
BARRACK BULLETIN

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Barrack, Rodos & Bacine

Prosecuting WorldCom: Setting a New Paradigm for Securities Class Actions

Leonard Barrack, Senior Partner, Barrack Rodos & Bacine

I am delighted to introduce this Special Edition of the Barrack Bulletin devoted exclusively to the prosecution of the WorldCom securities litigation. As you probably know, BR&B served as a lead counsel representing the lead plaintiff, our client, the New York State Common Retirement Fund, through its sole Trustee, the Comptroller of the State of New York, and the class. During the prosecution of the case, BR&B worked closely with the New York State Comptroller, first H. Carl McCall, and then Alan G. Hevesi, to achieve an extraordinary result for investors injured by the massive fraud at WorldCom.

On September 21, 2005, ten months after granting final approval to the first – and historic – settlement reached with the Citigroup defendants, District Judge Denise L. Cote granted final approval to the settlements reached with **all** remaining defendants in the case. The total recovery of **more than \$6.13 billion** for WorldCom investors consists of:

- The record-setting **\$2.575 billion** settlement from Citigroup, Inc., Salomon Smith Barney, its star telecommunications analyst, Jack Grubman, and Salomon's international affiliate. This settlement was reached on May 7, 2004, one day before the Second Circuit Court of Appeals was set to hear Citigroup's appeal of Judge Cote's decision certifying the class. Judge Cote granted final approval of this settlement on November 12, 2004.
- Settlements with the remaining underwriter defendants totaling **\$3.427 billion** that were reached in the three weeks leading up to the scheduled start date for the trial of the claims against these entities. The last settlement was reached with the J.P. Morgan defendants for **\$2.0 billion** – \$630 million **more** than had been demanded from J.P. Morgan at the time of the Citigroup settlement.
- A historic settlement totaling **\$60.75 million** with the former directors of WorldCom, also completed just days before the trial was to begin. These directors – who collectively lost approximately \$250 million on their personal holdings of WorldCom stock – agreed to pay **\$24.75 million** from their own pockets. In addition, the director's D&O insurers agreed to pay **\$36 million**, while their motions to rescind the insurance policies covering these directors and have the court declare them null and void were still pending.
- A settlement with Arthur Andersen LLP, WorldCom's outside auditor, for **\$65 million** after five weeks of trial (led by BR&B's trial team of Jeff Golan, Mark Rosen and Jeff Barrack) which Comptroller Hevesi insisted be wired to the settlement fund escrow account before dismissing the jury. Arthur Andersen also agreed to various contingent additional payments and confidential protections for the class if it were to become involved in a bankruptcy proceeding.
- Settlements with former WorldCom CEO Bernard Ebbers and CFO Scott Sullivan, with an estimated value of more than **\$40 million**, entered into just before sentencing in the criminal cases against them. These settlements called for both Ebbers and Sullivan to liquidate nearly all of their assets for the benefit of the class.

This Special Edition of the Barrack Bulletin focuses on the key aspects of the WorldCom case. It is written by the attorneys who were integral to the prosecution of the case:

- **Jeff Golan**, who spearheaded the case for BR&B, and had a lead role in the trial against Andersen, writes about the critical importance of the lead plaintiff's involvement in the case.
- **Mark Rosen**, who developed much of the case against the director defendants, writes about the landmark ruling made by Judge Cote with respect to the responsibilities of a director.

continued on page 2

Prosecuting WorldCom: A New Paradigm

continued from page 1

- **Jeff Barrack**, who developed much of the case against Andersen, writes about some of the evidence gathered against Andersen and the critical rulings relating to the case against Andersen.
- **Gerry Rodos and Pearllette Toussant** write about the ground-breaking rulings involving the underwriter defendants, which will likely establish the standards for underwriter due diligence for years to come.
- **Lisa Lamb and Beth Targan** write about their unique opportunity to interview the jurors after the conclusion of the trial against Andersen.
- **Chad Carder** writes about a key ruling in the case — allowing plaintiffs to introduce as evidence the Restatement issued by WorldCom.
- In addition, many of you read the Andersen trial notes written by **Regina Calcaterra**, which were posted daily at www.barrack.com.

As you will see from these articles, the prosecution of the WorldCom securities litigation established a new paradigm for the prosecution of so-called “mega-fund” securities class actions. This new paradigm encompasses the strategies and tactics BR&B used in the case:

- Even before the New York State Comptroller was appointed as lead plaintiff in August 2003, BR&B and its co-counsel launched an intensive investigation that allowed us to plead new facts concerning, among other things, the nefarious relationships between Citigroup, Salomon and Grubman, on the one hand, and WorldCom, Ebbers and Sullivan, on the other. Although Citigroup moved to sever certain of these “analyst claims” from the rest of the case, we were successful in opposing that motion, and thereby continued to prosecute all claims of the class together.
- Notwithstanding that the case was clearly made more difficult because we could not seek recovery from WorldCom as a result of its bankruptcy, we utilized the bankruptcy proceedings to our advantage. We asked the bankruptcy court to allow immediate discovery from the company, well before such discovery is generally permitted by the Private Securities Litigation Reform Act of 1995. Important rulings from both the bankruptcy court and the district court allowed us to obtain key documents from WorldCom near the outset of the case.
- After defeating the majority of the defendants’ motions to dismiss in May 2003, BR&B pushed for an

aggressive discovery schedule so that we try the case as expeditiously as possible. We obtained a court ruling requiring defendants to substantially complete their document productions by mid-October 2003. We then began an intensive document review protocol to handle the millions of pages produced, allowing us to begin fact-witness depositions by early February 2004.

- Although defendants sought a discovery schedule that would have stretched for years (and awaited the completion of all criminal cases against the indicted former WorldCom executives), we proposed that each side be limited to 60 deposition days (which could be split into half-day segments), and that all depositions be completed by the end of June 2004. This aggressive schedule was adopted by the court, and clearly set the stage first for the Citigroup settlement, and thereafter for setting a trial date in early 2005.
- In our class certification motion, we submitted detailed affidavits from one of our expert consultants, showing that there were discernable market price movements stemming from the defendants’ statements that we alleged were materially false and misleading. Obtaining class certification for all claims against the Citigroup defendants was a key factor that allowed us to negotiate, on a class-wide basis, the extraordinary settlement with those defendants.

“Every litigator knows that not everyone who calls themselves a litigator can actually try a case. After all, there are many ways in the world of litigation to be outstanding in your work, but lead counsel has attorneys who know how to try a case, and that is intended as a high compliment.”

U.S. District Judge Denise Cote

- **From the outset, we prepared this case to go to trial.** We developed evidence that allowed us to defeat the defendants’ motions for summary judgment (and to obtain a ruling granting, in part, *our* motion for partial summary judgment) as well as the majority of their pre-trial motions, including significant motions that sought (a) to have the case tried in three different phases, (b) to preclude the plaintiffs from introducing as evidence WorldCom’s restatement of its financial statements, and (c) to preclude expert testimony on the damages suffered on a class-wide basis.
- At trial, we used important portions of deposition testimony as well as documents produced by defendants and non-parties such as WorldCom and its auditor after Andersen. We questioned two former Andersen engagement partners as on cross-examination

continued on page 3

Prosecuting WorldCom: A New Paradigm

continued from page 2

in the plaintiffs' case-in-chief. When the trial was delayed for one week making a key witness unavailable, we successfully sought the court's permission to take an additional deposition of that witness to play to the jury as the plaintiffs' opening witness.

