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Underwriter Due Diligence: *WorldCom* and Beyond

By Jeremy W. Dickens, Paul Dutka, and Joshua S. Amsel

The very recent decision in *In re WorldCom, Inc. Securities Litigation*[1] throws a spotlight on one of the most nettlesome issues in corporate finance: the nature and extent of an underwriter's due diligence obligations in the context of a shelf registration under Securities and Exchange Commission ("SEC") Rule 415.[2] Shelf registration – "the process by which securities are registered to be offered or sold on a delayed or continuous basis"[3] – affords well-seasoned issuers virtually instantaneous access to the capital markets, but the speed of a shelf takedown, which can literally occur in days or even hours, materially limits the ability of underwriters to discharge their due diligence obligations in the same manner as in non-shelf offerings.

Indeed, the securities bar has petitioned the SEC for greater leniency in this regard, arguing that the benefits of shelf registrations

> are undermined by continuing to impose on financial intermediaries and other "gatekeepers" the responsibility to take the time necessary to do a sufficient due diligence investigation to assure quality disclosure without recognizing and mak-

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Does The Business Judgment Rule Apply To Business Decisions Made By A Debtor In Chapter 11?

By Diane Harvey and Margarita Platkov

The business judgment rule has been a fixture in the corporate board room for over a century.[1] Simply stated, the business judgment rule provides that:

> [I]n making a business decision, the directors are presumed to have acted independently, on an informed basis, in good faith, and in the honest belief that the decision is in the best interests of the corporation. A business decision will normally be sustained unless the presumption is rebutted in either of two ways: (i) the process, independence, or good faith of the directors is compromised; or (ii) the decision cannot be attributed to a rational business purpose.[2]

The business judgment rule affords certain liability protection to directors of companies who on the one hand, must make business decisions fraught with risk, while at the same time comply with fiduciary obligations owed to the shareholders of the corporation.

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> ing allowances for their difficulty or even inability to do so. It is not possible for underwriters and others to meet this standard in the current financing environment.[4]

But the SEC has hewed to the view that the integrated disclosure system – which enables the use of shelf registrations by permitting the issuer's prior Exchange Act filings to be incorporated by reference into its registration statement – "was intended to 'simplify disclosure and reduce unnecessary repetition and redelivery of information,' not to 'modify the responsibility of underwriters and others to make a reasonable investigation.'"[5] Thus, the SEC advised underwriters, concerned by the pressures that a shelf takedown imposes, to "'arrange [their] due diligence procedures over time for the purpose of avoiding last minute delays in an offering environment characterized by rapid market changes.'"[6]

This article examines Judge Cote's *WorldCom* decision and considers both its legal and practical implications for underwriters.

Factual And Procedural Background Of The Decision

Judge Cote's *WorldCom* decision arises in the context of the well-publicized accounting scandal and consequent collapse of WorldCom, Inc. ("WorldCom"), which resulted not only in the largest bankruptcy filing in American history, but also in the filing of myriad securities class actions. Among the defendants named in those litigations, which were consolidated in the Southern District of New York, were WorldCom's underwriters in connection with (i) a May 2000 debt offering valued at approximately $5 billion and (ii) a May 2001 debt offering valued at approximately $11.9 billion, which Judge Cote termed "the largest public debt offering in American history."[7]

The court's decision addresses the parties' (Lead Plaintiff's and certain of the underwriters' (the "Underwriter Defendants'"))[8] dueling motions for summary judgment. Lead Plaintiff moved for partial summary judgment on its claims under Sections 11 and 12(a)(2) of the Securities Act "with respect to certain statements in WorldCom's financial filings that the Lead

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Plaintiff contends are indisputably false and material."[9] The Underwriter Defendants moved for summary judgment on all claims under the "due diligence" and "reliance" defenses of Section 11, specifically arguing, among other things, that they

> were entitled to rely on WorldCom's audited financial statements and had no duty to investigate their reliability unless they had reasonable grounds to believe that they were not accurate, and that they were also entitled to rely on [certain] "comfort letters" from WorldCom's auditor [Arthur Andersen] for the interim unaudited WorldCom financial statements.[10]

Debate, summarized below, thus centered on the sufficiency of the Underwriter Defendants' due diligence efforts in connection with the 2000 and 2001 WorldCom debt offerings.

"Shelf registration . . . affords well-seasoned issuers virtually instantaneous access to the capital markets, but the speed of a shelf takedown, which can literally occur in days or even hours, materially limits the ability of underwriters to discharge their due diligence obligations in the same manner as in non-shelf offerings."

The 2000 Offering

WorldCom filed a shelf registration for its 2000 offering on April 12, 2000, and due diligence was conducted over nine days, from May 15 to May 23, 2000.[11] The court noted that the "only written record of due diligence performed by the Underwriter Defendants for the 2000 Offering" was a memorandum from underwriters' counsel, Cravath, Swaine & Moore LLP ("Cravath"), describing a single telephone conversation on May 17, 2000 between the Underwriter Defendants and then WorldCom CFO Scott Sullivan.[12] The memorandum reflects that Sullivan "predicted overall growth for the year 2000 would be about 14%, represented that the proceeds for the 2000 Offering would be used to repay 'commercial debt,' reported that WorldCom was experiencing a very competitive environment but that there were no changes in that environment since 1999, and stated that there were no other material issues."[13] The memorandum concludes with an outline of WorldCom's board minutes, a list of the company's public filings, references to the company's press releases, and a discussion of documents relating to the company's failed merger with Sprint.[14]

Judge Cote highlighted the Underwriter Defendants' reliance in connection with the 2000 offering on a May 19, 2000 Arthur Andersen "comfort letter" for WorldCom's first quarter financials and a May 23, 2000 "bringdown comfort letter,"[15] although the roughly six-week period between the April 12 filing of the shelf registration statement and the May 24 offering afforded the Underwriter Defendants time for additional due diligence.

The 2001 Offering

By early 2001, WorldCom's financial condition had deteriorated dramatically, leading the Underwriter Defendants (internally) and Standard & Poor's (publicly) to downgrade WorldCom's credit rating.[16] Given the company's credit situation, the Underwriter Defendants were faced with the dilemma whether to assist in restructuring WorldCom's credit facility, or to compete for investment banking positions in the massive debt offering that WorldCom planned for that spring.[17] WorldCom resolved the dilemma by informing its banks that they could participate in the offering only if they assisted in the restructuring.[18] Significantly, the court noted that "[t]here is evidence to suggest that several of the Underwriter Defendants decided to make a commitment to the restructuring of the credit facility and to attempt to win the right to underwrite the 2001 Offering, while at the same time reducing their own exposure to risk from holding WorldCom debt by engaging in hedging strategies."[19]

The Underwriter Defendants conducted due diligence for the 2001 offering between April 19 and May 16, 2001, which, as described in a May 16, 2001 Cravath memorandum, consisted of two telephone calls with Sullivan on April 30 and May 9, a May 9 telephone call with Sullivan and Arthur Andersen, and reviews of WorldCom's board minutes, a 1998 revolving credit agreement, SEC filings, and press releases.[20] Sullivan told the Underwriter Defendants that "WorldCom was comfortable with the current earnings per share, that there were no issues that could affect the company's credit rating, and that the company had nothing material to disclose that had not [already] been discussed with the investment bankers."[21] Arthur Andersen expressed similar views during its call and represented that "there were no accounting concerns."[22] The Underwriter Defendants were unaware and certainly were not informed by Sullivan that on April 20, 2001, WorldCom, at Sullivan's direction, began to engage in a "capitalization scheme" for the company's line costs that was intended to "make the E/R ratio for the first quarter of 2001 'fairly consistent' with the E/R ratio for the prior quarter."[23]

Arthur Andersen also issued two comfort letters in connection with WorldCom's first quarter financials, which, unlike its comfort letters from the previous year, omitted language regarding conformity with generally accepted accounting principles.[24] When this difference drew attention, one of the bankers "noted that the issue was important to understand but advised against getting 'too vocal' about it since 'WorldCom's a bear to deal with on that subject.'"[25]

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What happens to this classic rule of corporate governance when a company is financially troubled and has filed for bankruptcy protection? Courts have struggled with whether applying a pure business judgment rule is the right thing to do when a company is insolvent. The rationale for the business judgment rule still appears to exist in the bankruptcy context even though the playing field has changed. When the corporation reaches the point of insolvency, the firm's directors then owe fiduciary duties to the company's creditors, yet the directors continue to have the task to maximize the economic value of the company with all the attendant risks inherent in such an endeavor.[3]

In describing whether and to what extent business judgment principles should apply to decisions made by a debtor's board of directors, bankruptcy courts have tended to make complex assessments based upon the context of the business decision, the section of the Bankruptcy Code at issue, the business decision's potential impact on all creditors and the jurisdiction's own predilection as to whether business judgment principles should be utilized in the bankruptcy context.

