The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2006

PHILADELPHIA, MONDAY, JANUARY 23, 2006 VOL 233 • NO. 14 $3.00 ALM

SECURITIES

What's Become of Underwriting Due Diligence Since *WorldCom*?

BY JEFFREY A. BARRACK

Special to the Legal

JEFFREY A. BARRACK

is a partner in Barrack Rodos & Bacine, where he represents plaintiffs in securities fraud, antitrust and other class actions. He is a graduate of Clark University, Boston College and Temple University School of Law. Prior to joining the firm, Barrack served under the Philadelphia District Attorney and the U.S. Attorney assisting in the prosecution of complex white-collar crime in the Eastern District of Pennsylvania. He can be contacted by e-mailing jbarrack@barrack.com.

Judge Denise L. Cote's decisions last year in the *In re WorldCom Inc. Securities Litigation* clarified and developed the law concerning underwriters' and auditors' obligations of due diligence under the Securities Act of 1933.

These decisions sent tremors through the investment banking and accounting industries, prompting an evolution in the way investment bankers are trained and in the role that certified public accountants take in the performance of due diligence for a public offering. Cote's decisions highlight the tenuous relationship between auditors and investment bankers when an issuer offers its securities for sale to the public.

This column will briefly examine Cote's *WorldCom* decision addressing the obligations of underwriters when bringing a security to market, reported at 346 F. Supp. 2d 628 (S.D.N.Y. 2004), and then turn to the question of who remains as gatekeeper assuring investors of the transparent disclosure of financial and accounting information in public offerings. Underwriters and auditors best serve their roles as gatekeepers when bringing a security to market by exercising a high degree of care.

An underwriter may do so by its willingness to verify an issuer's accounting and financial information, and to evaluate any apparent red flags, with its own accountants. An auditor may do so by being fully and fairly responsive to the underwriter's accounting due diligence questions. As such they may each function in our capital markets — as contemplated by the federal securities laws — to substitute a philosophy of full disclosure for the philosophy of caveat emptor.

Cote's landmark decision concerning underwriter obligations reaffirmed the underlying purpose of the Securities Act enacted over 30 years ago; that liability flows mainly from the requirements for filing a registration statement and distributing prospectuses. The court explained that the Securities Act "was designed to assure compliance with [its] disclosure provisions ... by imposing a stringent standard of liability on the parties who play a direct role in a registered offering." Cote specifically noted that this design reflects Congress' sense that underwriters, issuers and accountants bear a "moral responsibility to the public [that] is particularly heavy."

Two of the affirmative defenses provided by the Securities Act comprise the "due diligence" defense. The first defense is the duty to conduct "an investigation in accordance with professional standards." The second applies when a Section 11 defendant is entitled to rely upon the opinion of an expert.

Where red flags regarding the reliability of an audited financial statement emerge, mere reliance by underwriters on an audit will not be sufficient to ward off liability. As Cote explained, "[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. What is at stake under Section 11 is ... the accuracy and completeness of the statements in the registration statement."

The court emphasized that if aggressive or unusual accounting strategies regarding significant issues come to light, a prudent underwriter may choose to consult with accounting experts to confirm that the accounting treatment is appropriate and that additional disclosure is unnecessary. While reflecting on underwriters' role as the "procurer and verifier of critical issuer-specific information," Cote described them as "reputational intermediaries" or "gatekeepers."

Acting with the degree of diligence that applies to a prudent man when managing his own property, underwriters should ask those questions and seek those answers that are appropriate in the circumstances. 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. If red flags arise from a reasonable investigation, underwriters will have to make sufficient inquiry to satisfy themselves as to the accuracy of the financial statements, and if unsatisfied, they must demand disclosure, withdraw from the underwriting process, or bear the risk of liability.

The investment banking industry reacted

Securities continues on **10**

Securities

continued from **5**

immediately, raising a host of questions. A principle focus of the reaction was on the type of independent verification needed for a reasonable investigation. Investment banking advisers heard the message sent by Cote, some now advocating that an "underwriter should also consider retaining an accounting expert to review the financials to confirm that they are appropriate. If not, a new audit may be necessary."

Pressure grew on investment banks to ensure the accuracy of financial disclosure in securities offerings, and by late 2005, it became apparent that independent accountants were cutting back their involvement in the offering process, setting the stage for what Baumann described as a possible new "financial disclosure crisis." As underwriters were being urged to verify financial information, auditors were becoming less willing to be active participants in the diligence process. By Aug. 23 a draft white paper of the American Institute of Certified Public Accountants (AICPA) titled "Auditor Attendance At Due Diligence Meetings With Underwriters," referred to as "White Paper II," added fuel to the fire.

