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A SECURITIES FRAUD AND CORPORATE
GOVERNANCE QUARTERLY

WORLDCOM: HOW A GROUND-BREAKING LITIGATION ALTERED THE LEGAL LANDSCAPE FOR LARGE SECURITIES CLASS ACTIONS AND FORCED WALL STREET TO FOREVER CHANGE ITS WAYS



Courtroom artist's rendering of the settlement hearings in the WorldCom Securities Litigation, featuring BLB&G partners Max Berger (left) and Sean Coffey (standing) and Alan Hevesi, Trustee of the New York State Common Retirement Fund, Lead Plaintiff in the case. As featured on CNBC, March 16, 2005.

By Max W. Berger, John P. ("Sean")
Coffey and John C. Browne

It was April 20, 2005 in a Federal courtroom in Lower Manhattan in New York. The former Arthur Andersen partner who had been responsible for Andersen's audits of WorldCom's financial statements for 1999, 2000 and 2001 — audits that had failed to detect nearly \$11 billion worth of improperly capitalized expenditures and other accounting gimmicks — was on the witness stand. The lead trial attorney for the plaintiff class of investors, led by the New York State Common Retirement Fund ("NYSCRF") and its

sole trustee, New York Comptroller Alan G. Hevesi, questioned the witness about a document that had been shown to the jury earlier by Andersen's lawyers. On the copy of the document shown to the jury, Andersen's lawyers had glossed over some typed text that had been crossed out and focused instead on a partially handwritten note in the margin which said WorldCom "capitalizes only those costs [that are] necessary." The investors' attorney asked whether the original version of the document was in the courtroom, so that the jury might be better able to see what words had been crossed out. The audit partner

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stepped down from the witness stand and strode confidently toward three large shelves of “audit working papers” that Arthur Andersen’s attorneys had earlier placed in front of the jury box with great fanfare. He smiled at the jury, selected a large binder from the middle shelf, and returned to the witness stand.

After flipping through the binder in silence for several minutes, the audit partner furrowed his brow and slowly leaned into the microphone: “I don’t see the original in here,” he said. The jury murmured and looked at each other with eyebrows raised. Then, on cue from the plaintiffs’ lawyer, the courtroom lights dimmed and, on a large white screen directly across from the jury, a video clip of the audit partner’s deposition, taken by the plaintiffs’ lawyers several months before trial, began to play. In the video clip, the audit partner took from the same binder the original version of the now-missing document and, after being told to hold it up to the light, was forced to confirm that the typed sentence that someone at Andersen had whited-out read: “[WorldCom’s] costs capitalized into projects is excessive.” This information, of course, was not disclosed to the investing public when Andersen issued clean audit opinions on WorldCom’s financial statements during the class period. Nor were those words discernible on the copy of the document shown to the jury by Andersen’s lawyers.

In the hush of the darkened courtroom, the plaintiffs’ attorney stopped the video clip and asked “where’s the original document?” When the audit partner had no answer, several members of the jury rolled their eyes and one scoffed aloud. In that single moment, Arthur Andersen’s credibility with the jury had evaporated. Two days later, Andersen agreed to pay \$65 million to settle the case and end the trial, bringing the total value of settlements to that point to over \$6.1 billion dollars and putting an excla-



Former WorldCom CEO Bernard Ebbers

mation point on one of the most remarkable cases in the history of securities class action litigation.

The “white-out moment” was a wonderful piece of courtroom drama rarely seen in large securities class actions, which typically settle well before trial. Yet it was merely the culmination of an extraordinary two and one-half year litigation effort — virtually light speed for a case of this size and complexity — that saw the plaintiff investors win victory after victory in pre-trial rulings. Indeed, the aggressive litigation strategy of the NYSCRF, coupled with the sheer volume of pre-trial “wins” for the plaintiff investors, literally re-wrote the book on how to litigate large securities class actions. It also left a string of precedents in its wake that have forever changed the landscape of class action securities litigation.

This article gives a broad overview of the WorldCom litigation from start to finish and highlights some of the unique litigation approaches taken by the NYSCRF and its counsel, placing particular emphasis on a number of strategic litigation decisions and highly favorable legal rulings that indelibly changed the “ground rules” for litigating large securities class-actions, and permanently changed the way that Wall Street, auditors, and corporate boardrooms do business.

The WorldCom Fraud And The Institutional Investor That Took Action

Prior to June 2002, the market viewed WorldCom as a unique success story: a telecommunications company founded by a former motel operator and night club bouncer, Bernie Ebbers, that had managed in less than two decades to grow into a Fortune 50 giant, employing more than 100,000 workers and raking in approximately \$40 billion in annual revenue. Trusting WorldCom’s published financial results and the consistently positive analyst reports issued by, among others, former Salomon Smith Barney star analyst Jack Grubman, “mom and pop” investors and talented institutional money managers alike loaded up on WorldCom stock. The large Wall Street investment banks got into the act as well. Touting WorldCom’s seemingly strong financial results and compelling growth story, no less than seventeen Wall Street banks — including Citigroup, J.P. Morgan Chase, Deutsche Bank, Bank of America and others — helped WorldCom market and sell approximately \$17 billion worth of investment grade bonds to the investing public in 2000 and 2001. The vast majority of these bonds were sold to large institutional investors, including dozens of public pension funds across the country.