Although most bankruptcy courts recognize the importance of deferring in some manner to the business judgment of a debtor, a handful of bankruptcy cases have held that the business judgment rule should not apply to decisions made by directors and officers of insolvent corporations, characterizing these directors and officers as 'trustees' for the creditors of the corporation and holding these decision-makers to a simple negligence standard.[4]

Perhaps the best way to analyze the application of the business judgment rule in the reorganization context is to focus on specific business decisions that are often encountered by a debtor during its reorganization. As the following examples demonstrate, even when bankruptcy courts insist that they are applying business judgment principles, courts tend to go beyond the business judgment rule presumption and review the substance of the business decision, in some cases even applying 20/20 hindsight to the soundness of the debtor's determinations.

Decisions By The Debtor To Approve Break-Up Fees

When a corporation in bankruptcy attempts to sell off all or a portion of its assets, it frequently offers bidding incentives to induce potential purchasers to enter into the bidding process. One form of bidding incentive which has become increasingly common in asset sales under Section 363 of the Bankruptcy Code is a break-up fee in the event that the sale is not consummated.[5] Break-up fees "are meant to compensate the potential acquirer who serves as a catalyst or 'stalking horse' which attracts more favorable offers."[6]

In the non-bankruptcy merger transaction, courts typically have denied the use of break-up fees only where such fees were the product of bad faith or would chill competing bids.[7] In the bankruptcy setting, on the other hand, three different standards for analyzing the appropriateness of breakup-fees have emerged: (1) the modified business judgment test; (2) the best interests of the estate test; and (3) the administrative expense test.

The Modified Business Judgment Test

Bankruptcy courts that apply the business judgment test will approve a break-up fee if (1) the debtor believes in its business judgment that such fees will benefit the estate; (2) there is no proof of self-dealing, and (3) there is no proof of specific harm to the bankruptcy estate.[8]

As the Court recognized in *In re 995 Fifth Avenue Assoc., L.P.*,[9] this test is akin to the one applied by courts reviewing break-up fees in the corporate takeover arena:

> In the corporate takeover context it is recognized that breakup fees are not illegal where they enhance rather than hamper the bidding. Breakup fees and other strategies may "be legitimately necessary to convince a 'white knight' to enter the bidding by providing some form of compensation for the risks it is undertaking." When reasonable in relation to the bidder's efforts and to the magnitude of the transaction, breakup fees are generally permissible. But if such a fee is too large, it may chill the bidding to the detriment of shareholders (or, if the company for sale is insolvent, its creditors). In such instances, the fee is not protected by the business judgment rule (which bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes) and is thus subject to court review.[10]

Under this modified business judgment standard,[11] bankruptcy courts consider whether the proposed break-up fee prohibits or chills the bidding and whether the amount of the proposed breakup fee was reasonable in relation to the size of the sale and the work and expense involved in negotiating the agreements.[12] In general, bankruptcy courts have found the average range of reasonableness for break-up fees and expenses is 1-4% of the purchase price, although a few courts have found higher percentages to be reasonable.[13]

The Best Interests of the Estate Test

Other bankruptcy courts have chosen a more rigorous standard to apply when evaluating the debtor's decision to approve a break-up fee. Under the best interests of the estate test, a bankruptcy court inquires (1) whether the bid is higher than it would have been had the break-up fee not been granted; (2) whether the break-up fee provided net value to the estate; (3) whether a break-up fee is necessary to start the bidding process; and (4) whether the amount of the fee is small relative to the overall benefit to the estate. Most courts applying this standard have denied motions to approve a break-up fee.

For example, in *In re America West Airlines, Inc.*,[14] the court refused to approve a break-up fee in connection with a § 363(b) asset sale, noting that since the debtor had already been "thoroughly marketed," the proposed break-up fee would not "induce further bidding or bidding generally" but could "potentially deplete [ ] assets that c[ould] be better utilized to help fund a plan of reorganization and continue to provide funds for professionals, attorneys, accountants and consultants to that end."[15]

The *America West* court expressly refused to apply business judgment principles, which it recognized had been applied outside of the bankruptcy context, concluding that: "[a]cquisition of an ongoing business which is in bankruptcy is fundamentally different from that of an acquisition involving parties not in bankruptcy."[16] Accordingly, the "standard is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will 'further the diverse interests of the debtor, creditors and equity holders, alike.'"[17]

A similar rejection of business judgment principles in analyzing the appropriateness of a break-up fee occurred in *In re Hupp Industries, Inc.*[18] There, the debtor sought authorization to enter into a letter of intent that would have provided for the sale of many of the debtor's assets under 11 U.S.C. § 363 and obligated the debtor to pay up to $150,000 in break-up fees and expenses if the deal were not consummated. The Creditors' Committee and a principal secured creditor objected. The court disallowed the break-up fee.

The *Hupp* court expressly rejected the business judgment test and listed seven factors to be considered in a determination of whether breakup fees would be appropriate: 1) whether the fee requested correlates with a maximization of value to the debtor's estate; 2) whether the underlying negotiated agreement is an arms-length transaction between the debtor's estate and the negotiating acquirer; 3) whether the principal secured creditors and the official creditors committee are supportive of the concession; 4) whether the subject break-up fee constitutes a fair and reasonable percentage of the proposed purchase price; 5) whether the dollar amount of the break-up fee is so substantial that it provides a "chilling effect" on other potential bidders; 6) the existence of available safeguards beneficial to the debtor's estate; and 7) whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the break-up fee.[19]

"The *America West* court expressly refused to apply business judgment principles, which it recognized had been applied outside of the bankruptcy context, concluding that: '[a]cquisition of an ongoing business which is in bankruptcy is fundamentally different from that of an acquisition involving parties not in bankruptcy.'"

The *Hupp* Court also cautioned that the fees must be "carefully scrutinized in § 363(b) asset sales to ensure that the debtor's estate is not unduly burdened and that the relative rights of the parties in interest are duly protected."[20]

In *In re S.N.A. Nut Co.*, an unsuccessful bidder in sale of Chapter 11 debtor's assets applied for reimbursement of costs and expenses incurred in an unsuccessful bid. The court, in finding the bidder could not recover cost and expenses, considered the application for break-up fees under § 11 U.S.C. 503 (b)[21] and under the 'best interests of the estate' test as articulated in *America West* and *Hupp*, namely "whether the interests of all concerned parties are best served by such a fee."[22]

The Court rejected the line of cases which have held that break-up fees and bidding incentives in general are analyzed under the business judgment rule:

> The ultimate question becomes, who pays the costs of investigating the potential subject of an auction? If Debtor agrees to reimburse a bidder or to pay the opportunity cost of bidding, then the creditors are paying those costs. The goal of a bankruptcy auction, however, is to maximize the return to the estate. The costs of bidding should be borne by those who are best able to bear them—the bidders who have voluntarily entered the bidding process, and who are bidding for a company with title free and clear of liens and with all the advantages provided by the Bankruptcy Code.[23]

In *In re Tiara Motorcoach Corp.*,[24] a Chapter 11 debtor moved under § 363 for authorization of the sale of certain assets and approval agreement to pay a break-up. The Bankruptcy Court refused to approve the break-up fee agreement, finding that it was not in the best interests of the estate, creditors and equity holders:

> This court agrees with the position taken in *S.N.A.*, *America West*, and *Hupp*. A sale pursuant to § 363 of the Bankruptcy Code is not in the ordinary course of business, and the business judgment of the debtor should not be solely relied upon. Rather, a court should insure that revenues are maximized and that the best interests of the debtor's estate, creditors and equity holders are furthered. Therefore, "[t]he proposed break-up fee must be carefully scrutinized to insure that the Debtor's estate is not unduly burdened and that the relative rights of the parties in interest are protected.[25]

The Administrative Expense Test

Under the administrative expense test, the allowance of a break-up fee in connection with a § 363 asset sale by a debtor depends on the claimant's ability to show that the fees were actually necessary to preserve the value of the estate, or, that the fees benefited the

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estate in a demonstrable way — *i.e.*, the test which an administrative creditor has to meet in order to recover for administrative expenses under § 503(b) of the Bankruptcy Code.[26] The Third Circuit's decision in *In re O'Brien Environmental Energy, Inc.*,[27] is a good example of how the administrative expense test is applied.