In all, we presented 14 witnesses and introduced over 600 exhibits in support of our case, and cross-examined all of Andersen's fact witnesses. It was then that Andersen agreed to produce its financial records for inspection and thereafter agreed to settle the claims against it.

"If the Lead Plaintiff had been represented by less tenacious and competent counsel, it is by no means clear that it would have achieved the success it did here on behalf of the Class."

U.S. District Judge Denise Cote

I am grateful to each and every member of the BR&B WorldCom team for the excellent and inspired manner in which they undertook their assignments, and created the paradigm for this successful case prosecution – one of the few to have gone to trial since passage of the PSLRA. Judge Cote's high praise of lead counsel's representation, both at the time of the Citigroup settlement and again at the end of the case, is a testament to the outstanding performance of the BR&B team:

The quality of the representation given by Lead Counsel is unsurpassed in this Court's experience with plaintiffs' counsel in securities litigation. Lead Counsel has been energetic and creative. Its skill has matched that of able and well-funded defense counsel.... Its negotiations with the Citigroup Defendants have resulted in a settlement of historic proportions. In sum, the quality of representation that Lead Counsel has provided to the class has been superb.

* * *

I have praised the performance of lead counsel in the past, and I do so again now. Lead counsel kept its eye on the big picture throughout the case but was also a master of the details that underpin any successful litigation. It understood the importance of preparation, as its performance at trial amply demonstrated. **Every litigator knows that not everyone who calls themselves a litigator can actually try a case. After all, there are many ways in the world of litigation to be outstanding in your work, but lead counsel has attorneys who know how to try a case, and that is intended as a high**

compliment. ... Thus, lead plaintiff chose exceptionally wisely in this case. It chose counsel who could not only create an overarching strategy for the litigation, manage extraordinary burdens during the discovery period, participate in a constant stream of motion practice and forcefully negotiate settlements, but who could also take the case to trial and make that ability to try the case a realistic threat that defendants had to factor in their settlement negotiations.

* * *

At trial against Andersen, the quality of Lead Counsel's representation remained first-rate. ... The size of the recovery achieved for the class – which has been praised even by several objectors – could not have been achieved without the unwavering commitment of Lead Counsel to this litigation.... **If the Lead Plaintiff had been represented by less tenacious and competent counsel, it is by no means clear that it would have achieved the success it did here on behalf of the Class.**

I hope that you enjoy this Special Edition of the Barrack Bulletin. ❖

INSIDE THIS ISSUE

Prosecuting WorldCom: Setting a New Paradigm for Securities Class Actions.....	1
The Client's Role in Prosecuting WorldCom: New York State Comptrollers Lead the Charge.....	4
A Note on Auditor Responsibility from the WorldCom Securities Litigation.....	7
The Significance of Achieving Certification of the WorldCom Class.....	8
Ruling on Admissibility of WorldCom Restatement Could Have Broad Implications.....	11
The WorldCom Jurors: What Did They Think?.....	11
New Standards of Director Liability Developed in WorldCom.....	14
Making Law Concerning an Underwriter's Obligations and Achieving Record Settlements with the Underwriter Defendants.....	15
Claims Filing Deadlines.....	6

The Client's Role in Prosecuting WorldCom: New York State Comptrollers Lead the Charge

Jeffrey W. Golan

Partner, Barrack, Rodos & Bacine

After the close of business on June 25, 2002, WorldCom ignited a firestorm by announcing that it had overstated its reported earnings by at least **\$3.8 billion**. Coming hard on the heels of the Enron debacle, the outcry over WorldCom's announcement from Congress, investor groups, and even the business community was immediate and overwhelming.

The New York State Comptroller H. Carl McCall did not hesitate. He and his staff knew that the New York State Common Retirement Fund, for which the Comptroller serves as the sole Trustee, had suffered a \$300 million loss as a result of its investments in WorldCom. If NYSCRF had lost that much, WorldCom investors as a whole must have suffered losses at least in the tens of billions of dollars. The Comptroller – whose experience included leading the prosecution of the record-setting *Cendant* class litigation – decided to take action. He called BR&B the morning of June 26th, and asked if we would lead the prosecution of the WorldCom cases.

We said yes.

From that point forward, we worked in a close collaboration with the Comptroller and his staff to obtain the largest possible recovery for the hundreds of thousands of WorldCom investors – including virtually every institutional investor in America and many others worldwide – who had been injured by the massive fraud that was WorldCom. The result of that effort has been staggering. Notwithstanding that WorldCom filed for bankruptcy protection and could not be sued, and that WorldCom's outside auditor, Arthur Andersen, had by that time essentially closed its offices, *over \$6.133 billion has been recovered for the benefit of the class*. Members of the class who purchased WorldCom bonds will likely recover *more than half of their damages*. The amount to be distributed to WorldCom stock purchasers alone totals *more than \$1.2 billion* – an amount that would be, by itself, one of the five largest securities class action recoveries in history. The extraordinary result in WorldCom underscores how important the leadership of a sophisticated institutional investor like the NYSCRF is to securities fraud class actions – as Congress envisioned when it passed the Private Securities Litigation Reform Act of 1995 (the "PSLRA").

The Productive Collaboration is Formed Right from the Start

From the beginning, the Comptroller's staff was involved in every phase of the case prosecution. Comptroller McCall's general counsel, Kris Burns, quickly provided the information we needed to file lead plaintiff motions by July 1, 2002 – just days after we spoke with Comptroller McCall and took on the case. The NYSCRF staff continued to provide us with necessary information as we prepared for the approaching lead plaintiff hearing. On August 15, 2002, the court appointed the NYSCRF as the lead plaintiff, and BR&B as a lead counsel.

But that was only the beginning. The Comptroller and his staff wisely approved the inclusion of other named plaintiffs in the Consolidated Complaint filed on behalf of the class. That decision was repeatedly cited with approval by Judge Cote throughout the case. The Comptroller's counsel reviewed and provided very helpful comments on the Consolidated Complaint, authorizing the inclusion of important claims against the Citigroup defendants when others were saying that such claims, relating to the research reports issued by Salomon Smith Barney and its star telecommunications analyst, Jack Grubman, should have been pled in a separate lawsuit. They reviewed and authorized us to file motions first in the bankruptcy court and then in the district court to seek discovery of documents that WorldCom had produced to various governmental agencies, discovery that we obtained well before the time that discovery would be allowed in most cases brought under the PSLRA.

The Collaboration Continues with Comptroller Hevesi

The change in the personnel in the Comptroller's Office brought about by the election of Alan G. Hevesi as the New York State Comptroller in November 2002, and Comptroller Hevesi's appointment of Alan Lebowitz as general counsel, did not alter the close collaboration. In fact, the collaboration intensified. Shortly after he took office, we briefed Comptroller Hevesi personally about the case, its history, and the unique opportunities that it presented. We continued to provide drafts of briefs and other court submissions to the Comptroller and his staff, and we reviewed with them the presentations we planned to make to the court in oral argument on the dismissal motions. Comptroller Hevesi appeared with us, at counsel table, for the May 16, 2003 argument on the motions to dismiss, which the court denied from the bench.

"The New York State Common Retirement Fund has been an exceptional lead plaintiff."

