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A FEW LESSONS FOR INTERNAL AND OUTSIDE COUNSEL FROM THE WORLDCOM COLLAPSE -- 20 YEARS LATER

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It has now been 20 years since the historic collapse of WorldCom, Inc. (“WorldCom” or the “Company”). A review of the WorldCom collapse yields some continuing lessons for corporate counsel.

On July 21, 2002, roughly five weeks after WorldCom publicly announced significant accounting irregularities resulting in charges of approximately $3.8 billion, the Company filed petitions for protection under Chapter 11 of the United States Bankruptcy Code. At that time it was the largest bankruptcy proceeding in U.S. history. A month later, the Company announced additional charges of approximately $3.3 billion. On August 6, 2002, the Honorable Arthur J. Gonzalez, Chief Judge of the United States Bankruptcy Court for the Southern District of New York, approved the appointment of Dick Thornburgh as Bankruptcy Court Examiner (the “Examiner”) with a broad mandate to investigate “any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the arrangement of the affairs of [WorldCom] by current or former management.”

The Examiner published several lengthy reports, the second of which focused on corporate governance issues. Although the Examiner did not conclude that counsel were aware of or participated in the fraud that led to the collapse of the Company, his report highlighted structural issues that contributed to the failures:

“These deficiencies reflect a virtual complete breakdown of proper corporate governance principles, making WorldCom the poster child for corporate governance failures. Every level of 'gatekeeper' that had the responsibility to promote and ensure proper corporate governance was derelict in its duties to some degree. Compounding the problem, a culture existed at WorldCom in which many who were aware of acts of wrongdoing and neglect stood silently by and took no steps to object. As a result, Management and the Board took numerous actions, or failed to take appropriate actions, that hurt WorldCom's shareholders, employees and creditors, and contributed to WorldCom’s rapid downfall.”

A number of findings by the Examiner that relate to legal counsel are as relevant today as they were then.

Remember when advising clients that attorney-client privilege can be waived or lost

As a threshold matter, it's worth noting that virtually all documents sought by the Examiner had to be produced for review, including detailed notes taken by internal counsel and other privileged communications. With the consent of the Company (under the supervision of the bankruptcy trustee), the Examiner obtained a court order providing that the delivery of such documents and other information, including emails, would not constitute a waiver of the attorney-client or other privilege. As a result, all communications with or notes recorded by counsel became available for review by the Examiner.

Counsel should remain mindful that ultimately, the attorney-client privilege belongs to the client and may be waived by the client. A company may consent to production of privileged communications, even without a non-waiver order as was entered in WorldCom. When a company files for bankruptcy, management of the company may shift from its prior executives to a bankruptcy trustee, who may view the waiver issue differently than prior management. In such situations, privileged communications may end up being produced to the government or private plaintiffs.

Avoid fragmented reporting lines in law department

The Examiner noted the fragmented structure of the law department, with some lawyers not reporting to the General Counsel, key lawyers geographically dispersed, and none at headquarters and therefore none in management's inner circle. His report also noted that the department received inadequate support from management which, in turn, was dominated by the CEO. As a result, the law department was culturally less influential than it would have been had a strong governance structure been in place. The report described the legal function at WorldCom as follows:

"At [the CEO's] direction, the Company's lawyers were in fragmented groups, several of which had General Counsels who did not report to WorldCom's General Counsel for portions of the relevant period; they were not located geographically near senior management or involved in its inner workings; and they had inadequate support from senior management. . . . The fragmentation of the legal department was [the CEO's] choice. None of the Company's senior lawyers was located in Jackson. He did not include the Company's lawyers in his inner circle and appears to have dealt with them only when he felt it necessary. He let them know his displeasure with them personally when they gave advice—however justified—that he did not like. In sum, [the CEO] created a culture in which the legal function was less influential and less welcome than in a healthy corporate environment."

A number of subsequent governmental investigations involving other public companies have identified failings where internal counsel reported to business executives rather than to the general counsel or other law department attorneys.

Ensure appropriate advice to board on fiduciary duties for material transactions

The Examiner criticized the WorldCom board of directors for deferring to management on strategic planning and M&A targets and analysis. The report also criticized counsel – both internal and outside – for not pressing the board to consider its fiduciary duties with respect to these transactions, even while recognizing that the corporate culture was not supportive of a strong legal function.