What happened next is, by now, sadly familiar. On June 25, 2002, WorldCom announced that its financial statements for 2001 and the first quarter of 2002 were materially false. In July 2002, WorldCom filed the largest bankruptcy in United States history and it soon emerged that the Company had been issuing false financial statements for several years. In March 2004, WorldCom filed a formal restatement with the SEC admitting that its earnings had been overstated by approximately \$68 billion since the first quarter of 2000, including nearly \$11 billion in overstated revenues resulting from improperly capitalizing fixed expenses such as line costs.

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As the true extent of the WorldCom fraud began to reveal itself in the summer of 2002, the NYSCRF, the second largest public pension fund in the country, decided to take action by seeking to be appointed Lead Plaintiff in the securities class action litigation. On August 15, 2002, Judge Denise Cote of the United States District Court for the Southern District of New York appointed the NYSCRF as Lead Plaintiff, and approved the NYSCRF's choice of Co-Lead Counsel, the firms of Bernstein Litowitz Berger & Grossmann LLP and Barrack Rodos & Bacine. As the next two and one-half years of litigation were to show, the energy and commitment of the NYSCRF, its sole trustee, New York State Comptroller Alan G. Hevesi, and Lead Counsel ensured that the WorldCom case would not be "litigation as usual," in which the Wall Street defendants could settle early and cheap.

The Complaint: Uncovering New Facts

Even before it was appointed Lead Plaintiff, the NYSCRF directed Lead Counsel to undertake an extensive investigation into the WorldCom collapse. In addition to engaging in a com-

prehensive review of publicly available information, Lead Counsel identified, located and interviewed dozens of potential witnesses with knowledge of the operations of WorldCom and its investment banks. Through this effort, Lead Counsel discovered that, at the same time that Citigroup's investment bank (Salomon Smith Barney ("SSB")) was lobbying senior WorldCom executives for business, its corporate sibling at Citigroup, the Travelers Insurance Company, had loaned nearly \$500 million to various business entities owned by WorldCom CEO Bernard Ebbers, including massive private timber farms in Alabama, Mississippi and Tennessee.

Based on this new information and other facts relating to the WorldCom collapse, Lead Counsel filed a consolidated amended complaint in October 2002. While WorldCom's bankruptcy filing prohibited claims against the company itself, the complaint asserted claims for fraud against SSB, Jack Grubman, Arthur Andersen, Ebbers, and former members of WorldCom's board of directors. The complaint also named as defendants the Wall Street investment banks that had underwritten, marketed and sold \$17 billion worth of WorldCom

bonds publicly issued in 2000 and 2001. The theory of the complaint was that the massive WorldCom fraud could never have happened if the company's board of directors, its bankers and its auditors — the vital "gatekeepers" whose job is to protect the investing public — had been performing their job. Unfortunately for investors, instead of acting as corporate guardians, these defendants were focused more on enriching themselves through the lucrative director, auditing, consulting and investment banking fees that WorldCom was doling out like so much candy.

The Initial Phases of the Litigation: Lifting the Discovery Stay and Cooperating With the Government

In most securities class action cases, filing the complaint kicks off a prolonged period of legal maneuvering where the parties do little more than file motions to dismiss, draft reams of legal briefs, and wait while the court takes months — sometimes years — to issue an opinion. This is because a provision of the Private Securities Litigation Reform Act ("PSLRA") imposes a "discovery stay," which prohibits the parties from con-

The Infamous Arthur Andersen "Whited-Out" Document

Risk	Contingement of Risk	Mitigation of Risk	Source of Risk	Key Procedures	Issues
Completed projects are not placed into service in a timely manner	Depreciation expense is underpaid	Projects that have not been placed in service but that are significantly past their expected completion date	Failure to establish a process for identifying completed projects or failure to follow established policies	<ul style="list-style-type: none"> Review policy related to placing assets in service. Discuss the status of any projects remaining on the open project listing but significantly past the expected completion date. 	<p>We reviewed any project expense reports submitted to the company and only those costs necessary to the functioning of the technical and engineering departments</p> <p><i>the client</i></p>
Asset retirements: <ul style="list-style-type: none"> Retired assets not timely retired Retired assets are returned Retired assets not disposed of in most efficient or effective manner 	Assets and related depreciation expense are calculated. Proceeds from retired assets not liquidated	Periodic review of assets for obsolescence. Review of past deposits of retired assets	Failure to establish a process for identifying assets no longer in use and removing them from the property ledger	<ul style="list-style-type: none"> Review policy related to retirements 	<p>Retired and assets have been removed from field projects. Otherwise, disposal policies adopted. We propose that the major periodic inventories of each location, including an obsolescence review</p>
Assets capitalized, partially expensed, or fully expensed are not properly capitalized	Assets are recorded and expenses are allocated	Consistency of policy in GAAP	Capitalization policy inconsistent with GAAP	<ul style="list-style-type: none"> Review policy related to capitalization of overhead 	<p>only those costs necessary to the functioning of the technical and engineering departments</p> <p><i>the client</i></p>

What was crossed out?
 "[WorldCom's] costs capitalized into projects is excessive."

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ducting any formal discovery into the allegations of the complaint until motions to dismiss are decided. This discovery stay is an immense advantage for defendants because, as time passes, public interest wanes, witnesses' memories fade, insurance policies and other assets are depleted, investor outrage subsides, and cases start to lose traction and momentum.

To avoid this result, four weeks after filing its complaint — and before defendants had even filed their motions to dismiss — the NYSCRF filed motions in the Bankruptcy Court and in the Federal District Court seeking to partially lift the discovery stay and obtain the documents that WorldCom had provided to Congress, the SEC, and the United States Attorney. In one of the first opinions in the country to grant this type of relief, the court ordered that the NYSCRF would be permitted access to these documents. The millions of documents WorldCom produced pursuant to this decision allowed Lead Counsel to develop a coherent and focused strategy early in the litigation. As discussed below, this also allowed the NYSCRF to push for the earliest possible trial date.