U.S. District Judge Denise Cote

The denial of the dismissal motions led to a flurry of activity, which proceeded even before we had a formal retention agreement with the Comptroller. Len Barrack, Gerry Rodos and I spoke and corresponded with Alan Lebowitz and his deputy general counsel, Maurie Peaslee, about every facet of the case prosecution, and the strategic decisions that would have to be made in the case. We shared with them, in advance, drafts of the papers we would file in support of our motion for class certification as well as the discovery requests we planned to send to defendants on an expedited basis. Lawyers from BR&B, most particularly Jeff Barrack and Pearlette Toussant, spoke on a daily basis with members of Mr. Lebowitz's extraordinary staff, including Diane Foody, Deborah Richards and Maureen Madden. Our lawyers went to Albany several times to ensure that the NYSCRF produced, as efficiently as possible, its

continued on page 5

The Client's Role

continued from page 4

documents relevant to the claims asserted in this case. We met with, and then represented, Mr. Peaslee and others from the NYSCRF at depositions that were taken for class purposes. And we provided the Comptroller and his staff with our preliminary analyses about the damages in the case, in advance of settlement talks that were ordered by the court in November 2002 (which went nowhere) and thereafter further ordered in September 2003.

The Retainer Agreement

As defendants proceeded with class discovery, and as we were pursuing formal discovery from defendants and numerous non-parties, we entered into a retainer agreement with the NYSCRF that formalized the already close collaboration. Key features of the retainer agreement included the following:

- **Retention of Consultants, Experts, and the Notice and Claims Administrator:** The retainer agreement required that the Comptroller's staff approve the retention of experts, consultants and the settlement administrator. We typically presented the staff with a number of qualified persons who might serve as experts and consultants, and the rates they would charge for their services. The Comptroller's counsel, primarily Alan Lebowitz and Maurie Peaslee, questioned us about the potential candidates. The result was the selection, at favorable rates to the class, of an eminently qualified set of experts and consultants, such as Harris L. Devor, our auditing and accounting expert, whom the jury praised for his effective teaching of the complex auditing and accounting principles that we demonstrated in the trial against Arthur Andersen. We employed a similar procedure when filling the administrator position. Through a bid proposal process, we selected, with important input from the Comptroller's staff, The Garden City Group, at a very good rate for the class.
- **Securing Assistance from Other Firms:** We also discussed with Messrs. Lebowitz and Peaslee the fact that defendants and others would be producing millions of pages of documents that we would have to review and analyze in a very short period of time. The Comptroller's staff actively participated in selecting the law firms approved to assist us. Indeed, in September 2003, Mr. Lebowitz joined us for an *in camera* session with Judge Cote where we sought and obtained the court's approval for a few firms (based primarily in New York and Philadelphia to reduce travel costs) to assist in the document review work.
- **Review and Approval of Court Filings:** The retainer agreement called for us to provide the Comptroller with drafts of all significant briefs and pleadings before we filed such documents with the court. We were able to

keep the client fully informed about all significant pleadings (including key motions and other filings made by defendants to which we responded on behalf of the plaintiffs throughout the case), and the client provided us with very useful feedback on our submissions.

The class has truly been well served by the invaluable participation of the New York State Common Retirement Fund as the lead plaintiff, represented in exemplary fashion by Comptrollers Carl McCall and Alan Hevesi.

- **Time and Expense Reports:** Pursuant to the retainer agreement, BR&B provided the client with quarterly status reports, including summaries of the time and expenses incurred for the case. This review process was described in detail in the affidavits that we and the client submitted in connection with the settlements in the case, and was cited with approval by the court.
- **Discussion of Key Strategic Decisions and Settlement Strategies:** Perhaps the most significant involvement of the Comptrollers and their staff came in discussions concerning key strategic decisions – most particularly, the negotiations that led to the record-breaking settlements in this case. There were many trips that we made to the Comptroller's offices, in New York City and in Albany, to discuss settlement strategy, including the decision to carry on separate negotiations first with counsel for the Citigroup defendants, and only later with other defendants in the case. We agreed in the retainer agreement to “vigorously represent the interests of the Class, to maximize the recovery for all WorldCom securities purchasers in this case [and] to maximize the recovery obtained from all named defendants and from any insurance proceeds.” As contemplated by the agreement, we met in person, by phone and through memos about the strategies that we would follow in seeking a settlement first with the Citigroup defendants; then with the director defendants; then with other underwriter defendants; next with Arthur Andersen; and finally with Ebbers, Sullivan and the other executive defendants. We provided the Comptroller with “talking points” for each of the potential settlements, and further worked with his media personnel on the press releases and other statements that the Comptroller might issue, as necessary and appropriate in a case of this magnitude and interest.

The Collaborative Efforts of Lead Plaintiff and Lead Counsel Result in Extraordinary Recoveries for the Class

The first recovery in the case was the settlement of the claims against the Citigroup defendants, reached only after protracted negotiations over the course of nearly eight months

continued on page 6

The Client's Role

continued from page 5

with counsel for the Citigroup defendants and very close collaboration with the Comptroller's Office. We shared with the Comptroller our damage estimates; our evaluation of the strengths and weaknesses of the case against the Citigroup defendants; and the positions that we sought to take in our discussions with the Citigroup defendants. The Comptroller and his staff provided us with valuable feedback, and authorized us to take actions that always safeguarded the interests of the class. The settlement was achieved only after a face-to-face meeting between Comptroller Hevesi and Citigroup's chief executive, Charles Prince. As Judge Cote wrote in her opinion approving the Citigroup settlement, the "[f]ace-to-face negotiations before Judge Sweet by Alan C. Hevesi, Comptroller of the State of New York, and Charles Prince, CEO of Citigroup, in the latter stages of the settlement process greatly facilitated the settlement." *In re WorldCom*, 2004 WL 2591402 at *5-6.

The Comptroller and his staff continued to be involved in each of the subsequent settlements. Comptroller Hevesi set the ground rules for the settlement with the director defendants. He insisted, given the egregious nature of the fraud at WorldCom, that each director make *a material payment from his or her personal assets, based on a detailed statement of his or her financial condition*. It was also the Comptroller who insisted — with our full support — that later-settling underwriter defendants not be allowed to settle the claims against them on terms that were more favorable than the settlement paid by the Citigroup defendants. Indeed, after the monolith of the underwriter syndicate was broken by the settlements with the Bank of America defendants and a group of four junior underwriters of the May 2000 bond offering, with just two exceptions, we required *each subsequently settling underwriter defendant to pay a "premium" to settle the claims against it*, to the great benefit of the class.

The collaboration continued through preparation for the trial against Andersen as well. The Comptroller attended various parts of the trial; Diane Foody attended the trial on a daily basis; and we spoke on a regular basis with Alan Lebowitz and Maurie Peaslee in person and via telephone as the trial proceeded. When Judge Cote suggested having further settlement discussions after the first few weeks of trial, the Comptroller was emphatic that we would enter into such discussions with Andersen *only if* Andersen provided documentation of its financial condition, and allowed the Comptroller's auditing staff to conduct "due diligence" on its financial condition. The Comptroller set the same conditions for the settlements that we eventually negotiated with former CEO Ebbers and former CFO Sullivan after the Andersen settlement.

Fittingly, Judge Cote recognized publicly the critical role played by Comptroller Hevesi and his staff at the fairness hearing for all of the 2005 settlements on September 9, 2005. As the Judge stated:

The New York State Common Retirement Fund has been an exceptional lead plaintiff. It has taken its responsibilities to represent the class as seriously as one must. At least this part of the PSLRA has worked well. The lead plaintiff has been an active participant in every stage of this case. Comptroller Hevesi has frequently attended conferences in person. Mr. Lebowitz, his counsel, and members of his staff have been in court on many occasions. And, of course, they have scrutinized all of the expenditures in this case, combing through invoices and time sheets, and have played an active role in all strategic decisions and the settlement discussions.