In *O'Brien*, ten purchasers submitted bids for the debtor's assets and three were deemed highest and best. The debtor then entered into a purchase agreement with Calpine Corporation. Calpine's obligation to perform under the purchase agreement was conditioned upon the parties' ability to obtain bankruptcy court approval for a break-up fee of $2,000,000 and expenses up to $2,000,000 under certain circumstances. The bankruptcy court refused to approve the break-up fee provision, holding that such a provision would chill, or at best, complicate the competitive bidding procedure. Despite the lack of bankruptcy court approval, Calpine reentered the bidding process. Ultimately, another entity purchased the debtor's assets, and Calpine filed an application for administrative expenses under section 503(b). Calpine's fee application was denied by the bankruptcy court. The district court affirmed the bankruptcy court's decision.

On appeal, the Third Circuit found the appropriate test to review the approval of a break-up fee was not the nine factor test articulated by the bankruptcy court, but rather, an assessment of whether the expense provided some tangible benefit to the debtor's estate. Applying this standard, the Third Circuit determined that the disappointed buyer had strong financial incentives to participate in the bidding for the debtor's assets regardless of the break-up fee and, therefore, a break-up fee was not necessary to induce Calpine to take part in the bidding.[28] Accordingly, the Third Circuit found no benefit to the estate and upheld the lower courts' denial of the administrative expense claim.[29]

As aptly noted in one article,[30] the Third Circuit's decision in *O'Brien* "reflects the general difficulty of obtaining court approval of bidding incentives after the bidding process. With the benefit of hindsight, courts can subject such incentives to the strictest scrutiny."[31]

Recently, an Iowa bankruptcy court applied the nine factor test articulated by the bankruptcy court in *O'Brien* rather than the Third Circuit's test. The Court in *In re Tama Beef Packing, Inc.*,[32] found that the unsuccessful bidder was entitled to a break-up fee noting that:

> [t]he fourth [*O'Brien*] factor . . . is the most significant factor in this analysis. Under the unique facts in this case the presence of AgriProcessors [the unsuccessful bidder] not only attracted another bidder to the auction, it is undisputed that there would have been no auction, or benefit to the estate, had AgriProcessors not agreed to participate.[33]

Executory Contracts

In the bankruptcy context, an executory contract is one in which material performance remains due on both sides. If performance on one side is completed, the contract is no longer executory.[34] Under § 365 (a) of the Bankruptcy Code, the trustee, subject to court approval, may assume or reject any executory contract or unexpired lease of the debtor. This provision of the Bankruptcy Code allows the assumption or rejection of executory contracts in order to permit the trustee or debtor-in-possession to use valuable property of the estate and to "'renounce title to and abandon burdensome property.'"[35] If the trustee or debtor-in-possession rejects an executory contract pursuant to § 365, "the other party to the rejected contract becomes a general creditor of the estate for any damages flowing from the rejection."[36]

Virtually all bankruptcy courts apply the business judgment rule in deciding whether to approve or disapprove a debtor's decision to reject or assume an executory contract.[37] These courts have held that fairness to the nondebtor contracting party is irrelevant in determining whether the debtor may reject a contract.[38] The only thing that matters is that the debtor has concluded in its business judgment that there is a benefit to the estate from rejection or assumption of the executory contract.

In a few bankruptcy cases, however, the amount of potential harm caused to the nondebtor contracting party has been deemed to be so severe that the bankruptcy court has departed from employing a pure business judgment rule and instead has determined to weigh the benefits and detriments to both the debtor and the other contracting party. These cases reflect a bankruptcy court's willingness to apply a more probing analysis when it perceives the need to apply the principles of equity.

For example, in *In re Petur U.S.A. Instrument Co.*,[39] the debtor, which marketed geotechnical instruments invented by one of its principals, sought to reject a 20 year licensing agreement with a closely held company formed solely for the purpose of marketing the debtor's products in Canada. The bankruptcy court concluded that the debtor had "properly exercised its business judgment and that rejection could well create additional profits and aid in reorganization."[40] Nevertheless, the bankruptcy court refused to authorize the debtor's rejection of the licensing agreement, finding that granting the motion would result in the destruction of the nondebtor licensee and that damage to the licensee would be grossly disproportionate to any benefit derived by general creditors of the debtor's estate. The bankruptcy court also noted that its conclusion "was supported by several additional factors,"[41] such as the inability of the debtor to show that it will be able to reorganize.

Similarly, in *In re Monarch Tool & Mfg. Co.*,[42] the debtor moved to reject an executory distribution contract which granted the distributor the exclusive right to sell debtor's products in the

United States. In denying the rejection motion, the court held that disproportionate damage to the non-debtor party to an executory contract provides a ground for disapproving rejection. The bankruptcy court noted that its decision to disapprove the debtor's rejection was "reinforced by other consequential facts," such as the fact that the debtor "does not presently have management competent to lead it to a successful reorganization. [Thus] [r]ejection of the contract . . . would not improve the fortunes of this Debtor."[43]

Recently, the Fifth Circuit considered whether business judgment principles should be the only measure when faced with a debtor rejecting an executory contract that might raise public interest concerns. In *In re Mirant Corp.*,[44] the Fifth Circuit remanded to the district court for a determination as to whether debtor Mirant should be able to reject a electricity purchase agreement with Potomac Electric Power. The Fifth Circuit "suggested" to the district court that a more "rigorous" standard than the business judgment rule should be used to determine the rejection motion. Specifically, the Fifth Circuit, in remanding the matter, instructed the district court to "carefully scrutinize the impact of rejection upon the public interest" so as to "ensure that rejection does not cause any disruption in the supply of electricity to other public utilities or to consumers."[45] This new "public interest" standard suggested by the Fifth Circuit may gain traction with other courts when faced with a debtor's rejection of an executory contract that could impact the public at large.

DIP Financing

One of the critical issues faced by a chapter 11 debtor-in-possession is the need for sufficient operating funds during the reorganization process. The debtor is prohibited from using cash collateral without court approval or the consent of the secured creditor (11 U.S.C. § 363(c)(2)), and, if the debtor's assets are encumbered, obtaining post petition financing from a new lender, at least at the beginning of the case, may be problematic. A debtor may elect to litigate with the secured lender to obtain the use of cash collateral. Another option is for the debtor to negotiate a postpetition financing arrangement with a secured creditor.

"Although courts list a number of factors that require close factual scrutiny by the bankruptcy court, as a practical matter, bankruptcy courts are reluctant to deny DIP financing agreements without which the debtor may be forced to liquidate."

Section 364 of the Bankruptcy Code provides that, if necessary, the post-petition lender may be given security in the debtor's assets, and a super priority ahead of all administrative creditors.[46] Such forms of external financing are known as debtor-in-possession financing ("DIP"). DIP financing arrangements under § 364 of the Bankruptcy Code are subject to the oversight of the bankruptcy court and most arrangements require prior judicial authorization.[47]

In order to secure approval of post-petition financing pursuant to 11 U.S.C. §§ 364(c) and/or (d), bankruptcy courts have found the debtor-in-possession bears the burden of proving the following three factors:

> [F]irst, that the proposed financing is an exercise of sound and reasonable business judgment; second, that no alternative financing is available on any other basis; third, that the financing is in the best interests of the estate and its creditors; and, as a corollary to the first three points, that no better offers, bids, or timely proposals are before the Court.[48]

Accordingly, a determination by the bankruptcy court that the financing transaction satisfies the business judgment rule (*i.e.*, that the debtor acted in good faith and in an informed manner) is just the starting point in obtaining approval of a DIP financing agreement.

Some courts have added still other factors to consider in deciding whether a DIP financing agreement should be approved. For example, in *In re Farmland Industries, Inc.*,[49] the Court held that the following enumerated factors should be considered by a bankruptcy court in determining whether a § 364 post-petition financing agreement should be approved:

(1) That the proposed financing is an exercise of sound and reasonable business judgment;
(2) That no alternative financing is available on any other basis;
(3) That the financing is in the best interests of the estate and its creditors;
(4) As a corollary to the first three points, that no better offers, bids, or timely proposals are before the court;
(5) That the credit transaction is necessary to preserve the assets of the estate; and
(6) That the terms of the transaction are fair, reasonable, and adequate, given the circumstances of the debtor-borrower and the proposed lender.

