

WORLDCOM CASE COULD LIMIT PROTECTIONS OF UNDERWRITERS & DIRECTORS

Steven Amen of our Omaha office writes:

A recent federal court ruling in the WorldCom, Inc. securities litigation could prevent underwriters and corporate directors from using a long-standing protection under federal securities laws to avoid liability in public offerings.

Due Diligence Defense

Generally, underwriters are liable if a registration statement used in a public offering does not properly state facts, or fails to state facts, that are material to the offering. Directors are also liable if they sign the registration statement.

However, underwriters and directors can avoid this liability if they can show that they are entitled to protection under the Securities Act of 1933 by being diligent in reviewing background information of the company issuing the registration statement.

For instance, underwriters can avoid liability for the portion of a registration statement that was included on the basis of the authority

of an "expert" (such as an accounting firm) if they can show that they did not have reasonable grounds to believe, and did not believe, the disclosure was untrue or incomplete (the so-called "reliance" defense). Traditionally, the "reliance" defense did not require the underwriter or director to make a separate investigation of the underlying facts.

The WorldCom Case

The WorldCom case arose out of two public offerings of debt securities in 2000 and 2001 for almost \$17 billion. Each of the registration statements for these offerings incorporated by reference WorldCom's audited and unaudited financial statements which had been filed earlier with the SEC. In June 2002, WorldCom announced a restatement of these financial statements due to massive fraud uncovered in its accounting process. In July 2002, WorldCom filed for bankruptcy.

The investors who purchased WorldCom's debt securities sued the investment banks that served as underwriters in the debt offerings for securities fraud. In defending against the lawsuit, the underwriters argued that they should be entitled to the "reliance" defense because information in the registration statements for the debt securities was based on the audit and other assurances, such as "cold comfort" letters, provided by Arthur Andersen, WorldCom's independent auditors.

IN THIS ISSUE:

- **WorldCom Case Could Limit Protections of Underwriters & Directors1**
- **SEC Acts to Reduce Market Timing.....1**
- **Bank Regulators Move on Community Reinvestment Act Rules2**
- **Base Closings Open Up Valuable Real Estate to Private Developers.....2**

The WorldCom Decision

The court rejected the underwriters' defense, finding that there were numerous "red flags" relating to the audited financial statements which made it unreasonable for the underwriters to blindly rely on them. Also, any non-audit assurances provided by the auditors were not covered by the "reliance" defense. Thus, to avoid liability, the underwriters would have to show that they themselves had conducted a reasonable investigation of WorldCom's financial statements.

This ruling could substantially increase the role played by underwriters in the stock offering process, because they may conduct detailed reviews of financial data despite the presence of audited financial statements. It also highlights the importance of a well-documented due diligence investigation to minimize delays in market-sensitive offerings, especially shelf offerings.■



SEC ACTS TO REDUCE MARKET TIMING

Market timing was made economically unattractive by a new rule adopted on March 3, 2005 by the Securities and Exchange Commission (SEC). Market timing was the focus of recent mutual fund scandals and involves the undesirable, but not illegal, practice by fund participants of rapid purchases and sales of fund shares during a trading day. This practice allows such traders to take advantage of short-term movements

in the marketplace but leaves longer-term investors in the funds with the undisclosed costs of frequent trading. The SEC rule, which takes effect in late 2006, would require mutual funds to impose a redemption fee of up to 2% on early redemptions of fund shares unless the mutual fund believes it is not necessary or appropriate. Funds would also have to enter into written agreements requiring information sharing and enforcement of market timing

restrictions with intermediaries (such as 401(k) plans). Money market funds, exchange traded funds, and funds that encourage and disclose the cost of active trading are exempt from the rule.

Broker-dealers and companies with 401(k) plans should advise their participants of this upcoming change and the effect on their financial planning options.■

BANK REGULATORS MOVE ON COMMUNITY REINVESTMENT ACT RULES

On March 11, 2005, the OCC, Federal Reserve and FDIC published a joint notice of proposed rulemaking that would revise their regulations implementing the Community Reinvestment Act (CRA). The proposed rules are intended to reduce the regulatory burden on community banks and, among other things, would:

- Amend the definition of “small bank” to mean a bank with assets of less than \$1 billion;
- Add a “community development test” for “intermediate small banks” (banks with assets of between \$1 billion and \$250 million) allowing them to allocate resources between community development loans, investments

and services;

- Subject “intermediate small banks” to a two-part CRA test, consisting of lending and community development tests;
- Exempt “intermediate small banks” from certain reporting obligations; and
- Include affordable housing in



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underserved rural areas and designated disaster areas in the definition of “community development.”

Separately, on March 2, 2005, the OTS published final rules modifying the way in which large thrifts (assets over \$1 billion) may comply with CRA. The final rules allow large thrifts to determine the combination of lending, investment, and services used to comply with CRA, with the only requirement being that lending must be 50% or greater.

In addition to the rule changes relating to CRA noted above, financial institutions should also be aware of new or alternate sources of CRA credit, such as the New Markets Tax Credit Program.■

BASE CLOSINGS OPEN UP VALUABLE REAL ESTATE TO PRIVATE DEVELOPERS

Paul Kalomiris, Program Manager -- Legislative Research, of our Washington, DC office writes:

The upcoming round of military base closings, also known as base realignment and closure, or BRAC, moved forward last week with President Bush’s nomination of eight of the nine members of the BRAC commission that decides on closings. The list of closings that will be considered by this commission will be issued by the Defense Department by May 16, 2005.

Although base closings, or downsizing them as forces move to other bases, has always generated concerns in affected local communities, such closings now may be creating investment opportunities for private developers and their investors. Recently, the Defense Department indicated it may use auctions and negotiated sales with private parties to dispose of base property.



U.S. Military Base

In the four previous BRAC rounds conducted from 1988 to 1995, the Defense Department generally limited sales of base property to the affected community or its local agencies or economic development groups. Now, sales and auctions to private developers might be more likely in communities in which the property represents a significant block of high-value real estate.

Recent examples include the auction of base property at the former Marine Corps Air Station El Toro in Orange County, Calif., with total winning bids of \$650 million; and the former San Pedro Navy Housing in Los Angeles,

which garnered an \$88 million winning bid.

DOD’s determination to divest property using auctions and negotiated sales means that private developers and investors will have increased access to, in many cases, extremely valuable real estate.■

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