BR&B wholeheartedly endorses the Judge's observations, and credits the close collaboration between the Comptrollers, their staffs and lead counsel for the extraordinary outcome of the WorldCom case with settlements totaling more than \$6.133 billion in a case in which the key participant in the fraud, WorldCom, could not be prosecuted. The class has truly been well served by the invaluable participation of the New York State Common Retirement Fund as the lead plaintiff, represented in exemplary fashion by Comptrollers Carl McCall and Alan Hevesi. ❖



*BR&B's Trial Attorneys
Jeffrey A. Barrack, Jeffrey W. Golan, Mark R. Rosen*

Claims Filing Deadlines

*Barrack Rodos & Bacine now provides up to date
claims filing information online.*

*Visit the Investor Resources Center at
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for detailed claims filing deadline information.

A Note on Auditor Responsibility from the WorldCom Securities Litigation

Jeffrey A. Barrack
Partner, Barrack, Rodos & Bacine

Introduction

On Tuesday, April 26, 2005, just days before closing arguments were scheduled, the parties in the WorldCom civil securities fraud trial announced that Arthur Andersen LLP — the hold-out defendant in the case — and New York State Comptroller Alan G. Hevesi had agreed to settle the case. The trial of the claims against Andersen was the only civil trial to arise from the collapse of WorldCom. At the preliminary approval hearing during the morning of April 26, Judge Denise L. Cote congratulated the parties on reaching the settlement and commended the parties for having presented a “fascinating trial.”

The WorldCom trial demonstrated that solid evidence of wrongdoing can enliven a trial expected to focus on dry accounting standards and principles.

Judge Cote’s comment drove home the fact that a good securities fraud case against an independent public accounting firm must be based on solid accounting concepts. These concepts, embodied in generally accepted auditing standards, or GAAS, and generally accepted accounting principles, or GAAP, can be rather dry for non-accountants. But a trial of these claims does not have to be uninteresting. In addition to presenting the jury with relevant accounting and auditing standards, the evidence against Andersen in this case took the form of emails from engagement partners about substantive audit risks; letters from audit partners to company accounting personnel pledging loyalty and commitment to the company; audit working papers that had been altered or covered with white-out tape; and secret struggles between the auditors and the company personnel over access to relevant audit evidence. The WorldCom trial demonstrated that solid evidence of wrongdoing can enliven a trial expected to focus on dry accounting standards and principles.

The case against Andersen was actually fairly straightforward. Lead plaintiff asserted that Andersen, which had been WorldCom’s outside auditor since the 1980’s, had failed to conduct adequate audits of WorldCom’s financial statements for the years 1999, 2000 and 2001, and that those financial statements were materially false and misleading. Lead plaintiff further asserted that the false financial statements artificially inflated the prices of WorldCom securities, causing damages to persons who purchased those securities during the class period, and that the 1999 and 2000 financial statements were also incorporated into the registration statements for WorldCom’s massive bond offering in May 2000 (\$5 billion) and May 2001 (\$11.8 billion). The trial was about whether Andersen was liable under the federal securities laws in connection with its issuance of the 1999, 2000 and 2001 audit opinions.

Standards for Auditor Liability

The Auditing Standards. Public companies must prepare their financial statements in accordance with GAAP. It is the auditor’s task to reasonably ensure that the financial statements comply with sound accounting practice. The accountant must perform this task regardless of pressure from managers who may seek to present the company’s financial results as favorably as possible.

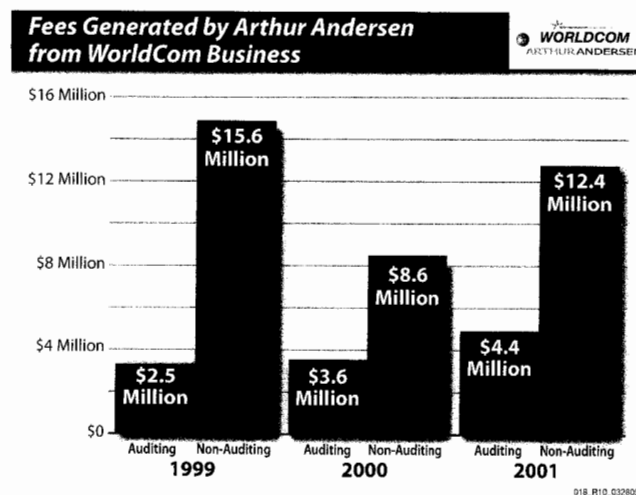
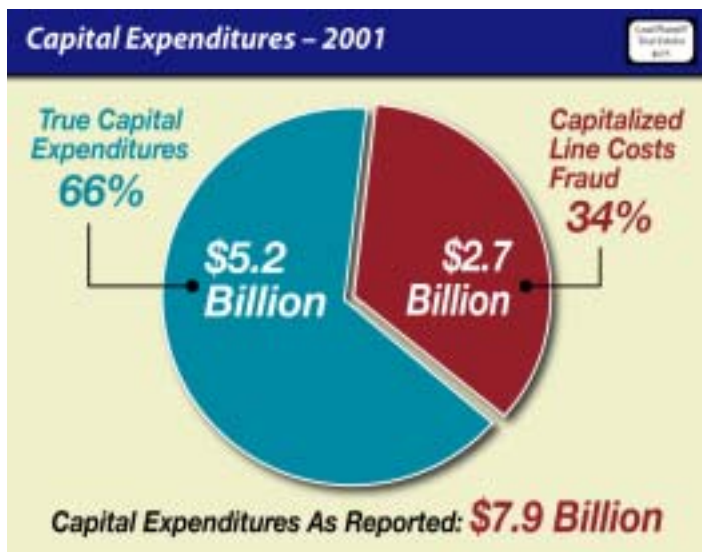
GAAS addresses the work that an auditor must do concerning the reliable presentation of a company’s financial position as a whole. An auditor expresses an opinion on the presentation of a company’s financial statements, results of operations, and cash flows of the company in conformity with GAAP. When an auditor represents that a company’s financial statements comply with GAAP, the auditor indicates his belief that the financial statements taken as a whole are not materially misstated. The auditor exercising due professional care must also employ “professional skepticism,” through which the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence. As Judge Cote put it: “GAAS compliance is imperative.”

Standards under the Securities Act of 1933. The Securities Act of 1933 governs the registration and public offering of equity and debt securities. Section 11 of the Act imposes a stringent standard of liability on parties who play a direct role in a registered offering. Section 11 provides that any signer, director of the issuer, preparing or certifying accountant, or underwriter, may be liable if any part of the registration statement is materially false. An accountant may be held liable only for those materially false statements which the accountant prepared or certified. Section 11 provides defendants other than the issuer of the security with an affirmative “due diligence” defense. An accountant’s “good faith compliance” with GAAS and GAAP generally discharges the accountant’s professional obligation to act with reasonable care and establishes the due diligence defense.

Standards under the Securities Exchange Act of 1934. Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 established by the SEC, govern the trading of securities in the public market and are the primary antifraud provisions of the federal securities laws. To state a cause of action under these antifraud provisions, a plaintiff must allege that the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with “scienter,” and that plaintiff’s reliance on defendant’s action caused injury. Any person, including an accountant, who makes a material misstatement (or omission) on which a purchaser or seller of securities relies, may be liable as a primary violator under Rule 10b-5. The requisite state of mind, or “scienter,” requires the plaintiff to prove facts that would support a finding that the defendant acted either intentionally or recklessly in making the false statement.

continued on page 10

The WorldCom Trial: A Picture is Worth a Thousand Words



The Significance of Achieving Certification of the WorldCom Class

One of the many significant accomplishments in the prosecution of the WorldCom securities litigation related to **class certification**. Courts frequently certify cases to proceed as class actions where plaintiffs allege that defendant companies and their management made false statements of fact to the investing public during the class period. In so doing, the courts apply the “fraud on the market” presumption to establish the reliance of class members on the fraudulent statements. “Fraud-on-the-market” presumes that each investor relied upon *all material information* disseminated to the market in deciding to purchase a security at a given price, even if a particular investor could not prove that he or she relied upon, or even was aware of, a particular statement.