Seeking these materials had another benefit as well: it opened a vital line of communication between the United States Attorney's office and the SEC on the one hand and the NYSCRF and Lead Counsel on the other. In large securities class actions, the government attorneys and the civil plaintiffs often work at cross-purposes. The government is focused on the criminal prosecutions of a handful of former employees and views the civil litigation as a disruptive side-show that can imperil the criminal case by prematurely disclosing key documents and testimony from key witnesses. For this reason, it is not uncommon for the government to seek to stay class action litigations pending resolution of criminal proceedings; a request that courts almost always grant.



Alan Hevesi, Sole Trustee of the New York State Common Retirement Fund

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Perhaps because members of Lead Counsel's trial team had previously worked in the United States Attorney's office, Lead Counsel was able to work cooperatively with the government so that the civil case and the criminal cases could proceed on a parallel track. Without this cooperation, it is likely that the government would have sought and obtained a broad stay of the WorldCom securities class action. If that had happened, then discovery in the civil case would have been halted until the

conclusion of Ebbers' criminal trial in March 2005. Instead, by March 2005 investors were already filing claims to share in what would ultimately be the history-making \$6.1 billion recovery that the NYSCRF and Lead Counsel achieved.

Pushing for an Early Trial Date

One of the core principles of the NYSCRF's litigation strategy was to push for a trial as quickly as possible. An early trial date has enormous advantages for plaintiffs: it forces reluctant defendants to confront the realities of litigation in a public realm, it engenders interest on the part of the press and the public and places the spotlight squarely on the misconduct of the defendants, it spurs settlement negotiations between principals rather than encouraging endless pre-trial jousting between attorneys, and it increases the chances that aggrieved investors will — in a timely manner — get their day in court.

Following the granting of its motion for class certification in October 2003, Lead Counsel proposed a streamlined deposition protocol that would limit each side to no more than sixty days of depositions. This proposal represented a carefully considered strategic decision on the part of the NYSCRF and Lead Counsel to limit the often far-too-lengthy period of pre-trial discovery, where deep-pocket defendants take hundreds of marginal or unnecessary depositions in an effort to exhaust the limited resources of the plaintiffs. Under Lead Counsel's proposal, the pre-trial deposition period in WorldCom would be efficient and reasonable, concluding by mid-summer 2004, and thus allow the trial to begin in early 2005. Predictably, the defendants vociferously opposed this approach, arguing that they needed to take “hundreds” of depositions and that a trial was a virtual impossibility until 2006 at the earliest. Fortunately for investors, the court adopted the NYSCRF's proposal in its entirety. (As it turned out, the defendants did not take any depositions

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for months and ultimately used barely half of their sixty days.)

Deprived of an open-ended deposition schedule, the defendants sought to extend the proceedings and postpone the trial through other means. Throughout the winter of 2004, the defendants brought numerous motions to stay discovery and pushed interlocutory appeals to the Second Circuit Court of Appeals. Lead Counsel vigorously opposed each of these motions, and the court sided with the plaintiffs each time, refusing to move the trial date of early 2005. These hard-fought rulings were vital to maintaining a “fixed” trial date and advancing the NYSCRF’s core litigation strategy.

Assisting Institutional Investors Whose Individual Claims Were Dismissed

At the same time that Lead Counsel was pushing for — and achieving — a quick trial date in the class action, a number of individual actions that had been filed by

