BARRACK BULLETIN

THE INSTITUTIONAL INVESTOR'S GUIDE TO SECURITIES CLASS ACTION LITIGATION

15 Years of SOX: The *WorldCom* and *Enron* Securities Cases

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The Sarbanes-Oxley Act of 2002 was enacted in response to, and concurrently with, the very high-profile and massive accounting scandals at WorldCom and Enron. With Enron already having filed for bankruptcy on Dec. 2, 2001, and with WorldCom ensnared in an investigation by the U.S. Securities and Exchange Commission over its accounting practices and loans to its officers and directors, the U.S. House of Representatives passed the first version of the bill that would eventually become SOX on April 24, 2002. Just three months later, the final version of the SOX legislation was passed in an overwhelmingly bipartisan fashion by both the House (423-3) and the U.S. Senate (99-0), and signed into law by President George W. Bush on July 30, 2002. By then, WorldCom, like Enron before it, had imploded, with its CEO, Bernie Ebbers, resigning from his post, its chief financial officer, Scott Sullivan, being fired after the discovery of the improper accounting of more than $3.8 billion in expenses, and the company filing for bankruptcy protection on July 21, 2002. Criminal charges against WorldCom executives, including Ebbers and Sullivan, would follow.

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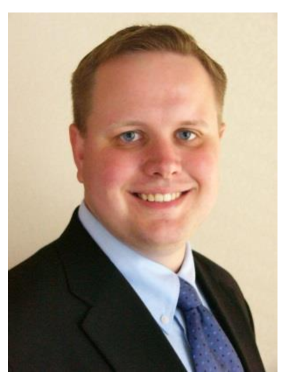
SOX was enacted to curb the types of egregious corporate governance failures that led to the WorldCom and Enron scandals. In an interview five years after SOX became law, Sen. Paul S. Sarbanes, the law's co-author, called SOX "the most far-reaching securities legislation since the original securities acts in 1933 and 1934" and stated that the intent of the legislation "was to establish a good solid framework within which people could go about their business" within a system that would screen out those acting in an unethical and dishonest way and "punish [that] dishonest behavior."[1] The measures SOX mandated were designed to ensure that corporate watchdogs — including officers, directors, in-house auditors and outside auditors — could and would perform active and meaningful oversight of public companies. In the words of Sarbanes, it was designed to enable "watchdogs to be watchdogs."[2]



Chad A. Carder

SOX established the Public Company Accounting Oversight Board to oversee the audits of public companies "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."[3] It sought to ensure auditor independence through a series of measures that, among other things, prevented public accounting firms that audit public companies from also contemporaneously providing significant non-audit services to those same companies.[4] It mandated that audit committee members of public company boards be independent, and that audit committees establish procedures for complaints or anonymous submissions regarding accounting, internal control and auditing matters.[5]

SOX also required corporate executives to certify that (1) the company's annual and quarterly reports did not contain any untrue statement of a material fact or material omissions; (2) the financial statements and information in the reports fairly presented in all material respects the financial condition and operations of the company; (3) the executive officers had designed, maintained and evaluated the effectiveness of the company's internal controls; and (4) the executive officers had alerted the company's auditors and audit committee about any significant deficiency in the company's internal controls and any fraud.[6]

The private securities litigations involving both WorldCom and Enron, which were ongoing at the time of SOX's enactment, assisted in ushering in the new era of corporate governance embodied in SOX. These cases and their massive landmark settlements served notice on board members, corporate executives, outside auditors, underwriters and financial advisers of the very real potential (and costly) consequences of being asleep at the switch in a post-SOX era.

Our firm, Barrack Rodos & Bacine, served as a co-lead counsel representing the lead plaintiff, the New York State Common Retirement Fund, through its sole trustee, the comptroller of the state of New York, and the certified class in the securities litigation involving WorldCom. During the prosecution of the case, our firm worked closely with the New York state comptroller and our co-lead counsel to achieve an extraordinary result for investors injured by the massive fraud at WorldCom. On Nov. 12, 2004, U.S. District Judge Denise L. Cote granted final approval of the historic $2.575 billion settlement reached with the Citigroup-related corporate and individual defendants — a settlement that set a benchmark that we exceeded in our subsequent negotiations with the other underwriter defendants. Ten months later, on Sept. 21, 2005, Judge Cote granted final approval to settlements reached with all remaining defendants in the case, including a settlement with Arthur Andersen, WorldCom's outside auditor, after five weeks of trial. The case settlements ultimately amounted to a total recovery of more than $6.19 billion for WorldCom investors.