The Examiner focused in particular on the acquisition of Intermedia, which was a material transaction with an initial estimated value of $6 billion. When approving the initial acquisition agreement at a hastily called meeting, the board received no briefing materials or analyses, nor any fairness opinion. Following shareholder litigation against the parties, management decided to agree to an amendment of the transaction in order to allow for the settlement of such litigation. At that time, the Company had the ability to terminate the agreement and potentially pursue a joint venture with another party instead that would have accomplished the core business objectives on a significantly cheaper basis. The Examiner determined that the decision to proceed with the acquisition instead of terminating the agreement and pursuing an alternative resulted in additional costs to the Company of $3 billion due to a large drop in proceeds from the sale of unwanted target assets and costs to settle the shareholder litigation and to support target operations.

The Examiner concluded that neither internal nor outside counsel viewed themselves as having responsibility to advise the board on fiduciary duties, emphasizing that they failed to advise directors on the risks of approving the amendment on the basis of limited data and without sufficient time for in-depth consideration. Further, the Examiner determined that "a vigilant and properly informed WorldCom Board probably would have rejected the amended Intermedia transaction."

Confirm receipt of proper corporate approvals before executing material agreements

To effect the amendment of the Intermedia agreement, outside counsel prepared a form of written consent by which the WorldCom board would document its approval. The General Counsel of WorldCom executed the amendment after being instructed to do so by management, who falsely advised him that the board had approved it. Although he failed to inquire about the timing or circumstances of such approval, the Examiner declined to fault him because, consistent with the fragmented organization of the law department, the General Counsel was often excluded from important board actions. However, the Examiner observed that "with the benefit of hindsight and the current regulatory climate . . . a general counsel in the future should insist on hard evidence of proper corporate approvals before executing important corporate documents." Ultimately, the board only considered the amendment at a subsequent meeting, when it ratified the transaction.

Build an appropriate record when directors act by written consent, and limit its use to appropriate circumstances

The Examiner questioned the willingness of outside counsel to prepare the form of written consent for directors to approve the amendment, stating:

“The Examiner questions counsel’s judgment in this regard, because written consents generally are appropriate only when a full Board meeting would be impractical or a waste of time or not feasible, and only when the Directors have otherwise [become] informed of all relevant facts. A WorldCom Board meeting, even by telephone, to consider the Intermedia merger amendment was not impractical and would have [been] appropriate, given the material changes to and overall increase in the price of the transaction. The Examiner has never received a satisfactory explanation for the use of the written consent.”

The Examiner cited Commentary to the Model Business Code for the proposition that written consents are appropriate when a formal meeting is a “waste of time” or involves a “noncontroversial” action. That Commentary has since been amended and no longer contains that specific language. However, as recently noted by a leading commentator:

“The assumption underlying the policy [allowing board action by written consent instead of through discussion at a meeting] is that meetings should be required except where the decision is so clear that the vote is unanimous and in writing. Nevertheless, these procedures are always subject to the requirement that the decision must be made with the requisite care.” Balotti, Finkelstein, Zeberkiewicz and Rohrbacher, Delaware Law Of Corporations & Business Organizations § 4.8 (2022) (*footnotes omitted*).

In the end, the Examiner declined to recommend claims against inside or outside counsel because it appeared management was determined to proceed and, in such circumstances, the Examiner did not believe counsel could be found in violation of any legal requirement that could support a claim by the company. However, the Examiner stated that he would have expected counsel to question the use of a written consent in these circumstances – where the amendment “was hardly a noncontroversial matter” and thus a meeting “to consider carefully whether to stick with the revised Intermedia deal would hardly have been a ‘waste of time’.”

Apply independent judgment and consider yellow flags when clearing stock trades instead of deferring to management

As a result of declining stock prices and facing significant margin calls, the CEO decided to engage in a complex forward sale transaction to generate proceeds and avoid publicly reporting a forced sale of stock. Because the transaction took place at the end of a fiscal quarter, internal counsel reached out to outside counsel, who cautioned about trading during this time – with quarterly earnings not yet announced. Further, the counterparty required confirmation by the Company that the transaction complied with its policies and securities laws. Internal counsel checked with the CEO and CFO who advised that there was no material nonpublic information.

The Examiner criticized internal counsel for deferring to management as to the absence of material nonpublic information, in light of cautions raised by outside counsel as well as several developments of which internal counsel was aware but had not discussed with outside counsel.

The Examiner concluded that “it was problematic for [internal counsel] to have relied on the judgment of a non-lawyer in clearing this transaction. Rather, the situation called for [him] to apply his own legal judgment, particularly because [the CEO] had approached him for legal advice about the forward sale and because outside counsel had told [internal counsel] of their concerns regarding . . . the sale.”

A 20th anniversary is an opportune time for reflection. Much has changed with the passage of Sarbanes-Oxley, Dodd-Frank and other reforms, which have improved the corporate governance environment generally. However, pressures on business executives remain ever-present, so that the examples of WorldCom and similar companies can still provide useful guidance for internal and outside counsel today.

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