

“A Crisis in Corporate Governance?
The WorldCom Experience”

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to

The Executive Forum
California Institute of Technology

The Athenaeum
Pasadena, California

Monday, March 22, 2004
7:00 pm

Today the American business and financial communities are pre-occupied as seldom before with the consequences of a flurry of investigations into allegations of corporate wrongdoing. The “Hall of Shame” of significant American businesses involved in these proceedings now includes the likes of Enron, WorldCom, Tyco, Adelphia, Global Crossing and HealthSouth – all discredited by illegalities or improper accounting practices. Numerous members of the management teams of these companies have had to face criminal prosecution or regulatory sanctions that have effectively ended their careers. Meanwhile, the venerable accounting firm of Arthur Andersen, once the “gold standard” of the accounting profession, has been forced from the field, and more investigations appear to be in the offing.

The spate of corporate scandals with which we must deal today is not unique. It is only the latest of those which have, from time to time, posed threats to our free enterprise system and its long-established record of efficient allocation of resources within our economy. Nonetheless, these episodes have significant consequences to the American business and financial communities in these opening years of the 21st century.

Indeed, some have suggested that these breakdowns have created a true crisis in corporate America – a proposition which I propose to examine with you this evening.

But first I would like to share with you some specific insights gained from my own service as the court-appointed Examiner in just one of these matters, that involving the bankruptcy of WorldCom, the largest such proceeding in American history.

The WorldCom case has become a kind of poster child for corporate governance failures in this new century. WorldCom, the world's second largest telecommunications company, filed for bankruptcy in the federal court in Manhattan in the summer of 2002, after the disclosure of massive accounting irregularities. I was appointed as Examiner by the bankruptcy court in August, 2002, filed my first interim report that November, a second interim report in June of 2003 and my final report earlier this year. My remarks tonight will, understandably, reference only the results of our completed investigations which have been made public. But even the public story provides a genuine case study in the failure of corporate governance and suggests a number of lessons in how to avoid its repetition.

I.

At the outset, I suspect you might logically ask, "What is a bankruptcy examiner? What does a bankruptcy examiner do?" Put simply, I was appointed by Judge Arthur Gonzales in the Bankruptcy Court in the Southern District of New York in Manhattan to carry out an independent investigation into "what happened" in the WorldCom matter. My job was to assure the judge that procedures and persons

involved in any past wrongdoing were not carried forward into the reorganized entity. We were also asked to identify potential causes of action that the company might have against third persons responsible for losses to the company and to make recommendations to aid in avoiding repetition elsewhere of the acts that caused the downfall of WorldCom. We worked closely with the U.S. Department of Justice and state prosecutors, although we had no criminal jurisdiction. We also worked with the SEC and other regulators, although we had no regulatory responsibility. And we worked with representatives of the creditors of the company and the Corporate Monitor appointed in connection with the SEC proceedings to fully develop the facts. Our completed reports are now in the hands of the public and the new management of WorldCom for their guidance. They are available on the website of our law firm, Kirkpatrick & Lockhart LLP, at www.kl.com.

What happened in the WorldCom case? Most of the deviations from proper corporate behavior of which we took note resulted from the failure of Board of Directors to recognize, and to deal effectively with, abuses reflecting what our reports identified as a “culture of greed” within the corporation’s top management. Others resulted from an abject failure of responsible persons within the company to fulfill their fiduciary obligations to shareholders. A third contributing factor was a lack of transparency between senior management and the Company’s board of directors. In the final analysis, what we saw was a complete

breakdown of the system of corporate governance. The checks and balances designed to prevent wrongdoing and irregularities simply failed to operate. As one of my colleagues noted: “The checks didn’t balance and the balances didn’t check!”

The actual fraud within WorldCom consisted of a number of so-called “topside adjustments” to accounting entries to prop up declining earnings. Mostly these consisted of improper drawdowns of reserves accumulated from its acquisition program and other sources and improper capitalization of costs which should have been expensed. It was, in short, a classic case of “cooking the books”

While WorldCom has not completed the restatement of its financials, the judge handling the SEC proceedings in New York reported that the company overstated its income by approximately \$11 billion, overstated its balance sheet by approximately \$75 billion and, as a result, caused losses in shareholder value of as much as \$250 billion, a significant amount of the latter, of course, in employee 401(k) retirement funds.