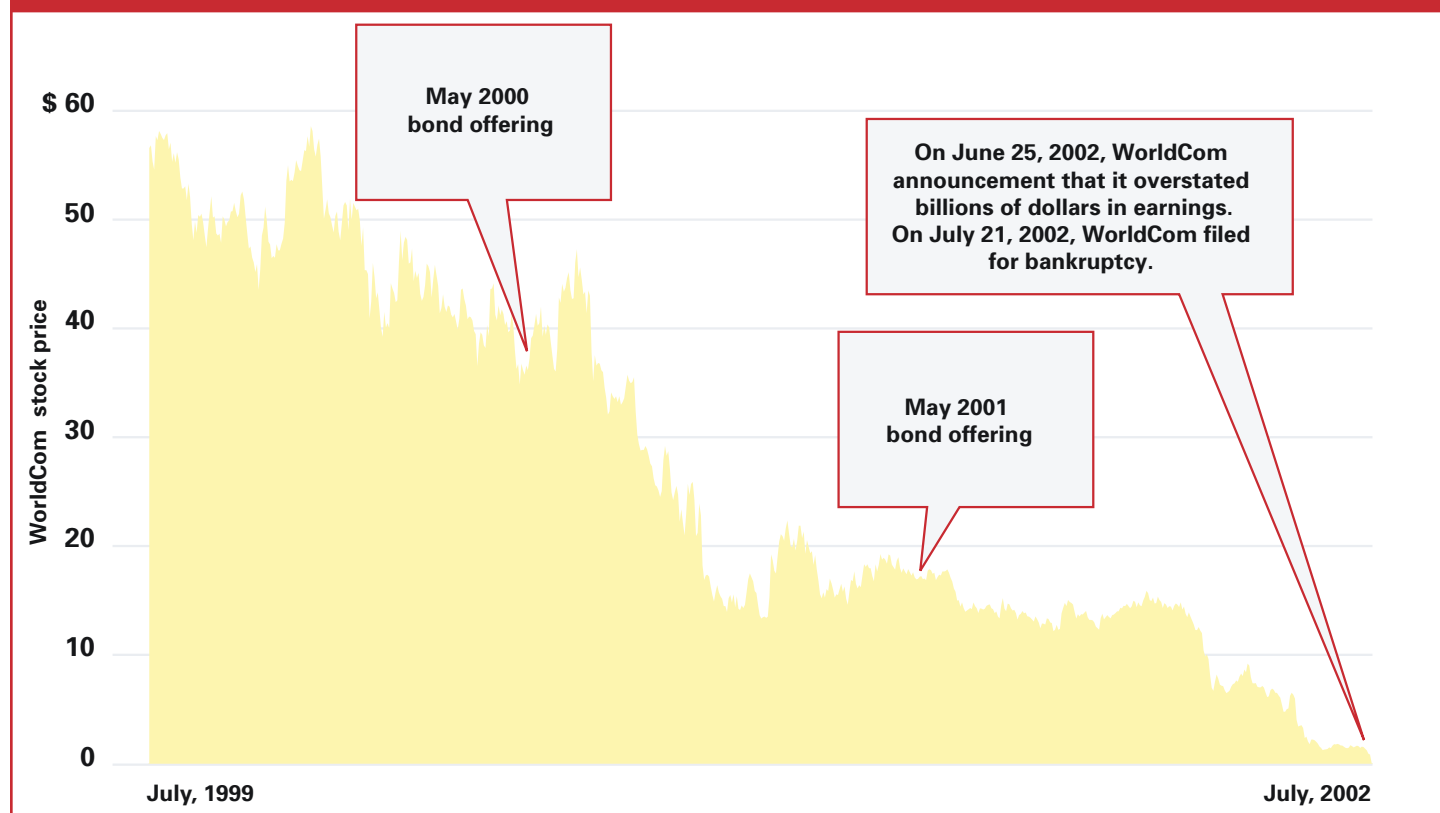
large institutional investors in state courts around the country were getting bogged down. In any instance where a large fraud is perpetrated on the investing public and a securities class action is filed, institutional investors which have been damaged by the fraud must make a decision as to how they want to proceed. Some institutional investors — like the NYSCRF here — believe that they can make a real difference in the outcome of a case, and thus seek to be appointed Lead Plaintiff. Other institutional investors must decide whether to participate in the class action or opt-out and pursue an individual litigation. As the WorldCom fraud unfolded in the summer of 2002, a number of institutional investors decided to file individual actions. This strategy ran into some difficulty when the court issued an opinion that severely limited — and in many instances cited the lapsed statute of limitations to completely extinguish — the relief available to these institutional investors.

The NYSCRF and Lead Counsel took immediate steps to assist the institutional investors that found themselves in this position. Consistent with the view that all investors who had not yet opted out — whether or not they had filed an individual action — were members of the class, the NYSCRF and Lead Counsel proposed to the court a means by which individual plaintiffs could re-join the class and share in any recovery eventually achieved in the class action litigation. Over the defendants’ opposition, the court accepted this proposal, describing it as “extremely helpful” to those institutional investors who otherwise may have been left without a recovery.

The Landmark Citigroup Settlement

The initial fruits of the NYSCRF’s and Lead Counsels’ intense litigation efforts were realized on May 10, 2004, when the NYSCRF announced that Citigroup (the corporate parent of Salomon Smith

WorldCom’s share price: The long slide down



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Significant Strategic Approaches

- ✓ Conduct an extensive pre-suit investigation of non-public sources of information.
- ✓ Litigate hard from the outset and don't let up.
- ✓ Befriend the government.
- ✓ Propose the shortest reasonable time period for pre-trial discovery.
- ✓ Insist on an early trial date and stick to it.
- ✓ Assist institutional investors that filed individual actions.
- ✓ Craft settlement demands that reasonably reflect both damages and risks of litigation and encourage partial settlements with willing defendants.
- ✓ Extract settlement premiums from defendants who refuse reasonable settlement offers early in the litigation.
- ✓ Given historic size and nature of fraud, seek personal assets of responsible directors.
- ✓ Make the principal executive wrongdoers empty their pockets.
- ✓ Take the case to trial if necessary.

Barney) had agreed to pay up to \$2.65 billion in cash to settle the claims asserted against it in the securities litigation. This unprecedented settlement was achieved in large part due to the intense involvement by representatives of the NYSCRF, including Comptroller Hevesi, who participated in face-to-face negotiations with the highest-ranking representatives of Citigroup. In announcing the settlement, Comptroller Hevesi stated "this settlement should serve as a wake-up call to those on whom the investing public depends to guard against corpo-

Lead Counsel vigorously opposed each of the defendants' motions, and the court sided with the plaintiffs each time, refusing to move the trial date of early 2005. These hard-fought rulings were vital to maintaining a "fixed" trial date and advancing the NYSCRF's core litigation strategy.

rate corruption such as occurred at WorldCom." As a *New York Times* editorial stated at the time, "ensuring that banks, lawyers and accountants who are implicated in corporate fraud pay heavily for their misdeeds is an important step toward restoring confidence in the integrity of the marketplace."

An Offer of Settlement is Rejected in June 2004 and the Price of Settlement Rises

Following the Citigroup settlement, the NYSCRF offered the other underwriters the opportunity to settle on the same pro rata terms as Citigroup. If the banks had accepted this offer, the total amount they paid would have been almost a billion dollars less than what they ultimately had to pay to settle ten months later (and also spared them enormous legal fees that *The Wall Street Journal* pegged at some \$13 million per month). However, the remaining banks, led by J.P. Morgan, loudly proclaimed that they bore no blame for the WorldCom collapse and insisted that Citigroup had overpaid in its settlement. In an attempt to evade any responsibility for the WorldCom debacle, they persisted in

their "scorched earth" litigation strategy, arguing that they had satisfied their "due diligence" obligations and that others were to blame, not they.

