conversation about WorldCom's E/R ratio (*i.e.*, its ratio of line cost expense to revenue²¹) contained in the 10-K.

The May 2001 Offering

By the May 2001 offering, Standard & Poor's had lowered its credit rating of WorldCom, and several underwriters had not only lowered their own internal credit ratings of WorldCom but also taken steps to lower their own credit exposure to the company.²² The May 2001 offering was nonetheless the largest public debt offering in American history.²³

WorldCom filed a shelf registration statement a week before the offering, and a prospectus supplement a few days before the offering.²⁴ The registration statement incorporated by reference WorldCom's Form 10-K for 2000, which included Arthur Andersen's unqualified audit opinion.²⁵ The registration statement also incorporated by reference WorldCom's Form 8-K for the first quarter of 2001 and WorldCom's unaudited financial statement for that quarter.²⁶ On the same day the registration statement was filed, and again a week later, Andersen issued comfort letters stating that it was aware of nothing indicating that the unaudited statement was "not determined on a basis substantially consistent with that of the corresponding amounts in the audited consolidated balance sheets of WorldCom as of December 31, 2000 and 1999"²⁷ Unlike the 2000 comfort letter, the 2001 comfort letters did not assert compliance with GAAP principles.²⁸ Although concerned about these comfort letters, the underwriters and their counsel did not pursue their questions because, one of the underwriters explained, "WorldCom's a bear to deal with on that subject."²⁹

The underwriters' due diligence, as described in a memorandum prepared by underwriters' counsel, occurred during a four-week period ending May 16, 2001.³⁰ The diligence consisted of questions forwarded to WorldCom, two telephone calls with WorldCom, one telephone call with WorldCom and Andersen, and review of board minutes, a credit agreement, SEC filings, and press releases.³¹ In the first call, Sullivan explained that WorldCom would use part of the proceeds to pay

²¹ *Id.* at 640.

²² *Id.* at 649-52

²³ *Id.* at 650.

²⁴ *Id.* at 652.

²⁵ *Id.* at 643, 652.

²⁶ *Id.* at 682, 683 n.52.

²⁷ *Id.* at 653-54.

²⁸ *Id.*

²⁹ *Id.* at 654.

³⁰ *Id.* at 652-53.

³¹ *Id.* at 653.

debt, that WorldCom was comfortable with its earnings per share, that its credit rating was not at risk, and that all material issues had been disclosed to the investment bankers.³² Asked whether WorldCom had a reserve for bad receivables, Sullivan mentioned the size of WorldCom's general reserve.³³ Asked about the competitive environment, Sullivan acknowledged surprise at the downturn in first quarter receivables, and stated that the WorldCom was not materially affected by the general economic slowdown but was affected by the telecommunications environment.³⁴ In the second call, Sullivan confirmed that there were no material changes since the prior call.³⁵ In the final call, Andersen stated that it had not issued any management letters to WorldCom and had no accounting concerns, and WorldCom and Andersen both stated that there was nothing else material to discuss.³⁶ In none of these calls did Sullivan reveal that WorldCom had treated \$771 million in ordinary line cost expenses as capital expenditures or that such treatment would affect WorldCom's E/R ratio.³⁷ Nor does the Court's opinion reveal any discussion of MCI's financial health or WorldCom's statement of its assets.

The Holding Regarding Expertised Parts of the Registration Statement

The Court denied the underwriter defendants' summary judgment motion on its reliance defense, rejecting the argument that the underwriter defendants were entitled to rely on Andersen's unqualified audit opinions for the 1999 and 2000 Form 10-Ks.

Regarding the 2000 offering, the Court found factual issues as to whether the discrepancy between WorldCom's E/R ratio, as contained in the 10-K, and the E/R ratio of WorldCom's competitors was a red flag. According to the Court, the discrepancy created factual issues as to whether the underwriters had reasonable ground to believe that the portion of the 1999 10-K concerning the E/R ratio was inaccurate. A jury, the Court ruled, would be entitled to find the discrepancy sufficient to have triggered a duty to investigate the reliability of the figures underlying the E/R ratio, notwithstanding that those figures had been audited.³⁸ The Court rejected the

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ The Court's opinion reveals no consideration of the *expressio unius* argument: Congress' inclusion of an investigation requirement in the due diligence defense indicates that, had Congress wished to include the same requirement in the reliance defense, which on its face makes no mention of investigation, Congress knew how to do so. In other words, the omission of any investigation requirement from the reliance defense represents a considered congressional determination to include no such requirement in the reliance defense. If the *expressio unius* argument is correct, then the *WorldCom* Court erred when it found an investigation requirement in the reliance defense's phrase "reasonable ground."