Before WorldCom, however, few courts had considered whether to apply the “fraud-on-the-market” presumption to certify a class for claims of investors against a research analyst and the analyst’s employer (for instance, a stock brokerage firm) based upon statements made in research reports by the analyst about a company that issued the stock. In WorldCom, lead counsel argued that there is no reason that the “fraud-on-the-market” presumption would not apply to statements made by a market analyst, and we further submitted detailed analyses, including an expert’s reports, to demonstrate that the

reports issued by Jack Grubman, Salomon Smith Barney’s star telecommunications analyst who wrote very positive reports about WorldCom, had a significant impact on the prices of WorldCom stock. The district court agreed that the “fraud-on-the-market” presumption should also apply to claims against an analyst who publicly issued false statements touting a company’s securities when those statements may be found to have had a material impact on the company’s stock prices. The court certified a class of investor claims against Salomon, Grubman and Salomon’s parent company, Citigroup, on October 24, 2003. *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267 (S.D.N.Y. 2003).

A word of caution: Judge Cote’s ruling may not be the final word on this issue. After the district court certified the class, the United States Court of Appeals for the Second Circuit agreed to hear an appeal of this issue. *See, Hevesi v. Citigroup Inc.*, 366 F.3d 70 (2d Cir. 2004). BR&B convinced the SEC to file an *amicus curiae* brief in support of our position on appeal. However, the Court of Appeals never resolved the issue because of the settlement reached between lead plaintiff and the Citigroup defendants – for \$2.575 billion – just before the appeal was set to be argued. Since that time, other federal judges have been divided on the question of certifying class action claims against analysts. *Compare DeMarco v. Robertson Stephens Inc.*, 2005 WL 120233 (S.D.N.Y. Jan. 20, 2005) (certifying class), and *DeMarco v. Lehman Bros., Inc.*, 222 F.R.D.243 (S.D.N.Y.2004) (declining to certify class). ❖

Barrack, Rodos & Bacine's WorldCom Team



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Seated (from left): Partner *Jeffrey A. Barrack*; associate *Beth R. Targan*; partner *Jeffrey W. Golan*; senior partner *Leonard Barrack*; partner *Mark R. Rosen*; associate *Pearlette V. Toussant*; and partner *Gerald J. Rodos*.

Standing (from left): Paralegal *Joseph J. Morrison*; associate *Lisa M. Lamb*; paralegal *Christopher A. Foulds*; associate *Chad A. Carder*; partner *William J. Ban*; paralegal/IT coordinator *Kenneth B. Lerner*; associate *Regina M. Calcaterra*; and paralegal *Nina A. McGarvey*.

Auditor Responsibility

continued from page 7

While there is a wealth of case law regarding the pleading of scienter, there are fewer cases describing the type of evidence needed to prove it at trial. The court in WorldCom noted that the “core requirement” in seeking to prove an auditor’s scienter is that the defendant lacked a genuine belief that the information disclosed in the financial statements was accurate and complete in all material respects. As Judge Cote wrote in her opinion denying Andersen’s motion for summary judgment:

A showing of shoddy accounting practices amounting at best to a pretended audit, or of grounds supporting a representation so flimsy as to lead to the conclusion that there was no genuine belief in back of it, have traditionally supported a finding of liability in the face of repeated assertions of good faith. In such cases, the fact finder may justifiably conclude that despite those assertions the danger of misleading was so obvious that the actor must have been aware of it.

The court further held that such proof can be presented through circumstantial evidence.

Auditors Defend Against Securities Claims Using Evidence of Concealment

Auditor defendants in federal securities litigation often present evidence to establish that management actively concealed improper accounting practices from the audit team. Because an independent accountant depends upon its client to provide the information base for the audit, it is almost always more difficult to establish scienter on the part of the accountant than on the part of the company or its chief financial executives. Where an accounting fraud is concealed, the finder of fact may well determine that an auditor is not liable, absent proof that the auditor knew of either a severe scope limitation on the audit or other “red flags” that should have placed the auditor on notice that more investigation of the financial statements was required.

“They actually didn’t do a bad job in identifying these risks, but in the execution of their job, they didn’t do what they said they were going to do.... The audit work in this area was pretty shoddy.”

Harris L. Devor, Accounting Expert

In the *WorldCom* case, there was no dispute that WorldCom’s management actively concealed the fraudulent accounting scheme from Andersen. Andersen emphasized evidence of the concealment at trial in an attempt to persuade the jury that WorldCom’s management actively concealed their fraud from fellow employees, from the underwriters of WorldCom’s

bond offerings, and from Andersen’s auditors. While it is not possible to know precisely what impact WorldCom’s concealment would have had on the jury, Judge Cote’s opinion denying Andersen’s summary judgment motion clearly made it an issue that the jury would have to decide. In that opinion, the court held that lead plaintiff had shown that “there are issues of fact as to whether the Andersen audit of WorldCom was so deeply flawed that Andersen acted with reckless disregard of whether WorldCom was engaged in fraudulent accounting practices and materially misstating its financial position in its annual financial statements.” The court found that the many “red flags” in WorldCom’s workpapers could be proof of recklessness or even intentional fraud on the part of Andersen. “The Lead Plaintiff’s identification of red flags allegedly ignored by Andersen helps to highlight one of many reasons why Andersen’s audit may be found not to have conformed with GAAS.” Explaining her ruling further, the court stated:

[Lead plaintiff alleges that] Andersen acted in willful blindness to the realities at WorldCom and in abrogation of its duty as an auditor. [Lead Plaintiff] has identified a host of audit failures, which would permit a jury to find that there was an egregious refusal to see the obvious, repeated failures to investigate the doubtful, and a pattern of acquiescence in improper accounting practices. There is no dispute that Andersen understood that its unqualified certification of the WorldCom financials would carry great weight with investors. This is sufficient to constitute proof of recklessness.

Harris L. Devor, lead plaintiff’s accounting and auditing expert testified at trial that internal Andersen documents showed a number of identified risks associated with WorldCom’s accounting. “They actually didn’t do a bad job in identifying these risks, but in the execution of their job, they didn’t do what they said they were going to do,” Mr. Devor told jurors. “The audit work in this area was pretty shoddy.”

Conclusion

In a press release announcing the settlement with Andersen, Comptroller Hevesi said that “there was a huge amount of damage that was done to the American economy. We are hopeful there are lessons to be learned from this litigation.” The trial against Andersen may go far in convincing auditors generally that they must make serious inquiries into management’s representations when conducting their audits, and especially follow through on the types of “red flags” that were so prevalent in the WorldCom case. ❖

Ruling on Admissibility of WorldCom Restatement Could Have Broad Implications

Chad A. Carder
Barrack, Rodos & Bacine

One of the most significant rulings in the WorldCom class action was a ruling on a motion filed by Arthur Andersen LLP, WorldCom's former auditor, to prevent the introduction of WorldCom's massive financial statement Restatement as evidence of the falsity of the financial statements issued by WorldCom (and audited by Andersen) during the period from 1999 to 2002. The Restatement was contained in the Form 10-K filed by the company with the SEC in connection with the reporting of its year-end 2002 financial statements, and was the culmination of more than eighteen months of investigation by the company, numerous outside consultants, and WorldCom's new auditor. The Restatement revealed that WorldCom had overstated its financial statements for the years 2000 and 2001 by \$70 billion, including, most notably, nearly \$9 billion of overstatements of earnings due to manipulations involving WorldCom line cost expenses, and \$55 billion of assets that WorldCom determined should have been written down at the end of years 2000 (\$47 billion) and 2001 (\$8 billion). In addition to serving as substantive evidence, the Restatement and its underlying work documents were also a key source of information for Harris L. Devor, lead plaintiff's auditing and accounting expert, who submitted various expert reports and testified for nearly three days during the Andersen trial.