The NYSCRF made it clear that the banks' choice to reject this reasonable settlement offer had consequences: namely, as time passed and the litigation continued, the price of settlement would increase. The rationale behind this approach is easy to see: if a defendant refuses to accept responsibility at an early stage of the litigation, the class of investors is prejudiced even if the defendant later settles, because the class has been forced to expend resources in needless litigation and has been deprived of the time value of any money received in settlement. Thus, the NYSCRF was determined that the class would not suffer from the churlish decision of these underwriter banks to reject a reasonable settlement offer and play a game of brinkmanship with the class.

Due Diligence Defense: The Court Puts New Teeth in an Old Law

The investment banks continued litigating throughout the summer of 2004, scoffing at any attempt to settle the case on fair terms. The underwriters eventually filed a summary judgment motion predicated on a "due diligence" defense under the securities laws. (Consistent with its novel and aggressive approach to the litigation, the NYSCRF defied convention and filed a *plaintiffs'* motion for partial summary judgment, seeking a ruling that the registration statement for WorldCom's enormous \$12 billion bond offering in 2001 was false and misleading as a matter of law.) The due diligence defense invoked by the defendants has existed since 1933, and provides that, if underwriters satisfy their obligation of conducting a "reasonable investigation" of the issuer, then they cannot be held liable for any fraud or misstatements later discovered in the issuer's public filings. Indeed, Wall Street banks regularly advertise their ability to investigate companies and

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were internally — and secretly — downgrading WorldCom’s credit rating and reducing their *own* exposure to that company *at the same time* they were urging the investing public to load up on WorldCom securities. Indeed, several banks bought credit default swaps — in effect, placing a bet that WorldCom would soon experience a “credit event” such as a restatement or bankruptcy. Not quite “calling a mirage a mirage.”

Ignoring these facts, the underwriters argued in their summary judgment motion that the law did not require them to uncover and disclose WorldCom’s lies. They claimed that they were entitled to rely on what management told them; they were not “experts” in financial statements and therefore could not have been expected to discover WorldCom’s \$68 billion worth of misstatements; and their obligations were relaxed because these offerings were conducted by a “mature” investment grade company pursuant to previously-

filed “shelf registrations.” The underwriters argued that they reasonably relied on WorldCom’s year-end audited financial statements and on so-called quarterly period “comfort letters” they received from Arthur Andersen. This view was widely endorsed by Wall Street. Indeed, the Bond Market Association and the Securities Industry Association filed “friend of the court” briefs supporting the underwriters’ arguments. Needless to say, Lead Plaintiff vigorously opposed the banks’ request for a “pass” on their role in the biggest corporate scandal of our time.

In December 2004, Judge Cote issued a landmark opinion that clearly reaffirmed the purpose of the Securities Act of 1933, and articulated the responsibilities of underwriters under the securities laws. In rejecting each of the underwriters’ arguments, the court wrote that “the public relies on the underwriter to obtain and verify relevant information

“discover the truth” about investment opportunities. For example, in 2001 J.P. Morgan, the lead underwriter on WorldCom’s bond offerings, openly boasted of its expertise in ferreting out the truth and its purported willingness to “call a mirage a mirage.”

In the WorldCom case, however, a number of extraordinary facts uncovered by Lead Counsel raised serious questions as to whether these investment banks had conducted *any* reasonable inquiry into WorldCom’s public statements. Lead Counsel’s scrutiny of internal bank documents revealed a remarkably dysfunctional atmosphere within these Wall Street powerhouses. Instead of conducting the due diligence required by law and expected by investors, the bankers devoted their energies to keeping Ebbes happy and thus positioning themselves to receive a larger share of the hundreds of millions of dollars of underwriting, consulting and lending fees being doled out by WorldCom. Lead Counsel’s discovery efforts also unearthed a blockbuster secret: many of the senior banks

Significant Legal Rulings

- ✓ PSLRA discovery stay lifted before motions to dismiss briefed.
- ✓ Early trial date set and “fixed.”
- ✓ Underwriters’ summary judgment motion denied: Imposing strict “due diligence” obligations on underwriters.
- ✓ Lead Plaintiffs’ partial summary judgment granted; Obviating need for jury to decide whether WorldCom’s 2001 offering materials were false.
- ✓ WorldCom’s financial restatement admitted into evidence.
- ✓ Plaintiffs permitted to present aggregate damages to the jury.
- ✓ “Blame the Victim” litigation tactics prohibited.
- ✓ Liability of lead underwriters might exceed the face amount of bonds they marketed and sold.
- ✓ The efficacy of a junior underwriter’s due diligence defense generally rises or falls with the lead underwriter’s due diligence.
- ✓ Andersen was racially discriminating in its juror strikes.

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I will challenge assumptions.
Especially my own.
I will leave the guesswork to others.

I will identify the cause,
not just the effect.
I will leave no room for wrong.

I will create maps.
I will be blind to nothing.
I will call a mirage a mirage.

I work for J.P. Morgan.