During the 1990s, favorable market views of WorldCom were sustained by a series of acquisitions. The company was, in fact, in an almost-constant acquisition mode during this period. This, in turn, generated great pressure to keep the stock price high, both to fuel the acquisition spree and to provide lucrative cash-outs for executive stock options. To do this, the company had to meet Wall Street’s earnings

expectations, but when, in 2000, a proposed merger with Sprint was disapproved by the government and the telecommunications boom came to an end, WorldCom earnings began to slip. Management first sought to utilize aggressive accounting techniques to shore up its eroding financial picture. When these were exhausted, management resorted to simple false entries to generate what could masquerade as genuine earnings and enable them to “make the numbers” and sustain the picture of a company continuing to meet Wall Street’s earnings targets. As a result, while, during the last thirteen quarters prior to bankruptcy, the Company consistently reported that it met those targets, in fact, it missed them in 11 out of 13 of those quarters and, in the last four quarters, actually should have reported losses. This house of cards finally collapsed in the summer of 2002 when internal auditors finally fingered substantial improprieties and, in short order, top officials were fired or resigned, earnings were restated, SEC and criminal investigations were initiated, and bankruptcy ensued.

II.

How could this have happened? There is enough blame to go around, to be sure, but our reports placed major responsibility on the members of the Board of Directors, especially upon those who served on its audit and compensation committees. Each of these entities was dominated by WorldCom CEO, Bernard Ebbers, and its CFO, Scott Sullivan. Board members exercised little diligence, asked few questions

and eventually became a mere rubber stamp for the ambitions of these two individuals. There was created within the Board what we styled a “culture of accommodation” which ceded virtually unlimited power to Messrs. Ebbers and Sullivan.

For example, during its acquisition spree the Company’s approach was almost totally ad hoc and opportunistic with little meaningful or coherent strategic planning. The Board frequently approved billion dollar deals with little or no information or discussion, often during brief telephone calls without a single piece of paper before them regarding the terms and conditions or implications of the transaction.

Significantly, although many present or former officers and directors of WorldCom told us that they had misgivings at the time regarding decisions or actions by Mr. Ebbers or Mr. Sullivan during the relevant period, there is no evidence that any of those officers and directors made any attempts to curb, stop or challenge conduct that they deemed questionable or inappropriate. It appears that the Company’s officers and directors went along with Mr. Ebbers and Mr. Sullivan, even under circumstances that suggested corporate actions were at best imprudent, and at worst inappropriate and fraudulent.

Similarly, there is no evidence that WorldCom management or the Board of Directors reasonably monitored the Company's debt level and its ability to satisfy its outstanding obligations. Messrs. Ebbers and Sullivan had virtually unfettered discretion to commit the Company to

billions of dollars in debt obligations with little meaningful oversight. WorldCom's issuance of more than \$25 billion in debt securities in the four years preceding its bankruptcy was clearly facilitated by its massive accounting fraud which allowed it to falsely present itself as creditworthy and "investment grade." The Board again passively "rubber-stamped" proposals from Messrs. Ebbers or Sullivan regarding these borrowings, most often via unanimous consent resolutions that were adopted after little or no discussion.

Our investigation also raised significant concerns regarding the circumstances surrounding the Company's loans of more than \$400 million to Mr. Ebbers. As detailed in our Reports, the compensation committee of the Board agreed to provide these enormous loans and a separate guaranty for Mr. Ebbers without initially informing the full Board or taking appropriate steps to protect the Company. Further, as the loans and guaranty increased, the committee failed to perform appropriate diligence that would have clearly demonstrated that the collateral offered by Mr. Ebbers was grossly inadequate to support the Company's extensions of credit to him, in light of his substantial other loans and obligations. Our investigation reflected that the Board was similarly at fault for not raising any questions about the loans and merely adopting, without meaningful consideration, the recommendations of the compensation committee.