Although courts list a number of factors that require close factual scrutiny by the bankruptcy court, as a practical matter, bankruptcy courts are reluctant to deny DIP financing agreements without which the debtor may be forced to liquidate.[50]

Some courts have recognized that the debtor has very little bargaining power in negotiating DIP financing arrangements and have sought to level the playing field a bit. For example, at the request of the Delaware District

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Court, Chief Judge Walsh of the Delaware Bankruptcy Court submitted a letter in April, 1998 commenting on the terms of first day DIP financing orders that, "should be avoided" so as to "eliminate some of the most objectionable features of such orders."[51] These prohibitions include:

(i) absent exigent circumstances, a proposed DIP order "should not grant to a lender a lien on avoidance actions,"

(ii) a proposed DIP order should not "divest the debtor, or any other party in interest, of any discretion in the formulation of a plan,"

(iii) a proposed DIP order should provide that the debtor is only obligated to reimburse a lender for "reasonable attorneys fees and costs and such reimbursement should not apply to "the lender's defense to challenges by a committee to the lender's prepetition security position."

Conclusion

Most bankruptcy courts recognize that applying business judgment principles in some form to business decisions made by debtors in the bankruptcy reorganization setting is as appropriate as in regular non-bankruptcy situations. These courts recognize that the debtor-in-possession is required to take risk and be innovative in its decision-making without fear of judicial hindsight.

Bankruptcy courts that apply the business judgment rule to a corporate decision made by a debtor, however, often interject considerations of fairness and reasonableness that are not present in a traditional business judgment rule analysis. These courts take the view that a more searching standard of review (which focuses on the substance of the decision) is desirable in order to better protect the interests of the bankruptcy estate and its creditors.

1. Support for judicial deference toward directors can be found in nineteenth-century cases and early twentieth-century cases. For example, in *Robinson v. Pittsburgh Oil Refining Corp.*, 126 A. 46, 48 (Del. Ch. 1924), the court used language that closely resembles the modern rule: "It follows, therefore, that the directors of the defendant corporation are clothed with that presumption which the law accords to them . . . [T]he sale in question must be examined with the presumption in its favor that the directors who negotiated it honestly believed that they were securing terms and conditions which were expedient and for the corporation's best interests." *See* 1 Dennis J. Block, Nancy E. Barton & Stephen A. Radin, *The Business Judgment Rule*, at 1 (5th ed. 1998) (citing the over 100 year old Supreme Court decision in *Briggs v. Spaulding*, 141 U.S. 132 (1891), which acknowledged that directors must act as would "ordinarily prudent and diligent men . . . under similar circumstances, and in determining that . . . the usages of business should be taken into account").

2. E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 Bus. Law. 393, 394 (1997) (footnote omitted).

3. *See Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, No. C.A. 114-N, 2004 WL 2647593, at * 13 (Del. Ch. Nov. 17, 2004).

4. *See Askanase v. Fatjo*, No. H-91-3140, 1993 WL 208440, at *5 (S.D. Tex. April 22, 1993) ("[T]he business judgment rule and other rules applicable to solvent corporations are of no effect in the context of insolvency"), *aff'd*, 130 F.3d 657 (5th Cir. 1997); *N.Y. Credit Men's Adjustment Bureau v. Weiss*, 305 N.Y. 1, 110 N.E.2d 397 (1953) (court did not apply business judgment rule in finding directors liable to creditors for negligence in selling the assets of an insolvent company for inadequate value); *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944) ("The fact which creates the trust is insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency").

5. 3 Collier on Bankruptcy ¶ 363.03[7] (15th ed. rev. 2004).

6. *In re Marrose Corp.*, 1992 WL 33848, at *5 (Bankr. S.D.N.Y. Feb. 15, 1992).

7. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*, 506 A.2d 173, 183-85 (Del. 1986). *See also Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 578 (11th Cir. 1988) ("Termination fees, when reasonable in relation to the bidder's efforts and to the magnitude of the transaction, are generally permissible, unless they are used in combination with other impermissible defense tactics") (citations omitted).

8. *In re 995 Fifth Ave. Assocs., L.P.*, 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989), *In re Integrated Res., Inc.*, 147 B.R. 650, 657 (S.D.N.Y. 1992).

9. 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989).

10. *Id*. at 28 (citations omitted).

11. *See* Eli R. Levy, *Corporate Courtship Gone Sour: Applying a Bankruptcy Approach To Termination Fee Provisions in Merger and Acquisition Agreements*, 30 Hofstra L. Rev. 1361, 1392 (2002) (describing the standard applied by *In re 995 Fifth Avenue Assoc*. as a "modified" business judgment rule review).

12. *995 Fifth Avenue*, 96 B.R. at 28-29.

13. *See In re Tama Beef Packing Inc.*, 312 B.R. 192, 194 (Bankr. N.D. Iowa, 2004).

14. 166 B.R. 908 (Bankr. D. Ariz. 1994).

15. *Id.* at 912-13.

16. *Id*. at 911.

17. *Id.* at 912 (citation omitted).

18. 140 B.R. 191 (Bankr. N.D. Ohio 1992).

19. *Id.* at 194.

20. *Id*. at 196.

21. 11 U.S.C. § 503 provides that an entity is allowed an administrative expense for the costs and expenses incurred in preserving the bankruptcy estate: "(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including–
(1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case."

22. 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995).

23. *Id*. at 106 .

24. 212 B.R. 133 (Bankr. N.D. Ind. 1997).

25. *Id.* at 137 (quoting *America West*, 166 B.R. at 912) (footnote omitted).

26. *See* note 21.

27. 181 F.3d 527 (3rd Cir. 1999).

28. 181 F.3d at 537 ("[W]hen Calpine decided to reenter the bidding, it knew that it risked not receiving any break-up fees or expenses. Its decision to proceed in the face of this risk undercuts its current contention that it viewed the fees and expenses as necessary to make its continued involvement worthwhile. Indeed, the fact that O'Brien turned out to be worth at least $52 million more than Calpine's original bid (judging from what NRG was ultimately willing to pay) strongly suggests that it was the prospect of purchasing O'Brien cheaply, rather than the prospect of break-up fees or expenses, that lured Calpine back into the bidding").

29. *Id*. at 537-38.

30. Robert T. Kugler & Douglas R. Boettge, *In Search Of The Elusive Break-Up Fee,* 19-SEP Am. Bankr. Inst. J. 14, 36 (2000).

31. *Id.* at 37.

32. 290 B.R. 90 (8th Cir. BAP (Iowa) 2003).

33. *Id.* at 98.

34. 3 Collier on Bankruptcy ¶ 365.01 (15th ed. rev. 2004). The general definition of an "executory contract" is simply "[a] contract that remains wholly unperformed or for which there remains something still to be done on both sides." BLACK'S LAW DICTIONARY 512 (8th ed. 2004). *See also In re Bellamah Cmty. Dev*., 107 B.R. 337, 341 (Bankr. D.N.M. 1989) ("Congress did not define the term 'executory contract', however, the definition of an executory contract has been set forth by Professor Vern Countryman and is widely accepted. A contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other") (quoting Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973)).

35. *In re Orion Pictures Corp.*, 4 F.3d 1095, 1098 (2d Cir. 1993) (quoting 2 Collier on Bankruptcy ¶ 365.0[1] (15th ed. 1993)).

36. *In re Minges*, 602 F.2d 38, 41 (2d Cir. 1979).

37. *See generally In re Minges*, 602 F.2d 38 (2d Cir. 1979). For some types of executory contracts, a different rejection standard than the business judgment test has been mandated either by statute or case law. *See NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984), where the U.S. Supreme Court held that a somewhat stricter standard than the business judgment standard applies to approval or rejection of collective bargaining agreements. The Court described that standard as higher one than the business judgment rule, but a lesser one than would require the DIP to demonstrate that its reorganization would fell unless rejection is permitted. The U.S. Supreme Court held that the bankruptcy court should balance the interests of all affected by the rejection – the debtors, the creditors, and employees and in striking that balance, the "Court must consider not only the degree of hardship faced by each party, but also any qualitative differences between the types of hardship each may face." *Id*. at 527. The Supreme Court specifically cautioned that the "Bankruptcy Court must focus on the ultimate goal of Chapter 11 when considering these equities. The Bankruptcy Code does not authorize free-wheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the reorganization." *Id*. After the *Bildisco* decision, Congress enacted Pub. L. No. 98-353, amending the Bankruptcy Code to establish a procedure for and the conditions under which collective bargaining agreements may be rejected. 11 U.S.C. § 1113. *See Int'l Bhd. of Teamsters v. IMI Freight, Inc*., 789 F.2d 1460, 1451 (10th Cir. 1986) ("This statute 'adheres to the spirit of [the] unanimous Supreme Court opinion.'" (citation omitted). Therefore, "[w]hile new procedural requirements have been imposed [by 11 U.S.C. § 1113], the approach to the required balancing of the equities should not be different from the instruction provided in *Bildisco*").