JPMorgan participates in the J.P. Morgan Chase & Co. (Incorporated in New York)

Lead Plaintiff
Trial Exhibit
90

A J.P. Morgan advertisement from March 2000 trumpeting the company's due diligence practices.

and then make sure that essential facts are disclosed." The court rejected the underwriters' argument that their obligations to investigate a company's interim financials were satisfied simply upon receipt of a "comfort letter" from an accountant, stating that underwriters are required to conduct an independent verification of an issuer's financial statements. And even when an auditor has

provided a formal year-end audit opinion, an underwriter had an obligation to probe the financial statements if, as at WorldCom, there were red flags concerning those financial statements. (The Court also granted the bulk of Lead Plaintiffs' summary judgment motion, obviating the need for the jury to decide whether the 2001 Offering was false and misleading.)

The repercussions from the Court's opinion were quickly felt on Wall Street. Wall Street law firms began offering seminars on the "new" due diligence obligations of underwriters. There was even talk within Wall Street about lobbying Congress or the SEC to pass new regulations that would severely circumscribe the reach of the court's opinion. The practical implications were clear: underwriters will no longer be able to conduct an illusory "due diligence" investigation. Instead, they will have to actively verify an issuer's disclosures; they will have to assign experienced bankers and lawyers to investigate issuers; and they will have to do more than accept at face value management's or auditors' assurances. In other words, these corporate gatekeepers will have to do the job Congress demanded of them over seven decades ago. Of course, if the gatekeeper underwriting banks had done their jobs prior to underwriting WorldCom's bonds, then the massive WorldCom fraud would have been stopped years earlier.

Winning the Critical Pre-Trial Motions

Following the landmark summary judgment ruling, Lead Counsel intensified its efforts to prepare for trial. So did the underwriters, who began enlisting attorneys from New York, Los Angeles and Chicago to form a trial team that at one point was over a hundred strong. The underwriters filed a plethora of legal briefs aimed at impairing the ability of the NYSCRF to present its case at trial. But, as had happened to the underwriters so many other times in this historic litigation, their plan backfired. The spate of legal filings in the months before trial led to dozens of critical rulings from the court in favor of the NYSCRF. These rulings not only greatly enhanced the ability of the NYSCRF to present a winning case at trial, but also announced legal precedents that — like the landmark opinion discussed above — will rebound to the benefit of aggrieved investors in securities class actions for years to come. These include:

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■ **Allowing Evidence of WorldCom's Restatement.** The underwriters and Arthur Andersen argued that WorldCom's publicly-filed restatement — in which WorldCom *admitted* that it had misstated its financials by as much as \$68 billion — was inadmissible hearsay that could not be presented to the jury. As absurd as this argument sounds, it had some legal viability as demonstrated by the fact that the restatement was deemed inadmissible in the Bernard Ebbers' criminal trial. Judge Cote deemed the restatement admissible, however, thus setting a precedent that will help ensure that future plaintiffs in securities class actions do not have to engage in a quixotic enterprise of proving a fraud that the company itself has admitted.

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■ **Allowing Evidence of Aggregate Damages.** The underwriters also sought to exclude from the jury as "unfairly prejudicial" any evidence about the billions of dollars of aggregate damages suffered by the class. The Court firmly rejected this argument.

■ **Prohibiting a "Blame the Victim" Approach.** As trial neared, it became clear that the underwriters intended to "blame the victim" in front of the jury by arguing that the NYSCRF and others had failed to investigate WorldCom and therefore were responsible for their own losses. (Of course, this argument

ignored the fact that the underwriters themselves were arguing that the fraud at WorldCom was so secret that they couldn't have discovered it.) The Court rejected this approach, holding that the actions of any single investor were irrelevant to determining whether the underwriters had satisfied their due diligence obligations.

■ **Holding the Lead Underwriters Accountable.** Throughout the litigation, the underwriters had argued that the securities laws limited their liability to the amount of bonds that each underwriter actually sold. However, on the eve of trial, the court issued an opinion that called this assumption into question. The Court noted — without deciding — that it was possible that lead underwriters could be held responsible for the entire amount of bonds sold by the underwriting syndicate. This greatly increased the potential liability for underwriters, and provides future plaintiffs with ammunition to press this argument in front of other courts.

■ **The Sins of the Lead Underwriters Will be Visited on the Syndicate.** Even though SSB was no longer in the case by virtue of the Citigroup settlement, Lead Plaintiff obtained a ruling confirming that, to the extent SSB as lead underwriter had failed to investigate red flags at WorldCom, the junior underwriters who relied on SSB's purported due diligence were liable for SSB's failures.



Historic Settlements: The Underwriting Syndicate Splits Apart and Former Directors Pay From Their Own Assets

In the final months before trial, as the Court issued ruling after ruling in favor of the NYSCRF, most of the remaining defendants began to sue for peace.

After litigating as a unified block for over two and one-half years, the underwriting syndicate finally broke apart under the pressure of the impending trial and the weight of the numerous pre-trial victories won by the NYSCRF. On March 3, 2005, Bank of America settled for a total payment of \$460.5 million in cash. Over the next two weeks, each remaining member of the syndicate agreed to settle, with the last holdout — J.P. Morgan — agreeing to pay \$2 billion on March 16, 2005. In keeping with the promise it made in June 2004, the NYSCRF insisted that the total value of the settlements from the late-settling underwriters significantly exceed the pro-rata share of the Citigroup settlement. Indeed, J.P. Morgan's \$2 billion payment represented a staggering 45% premium over the Citigroup rate. In total, the underwriters who waited until March 2005 to settle paid almost a billion dollars more than the offer they rejected in June 2004.