From a corporate governance perspective, I believe the loans to Mr. Ebbers are troubling for an additional reason. These extraordinary loans highlighted the extent of Mr. Ebbers' business activities that were not related to WorldCom. Among the investments undertaken by Mr. Ebbers were the purchase of the largest tract of real estate in Canada, timber interests in Mississippi, a Georgia boatyard and others. In our view, the Board should have questioned whether these non-WorldCom business activities were consistent with the need for Mr. Ebbers to devote sufficient time and attention to managing the business of such a large and complex company as WorldCom. However, it appears that the Board did not even raise questions, much less do anything to attempt to persuade Mr. Ebbers to divest himself of his other businesses or otherwise limit his non-WorldCom business activities. To the contrary, the compensation committee and the Board actually provided much of the massive funding that facilitated Mr. Ebbers' personal business activities.

Next only in importance to the absence of internal controls as a cause of this debacle was the lack of transparency between senior management and the Board of Directors at WorldCom. While the latter does not directly translate to the massive accounting fraud committed by the Company, I believe that this failing helped to foster an environment and culture that permitted the fraud to grow dramatically. A culture and internal processes that discourage or implicitly forbid scrutiny and

detailed questioning are breeding grounds for fraudulent misdeeds. In tandem with the accounting irregularities, these shortcomings fostered the illusion that WorldCom was far more healthy and successful than it actually was during the relevant period.

III.

Other “gatekeepers” were deficient as well. The audit committee of the Board failed to devise a work plan with the internal auditors and the outside accountants, Arthur Andersen, to create the necessary seamless web of audit capability to monitor this far-flung enterprise. In fairness, it appears that neither the audit committee nor the internal auditors were seized with actual notice of accounting irregularities. And, to their considerable credit, they took significant and responsible steps once these shortcomings were discovered in the spring of 2002. Nevertheless, much was allowed meantime to slip between the cracks in terms of accounting improprieties. Arthur Andersen identified WorldCom as a “maximum risk” client, but failed to act consistently with that label by drilling down into the numbers and performing the necessary tests consistent with that designation. They exercised none of the professional skepticism which is inherent in the responsibilities of an outside accounting firm. The internal audit operation within the company, at the same time, was purposely diverted away from auditing responsibilities and concentrated upon increased efficiencies and cost-cutting instead of internal “policing.” Moreover, it was understaffed,

underpaid and under-qualified to carry out a responsible internal audit function. As a result, these entities were effectively neutralized as a source of oversight or inquiry into improprieties that were occurring during this period. In fact, our Reports found “the audit committee, the Internal Audit Department and Arthur Andersen allowed their mission to be shaped in ways that served to conceal and perpetuate the Company’s accounting fraud.”

And there was more. Consider the Company’s relationship with its investment bankers whose services were constantly required in its acquisitions and borrowing. Salomon Smith Barney (SSB) became and remained the lead investment banker to WorldCom only after allocating to Mr. Ebbers and other executives within WorldCom a disproportionate number of shares of initial public offerings of so-called “hot” stocks – allocations which reaped for Mr. Ebbers alone profits of some \$12 million. SSB offered other financial benefits to him as well to help sustain his shaky personal finances. In our view, the actions of SSB came perilously close to commercial bribery, that is the extending of favors to the CEO of a company simply to assure that lucrative investment banking business went to them. And it was lucrative indeed. SSB earned over \$100 million in fees during this period. Meanwhile, its top telecommunications security analyst, Jack Grubman, was to issue a string of euphoric reports on the worth of WorldCom stock which didn’t end even as the Company plunged into the abyss. Incidentally,

Grubman himself was paid \$20 million a year for his efforts and, even after his activities had been disclosed, received a severance payment of \$30 million.

One new area was identified in our final report. While somewhat complicated, it deserves mention as one more indication of the tendency of WorldCom to push the envelope when it came to the propriety of corporate actions. Pursuant to a scheme concocted by their current outside auditors, KPMG, WorldCom adopted a so-called state tax minimization program during the 1990's which, as its name suggests, was designed to help them avoid state taxes in amounts eventually growing to the hundreds of millions of dollars. Our report found this scheme to be both conceptually unsound and lacking in economic substance. The company improperly styled some \$20 billion in obligations by its subsidiaries to itself as so-called "royalties" for what WorldCom designated as "management foresight;" that is, the subsidiaries were to have the advantage of WorldCom's supposed "management foresight" for which they would pay a healthy fee. These "royalty" amounts were accounted for in a way that dramatically reduced the taxable income of certain WorldCom subsidiaries for state tax purposes. Interestingly, these amounts, while they were accrued, were never actually paid to WorldCom. Further, and most significantly, our study of the law indicated clearly that the designation of "management foresight" as an intangible asset capable of being the

subject of a legitimate royalty payment was questionable at best. Today, significant questions remain regarding whether WorldCom improperly avoided paying hundreds of millions of dollars in state income taxes as a result of this program. KPMG, incidentally, received fees of \$9.2 million in connection with the program.