Judge Cote's decision allowing WorldCom's Restatement into evidence is significant for many reasons, including its potential value as precedent in future securities cases.

Andersen argued that the Restatement was inadmissible because it constituted hearsay, which is an out-of-court statement offered to prove the truth of the statement itself. While a restatement of prior financial statements by a company may be admissible into evidence as a statement of a party (one of several recognized exceptions to the hearsay rule), that hearsay exception did not apply here because WorldCom – the party making the statement – was not a defendant in this litigation because of its bankruptcy. Thus, one of the other hearsay exceptions would have had to apply in order for the Restatement to be admissible.

Lead plaintiff argued, among other things, that the Restatement was admissible under the so-called "Business Records Exception" to the hearsay rule, which allows the admission of certain memoranda, reports, or records if they are contemporaneous, kept in the course of a regularly conducted business activity, and are trustworthy. After rejecting Andersen's contention that the Restatement was not relevant, Judge Cote agreed with plaintiff that the Restatement was indeed

continued on page 13

The WorldCom Jurors: What Did They Think?

Beth R. Targan and Lisa M. Lamb
Barrack, Rodos & Bacine

The science of picking a jury has become somewhat of a phenomenon: there are talk shows about it; there is an entire industry of jury consultants; and attorneys in high-stakes litigation undertake extensive preparations for the selection of a jury that will best serve the interests of their clients. Attorneys choose jurors based on their responses to questions, often posed to them through a written questionnaire that is distributed to the entire pool of potential jurors in advance of the first day of trial, and orally by the court (and sometimes the lawyers) about each potential juror's background, experiences, opinions, and overall ability to serve as a fair and impartial juror. Indeed, in selecting a jury, the various sides in a lawsuit make decisions about which potential jurors, among those initially placed "in the box" on a rolling basis, they wish to *exclude* from the jury.

Selection of the WorldCom Jury

In WorldCom, Arthur Andersen, WorldCom's former auditor, was the only defendant at trial because the other non-executive defendants had settled the claims against them in the weeks and days leading up to the trial. The lawyers for both sides were presented with a pool of more than 250 potential jurors, and charged with selecting 10 people to listen to and evaluate evidence over an estimated six- to eight-week period in what many have called the largest securities fraud case in history. The judge had decided on a jury of 10 to ensure that at least 6 would be able to participate by the time of jury deliberations.

The 262 people within the jury pool resided within the Southern District of New York, which includes Manhattan and the Bronx, and Westchester, Rockland, Putnam, Orange, Dutchess and Sullivan counties. Each potential juror completed a preliminary questionnaire, jointly prepared by counsel for each side and approved by the court, containing questions about the background and experiences of the potential jurors, any associations they may have had with the parties or potential witnesses, and other constraints that might impair their ability to serve on the jury, given the trial's expected length.

After a 24 hour review period for the responses, counsel submitted a mutually agreed upon list of potential jurors to be excused from the pool. Based on this list, 72 of the 262 potential jurors were excused from the jury pool. On Monday, March 28, 2005, the court provided the remaining potential jurors with preliminary instructions, and began questioning the prospective jurors about their qualifications to serve, in order to determine whether each individual could fairly and objectively weigh the evidence. The court dismissed many potential jurors during the questioning (including those who did not appear unbiased for various reasons, and many for whom a six- to eight-week trial would have been a significant hardship). In addition, counsel for

continued on page 12

The Jurors

continued from page 11

both sides were given the opportunity to challenge a candidate based upon his or her suitability to serve. At the end of the process, when there were 16 potential jurors “in the box,” each side had the opportunity to exercise three “peremptory” challenges through which they were able to strike a potential juror without providing a reason.

It was during this peremptory challenge process that an uncommon but very serious issue arose. Andersen used all three of its peremptory challenges to dismiss African-American women. Peremptory challenges, however, may not be used to keep members of a particular race or sex off of a jury. Lead plaintiff objected to Andersen’s use of peremptory challenges in this manner, raising the ruling in *Batson v. Kentucky*, 476 U.S. 79 (1986), in which the Supreme Court held that the racially discriminatory exercise of peremptory challenges violated the equal protection rights of both a defendant *and* the challenged juror. Although Andersen claimed that it had struck these jurors because they did not have an adequate educational background, Judge Cote found that at least one of the three women was significantly more educated than some of the other jurors whom Andersen had not sought to strike. Indeed, this potential juror had worked with accounting records at her place of employment. The court found intentional and purposeful use of a race-based challenge, and *reinstated* the improperly dismissed juror, bringing the number of WorldCom jurors to eleven. We welcomed the reinstatement and proceeded to trial the next morning.

The positive reactions of the jurors to the evidence involving complex accounting principles and auditing procedures demonstrated the importance of preparation and presenting highly credible fact and expert witnesses in cases of this type.

The jury, consisting of five men and six women, reflected a broad cross-section of New Yorkers, including a healthcare social worker, a restaurant owner, a retired NYC sanitation worker, a retired NYC substitute teacher, an electrician/mechanical worker, a geologist, and an IT manager for a New York law firm. Three of the members of the jury were African-American (all female), four were Hispanic (two females and two males), and four were Caucasian (one female and three males). From our perspective, we were delighted to see this broad diversity. Throughout the trial, it became clear that these jurors took their responsibilities seriously and knew the significance of the decisions they would be asked to reach.

The Jurors’ Reactions

After the first two weeks of trial, the court suggested that, having seen the type of evidence and arguments that had been raised to that point, the parties should make a final attempt to resolve the case by settlement. Andersen agreed to the condi-

tion set by lead plaintiff — that Andersen provide its confidential financial books and records to lead plaintiff and its counsel during the negotiation process. Within days of the anticipated end of the trial, the parties agreed to settle the claims against Andersen. Even though the jurors had listened attentively to the evidence and counsel’s arguments for nearly five weeks, they never had the opportunity to reach a verdict.