The next group to settle was the former directors. After an earlier settlement deal failed, on March 21, 2005, the NYSCRF reached an historic settlement with WorldCom's former directors, in which the class received a total of \$60.75 million dollars. Setting a remarkable precedent, \$24.75 million of the settlement was paid out of the directors' own pockets — an amount representing over 20% of the personal net worth of the directors as a group. Before agreeing to this settlement, the NYSCRF insisted on reviewing detailed information regarding the directors' finances and had each director sign a sworn statement attesting to the truthfulness of the information provided to the NYSCRF.

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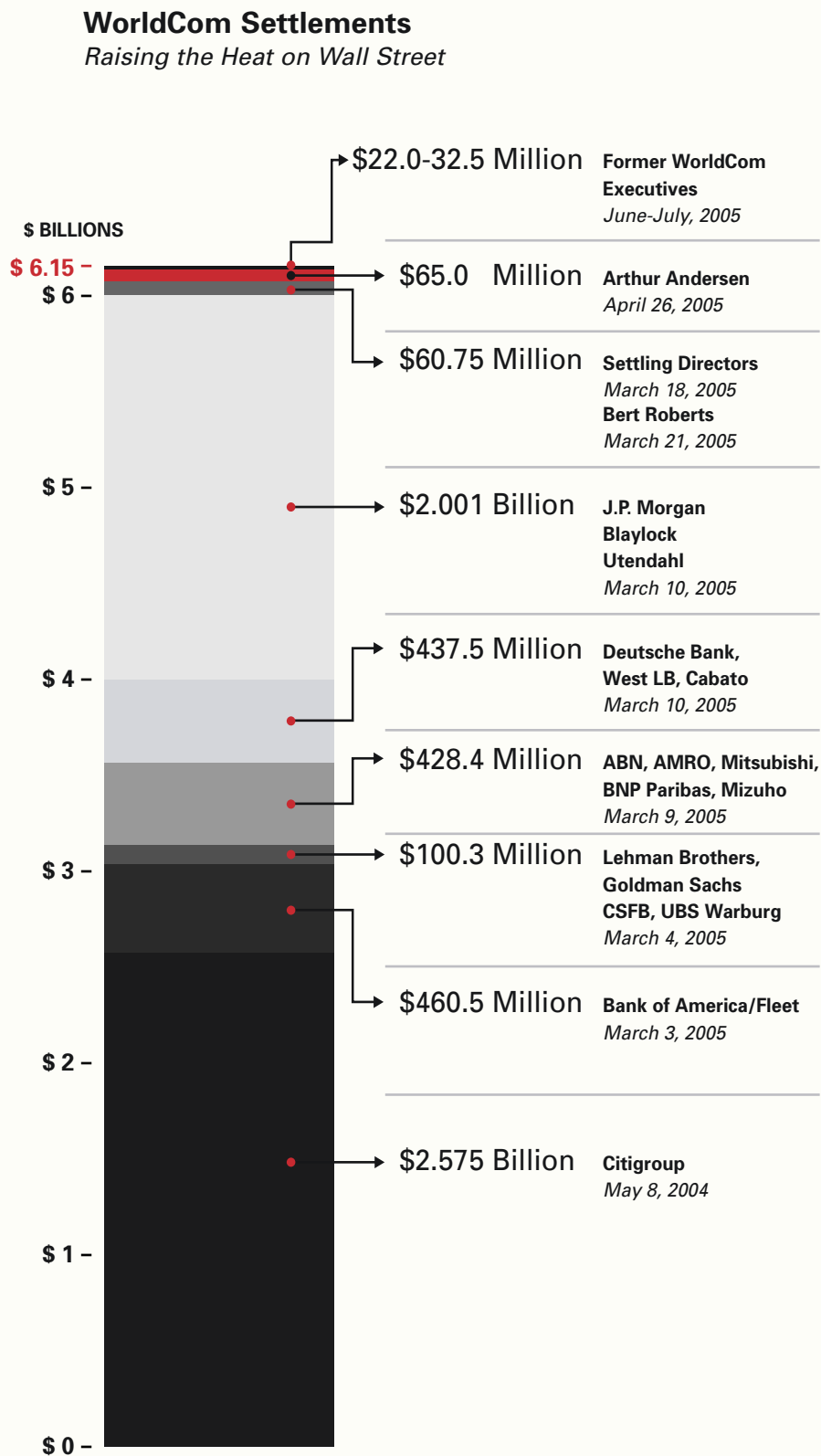
The Trial Against Arthur Andersen

Proving that their threat to take the case to trial was a live one, on March 27, 2005 the NYSCRF and Lead Counsel began the trial against the last remaining defendant, Arthur Andersen. The case was exciting from the start. During jury selection, when Andersen used all three of its peremptory challenges to dismiss non-white jurors from the panel, Lead Counsel challenged Andersen's tactics. The court found "intentional purposeful use of a race-based challenge" on the part of Andersen, and reinstated one of the improperly dismissed jurors. The final impaneled jury included a retired substitute teacher, a healthcare worker, a social worker, a restaurateur, a retired sanitation employee, a geologist, and an employee of a New York law firm.

From the drama of opening statements through the grind of nearly five weeks of trial, the NYSCRF and Andersen clashed over what Andersen knew or should have known about the fraud at one of its largest audit clients. Working out of their "war room" in lower Manhattan, the Lead Counsel trial team prepared each day for challenges such as cross-examination of Andersen's audit team, and reducing the blizzard of accounting and telecommunication jargon into terms a jury could comprehend. After Lead Plaintiff rested its case in the third week of trial, Andersen finally agreed to what had been the NYSCRF's long-standing precondition to any settlement discussion — that Andersen, which claimed an inability to pay any sum given its defunct status, had to open financial books to Lead Plaintiffs' scrutiny.