underwriter defendants' argument that a red flag arises only when an underwriter has "clear and direct notice" of an accounting issue.³⁹ Rather, the Court held, the standard is whether the underwriter has demonstrated that it had "no reasonable ground to believe and did not believe" that the registration statement contained a material misstatement. The Court added that this standard is "given meaning by what a 'prudent man' would do in the management of his own property."⁴⁰

Regarding the 2001 offering, the Court held that, as with the 2000 offering, there were factual issues as to whether the E/R discrepancy was a red flag.⁴¹ The Court also held that the deterioration in the long-distance business of MCI, which WorldCom had acquired, created factual issues as to whether the underwriters should have questioned the accuracy of WorldCom's reported assets.⁴² The Court noted that of MCI's \$47 billion purchase price, \$29 billion represented goodwill, an intangible asset.⁴³ As the Court held, a jury could find that factual issues created by MCI's decline raised a red flag triggering a duty to inquire into the accuracy of WorldCom's statement of its assets.⁴⁴ Finally, in a victory for the underwriters, the Court held that the underwriters' knowledge of CEO Bernard Ebbers' personal financial dependence on WorldCom's financial health did not give the underwriters reason to believe the audited financials inaccurate.⁴⁵ Without evidence that the underwriters had reason to consider Ebbers untrustworthy, his own financial dependence on WorldCom's financial health did not constitute a red flag indicating that Ebbers may have caused a manipulation of the audited financial statements.⁴⁶

The Holding Regarding Non-Expertised Parts of the Registration Statement

The Court further rejected the argument that, as long as the lead plaintiff could not prove the underwriters to have been on notice of any accounting red flags, the underwriters were entitled to rely on Andersen's comfort letters concerning WorldCom's unaudited interim financials for the first quarters of 2000 and 2001.⁴⁷ The Court held that, even in the absence of red flags, the underwriters were not entitled to rely on the unaudited financials, and that, in the presence of red flags, the underwriters' investigation should have been more searching.⁴⁸ Thus, the Court found factual issues

³⁹ *Id.* at 679.

⁴⁰ *Id.* (quoting 15 U.S.C. § 77k(c) ("the standard of reasonableness shall be that required of a prudent man in the management of his own property.")).

⁴¹ *Id.* at 681.

⁴² *Id.* at 680.

⁴³ *Id.* at 680 n.50.

⁴⁴ *Id.* at 681.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 681-82.

⁴⁸ *Id.* at 683.

as to whether the underwriters conducted a reasonable investigation of either set of unaudited financials.⁴⁹ Specifically, the Court cited the paucity of conversations with WorldCom or Andersen, the cursory nature of those inquiries, the failure to challenge any of the answers, and the failure to investigate issues prominently raised in the underwriters' own internal evaluations of WorldCom or in the press.⁵⁰ Regarding 2001, as the Court noted, there were factual issues as to whether the underwriters' investigation was sufficiently searching, given that the underwriters had internally lowered WorldCom's credit rating, had limited their own credit exposure to WorldCom, and thus knew of the financial decline of WorldCom and the industry generally.⁵¹ Comfort letters, while important evidence concerning the reasonableness of the underwriters' investigation, are not sufficient by themselves to establish the due diligence defense.⁵² The Court added that, even if no reasonable investigation would have uncovered a fraud, the underwriter can still prevail on its defense, as long as it conducted a reasonable investigation.⁵³

The Court acknowledged the underwriters' arguments (1) that their continuous learning about the industry, in the context of shelf registration and integrated disclosure (*i.e.*, incorporation by reference into Securities Act registration statements of periodic Exchange Act reports) and Rule 176⁵⁴ (which describes circumstances relevant to determining what constitutes a reasonable investigation), satisfied the reasonable investigation requirement for both offerings, and (2) that shelf registration and integrated disclosure, which drastically accelerate the offering process, would leave underwriters too little time to satisfy the traditional due diligence standard.⁵⁵ But the Court, noting that the underwriters had not moved for summary judgment on these grounds, declined to address them.⁵⁶ Nonetheless, the Court held that, despite changes in the offering process and its timing, the "prudent man" standard and "the ultimate test of reasonable conduct" remain "unchanged."⁵⁷

C. Looking Forward: Future Due Diligence

The *WorldCom* opinion raises many issues.

⁴⁹ *Id.* at 683.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.* at 683-84.

⁵⁴ 17 C.F.R. § 230.176.

⁵⁵ 346 F. Supp. 2d at 682, 684-85; *see also id.* at 666-72.

⁵⁶ *Id.* at 684-85.

⁵⁷ *Id.* at 684-85. The Court also noted that the SEC had "expressly rejected the consideration of competitive timing and pressures when evaluating the reasonableness of an underwriter's investigation." *Id.* at 670 (quoting Regulation of Securities Offerings, SEC Release No. 7606A, 63 Fed. Reg. 67174, 67231 (1998)).

