Uncertainty Looms for Underwriters After WorldCom

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After 13 investment banks agreed to pay more than $4 billion to settle securities claims stemming from their role as WorldCom's underwriters, the rules under which they operate remain in doubt.

While the banks know that the standard of care expected of them is higher than in the past, just how much higher is unclear. The uncertainty comes at a time when the banks' potential liabilities have skyrocketed by the precedent-setting WorldCom settlements.

Making matters worse is the lack of specific guidance from courts and the Securities and Exchange Commission on the level of due diligence underwriters are expected to conduct, particularly with shelf-registrations, the type of filing used to sell WorldCom bonds in 2000 and 2001.

Southern District Judge Denise Cote provided some clues in December in a decision in which she rejected most of the underwriters' motion for summary judgment in the on-going WorldCom securities class action. Plaintiffs sued the investment banks, claiming they failed to conduct appropriate due diligence in violation of their duties as underwriters under securities law.

For the three defendants that have not settled, jury selection begins today.

Judge Cote's 159-page ruling, which called upon underwriters to conduct traditional and stringent due diligence, ultimately said it would be left for jurors to decide whether the banks had gone far enough. If the remaining underwriters settle, as most experts expect, the industry will lose the opportunity to have Judge Cote's standards reviewed and tested by an appellate court, leaving them at a loss for clear-cut rules needed to effectively participate in underwriting shelf-registrations in the future.

The amount of the WorldCom settlements has made the industry anxious for direction. The billions of dollars underwriters have agreed to pay to plaintiffs catapulted this case to the largest ever securities class action settlement. Only one other settlement in the securities setting, involving Cendant, ever reached the $1 billion mark.

Shelf-Offering

In 2000 and 2001, WorldCom issued $16.9 billion in bonds underwritten by 16 investment banks. JP Morgan Chase, which has not settled, and Citigroup's Salomon Smith Barney division, which settled for $2.57 billion last year, were lead underwriters. Fourteen others were junior underwriters.

As a large company with an established track record, WorldCom issued these bonds through a shelf-offering.

The SEC established shelf-offerings in the 1980s, said Robert Wise, Jr. of Davis Polk & Wardell, to make it easier and quicker for established companies to issue new shares or bonds. If a company already had a high credit rating and hefty market capitalization, it could refer in its SEC filings to its annual and quarterly filings instead of having to include them in every registration. More importantly, the shelf rule change allowed issuers to make one registration filing and then file shorter supplements when they issued new stock or bonds at a later date. The flexibility allowed companies to act quickly in tapping capital markets at favorable times.

This added flexibility had a dark-side, however. The speed at which shelf-registrations wrapped up, said Mr. Wise, who wrote an amicus brief on behalf of the Securities Industry Association and the Bond Market Association in the WorldCom case, gave underwriters little time to conduct much due diligence. Both associations supported the underwriters' motions in WorldCom.

"There is a disconnect between the way the offering process has developed and the law," said Yaacov Gross of Morrison & Foerster. The law remained fixed on decades-old standards in which underwriters conducted months of due diligence while shelf-registrations could go from start to finish in a week's time. "There's not much an underwriter can do within a week," Mr. Gross said.

For WorldCom's offerings, the 14 junior underwriters, following industry practice, relied on due diligence conducted by the lead two.

The inconsistency between stringent legal standards and fast-paced shelf-registrations led underwriters years ago to implore the SEC for a safe-harbor that would provide clear guidelines to absolve them from liability, Mr. Wise said.

But instead, the commission largely applied the same strict due diligence requirements to shelf registrations as it had for run-of-the mill offerings. It recommended that underwriters regularly analyze their issuer clients to keep up with the rapid-paced requirements of shelf-registrations.

"One day," Mr. Wise said, "people always knew it would hit the fan and the name of that day is WorldCom."

When news of WorldCom's accounting fraud erupted in 2002, the company fell into bankruptcy from which it emerged last April as MCI. Five former executives pleaded guilty to securities fraud.

On Tuesday, WorldCom's former CEO, Bernard Ebbers, was found guilty of nine counts of securities fraud and related crimes by a jury before Southern District Judge Barbara Jones.

Meanwhile, bondholders, who had lost billions of dollars and were precluded by the Chapter 11 bankruptcy from suing WorldCom, brought the class action against the underwriters, analysts, and former directors and executives. The plaintiffs are led by New York State Comptroller Alan Hevesi, and lead plaintiffs' attorneys Bernstein Litowitz Berger & Grossmann and Barrack, Rodos & Bacine of Philadelphia.

The big question was, should the underwriters have relied on information in WorldCom's audited annual report and "comfort letters" produced by Arthur Andersen for the period after the annual report.

"It's frequently the case... that not much more was done" than accept information from auditors at face value in issuing investment grade bonds.

These practices placed underwriters under a cloud of uncertainty since the inception of the shelf-registration, said Mr. Wise. Industry players expected, perhaps hoped, that in appreciation of market conditions, courts would apply softer standards instead of the SEC's rigorous rules, said Mr. Wise.

The first test in a courtroom occurred with Judge Cote.

Her decision dashed their hopes.

Judge Cote's Decision
While acknowledging concerns from the American Bar Association and academics about the difficulty of applying decades-old strict, and perhaps outdated, standards to today's fast-moving capital markets, Judge Cote in December applied traditional standards of due diligence to underwriters in the shelf-registration setting.

Working from very little precedent, the judge held that when "red flags" appear, underwriters have a duty to investigate.

"If red flags arise from a reasonable investigation, underwriters will have to make sufficient inquiry to satisfy themselves as to the accuracy of financial statements, and if unsatisfied, they must demand disclosure, withdraw from the underwriting process, or bear the risk of liability," Judge Cote wrote.

Neither the existence of audited financial statements nor the reliance on experts obviated that obligation, said the judge.

If the industry is looking for standards that the judge has declined to provide, it must now move to convince Congress or the SEC to provide them.

Such a campaign is not imminent, as news of WorldCom's fraud and host of settlements will chill any such discussions for the foreseeable future, said Mr. Wise. "I'm not going to hold my breath."

This leaves the industry with few options.

Uncertain World
Underwriters are searching for certainty that has evaded them since the inception of the shelf-registration.

"The real lesson on WorldCom is that it will be very hard to get," said Mr. Wise.

One thing is clear. "The legal landscape... for underwriters... even if it's an investment grade company... is that they're not going to be able to rest solely on audited financials and comfort letters," he said.

This has placed strains on an industry in which underwriters compete vigorously to meet client demands. Underwriters face pressure to finalize shelf-registrations quickly. If they tell clients they need weeks and months to conduct more due diligence, the client may look elsewhere.

In the meantime, "People will muddle through," Mr. Wise predicted. Industry bankers and lawyers are discussing options, he said, but there are no clear resolutions at a time when the ink on the settlements has yet to dry.

The settlements with plaintiffs also offer no guidance. Some class action settlements require defendants to change practices or implement preventative governance measures.

These settlements do not include any such provisions, said John Coffey of Bernstein Litowitz, who represents the plaintiffs.

"I think the best way of getting the attention of Wall Street banks and how they conduct their business is to hit them where it hurts --- their wallets," he said.