After the announcement and preliminary approval of the Andersen settlement, the court allowed counsel to speak with the individual jurors about their impressions of the case. This extremely rare and exciting opportunity provided the parties and their attorneys with insights into the presentation of the case, as well as invaluable knowledge for future litigation. Eight of the nine jurors who remained in the jury by the end of the fifth week agreed to be interviewed. Indeed, they were eager to share with us, and each other, their views of the evidence, the witnesses, and the lawyers. It was during the group interview – which lasted for nearly two hours – that it became clear just how much the jurors had listened, learned, and fulfilled their duty as evaluators of the evidence:

- The jurors first suggested that there should have been more parties who were liable for this fraud. We informed them, at that point, that recoveries had been achieved from the other defendants in the case, and they appeared relieved to learn that other culpable parties had agreed to compensate the injured investors.
- All of the jurors believed that WorldCom’s financial statements for the years ended 1999, 2000 and 2001 were false. Some jurors even expressed the belief that the 1998 financials seemed a “little off.”
- Seven of the eight jurors had decided, in their own minds, that Andersen had been negligent in its audits, and the eighth believed that while Andersen could have done more, she had not concluded at that point whether Andersen had been negligent. Each of the jurors felt that while Andersen’s personnel did not necessarily know there was a fraud (which we conceded at trial), Andersen had turned a blind eye to obvious “red flags” and that these warning signs should have caused Andersen to undertake a more expansive audit and dig deeper to inspect WorldCom’s books and records. However, the “jury was out” on whether Andersen’s misconduct had risen to a level of an intent to deceive.
- Overall, the jurors thought that the evidence showed there was a conflict of interest between WorldCom and Andersen, and Andersen should have been more persistent when searching for information that WorldCom management failed to provide.
- During the trial, we introduced evidence about an auditor’s role in conducting a proper audit, and it was hotly disputed as to whether Andersen had full and unfettered access to WorldCom’s general ledger. The

continued on page 13

The Jurors

continued from page 12

jury clearly credited the evidence we introduced as part of the plaintiffs' case that Andersen did *not* have full access to the general ledger and should have requested such access in order to complete a proper audit.

- The jurors believed that the weakening condition of the telecom industry in 2000 and 2001 should have alerted Andersen that a more comprehensive analysis of WorldCom's reported earnings and the value of its assets was necessary to comply with generally accepted auditing standards. In contrast, the jurors also cited the correspondence between WorldCom and the SEC at the time of WorldCom's acquisition of MCI in 1998 (which Andersen stressed at trial) as potentially persuasive evidence that Andersen had no reason, at that time, to question WorldCom's accounting treatment of certain items.

We also had the opportunity to question the jurors about their reactions to witnesses and the lawyers who presented the case. **Harris L. Devor**, our accounting and auditing expert, was the jury's favorite witness. They thought that Mr. Devor explained everything clearly, "like a teacher" and was "not condescending." The jurors thought that he was the best witness for the "lay person." The jury also found Mr. Devor to be believable and reliable, and stated that he had "nothing to hide." It was clear from discussions with the jurors that, from their perspective, Mr. Devor was a key witness in the case.

BR&B's lead trial lawyer, **Jeff Golan**, examined Mr. Devor, among other witnesses, and also cross-examined one of Andersen's audit engagement partners. The jurors thought highly of Jeff's style of presentation, and uniformly described him as believable, credible, precise, and straightforward. They noted that he "never gave up" on examinations despite the sometimes vague and non-responsive answers given by the Andersen witness who Jeff questioned on cross-examination. The jurors further agreed that Jeff's cross-examinations were "right on point" and "extremely effective" in getting to the heart of the matters at issue.

David Stark, examined by BR&B partner **Jeffrey Barrack**, provided expert testimony about WorldCom's system for keeping its general ledger. Mr. Stark was extremely well received by the jury. The jury believed Mr. Stark's testimony was convincing and showed how easily the fraud could have been uncovered if Andersen had just looked in the right places. The jury found Jeff's examination of Mr. Stark interesting and stated that they were able to easily follow the somewhat complicated subject matter of the examination. His questions were comprehensive and thorough, and the jury further liked the fact that he always had a smile on his face and spoke clearly.

The positive reactions of the jurors to the evidence involving complex accounting principles and auditing procedures demonstrated the importance of preparation and presenting highly credible fact and expert witnesses in cases of this type. It was clear that the BR&B lawyers who presented the case to the jury established themselves as highly credible and trustworthy in the eyes of the jurors, and engendered the kinds of relationships with the jurors that – had the case proceeded to verdict – would have greatly benefited the class. ❖

Restatement

continued from page 11

a business record. The Judge noted that the Restatement was prepared at or near the time of the accounting review which preceded its creation and that WorldCom was under a *duty* to issue restated financial statements pursuant to applicable SEC regulations and generally accepted accounting principles ("GAAP").

Andersen also argued that the Restatement was unreliable, and that WorldCom's new management had an improper motive to inflate the magnitude of previous overstatements. The court rejected this argument, holding that the motive behind preparation of a business record is generally not a reason to exclude evidence. The court also noted that any argument concerning the reliability of the evidence applied to the weight of the evidence, and that a person's alleged improper motive can be pursued in cross-examination at trial. Moreover, since the Restatement was required to comply with GAAP, WorldCom would be subject to additional liability for violations of the securities laws if it filed a false Restatement. The court also rejected Andersen's argument that the Restatement would be unfairly prejudicial, pointing out that Andersen had identified no specific prejudice that it would suffer as the result of the Restatement's admission.

Finally, Judge Cote held that even if the Restatement did not constitute a business record, it would still be admissible into evidence under the residual or "catch-all" hearsay exception. This exception allows the admission of evidence having "equivalent circumstantial guarantees of trustworthiness" when its admission would best serve the "interests of justice."

Judge Cote's decision allowing WorldCom's Restatement into evidence is significant for many reasons, including its potential value as precedent in future securities cases. Only one other decision had allowed the introduction of a restatement in a case in which the issuer was not a defendant, but that case involved an SEC enforcement action against former executives of the subject company (Sunbeam). *See SEC v. Uzzi*, 2003 U.S. Dist. LEXIS 15608 (S.D. Fla. January 21, 2003). The court rejected Andersen's argument that the decision in *Uzzi* should not be applied to a private securities case, and similarly held that the Restatement was admissible in our trial against Andersen. Thus, this decision will likely assist class plaintiffs in future cases attempting to prove that financial statements issued by other companies were false and misleading when issued, a necessary element of many securities law claims. ❖

New Standards for Director Liability Developed in WorldCom

Mark R. Rosen

Partner, Barrack, Rodos & Bacine

The WorldCom litigation spawned a number of significant rulings concerning the liability of directors for securities claims. Collectively, these rulings decisively reject the “see no evil, hear to evil” mantra frequently recited by directors of corporations involved in securities fraud, and will likely prompt greater scrutiny by members of corporate boards of management actions and representations in the future. The court’s ruling on one particular motion provides significant guidance concerning the potential liability and defenses of corporate directors.

The motion was filed on behalf of Bert C. Roberts, Jr., the former chairman of the WorldCom board, who initially refused to join in the settlement reached with the other eleven board members and who moved for summary judgment dismissing all claims against him. In the course of considering and rejecting Mr. Roberts’ motion, Judge Cote clarified the standards governing corporate directors and others charged with culpability.

The court first addressed the standard governing the affirmative defenses to liability under Section 11 of the Securities Act of 1933. Section 11, which concerns statements made in registration statements filed with the SEC in connection with public offerings of stocks and bonds, imposes strict liability upon several groups, including directors, who sign, or are otherwise connected to, registration statements that contain a material false statement or material omission. However, that strict liability is tempered by an affirmative defense of “due diligence.” A successful “due diligence” defense relieves a defendant (other than the issuer of the security) from liability for any damages arising from such materially false statements or omissions.

Judge Cote also stressed that directors are not excused from performing meaningful due diligence investigation simply because there are other professionals, such as underwriters or auditors, involved in the securities offering

In denying Roberts’ motion, the court explained that there are not one, but 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 (the “expertised” portion of the registration statement), then the defendant asserting this affirmative defense has the burden to prove that, at the time the registration statement became effective, he (1) had no reasonable ground to believe, *and* (2) did not, in fact, believe, that the statements were false or contained material omissions. On the other hand, 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, he (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 man in the management of his own property.