38. *See In re Patterson*, 119 B.R. 59, 61 (Bankr. E.D. Pa. 1990) (fairness to the buyer is irrelevant in determining whether a debtor may reject a contract).

39. 35 B.R. 561 (Bankr. W. D. Wash. 1983).

40. *Id.* at 563.

41. *Id*. at 564.

42. 114 B.R. 134 (Bankr. S.D. Ohio 1990).

43. *Id.* at 137.

44. 378 F.3d 511 (5th Cir. 2004).

45. *Id*. at 525.

46. Sections 364(c) and (d) of the Bankruptcy Code provide:

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt–

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if–

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

47. *In re Ellingsen MacLean Oil Co.*, 65 B.R. 358, 362 (W.D. Mich., 1986), *aff'd*, 834 F.2d 599 (6th Cir. 1987) ("Because the interests of other creditors may be prejudiced through the granting of a section 364(c) priority, due process requires that such creditors receive notice and a chance to object to the priority at a hearing before the bankruptcy court.") (citing *Mullane v. Cent. Hanover Bank and Trust Co.*, 339 U.S. 306 (1950) and *In re Adamson Co.*, 29 B.R. 937 (Bankr. E.D. Va. 1983)).

48. *In re Phase-I Molecular Toxicology Inc.*, 285 B.R. 494, 495-96 (Bankr. D.N.M. 2002) (quoting *In re W. Pac. Airlines, Inc.*, 223 B.R. 567, 572 (Bankr. D. Colo., 1997)).

49. 294 B.R. 855, 879-882 (Bankr. W.D. Mo., 2003).

50. George G. Triantis, *A Theory of the Regulation of Debtor-In-Possession Financing*, 46 Vand. L. Rev. 901, 909 (1993).

51. *See also Northern District of California Guidelines for Cash Collateral and Financing Stipulations* at 8 ("Provisions that operate, as a practical matter, to divest the debtor in possession of any discretion in the formulation of a plan or administration of the estate or limit access to the court to seek any relief under other applicable provisions of law . . . will not normally be approved").

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Section 11's "Due Diligence" And "Reliance" Defenses

Section 11 of the Securities Act of 1993 creates a private right of action for the filing of a registration statement that "contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[26] In enacting this provision, Congress specifically sought to subject underwriters,[27] among other non-issuers involved in the process of offering securities to the public, to the liability provisions of the federal securities laws, because doing so "'would provide the necessary incentive to ensure their careful investigation of the offering.'"[28]

But, as Judge Cote acknowledged in *WorldCom*, Congress "specifically rejected the notion of underwriters as insurers," requiring instead that underwriters "'exercise diligence of a type commensurate with the confidence, both as to integrity and competence,' placed in them by those purchasing securities."[29] In this connection, Section 11 provides two distinct, but interrelated affirmative defenses for underwriters.

The first defense, known as the "due diligence" defense, applies to the "non-expertised" portions of registration statements[30] and shields the underwriter from liability if

> he had, after reasonable investigation, reasonable ground to believe and did believe, at the time [a non-"expertised"] part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.[31]

The due diligence defense, which, by its terms, creates a negligence standard of liability for underwriters,[32] applies *only* if the underwriter conducts a "reasonable investigation." Although the question of precisely what constitutes a "reasonable investigation" is not susceptible to "a rigid rule suitable for every case defining the extent to which such verification must go,"[33] Judge Cote, noting the paucity of caselaw in this area, referred to the Southern District of New York's 1968 decision in *Escott v. BarChris Construction Corp.* for a description of the nature of the required inquiry:

> The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. *To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company.* It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. *In order to make the underwriter's participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them.* They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.[34]

Accordingly, "while an underwriter is not 'expected to possess the intimate knowledge of corporate affairs of inside directors,' his obligation is to conduct a meaningful investigation, 'not merely . . . listen[ ] to management's explanations of the company's affairs.'"[35]

In contrast, the second affirmative defense – known as the "reliance" defense – applies to the "expertised" portions of a registration statement and provides that an underwriter will not be held liable if

> he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.[36]

"After *WorldCom*, underwriters apparently must take responsibility for questioning not only the issuer's conduct when suspicious facts arise, but also questioning why the issuer's financial performance – as measured by one performance ratio in this case (*i.e.*, the E/R ratio) – is better than that of its competitors."

With respect to the reliance defense, Judge Cote – again noting that "[n]either the Supreme Court nor the Second Circuit has explored this area of law in any significant way"[37] – referred to Justice Powell's dissent in *John Nuveen & Co. v. Sanders*,[38] in which he explained that Section 11

> explicitly absolve[s] [an underwriter] of the duty to investigate with respect to "any part of the registration statement purporting to be made on the authority of an expert" such as a certified accountant if "he had no reasonable ground to believe and did not believe" that the information therein was misleading. This provision is in the Act because, almost by definition, it *is* reasonable to rely on financial statements certified by public accountants.[39]

Section 11(a)(4) specifically identifies an accountant as an expert, but an accountant's opinion qualifies as an expert's opinion for Section 11's reliance defense only if the following three prerequisites are met: (i) the opinion must be reported in the registration statement; (ii) it must be an audit opinion; and (iii) the accountant must consent to the inclusion of the opinion in the registration statement.[40] Consequently, "[u]nderwriters can rely on an accountant's audit opinion incorporated into a registration statement in presenting a defense under Section 11(b)(3)(C)," but "may *not* rely on an accountant's comfort letters for interim financial statements in presenting such a defense. Comfort letters do not 'expertise any portion of the registration statement that is otherwise non-expertised.'"[41]

Importantly, as discussed below, Judge Cote cautioned that "underwriters' reliance on audited financial statements may not be blind. Rather, where 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability."[42]

Due Diligence In The Context Of Shelf Registrations

To ensure that investors are furnished with "meaningful, nonduplicative information both periodically and when securities distributions are made to the public,"[43] the SEC, beginning in the late 1960s, sought to integrate the disclosure requirements of the Securities and Exchange Acts.[44] This was accomplished in large part through the adoption of Form S-3 in 1982, which created "a streamlined registration form available only to certain well-capitalized and widely followed issuers about which a significant amount of public information is already available."[45] A Form S-3 registration – otherwise known as a "short form" registration –

allows the registrant to incorporate by reference into the registration statement the registrant's extensive Exchange Act reporting, including its most recent Form 10-K and all subsequent periodic Exchange Act filings through the termination of the offering.[46]

The SEC's adoption of Form S-3 was accompanied by its adoption of Rule 415, which enables all Form S-3 eligible registrants to engage in shelf registration – "the process by which securities are registered to be offered or sold on a delayed or continuous basis"[47] – "in an amount . . . reasonably expected to be offered and sold within two years from the initial effective date of the registration."[48] Shelf registration was intended to provide the issuer with "'procedural flexibility' to vary 'the structure and terms of securities on short notice,'"[49] and the adoption of Rule 415 in 1982 (and its subsequent amendment in 1992) furthered that purpose by, among other things, expanding the types of securities that could be offered "off the shelf."

As could be expected, these developments dramatically reduced the time and expense involved in the offering process, "thus enabling more 'rapid access to today's capital markets.'"[50] But as also could be expected, these developments raised concerns with underwriters that were left with only a fraction of the time they previously had to complete their due diligence:

> [T]his reduction in preparation time, together with competitive pressures, will restrict the ability of responsible underwriters to conduct what would be deemed to be a reasonable investigation, pursuant to Section 11, of the contents of the registration statement. . . . [I]ssuers may be reluctant to wait for responsible underwriters to finish their inquiry, and may be receptive to offers from underwriters willing to do less.[51]

Notwithstanding the underwriters' misgivings, the SEC has held underwriters to their historical due diligence obligations, emphasizing that its promulgating an integrated disclosure system was intended to speed up the offering process, not to loosen due diligence standards.[52] Thus, underwriters – in light of the increased use of shelf registrations – were advised by the SEC to "'arrange [their] due diligence procedures over time for the purpose of avoiding last minute delays in an offering environment characterized by rapid market changes.'"[53] As Judge Cote explained:

> At the time the SEC finalized the shelf registration rule . . . it again recognized that "the techniques of conducting due diligence investigations of registrants qualified to use short form registration . . . would differ from due diligence investigations under other circumstances." Nonetheless, it stressed the use of "anticipatory and continuous due diligence programs" to augment underwriters' fulfillment of their due diligence obligations.[54]

With the SEC having repeatedly expressed its view, the question remained how the courts would frame an underwriter's due diligence obligations in the time-sensitive context of a shelf registration. As made clear below, Judge Cote adheres to the SEC's view.