After a team of NYSCRF auditors examined Arthur Andersen's books, Andersen agreed to settle for \$65 million in cash, a number that, given the access to Andersen's finances, the NYSCRF knew represented a significant portion of Arthur Andersen's remaining assets. As Comptroller Hevesi explained in a press release issued on April 26, 2005: "we believe this recovery of cash... was

Total WorldCom Recoveries — Over \$ 6.15 Billion



Advocate

much preferable to putting Andersen into bankruptcy in the event the jury rendered a large verdict.”

Final Justice: Making the Top Two WorldCom Executives Empty Their Pockets

The conclusion of the Andersen trial left two final, but significant, “loose ends” in the case — former WorldCom CEO Ebbers and former WorldCom CFO Scott Sullivan. The civil litigation against each had been suspended during their criminal cases, but with each man about to be sentenced to jail (and the Government certain to seek forfeiture of their assets) the NYSCRF and Lead Counsel approached the U.S. Attorney’s Office with a novel proposal: permit Lead Plaintiff and Lead Counsel to negotiate with these two defendants and make sure that their assets go to the victims of their crimes as efficiently as possible.

The pitch to the Government presented a “win-win” situation. The Government was presented with two challenges as it approached the Ebbers and Sullivan sentencing dates. First, it was required by a recently enacted victims’ rights law to notify each potential victim of the WorldCom scandal of their right to appear at the sentencing or write to the sentencing judge beforehand — a process that would entail over four million pieces of mail and cost well over a million dollars. Second, assuming the Government decided to distribute the money recovered from Ebbers and Sullivan to the WorldCom investors (as opposed to simply depositing in the U.S. Treasury, which Lead Plaintiff vigorously opposed), the Government would have to find a means to distribute the money to investors. In stepped the NYSCRF and Lead Counsel.

First, they explained how, with over \$6 billion to distribute and hundreds of

thousands of claims forms already being processed, Lead Plaintiff was already in position to efficiently distribute any additional funds obtained from Ebbers and Sullivan. Second, Lead Counsel declared it would seek no fee from whatever assets were obtained from those defendants. And third, Lead Plaintiff offered to let the Government “piggy back” on an upcoming Class mailing and insert the required victims notice in the same envelope, obviating the need for a second expensive mailing.

U.S. Attorney David Kelley agreed and let the NYSCRF (led by its indefatigable General Counsel Alan Lebowitz) and Lead Counsel deal directly with counsel for Ebbers and Sullivan. Aware that each defendant hoped to appear at sentencing able to declare that he had made his peace with investors, the NYSCRF extracted unprecedented concessions from each former executive. Sullivan,

Late Settlement Premiums

Bank	Settlement Date	Settlement Amount Offered in May 2004 <i>In Millions</i>	Settlement Amount Achieved <i>In Millions</i>	Premium
Citigroup	May 7, 2004	\$2,575.0	\$2,575.0	None
Bank of America/Fleet	March 3, 2005	\$460.5	\$460.5	None
CSFB, GoldmanSachs, Lehman Bros.,UBS	March 4, 2005	\$100.3	\$100.3	None
ABN Amro	March 9, 2005	\$265.1	\$278.4	5%
BNP Paribas, Mitsubishi Sec., Mizuho	March 9, 2005	\$132.7	\$150.0	13%
Caboto, WestLB	March 10, 2005	\$99.5	\$112.5	13%
Deutsche Bank	March 10, 2005	\$276.5	\$325.0	17.5%
J.P. Morgan	March 16, 2005	\$1,370.0	\$2,000.0	45%

Advocate



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who had essentially no assets other than the huge estate he was building in Boca Raton, Florida, was required to turn over that estate. (It was sold for \$9 million, netting about \$4 million to the Class after construction and attorneys' liens were satisfied.) As part of the settlement, Sullivan was also required to turn over what little was left in his WorldCom 401(k) account.

Ebbers was made to pay even more dearly. In addition to surrendering his multi-million dollar mansion in Mississippi, Ebbers was required to wire over \$5 million to Lead Plaintiff's custody at the time of his sentencing, to assign his multi-million dollar tax refund to the Class, and to consent to appointment of a trustee to liquidate his timber farms, rice farms, trucking business, and other assets. Based on the conservative estimated value of those assets and a sharing arrangement with MCI (which agreed to compromise its superior creditor position arising from WorldCom's \$400 million loans to Ebbers), the Class could receive \$45 million or more from the settlement with Ebbers.

At the hearing preliminarily approving these two settlements, Judge Cote noted that the settlements left Ebbers —

a former billionaire — with \$50,000 and a modest house for his wife, and left Sullivan nearly destitute.

Conclusion

In the final tally, there can be no debate that the aggressive litigation strategy of the NYSCRF, coupled with a remarkable number of favorable legal rulings obtained from the court, has permanently changed the landscape in which these cases will be litigated in the future. Indeed, the impact of NYSCRF's strategy of extracting significant premiums from defendants who insist on playing brinksmanship by litigating a case until the eve of trial has already been felt in other securities class action cases. But the most important and long-lasting impact of the WorldCom litigation will be felt on Wall Street. As Comptroller Hevesi put it: "There is already evidence that underwriters are improving their diligence, accounting firms are strengthening their audits and boards of directors are empowered to ask tougher questions of management. Those protections will restore confidence in our capital markets and encourage millions of Americans to continue to invest." ■

Contact Us

We welcome input from our readers. If you have comments or suggestions, please contact Editor Timothy DeLange, at 800-380-8496 or timothyd@blbglaw.com. If you would like more information about our firm, please visit our website at

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