First, what constitutes a red flag? How red must the flag be to trigger a duty to investigate? Offering little concrete guidance, the opinion states that where an ordinary business event ends and a red flag begins is a question of fact,⁵⁸ and that any information causing an underwriter to lose confidence in the accuracy of those parts of the registration statement based on audited financials would be a red flag.⁵⁹ More helpfully, the opinion indicates that, in a due diligence investigation, deeper inquiry – including retention of accountants – may be warranted by discovery of “aggressive or unusual accounting strategies regarding significant issues.”⁶⁰ More alarmingly, the opinion effectively states that, in a competitive industry, any meaningful superiority of one company over another in any financial category could raise a red flag.⁶¹

Second, when, if ever, will summary judgment be available for an underwriter’s due diligence or reliance defense? Circuit precedent indicates that, where the underlying historical facts are not disputed, summary judgment is an appropriate vehicle for resolving such defenses, even though they involve reasonableness determinations.⁶² Even the *WorldCom* opinion suggests that summary judgment is appropriate where “underwriters have demonstrated extensive due diligence efforts” and have “conducted a meaningful investigation.”⁶³ Nonetheless, it appears likely that *WorldCom* will make summary judgment more difficult to obtain and that underwriters will face greater settlement pressure as a result.

Third, will underwriters now have to retain their own accounting experts to investigate the accuracy of financial statements? The *WorldCom* opinion disclaims any such retention requirement, yet acknowledges that underwriters may wish to retain accountants as a matter of prudence.⁶⁴ Insofar as such retention becomes common, underwriters will likely include this added cost in their fees. Underwriters may also, or alternatively, hire and field personnel with accounting backgrounds.

Fourth, will the opinion discourage shelf registration? The beauty of shelf registration is that it allows the issuer quick access to the capital markets. Unfortunately, that speed means less time for underwriters to conduct due diligence. The *WorldCom* opinion heightens the tension between the underwriter, who must still perform the same diligence, and the issuer, who wants to get to market at ever greater speeds. One solution may be continuous diligence by underwriters, so that when the

⁵⁸ *Id.* at 679.

⁵⁹ *Id.* at 673.

⁶⁰ *Id.* at 684.

⁶¹ *Id.* at 678-79.

⁶² *In re Software Toolworks Sec. Litig.*, 50 F.3d 615, 621-22 (9th Cir. 1994). By contrast, the *WorldCom* opinion is not binding precedent in any court. *See Colby v. J.C. Penney Co.*, 811 F.2d 1119, 1124 (7th Cir. 1987) (federal district court decisions not binding precedent). Because opinions concerning the due diligence and reliance defenses are few and far between, the *WorldCom* opinion will probably be cited quite frequently as persuasive authority.

⁶³ 346 F. Supp. 2d at 676, 677.

⁶⁴ *Id.* at 684.

issuer wants to make a speedy offering, much diligence will already have been conducted. Some issuers may recoil at the consequent monitoring and disclosure, but there may be no alternative for underwriters.

Fifth, whither the comfort letter? Now that *WorldCom* impedes the ability of underwriters to shift risk to auditors, and now that the comfort letter hardly provides the comfort once assumed, comfort letters may have little utility in the future. Although the opinion states that comfort letters are an important piece of evidence regarding the reasonableness of an investigation, they are insufficient by themselves to establish a due diligence defense and thus will need supplementation. But if that supplementation is effectively a mini-audit, conducted on a quarterly basis, then the mini-audit may simply supplant, rather than supplement, the comfort letter.

Sixth, how can underwriters document their diligence? It is remarkable, as the opinion noted, that the memorandum describing the diligence for WorldCom's 2000 offering did not even identify who participated in the call with WorldCom. If you are an underwriter, you would want to be front and center in every item of documentation, demonstrating beyond doubt that you participated fully in all phases of diligence.

Seventh, will co-managing underwriters (*i.e.*, non-lead underwriters) now participate in diligence? Until *WorldCom*, non-lead members of the underwriting syndicate did not participate in diligence and simply relied on the diligence performed by the lead.⁶⁵ Going forward, the non-lead who remains at a double remove from the investigation – relying on the lead, who relies on the auditor – has a double risk of losing its diligence defense. If the teaching of *WorldCom* is that leads may not rely blindly on auditors, then a fortiori non-leads may not rely blindly on leads.

Eighth, will diligence sessions become interrogations? *WorldCom* excoriated the underwriters for asking too few and too general questions, for passively accepting conclusory and non-responsive answers, and for failing to ask tough follow-up questions. In the world of diligence, the days of gentlemanly exchanges and honor-code examinations may be over.

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⁶⁵ See, e.g., *id.* at 647, 652.