White Paper II provided guidance under auditing standards for an auditor's conduct at due diligence meetings with underwriters. The AICPA's audit practices task force distributed White Paper II to the Bond Market Association (BMA) and the Capital Markets Subcommittee of the Securities Industry Association (SIA) and to the Financial Reporting Committee of the New York City Bar Association. The task force scheduled a discussion meeting at the New York City offices of the AICPA on Oct. 11. "It is important to note that the so called White Paper II was a draft, for discussion purposes only," said the AICPA's Director of Public Affairs Anne Sittmann.

White Paper II proposed:

- Prohibiting auditors from discussions regarding weaknesses in an issuer's internal controls, or any deceit, fraud or illegal acts perpetrated by management;
- Prohibiting auditors from speaking up or contradicting the issuer's management when management provides underwriters with misinformation; and
- Prohibiting auditors from discussing other key topics, such as communications with the issuer's prior auditor, its audit committee, risk assessments and completeness of the issuer's disclosures in its management's discussion and analysis.

The reaction to White Paper II by the New York bar, BMA and SIA was swift and condemning. BMA and SIA expressed a concern in an Oct. 6 letter to the task force that the draft was not advisory but "is an edict requiring auditor silence about a host of important subjects." The associations explained that "the document is replete with mandates to auditors about what they must not do." Even in areas where White Paper II simply advises auditor caution, the existence of such a warning from the AICPA arguably has the real effect of causing general auditor conduct to "toe the line," and the associations expressed a concern that investors would be put at risk.

"The draft leaves nothing of substance that the underwriters may discuss with auditors," wrote Edward Forst, BMA's chair, and Daniel J. Ludeman, SIA's chair. In a Sept. 30 letter to the task force, the New York bar complained that White Paper II "adopts an approach that inappropriately marginalizes the auditor's role as one of the key participants in the due diligence process." The concern was that, with neither rule making, standard setting authority nor an open discussion that included participation by investors who may wish to be involved in the process, the AICPA was putting an end to auditor involvement in due diligence.

As investment bankers realized that courts, including Cote in *WorldCom*, will hold them responsible where red flags or other concerns exist regarding a company's financial and accounting disclosure, even in its audited financial statements, and require underwriters to engage in a further due diligence effort, including additional discussions with the

Securities continues on **11**

Securities

continued from **10**

auditors, or otherwise, they opposed White Paper II on the basis that it would virtually prohibit auditors from participating constructively in that effort, even when requested to do so by their issuer clients. For these and other reasons, the Associations urged the AICPA to withdraw the proposal.

Tensions at the Oct. 11 meeting in the AICPA's New York offices ran high. Micah S. Green, BMA's president and CEO, and Marc E. Lackritz, SIA's president, were "dismayed by the remarks made by the representatives of the Big Four audit firms who spoke as members of the AICPA task force." The meeting lasted two hours and was attended for the AICPA by representatives of six audit firms, for the associations by representatives of nine investment banks and by representatives of the New York bar and several law firms. The associations attacked the AICPA as taking "anti-investor positions" and requested that the AICPA publicly repudiate White Paper II and establish a forum that included participation by institutional investors and regulators.

On Oct. 28, White Paper II was shelved. The AICPA and the associations announced that they were continuing the discussions regarding auditor participation in underwriter due diligence and that the discussions would involve investors, issuers and regulators. The AICPA stated that the White Paper II "has been put aside in favor of a 'clean sheet of paper.'"

AICPA spokesperson Anne Sittman explained that while the issue of auditor attendance at underwriter due diligence meetings is being discussed, the parties have agreed to "radio silence" on it. She would not comment on what if any role the SEC or the Public Company Accounting Oversight Board (PCAOB) has taken in the discussions. A representative from the SEC refused to comment. Jon Teal of BMA explained that representatives of the SEC and the PCAOB have been copied on all related correspondence, and that "we at BMA believe these discussions should be inclusive, full and complete."

As underwriters and auditors further develop their vital roles in the rigorous investigation required by the Securities Act's due diligence defense, a middle ground may be found between the extremes of requiring an underwriter to "do an audit" and requiring an auditor to "do the underwriting." Certainly, it would be a good thing for an underwriter to have the ability and competence to vet an issuer's accounting and financial information, and even evaluate any apparent red flags, with its own expert accountants.

Indeed, as Cote pointed out, there may be times when doing so is necessary for the underwriter's investigation to be sufficiently reasonable under the circumstances. On the other hand, it would also be a good thing for an issuer's auditor to be fully and fairly responsive to an underwriter's accounting due diligence inquiries. Retainer agreements with issuers can be modified to require issuer consent for the auditor to be so responsive; resolutions by audit committees may further provide issuer consent and encourage auditor responsiveness to underwriter inquiries.

By taking these steps, both investment bankers underwriting securities offerings and public accountants auditing and reviewing the financial statements of the issuer may properly serve their unified role as gatekeepers and function to help ensure the transparency of disclosures in our capital markets.

When these two powerful gatekeepers keep their watch, even the most daring corporate wrongdoer will hesitate before disseminating false and misleading financial and accounting information to investors in the market. •