The Merits Of The Underwriter Defendants' Summary Judgment Motion

The Underwriter Defendants moved for summary judgment on each of the alleged misstatements in the 2000 and 2001 registration statements, arguing that they were entitled to the "reliance" and "due diligence" defenses under Section 11 because with respect to (a) WorldCom's audited (and thus, expertised) financial statements, they had no reasonable ground to believe and did not believe they were untrue, and (b) the unaudited interim financial statements, *i.e.*, the (non-expertised) comfort letters issued by Arthur Andersen, after a reasonable investigation, the Underwriter Defendants believed them to be true.

The Audited Financial Statements

The court began its analysis with the Underwriter Defendants' alleged reliance on the expertised portions of the 2000 and 2001 registration statements – *i.e.*, the unqualified "clean" audit opinions issued by Arthur Andersen. Lead Plaintiff argued that, even with respect to the audited figures, the Underwriter Defendants nevertheless had an obligation to conduct a reasonable investigation into any red flags in the registration statements, whether contained in the audited figures themselves, or related in such a way as to "have required further [inquiry] about the discrepancy between the audited [and any unaudited] figures."[55]

In response, the Underwriter Defendants' argued that "an audited figure can never constitute a red flag and impose a duty of investigation" and that, with respect to facts "extraneous" (but related) to the audited figures, "the standard that should apply is whether they had 'clear and direct notice' of an 'accounting' problem."[56]

Dismissing the Underwriter Defendants' position as akin to asserting a right to rely on audited financial statements under all circumstances ("blind reliance," in the court's words), Judge Cote observed, "where 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability."[57] A "red flag," said the court, can be one of two things. "First, red flags can be those facts which come to a defendant's attention that would place a reasonable party in defendant's position 'on notice that the audited company was engaged in wrongdoing to the detriment of its investors.'"[58] The court said that this formulation, often used in the context of claims arising under Section 10(b) of the Exchange Act, is particularly helpful in assessing whether a defendant's conduct was such "an extreme departure from the standards of ordinary care" that it is a reasonable inference that the defendant acted intentionally to defraud or was reckless in disregarding the possibility of wrongdoing by another party.[59] Yet, having reviewed the underwriters' due diligence in connection with the 2000 and 2001 offerings, there is no suggestion by the court that the underwriters acted other than in

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accordance with customary practice.

In addition to those red flags suggesting a defendant acted fraudulently or recklessly, the court identified a second type of red flag, which it characterized as "facts or circumstances that 'would suggest to an investor of ordinary intelligence the probability that she has been defrauded.'"[60] Formulated differently, the court said that "[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements is a red flag, whether or not it relates to accounting fraud or an audit failure."[61]

With these standards in mind, the court concluded that there were two sets of undisputed facts that a jury could conclude put the underwriters on notice that reliance on the audited financial statements without further investigation was unreasonable.[62] First, as to the 2000 offering, the court held that a jury could find that the differences between WorldCom's "E/R" ratio (the ratio of line cost expense to revenues, a performance measure commonly used to evaluate fixed line telecommunications companies, and one derived directly from WorldCom's financial statements) and the comparable measures of its closest competitors constituted a red flag. Second, as to the 2001 offering, the court held that in addition to the E/R ratio, a jury could find there was a red flag because AT&T and Sprint, WorldCom's principal competitors, recorded asset impairment charges related to their core networks in 2000 while WorldCom did not.

The facts the *WorldCom* decision considers possible "red flags" are likely to surprise many in the underwriter community. Before *WorldCom*, the "most prominent recent discussion"[63] of an underwriter's ability to rely on audited financial statements was *In re Softwork Toolworks Inc. Securities Litigation*.[64] In *Toolworks*, the plaintiffs argued that specific red flags precluded the underwriters from relying on the issuer's audited financial statements. First, the plaintiffs asserted that, having discovered a memorandum revealing the backdating of a sales contract so as to allow the issuer to record revenue in a particular year, the underwriters were thereafter precluded from relying on the audited financial statements. The district court disagreed and the appellate court affirmed the trial court's decision. Why did the court reach this result? It was because the underwriters, having found evidence of potential wrongdoing, demanded explanations from the independent auditor, required the auditor to provide written confirmation of the accounting treatment for specific contracts, and consulted with another public accounting firm to confirm the accounting treatment.[65] Clearly, the underwriters recognized that the backdating memorandum required further investigation.

The second red flag alleged in *Toolworks* was that the underwriters, having read the contracts under which the issuer is alleged to have improperly booked revenues, should have realized that the company's financial statements were suspect. The court firmly rejected this argument. Quoting its holding in another case, the Ninth Circuit said, "It is absurd in these circumstances for plaintiffs to suggest that the other defendants, who are not accountants, possibly could have known of any mistakes by [the auditors]. Therefore, even if there were errors in the financial statements, no defendant except [the auditor] can be liable under Section 11 on that basis."[66] Until *WorldCom*, underwriters – unless brought face to face with obvious evidence of potential wrongdoing by the issuer or its auditors – would have thought that the accounting decisions reflected in audited financial statements "represent precisely the type of 'certified' information on which section 11 permits non-experts to rely."[67]

WorldCom changes the rules of the game for underwriters in no small measure. Previously, underwriters knew that when confronted with evidence of potential wrongdoing by the issuer or its auditor (*e.g.*, the backdating memorandum at issue in *Toolworks*), they were on notice of the need to further investigate the issuer's audited financial statements before relying on them. After *WorldCom*, underwriters apparently must take responsibility for questioning not only the issuer's conduct when suspicious facts arise, but also questioning why the issuer's financial performance – as measured by one performance ratio in this case (*i.e.*, the E/R ratio) – is better than that of its competitors. Moreover, *WorldCom* suggests that underwriters have an obligation to demand that an issuer explain the accounting decisions taken by its competitors, and not by it (*e.g.*, the asset impairment write downs by AT&T and Sprint).

In a sense, the lessons of *WorldCom* are not marked departures from traditional underwriting due diligence practice, at least in the context of initial public offerings or offerings conducted less rapidly than many shelf-takedowns. Underwriters traditionally have meaningful expertise in the issuer's particular industry and are aware of how the issuer and its financial performance compare to its competitors. The underwriters and their counsel typically examine the disclosure documents of comparable companies to see whether there are risks, trends and uncertainties identified by or affecting other industry players that one might also expect to affect the issuer. Information gleaned from those sources, and from industry research reports, credit rating agency reports, securities analysts reports, trade journals and other media all factor into the due diligence process and provide fodder for questions posed to issuers.[68]

But *WorldCom* goes beyond emphasizing an underwriter's duty to make a critical inquiry into the issuer and its business. Instead, *WorldCom* suggests that the underwriters involved in a particular transaction must have a deeper understanding of industry, financial and accounting matters than all other observers of the company and its competitors. The *WorldCom* court, for example, discounts entirely the Underwriter Defendants' argument – uncontested by Lead Plaintiff – that the differences between WorldCom's E/R ratio and the similar ratios of its competitors were known throughout the market and had not attracted public comment from those who make their living trading or advising those who trade securities.[69] To equate the underwriters' obligation "to bring their expertise to bear"[70] with an obligation to be smarter than all others who study the company seems unfair and, in a meaningful sense, unreasonable.[71] Moreover, although the Underwriter Defendants – as well as everyone else involved in these offerings – certainly knew that AT&T and Sprint had recorded asset impairment charges while WorldCom had not, it goes against the lessons of the *Toolworks* case to require underwriters to second-guess such fundamental matters of accounting judgment, at least without evidence learned from the issuer or its auditors suggesting wrongdoing.