The last part of our charge from the judge was to identify how WorldCom could recoup from those responsible for its demise into bankruptcy, some of the losses that were suffered. In our Reports, we identified a number of potential claims against third parties to recover damages because of the losses suffered by shareholders due to the catalog of wrongs that I have described to you. Included among those identified as potential subjects of these claims were former members of management and the Board of Directors and its constituent committees for violation of their fiduciary duties to shareholders. Secondly, claims potentially exist against outside accountants for professional malpractice and negligence and against the investment bankers for exerting improper influence upon the process of choosing and engaging their services during this period of time. These, of course, are potential claims only, and we recognize that it is up to the present Board of Directors to make a careful cost-benefit analysis as to whether or not it is worthwhile to pursue them. It may well be that some of the individuals against whom these claims might be asserted have insufficient assets which make them judgment proof and that pursuing litigation against them might be an

empty act. It might also be that the legal fees involved in bringing some of this litigation would be such that they would render it unwise to do so. Frankly, we would expect that a thorough legal analysis would be made by the corporation of all of these claims before any are undertaken.

IV.

As might be expected, WorldCom and the other corporate debacles which followed the burst of the speculative bubble of the 1990s have produced a flood of legislative and regulatory responses. What kinds of challenges are posed by these new requirements?

Among the dictates of the Sarbanes-Oxley Act of 2002 and/or accompanying regulations issued by the SEC, the New York Stock Exchange and the NASD are those that compel corporate CEOs and CFOs to certify as to the accuracy of financial statements filed with the SEC; that require listed companies to adopt corporate governance guidelines or codes of ethics addressing the conduct of directors or officers; that forbid corporations to extend credit to their directors or officers; that provide for forfeiture of bonuses and profits from the sale of company stock if restatements have been made as a result of “misconduct” in financial reporting; that require all members of audit, compensation and nominating or governance committees to be “independent” and that at least one member of the audit committee have accounting expertise; and that impose stricter supervision over outside auditors. The New York Stock Exchange (as does the NASD) now

explicitly requires that a majority of board members of listed companies be what they define as “independent”; that CEOs certify annually that the company has not violated the Exchange’s corporate governance listing standards; and that shareholder approval be obtained for all equity compensation plans.

Sarbanes-Oxley also promises to change vastly the relationship between corporations and their counsel. In our second interim report, we expressed specific misgivings about the degree to which both “inside” and “outside” counsel to WorldCom did not believe it was their responsibility to remind Board members of their fiduciary obligations to become adequately informed concerning the company’s business and operations, even in instances where it was obvious that the Board lacked sufficient information to fulfill its responsibilities. These shortcomings, to be sure, were no doubt exacerbated by a WorldCom culture that was not generally supportive of a strong legal function, but this should not have prevented counsel from meeting their obligations to their corporate clients.

The Sarbanes-Oxley Act requires that the SEC set minimum standards requiring that attorneys for publicly traded companies report “evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company” to the chief legal officer or the CEO and, failing to receive “an appropriate response,” to the audit or other independent committee of the board. Rules adopted or under

consideration by the Commission under this section raise a whole raft of questions regarding these “up the ladder” reporting requirements. Even more important, the American Bar Association has adopted changes to its Model Ethical Rules to permit disclosure of client confidences where lawyers’ services have been used to perpetuate an ongoing fraud and the SEC is considering an even broader so-called “noisy withdrawal” rule for counsel to public companies.

More authority in the form of regulatory response and increased budgets for the SEC and other investigative agencies will no doubt produce much closer scrutiny of corporate practices and, if history is a guide, will likely uncover new and even more sophisticated schemes designed to defraud the public.