The court further 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 thoroughness of a defendant’s investigation will vary depending, in part, upon the importance of their role in the distribution of the securities. The court held that a director’s due diligence obligations in particular must be evaluated based upon his or her involvement in the company’s activities. The standard may vary from director to director, even in the same corporation. 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. Judge Cote found that what constitutes a “reasonable investigation” and “reasonable ground to believe” varies with the involvement of the individual, his expertise, and his 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 the company’s outside auditors at face value.

Judge Cote also stressed that directors are not excused from a meaningful due diligence investigation simply because there are other professionals, such as underwriters or auditors, involved in the securities offering. Indeed, even when dealing with an audited financial statement, 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 the audited financial statement or any other expertised statement may be liable under Section 11.

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 do not easily lend themselves to resolution as a matter of law. Thus, *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 MCI), he had to show that he conducted some investigation to qualify for the due diligence defense. Guided by these standards, Judge Cote held that Roberts’ asserted reliance upon fellow directors, experts and professionals and on his review of the materials management provided to the board, *was not sufficient* to establish his right to summary judgment based upon due diligence. Notably, on the eve of trial and immediately after Judge Cote denied Roberts’ motion, Roberts agreed to pay \$4.5 million from his personal assets to settle the class claims against him. ❖

Making Law Concerning An Underwriter's Obligations and Achieving Record Settlements with the Underwriter Defendants

Gerald J. Rodos
Partner, Barrack, Rodos & Bacine
Pearlette V. Toussant
Barrack, Rodos & Bacine

The WorldCom case developed much needed law concerning an underwriter's obligations of due diligence when bringing a security to market.

The Claims Against the Underwriters

Plaintiffs brought claims against the underwriters of WorldCom's 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. These were massive bond offerings by any measure. The May 2000 offering was for \$5 billion of 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 offerings were led by investment banking giants Salomon Smith Barney and J.P. Morgan. 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.

The court noted — as lead plaintiff had argued — that the public relies on underwriters to conduct a reasonable investigation into the statements made in a registration statement, including financial statements. The court held that, in conducting their investigation, the underwriters were required to exercise a high degree of care.

In the complaint, plaintiff alleged that the underwriters could not rely blindly on audit opinions issued by 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 plaintiffs alleged existed between the underwriters and their affiliates, on the one hand, and WorldCom, Ebbers and 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.

At the time, this area of law – the standard by which an underwriter is judged to be liable for the statements made in a registration statement – was surprisingly undeveloped. The cases discussing the standard were decades old. *See, e.g., Feit v. Leasco Data Processing Equip. Corp.*, 332 F.Supp. 544, 582

(E.D.N.Y. 1971); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 370-71 (2d Cir. 1973). Thus, the court's decision, which denied the underwriters' summary judgment motion in all significant respects, was ground-breaking. *See In re WorldCom Sec. Litig.*, 346 F.Supp.2d 628 (S.D.N.Y. 2004).

The Motions for Summary Judgment

Lead plaintiff and the underwriters each moved for summary judgment. Lead plaintiff moved for summary judgment against the underwriters on the ground that the financial statements incorporated into the 2000 and 2001 Registration Statements were false and misleading. The underwriters conceded that WorldCom's reporting of line costs and capital expenditures for the first quarter of 2001 was false, but argued that they could not be liable for the misrepresentations in those financial statements or for the alleged misrepresentations in the 1999 and 2000 year-end financial statements. They contended that: (a) they had acted reasonably in relying on Arthur Andersen's audits and comfort letters; and (b) they had no duty to investigate the reliability of the financial statements so long as they had "no reasonable ground to believe" that the financial statements were false.

On December 15, 2004, the court granted partial summary judgment to lead plaintiff, finding the 2001 Registration Statement false and misleading, and leaving for trial the issue of whether the underwriters had satisfied their due diligence obligations with respect to the 2001 Registration Statement. The court denied in all significant respects the underwriters' motion for summary judgment.

The Underwriters' Due Diligence Defenses Are Flatly Rejected

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. The court noted — as lead plaintiff had argued — that the public relies on underwriters to conduct a reasonable investigation into the statements made in a registration statement, including financial statements. The court held that, in conducting their investigation, the underwriters were required to exercise a high degree of care. While the court agreed with the underwriters that they were entitled to rely on Andersen's audit opinions for the year-end financial statements,

continued on page 16



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Underwriter Obligations

continued from page 15

the court found that the underwriters were *not* entitled to rely on Andersen's "comfort" letters (letters that 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, even the 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 of liability." See *In re WorldCom*, 346 F.Supp.2d at 672.

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. Among other things, plaintiffs cited evidence and argued that: (a) WorldCom's earnings-to-revenue ratio, an important profitability standard, was significantly lower 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; and (b) the deterioration of WorldCom's MCI long-distance business should have led the underwriters to question the accuracy of WorldCom's reported assets in connection with the 2001 offering. The court held that these factors, among others, demonstrated that factual issues concerning the reasonableness of the underwriters' investigation precluded the court from ruling as a matter of law in the underwriters' favor. 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.

To our knowledge, this was the first case in which plaintiffs had "broken" an underwriting syndicate, and negotiated separate settlements with underwriters on an individual basis, rather than as a part of an overall settlement.

Lead Plaintiff Settlements with the Underwriters

After the court's decision, settlement discussions with the underwriter defendants intensified. Lead counsel, on behalf of lead plaintiff, engaged in settlement discussions with counsel for Bank of America and concurrently, but separately, with counsel for a group of four junior underwriters (Lehman Brothers, First Boston Credit Suisse LLC, Goldman Sachs and UBS Warburg LLC) that had participated only in the May 2000 bond offering. Significantly, even though these underwriters were not lead underwriters in either of the offerings, the recoveries from BOA and the four junior underwriters were at the same rate as had

been achieved with respect to the bond claims involving lead underwriter Salomon, taking into account the respective amounts underwritten by these defendants.

The BOA and junior underwriter settlements were reached in early March 2005, just weeks before the trial was set to begin. As trial preparations continued against the other underwriter defendants, lead counsel negotiated other settlements, on an individual basis, with counsel for each of the remaining underwriter defendants. With just two exceptions that took into account the financial capabilities of two smaller entities, Comptroller Hevesi insisted on settlements that exceeded the rate of the bond settlement achieved in the Citigroup settlement. The process culminated in the negotiations with J.P. Morgan (which had earlier opposed certain aspects of the settlements reached with the Citigroup defendants, the directors defendants and even earlier-settling underwriter defendants) which resulted in a \$2 billion settlement, just a few days before the trial was set to begin. The J.P. Morgan settlement rate was significantly higher than the rate achieved through the Citigroup settlement.

To our knowledge, this was the first case in which plaintiffs had "broken" an underwriting syndicate, and negotiated separate settlements with underwriters on an individual basis, rather than as a part of an overall settlement. This strategy was highly effective in achieving extraordinary recoveries on behalf of investors with claims against the underwriter defendants. ❖

About the Publisher...

The logo for Barrack, Rodos & Bacine, featuring the letters 'BR&B' in a stylized font. The 'B' on the left is red, the '&' is yellow, and the 'B' on the right is blue.

Barrack, Rodos & Bacine

Barrack, Rodos & Bacine is a boutique law firm that has been extensively involved in class and derivative actions alleging violations of securities laws since 1976. The firm, with attorneys in offices located in Philadelphia, San Diego, New York, and New Jersey, has been appointed by federal judges throughout the country as lead counsel in over 30 cases since the passage of the PSLRA and represents a number of institutional investors in securities class actions. The Barrack Bulletin is edited by BR&B partner Leslie Bornstein Molder.

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