The Unaudited Financial Statements

The *WorldCom* decision holds that receipt of an accounting "comfort letter," by itself, is not sufficient to demonstrate that the underwriters performed adequate due diligence with respect an issuer's unaudited (and therefore "non-expertised") financial statements. In the abstract, it is difficult to take exception with the court's decision on this point. There is no doubt that unaudited financial statements are not "expertised," and there is no doubt that a comfort letter is not the same as an expert's report, thus entitling an underwriter to assert a reliance defense. Nevertheless, the *WorldCom* decision will create consternation and confusion in underwriting circles because, in the absence of evidence suggesting fraud or error in unaudited financial statements, the traditional practice of holding conversations with the issuer's senior financial management coupled with holding conversations with the auditors, in both cases to inquire about the issuer's financial performance in the interim period covered by the unaudited financial statements, and receipt of a comfort letter have been viewed as synonymous with conducting a reasonable investigation.

Of course, it is entirely possible that the jury will conclude that the WorldCom underwriters conducted a reasonable investigation.[72] Unfortunately, the Underwriter Defendants' due diligence procedures in this case clearly did not impress Judge Cote, who sided with Lead Plaintiff in concluding that the reasonableness of the underwriters' investigation is a question for the jury to decide. Indeed, the real lesson of *WorldCom* may well be "*caveat underwriter*," at least when a plaintiff claims:

> that having internally downgraded WorldCom's credit rating and having taken steps to limit their exposure as WorldCom's creditors, the Underwriter Defendants were well aware that WorldCom was in a deteriorating financial position in a troubled industry, and that a reasonable investigation would have entailed a more searching inquiry than that undertaken by the Underwriter Defendants.[73]

The Lead Plaintiff has also argued that

> evidence of the limited number of conversations with the issuer or its auditors, the cursory nature of the inquiries, the failure to go behind any of the almost formulaic answers given to questions, and the failure to inquire into issues of particular prominence in the Underwriter Defendants' own internal evaluations of the financial condition of the issuer or in the financial press,

showed an inadequate investigation by the underwriters.[74]

It would be comforting to take the view that the *WorldCom* decision should be limited to its facts. Rarely does the phrase "hard facts make bad law" seem more apposite. Nevertheless, until we know the denouement of the WorldCom litigation, or another significant decision addressing the due diligence defense appears, underwriters and their counsel will be left to grapple with deciding whether, and how high, *WorldCom* has raised the bar for future due diligence exercises and, if so, what procedures are available to them to meet the standard posed by the *WorldCom* court:

> The term "reasonable investigation" encompasses many modes of inquiry between obtaining comfort letters from an auditor and doing little more, on one hand, and having to re-audit a company's books on the other. Nonetheless, if aggressive or unusual accounting strategies regarding significant issues come to light in the course of a reasonable investigation, a prudent underwriter may choose to consult with accounting experts to confirm that the accounting treatment is appropriate and that additional disclosure is unnecessary.
>
> Underwriters perform a different function from auditors. . . . They are not being asked to duplicate the work of auditors, but to conduct a reasonable investigation. If their initial investigation leads them to question the accuracy of financial reporting, then the existence of an audit or a comfort letter will not excuse the failure to follow through with a subsequent investigation of the matter.[75]

"[T]here is one clear lesson from *WorldCom*. Against the backdrop of a massive fraud, when the underwriter itself has doubts about the issuer's financial condition and is actively taking steps to minimize its exposure to that client, the due diligence record will be viewed in hindsight with a much greater degree of skepticism than is likely in other cases."

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Conclusion

WorldCom requires rethinking what constitutes a reasonable due diligence investigation with respect to accounting and financial matters, whether or not the context involves a shelf offering. The nature of the "red flags" that deprive an underwriter of its ability to rely on audited financial statements without further inquiry has been changed. Underwriters and their counsel can no longer look only to suspicious evidence coming from the issuer's or its auditors' files to cause them to probe more deeply into audited financial statements. Now they must be concerned over whether deviations between an issuer's financial performance and that of its peers, or whether accounting decisions made by other industry participants and not by the issuer, raise questions of such significance that a searching inquiry into the audited financial statements, possibly with the assistance of another accounting firm, is necessary. With respect to unaudited financial statements, the underwriting community now faces significant uncertainty about what sort of inquiry it must make – what precisely does it mean to engage in an investigation that is something between relying on a comfort letter without more and auditing the issuer's auditor?

Of course, there is one clear lesson from *WorldCom*. Against the backdrop of a massive fraud, when the underwriter itself has doubts about the issuer's financial condition and is actively taking steps to minimize its exposure to that client, the due diligence record will be viewed in hindsight with a much greater degree of skepticism than is likely in other cases. Moreover, in this particular context, the argument that the offering was done as a takedown from a shelf registration statement and therefore there was not time to do more is unlikely to find a sympathetic hearing.

1. 346 F. Supp. 2d 628 (S.D.N.Y. 2004).
2. 17 C.F.R. § 230.415 (2003). Rule 415 permits all Form S-3 (or "short-form") eligible registrants to engage in shelf registration "in an amount . . . reasonably expected to be offered and sold within two years from the initial effective date of the registration." *Id.* at §§ 230.415(a)(1)(x), (a)(2).
3. *WorldCom*, 346 F. Supp. 2d at 667.
4. ABA Committee on Federal Regulation of Securities, *A Major Issues Conference: Securities Regulation in the Global Internet Economy, Comments on Securities Act Reform* (Nov. 14-15, 2001); *see also* Brief of the Securities Industry Association and the Bond Market Association, *Amici Curiae*, in Support [of] the Motion of Underwriter-Related Defendants for Summary Judgment (*hereinafter*, the "SIA/BMA Brief"), at 1-2 ("Shelf registration offerings have become an essential part of the capital raising markets in the United States, but the future of such offerings would be put in jeopardy if the Court were to issue a ruling that required an underwriter to perform the same due diligence for a shelf offering as it would for an offering involving a pre-effective waiting period. If underwriters were required to utilize the same time-consuming diligence procedures with respect to offerings off of a shelf registration as they use for non-shelf deals, then either underwriters would have to be willing to proceed without the statutory diligence defense Congress intended them to have or issuers would not be able to have the benefit of underwritten financing off of a shelf registration, as the SEC intended they should").
5. *WorldCom*, 346 F. Supp. 2d at 669 (quoting *Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act*, SEC Release No. 6335, 1981 WL 31062, at *10 (Aug. 6, 1981)).
6. *Id*.
7. *WorldCom*, 346 F. Supp. 2d at 650.
8. The Underwriter Defendants were Salomon Smith Barney, Inc., now d/b/a Citigroup Global Markets Inc. and Salomon Brothers International Limited (collectively, "SSB"); J.P. Morgan Chase & Co., J.P. Morgan Securities, Ltd., and J.P. Morgan Securities, Inc. (collectively, "J.P. Morgan"); Banc of America Securities LLC; Chase Securities Inc.; Lehman Brothers Inc.; Blaylock & Partners, L.P.; Credit Suisse First Boston Corp.; Deutsche Bank Alex. Brown, Inc., n/k/a Deutsche Bank Securities, Inc.; Goldman, Sachs & Co.; UBS Warburg LLC; ABN/AMRO Inc.; Utendahl Capital; Tokyo-Mitsubishi International plc; Westdeutsche Landesbank Girozentrale; BNP Paribas Securities Corp.; Caboto Holding SIM S.p.A; Fleet Securities Inc.; and Mizuho International plc. In November 2004, SSB (as well as certain other named Citigroup, Inc. affiliates) settled with class plaintiffs.
9. *WorldCom*, 346 F. Supp. 2d at 637.
10. *Id*.
11. *See id*. at 645, 647.
12. *Id*. at 647-48.
13. *Id*. at 648.
14. *See id*.
15. *Id*. at 682-83.
16. *Id*. at 649, 650. The court explained that "during the weeks that followed, several of the Underwriter Defendants made a commitment to WorldCom to help it restructure its massive credit facility. In doing so, there is evidence that at least some of the Underwriter Defendants internally expressed concern again about WorldCom's financial health." *Id*.
17. *See id*. at 651.
18. *See id*.
19. *See id*.
20. *See id*. at 652-53.
21. *Id*. at 653.
22. *Id*.
23. *Id*. at 641. On that date alone, WorldCom transferred approximately $771 million in line costs to a capital account named "prepaid capacity." *Id*.
24. *See id*. at 653-54.
25. *Id*. at 654.
26. 15 U.S.C. § 77k(a).
27. Defined as a "'person who buys securities directly or indirectly from the issuer and resells them to the public, or performs some act (or acts) that facilitates the issuer's distribution.'" *WorldCom*, 346 F. Supp. 2d at 662 (quoting *In re WorldCom, Inc. Sec. Litig.*, 308 F. Supp. 2d 338, 343 (S.D.N.Y. 2004)).
28. *WorldCom*, 346 F. Supp. 2d at 662 (quoting *The Regulation of Securities Offerings*, SEC Release No. 7606A, 63 Fed. Reg. 67174, 67230, available at 1998 WL 833389 (Dec. 4, 1998)).
29. *Id*. (quoting H.R. Conf. Rep. No. 73-152, at 277 (1933)).
30. As discussed more fully below, the non-expertised portions of a registration statement are those portions that do not constitute, or do not expressly rely on, an expert's opinion.
31. 15 U.S.C. § 77k(b)(3)(A).
32. *WorldCom*, 346 F. Supp. 2d at 662 (citing *Ernst & Young v. Hochfelder*, 425 U.S. 185, 208 (1976)).
33. *Escott v. BarChris Constr. Corp*., 283 F. Supp. 643, 697 (S.D.N.Y. 1968).
34. *Id*. at 697 (emphasis added); *Ades v. Deloitte & Touche*, 1993 WL 362364, at *19 (S.D.N.Y. Sept. 17, 1993) ("[R]easonable due diligence will normally involve a careful review of the issuer's financial statements and important contracts").
35. *WorldCom*, 346 F. Supp. 2d at 675 (quoting *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 581-82 (E.D.N.Y. 1971)); *see also id*. ("'Tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate'") (quoting *Feit*, 332 F. Supp. at 582).
36. 15 U.S.C. § 77k(b)(3)(C).
37. *WorldCom*, 346 F. Supp. 2d at 671.
38. 450 U.S. 1005 (1981).
39. *Id.* at 1010 (citation omitted); *see also id*. at 1010 n.4 (reliance on certified financial statements is "essential to the proper functioning of securities marketing, to the trading in securities, to the lending of money by banks and financial institutions, and to the reliance by stockholders on the reports of their corporations").
40. *WorldCom*, 346 F. Supp. 2d at 664-65; *see also*