The consequences of these changes are already becoming apparent:

1. Compliance costs will increase substantially as a result of new burdens placed on corporations and their officials.
2. Compensation for directors will no doubt have to be increased due to the greater burdens and increased cost of compliance on their parts. The Corporate Monitor in the SEC proceedings against WorldCom, for example, recommended annual compensation of not less than \$150,000 for directors of the reorganized company.

3. As a practical matter, it is my personal view that the days of one individual serving on as many as 8 to 10 corporate boards at a time are over, due to increased time demands and exposure. Credentials for directors henceforth will more likely, as one observer noted, “rest on substance and not celebrity.” Equally significant, my sense as well is that boards will be increasingly wary about permitting their own CEOs to serve on other boards of publicly held companies.
4. Liability for corporate directors is still a developing field, to be sure, but recent court decisions have already pointed to an expanded potential for directors’ liability in connection with approvals of excess salaries and other compensation and perquisites for top management.
5. The “Big Eight” accounting firms have now become “The Big Four,” or as some would have it, “The Final Four,” and these firms will have to be much more constrained in serving today’s corporate clients. They will have to be on the lookout for conflicts in the providing of unrelated services. Many clients of the major accounting firms paid them substantially more for consulting than for auditing during this boom period. What one would hope is resurrected is the traditional concept of the certified public accountant as the flinty-eyed independent

watchdog with a green eye shade who strikes fear into the heart of those tempted to play fast and loose with the company's financial accounts; not the lap dog which is tempted "to go along to get along" for fear of losing lucrative consulting revenue when improperly aggressive accounting strategies are proposed by management. As indicated, outside accountants will have to regularly confer with internal audit personnel, independent directors and the board's audit committee to insure that all are "singing from the same sheet music" on accounting issues. No doubt, the Public Company Oversight Accounting Board established under the Sarbanes-Oxley Act will prescribe more specifics to ensure the independence of auditing firms and the rigor of their auditing procedures.

The cure for many of the ills already identified, in this as in previous eras of corporate wrongdoing is, in my view, a strong dose of leadership which emphasizes honesty, integrity, character and transparency in the conduct of corporate affairs. I agree with what one observer noted:

"The tragedy which has befallen millions of shareholders of public corporations both within and without the United States might have been avoided had the independent board members remained independent and exercised the fiduciary duties imposed upon them by federal and state laws."

In the final analysis, a culture which emphasizes ethical conduct will make more difference than all the laws and regulations promulgated by various governmental agencies. Often the temptation is to view additional statutory and regulatory enactments as government-imposed impediments to smooth and efficient corporate governance. And there is, to be sure, some of that in this latest round. But here opportunities exist as well. Over the past six months, I have had the opportunity to speak to chapters of the National Association of Corporate Boards on both coasts and from these discussions emerged a common view – a view that these changes, put simply, offer the opportunity to empower the “good guys.”

By the “good guys,” I mean men and women who

- As directors, will be less reluctant to subject questionable proposals by management to thorough scrutiny and more eager to fulfill their fiduciary responsibilities to shareholders
- As members of management, are willing to be more transparent and are genuinely committed to getting feedback from a truly independent board of directors

- As auditors, will be more skeptical regarding aggressive accounting schemes of a suspect nature and less willing to use their auditing roles to leverage other unrelated consulting engagements
- As corporate lawyers, will be less reluctant to raise questions regarding legal issues arising from proposed corporate actions and more willing to provide unvarnished advice on questionable transactions
- As investment bankers, will seek to perform their vital function in the American free enterprise system without offering improper financial inducements to obtain business
- As investment analysts, will “call ‘em as they see ‘em” and inform, rather than delude, the investing public as to the true worth of potential investments

All of these can go a long way toward renewing the faith of all Americans in the integrity of corporate governance and the free

enterprise system upon which our financial well-being and quality of life depends.

Last year, prior to my appointment as the WorldCom Examiner, I made an instructional film for distribution to corporate America, dealing with today's legal and ethical challenges. Its message was a simple one: "Do the right thing." At bottom, when all is said and done, this is the basic lesson taught by recently disclosed shortcomings in corporate governance. And it is a message that must be taken to heart within America's business and financial communities if they are to continue to prosper and maintain the confidence of the investing and taxpaying public.

A crisis in corporate governance? I think not. Especially if the "good guys" respond to the challenge to "do the right thing" in fulfilling their responsibilities.