One of the most significant components of the $6.19 billion recovery, from a corporate governance perspective, was a $60.75 million settlement reached with WorldCom's directors. Before *WorldCom*, it was virtually unheard of for directors to personally contribute to securities fraud settlements from their own assets, in addition to payments from directors' and officers' liability insurance. But given the egregious nature of the fraud at WorldCom, the New York state comptroller insisted that each of the former WorldCom outside directors make a material payment from his or her personal assets based on a detailed statement of his or her financial condition. Ultimately, the WorldCom director-defendants agreed to pay a total of $24.75 million from their own pockets, an amount equal to 20 percent of their combined net worth exclusive of primary residences and retirement accounts, to settle the claims asserted against them. This was even after the directors had lost approximately $250 million as a group based on their own holdings of WorldCom stock. With the settlement of the claims of the class against WorldCom's former directors, notice was formally served that persons who sit on boards of directors of public companies may be held personally liable to investors who suffer losses from egregious corporate fraud.[7]

That point was driven home when a settlement with outside directors in the *Enron* case was announced within days of the initial director settlement in *WorldCom*. The class action involving Enron, led by The Regents of the University of California, recovered more than

$7.2 billion, the largest securities fraud litigation recovery in history. That recovery included a settlement with Enron's outside directors that required the outside directors who had benefited from their insider sales of Enron stock to pay $13 million directly from their own pockets as part of the overall $168 million settlement with the director-defendants in the *Enron* case.

While the magnitude of the total recoveries in the *WorldCom* and *Enron* cases were remarkable, the announcement of the settlements with each company's directors that called for the directors to contribute a portion of their own personal assets to each settlement sent shock waves throughout corporate governance circles. A number of the country's large securities class action defense firms issued client alerts in the immediate aftermath of the WorldCom director-defendants settlement, imploring those already serving or considering serving as directors of public companies to exercise enhanced scrutiny over every area of a company's business, including compliance, executive compensation and audit matters. The director settlements in *WorldCom* and *Enron* were at the vanguard of what was hoped to be a new era of corporate accountability that was embodied in SOX, and complemented SOX by ensuring a renewed focus on active corporate governance while giving directors a strong and unique incentive to exercise proper oversight over the company, its executives and its auditors.

In the Jan. 15, 2014, edition of The Wall Street Journal, Alan Murray, the president of the Pew Research Center in Washington, D.C., reviewed "Boards That Lead" by Ram Charan, Dennis Carey and Michael Useem. In the book review,[8] Murray wrote that corporate boards "came alive" with the WorldCom settlement:

> Corporate boards of directors have been around for centuries, but for most of that time they were inert — rubber-stamping CEO proposals with minimal oversight. They came alive, like Geppetto's puppet, barely a decade ago. *I trace their animation to Jan. 7, 2005, when 10 former directors of WorldCom agreed to pay investors $18 million out of their own pockets as part of a settlement in the giant accounting-fraud case.* [Authors' note — the settlement amount was increased when the two remaining directors settled before the trial of the case.] Before then, a book called "Boards That Lead" — as Ram Charan, Dennis Carey and Michael Useem have titled their latest — would have seemed oxymoronic and probably triggered protests from the Business Roundtable. Boards weren't supposed to lead. They were supposed to monitor — and they didn't even do that very well. *But post-WorldCom, post-Enron, post-Sarbanes-Oxley, post-Dodd-Frank, boards have become the big guys on the block.* The new laws and stock-market listing standards have forced them to take greater oversight roles, and the court cases have raised the stakes if they fail. They responded by taking charge, in part to protect their own pocketbooks, and this has changed the governance equation of America's big businesses.

In the 15 years since SOX, there has been an ongoing debate as to whether its requirements have been an effective and efficient means of preventing the type of fraud seen pre-SOX or whether they have been unnecessarily onerous and costly. Some critics have called SOX a case of overcorrection in the wake of the accounting scandals at WorldCom and Enron. But looking back over securities fraud litigation in the post-SOX era, after the furor over the scandals at WorldCom and Enron subsided,[9] there is evidence that notwithstanding some notable fraudulent schemes implemented by corporate insiders — some of which have been facilitated by either complicit or lax gatekeepers (including outside auditors, underwriters, financial advisers and rating agencies) — SOX has enhanced to some degree the transparency of public companies and provided some measure of accountability for the executives, board members and auditing firms tasked with oversight of those companies.[10] It is likely not a coincidence that the recoveries achieved by the lead plaintiffs in the Enron and WorldCom cases still rank as the largest two recoveries in securities class action litigation in the United States.