17 C.F.R. § 230.436.

41. *WorldCom*, 346 F. Supp. 2d at 666 (quoting William F. Alderman, *Potential Liabilities in Initial Public Offerings, in How to Prepare an Initial Public Offering 2004*, at 405-06 (2004)) (emphasis added). SEC Rule 436 expressly provides in this regard that "a report on unaudited interim financial information . . . by an independent accountant who has conducted a review of such interim financial information shall not be considered a part of a registration statement prepared or certified by an accountant or a report prepared or certified by an accountant within the meaning of section 7 and 11 of the [Securities] Act." 17 C.F.R. § 230.436(c).

42. *WorldCom*, 346 F. Supp. 2d at 672.

43. *Reproposal of Comprehensive Revision to System for Registration of Securities Offerings*, SEC Release No. 6331, 1981 WL 30765, at *2 (Aug. 6, 1981).

44. SEC Release No. 6335, 1981 WL 31062, at *1.

45. *Shaw v. Digital Equip. Corp*., 82 F.3d 1194, 1205 (1st Cir. 1996).

46. *WorldCom*, 346 F. Supp. 2d at 667.

47. *Id*.

48. 17 C.F.R. §§ 230.415(a)(1)(x), (a)(2).

49. *WorldCom*, 346 F. Supp. 2d at 667 (quoting *Shelf Registration*, SEC Release No. 6499, 1983 WL 408321, at *4 (Nov. 17, 1983)); *see also* SIA/BMA Brief at 3 ("The benefits of shelf registration include lowering compliance costs, promoting innovative distributions, and decreasing the cost of raising capital. The flexibility afforded by shelf registration in terms of timing an offering allows a registrant to move quickly to take advantage of 'market windows' and, for example, obtain favorable interest rates on debt before market conditions change") (citations omitted).

50. *WorldCom*, 346 F. Supp. 2d at 668 (quoting SEC Release No. 6335, 1981 WL 31062, at *4).

51. SEC Release No. 6335, 1981 WL 31062, at *5 (reporting views of some commentators).

52. *WorldCom*, 346 F. Supp. 2d at 669 (quoting SEC Release No. 6335, 1981 WL 31062, at *10).

53. *Id.*

54. *Id*. at 670 (internal citations omitted).

55. *Id*. at 678-79. Lead Plaintiff specifically pointed to a discrepancy between WorldCom's expense to revenue (E/R) ratio, which was lower than the equivalent ratio for two of WorldCom's chief competitors, Sprint and AT&T. *See id.* at 678. The court noted that WorldCom's E/R ratio was 43 percent, compared to 46.8 percent for AT&T and 53.2 percent for Sprint. *See id.* at 678 n.47. Lead Plaintiff posited that "[I]n the extremely competitive market in which WorldCom operated, that discrepancy triggered a duty to investigate such a crucial measurement of the company's health." *Id*. at 678.

56. *Id.* at 679.

57. *Id.* at 672.

58. *Id*. (citation omitted).

59. *Id*.

60. *Id*. at 672-73 (citation omitted).

61. *Id*. at 673.

62. The court rejected one other potential red flag asserted by Lead Plaintiff that related to the extent to which WorldCom's CEO's personal net worth depended on the continued success of WorldCom. Lead Plaintiff asserted that the CEO's very large indebtedness to WorldCom raised a "motive and opportunity" red flag. The court ruled against Lead Plaintiff on this point, saying that without evidence of the CEO's actual involvement in the accounting decisions later shown to be fraudulent, the mere fact of the CEO's financial condition and dependence on the company was not sufficient to put the underwriters on notice of the need to question the reliability of the company's audited financial statements. *See id.* at 681.

63. *Id*. at 676.

64. 50 F.3d 615 (9th Cir. 1994).

65. *Id*. at 624.

66. *Id*. (citation omitted).

67. *Id*. (citation omitted).

68. The SEC has long recognized that by facilitating delayed and continuous offerings through the shelf registration procedure, the amount of due diligence performed by underwriters will necessarily vary with the issuer and the circumstances surrounding it. This was the reason for the adoption of Rule 176 under the Securities Act, which established six non-exclusive criteria for assessing the reasonableness of an underwriter's due diligence in the context of a shelf offering. *See* 17 C.F.R. § 230.176. However, although the *WorldCom* decision discusses at length the fact that the offerings in question were shelf offerings and is at pains to explain how these types of offerings fit into the US capital markets, there is nothing in the opinion that suggests the concerns the court had about the nature of the red flags confronting the underwriters is of relevance only in the context of shelf offerings. Put differently, in securities litigation relating to a non-shelf offering, when the underwriters presumably have more time to conduct their investigation into an issuer, the failure to dig deeper based on the existence of the sort of red flags the *WorldCom* court identifies surely will be examined even more critically by a court.

69. It is interesting to contrast *WorldCom*, in which the court dismissed the absence of negative press and security analyst commentary as irrelevant to determining whether the underwriters were on notice of a red flag demanding further investigation, and another case in which the court said that substantial negative and critical press and analyst commentary was not sufficient to put the plaintiff on notice to inquire into the possibility of fraud. In *In re Ames Department Stores Note Litigation*, 991 F.2d 968 (2d. Cir. 1993), the Second Circuit rejected a summary judgment motion based on the alleged running of the statute of limitations. In this Section 10(b) case, the defendant argued that the plaintiffs were time barred from asserting their claims because numerous press articles and securities analyst reports critical of the issuer should have put them on notice with respect to the possibility of fraud. In *Ames*, the court identified 17 critical news articles and analyst reports that appeared between November 30, 1989 and January 15, 1990, the relevant class period in that case. The court held that these articles could not have put the plaintiffs on notice of a potential fraud. "The analysts' guarded reports following the January 10 release support the noteholders' position that they could not have been on notice of the impending collapse; they detected at most distress signals, as reflected by the modest decline in the market value of the notes." *Id.* at 981. In *WorldCom*, the difference between WorldCom's E/R ratio and those of its competitors attracted no public comment, yet, according to the court, the existence of the difference was a "storm warning." In *Ames*, 17 critical public analyses of the issuer in a six-week period did not suffice to put a prudent investor on notice to inquire into the issuer's financial condition.

70. *WorldCom*, 346 F. Supp. 2d at 679.

71. Indeed, many underwriters will find the suggestion that they need to perform the sort of fundamental research that one typically associates with a research analyst as well beyond their job description.

72. The trial is scheduled to start on February 28, 2005.

73. *Id*. at 683.

74. *Id*.

75. *Id*. at 684 (citation omitted).