Thus, while instances of corporate fraud, deception and concealment have certainly continued since SOX became law 15 years ago, it is nonetheless fair to say that the enactment of SOX and the court decisions and recoveries achieved through the WorldCom and Enron securities class actions helped to usher in an era of increased corporate transparency, corporate accountability and legal incentives that continue to significantly shape our corporate and legal landscapes.

Jeffrey W. Golan, a co-managing partner in the Philadelphia office of Barrack Rodos & Bacine, headed up the firm's trial team in In re WorldCom Inc. Securities Litigation. Chad A. Carder is a partner in the firm's Philadelphia office and also worked on the case.

DISCLOSURE: Barrack Rodos & Bacine served as a co-lead counsel representing the lead plaintiff, the New York State Common Retirement Fund, through its sole trustee, the comptroller of the state of New York, and the certified class in the securities litigation involving WorldCom. Both authors worked on the case.

ENDNOTES:

[1] Dick Carozza, An Interview with Sen. Paul S. Sarbanes, Sarbanes-Oxley Act Revisited, Fraud Magazine (May/June 2007). Available at http://www.fraud-magazine.com/article.aspx?id=442

[2] Carozza, supra.

[3] 15 U.S.C. § 7211(a).

[4] 15 U.S.C. § 78j-1(g)-(l).

[5] 15 U.S.C. § 78j-1(m).

[6] 15 U.S.C. § 7241; see also 15 U.S.C. § 7262.

[7] Apart from the extraordinary recoveries achieved, the *WorldCom* case also generated many significant rulings that continue to shape the legal landscape in securities litigation concerning the liability of executives, directors, underwriters and auditors. Three of the most instructive are the decisions: (a) granting in part lead plaintiff's motion for partial summary judgment and denying in major part the underwriter defendants' motion for summary judgment (*In re WorldCom Inc. Sec. Litig.*, 346 F. Supp.2d 628 (S.D.N.Y. 2004)); (b) denying the motion for summary judgment filed by Arthur Andersen LLP, which served as WorldCom's outside auditor (*In re WorldCom Inc. Sec. Litig.*, 352 F. Supp.2d 472 (S.D.N.Y. 2005)); and (c) denying the motion for summary judgment filed by Bert C. Roberts Jr., the former chairman of the board at WorldCom and one of the two directors who initially refused to join in the settlement with WorldCom's other directors (*In re WorldCom Inc. Sec. Litig.*, Master File No. 02 Civ. 3288 (DLC), 2005 U.S. Dist. LEXIS 4193, 2005 WL 638268 (S.D.N.Y. Mar. 21, 2005)). These rulings have been cited regularly and continue to be cited today when courts weigh the liability of executives, directors, underwriters and auditors under the federal securities laws.

A more complete summary of the *WorldCom* litigation can be found in the Barrack bulletin issued in the fall of 2005, which is available at http://www.barrack.com/sites/default/files/BB_volume9_fall_2005.pdf

[8] Available at https://www.wsj.com/articles/book-review-8216boards-that-lead8217-by-ram-charan-dennis-carey-and-michael-useem-1389828325?KEYWORDS=charan&tesla=y (emphasis added).

[9] In his interview with Fraud Magazine, Sarbanes noted that the "blow to investor confidence at the time of Enron and WorldCom was of major proportions" and he cautioned against "forget[ting] the magnitude of the losses" including that "[t]housands of jobs were lost; retirement savings dried up." Carozza, supra.

[10] For example, a comprehensive 2014 article reviewing findings from more than 120 papers from multiple disciplines evaluating the impact of SOX concluded, among other things, that there is evidence that "some of the early concerns about SOX were likely overblown" and that "[o]verall, there appears to have been an improvement in financial reporting quality after SOX, some of which can be attributed to section 404." Srinivasan, Suraj, et al., "SOX after Ten Years: A Multidisciplinary Review," Accounting Horizons (Vol. 28, No. 3, pp. 627-71, September 2014). [Authors' note — Section 404 is the SOX provision that mandates that all publicly traded companies must establish internal controls and procedures for financial reporting and must document, test and maintain those controls and procedures to ensure their effectiveness].