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WorldCom Case Study Update 2006[1]

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Read the original case.

In December 2005, two years after this case was written, the telecommunications industry consolidated further. Verizon Communications acquired MCI/WorldCom and SBC Communications acquired AT&T Corporation, which had been in business since the 19th Century. The acquisition of MCI/WorldCom was the direct result of the behavior of WorldCom's senior managers as documented above. While it can be argued that the demise of AT&T Corp. was not wholly attributable to WorldCom's behavior, AT&T Corp.'s decimation certainly was facilitated by the events surrounding WorldCom, since WorldCom was the benchmark long distance telephone and Internet communications service provider. Indeed, the ripple effect of WorldCom's demise goes far beyond one company and several senior managers. It had a profound effect on an entire industry.

This postscript will update the WorldCom story by focusing on what happened to the company after it declared bankruptcy and before it was acquired by Verizon. The postscript also will relate subsequent important events in the telecommunications industry, the effect of WorldCom's problems on its competitors and labor market, and the impact WorldCom had on the lives of the key players associated with the fraud and its exposure.

From Benchmark to Bankrupt

Between July 2002 when WorldCom declared bankruptcy and April 2004 when it emerged from bankruptcy as MCI, company officials worked feverishly to restate the financials and reorganize the company. The new CEO Michael Capellas (formerly CEO of Compaq Computer) and the newly appointed CFO Robert Blakely faced the daunting task of settling the company's outstanding debt of around $35 billion and performing a rigorous financial audit of the company. This was a monumental task, at one point utilizing an army of over 500 WorldCom employees, over 200 employees of the company's outside auditor, KPMG, and a supplemental workforce of almost 600 people from Deloitte & Touch. As Joseph McCafferty notes, "(a)t the peak of the audit, in late 2003, WorldCom had about 1,500 people working on the restatement, under the combined management of Blakely and five controllers…(the t) otal cost to complete it: a mind-blowing $365 million"(McCafferty, 2004).

In addition to revealing sloppy and fraudulent bookkeeping, the post-bankruptcy audit found two important new pieces of information that only served to increase the amount of fraud at WorldCom. First, "WorldCom had overvalued several acquisitions by a total of $5.8 billion"(McCafferty, 2004). In addition, Sullivan and Ebbers, "had claimed a pretax profit for 2000 of $7.6 billion" (McCafferty, 2004). In reality, WorldCom lost "$48.9 billion (including a $47 billion write-down of impaired assets)." Consequently, instead of a $10 billion profit for the years 2000 and 2001, WorldCom had a combined loss for the years 2000 through 2002 (the year it declared bankruptcy) of $73.7 billion. If the $5.8 billion of overvalued assets is added to this figure, the total fraud at WorldCom amounted to a staggering $79.5 billion.

Although the newly audited financial statements exposed the impact of the WorldCom fraud on the company's shareholders, creditors, and other stakeholders, other information made public since 2002 revealed the effects of the fraud on the company's competitors and the telecommunications industry as a whole. These show that the fall of WorldCom altered the fortunes of a number of telecommunications industry participants, none more so than AT&T Corporation.

The CNBC news show, "The Big Lie: Inside the Rise and Fraud of WorldCom," exposed the extent of the WorldCom fraud on several key participants, including the then-chairmen of AT&T and Sprint (Faber, 2003). The so-called "big lie" was promoted through a spreadsheet developed by Tom Stluka, a capacity planner at WorldCom, that modeled in Excel format the amount of traffic WorldCom could expect in a best-case scenario of Internet growth. In essence, "Stluka's model suggested that in the best of all possible worlds Internet traffic would double every 100 days" (Faber, 2003). In working with the model, Stluka simply assigned variables with various parameters to "whatever we think is appropriate"(Faber, 2003).

This was innocent enough, had it remained an exercise. A problem emerged when the exercise was extended and integrated into corporate strategy, when it was adopted and implemented by WorldCom and then by the telecommunications industry. Within a year, "other companies were touting it" and the model was given credibility it should not have been accorded (Faber, 2003). As Stluka explains, "there were a lot of people who were saying 10X growth, doubling every three to four months, doubling every 100 days, 1,000 percent, that kind of thing" (Faber, 2003). But it wasn't true. "I don't recall traffic ... in fact growing at that rate … still, WorldCom's lie had become an immutable law." Optimistic scenarios with little foundation in reality began to spread and pervade the industry. They became emblematic of the "smoke and mirrors" behavior not only at WorldCom prior to its collapse, but the industry as a whole.

Fictitious numbers drove not just WorldCom, but also other companies as they reacted to WorldCom's optimistic projections. According to Michael Armstrong, then chairman and CEO of AT&T, "For some period of time, I can recall that we were back-filling that expectation with laying cable, something like 2,200 miles of cable an hour" (Faber, 2003). He adds: "Think of all the companies that went out of business that assumed that that was real."

The fallout from the WorldCom debacle was significant. Verizon obtained the freshly minted MCI for $7.6 billion, but not the $35 billion of debt MCI had when it declared bankruptcy (Alexander, 2005). Although WorldCom was one of the largest telecommunications companies with nearly $160 billion in assets, shareholder suits obtained $6.1 billion from a variety of sources including investment banks, former board members and auditors of WorldCom (Belson, 2005). If this sum were evenly distributed among the firms 2.968 billion common shares, the payoff would (have been) well under $1 a share for a stock that peaked at $49.91 on Jan. 2000" (Alexander, 2005, 3).

There are more losers in the aftermath of the WorldCom wreck. The reemerged MCI was left with about 55,000 employees, down from 88,000 at its peak. Since March 2001, however, "about 300,000 telecommunications workers have lost their jobs. The sector's total employment-1.032 million-is at an eight year low" (Alexander, 2005, 3). The carnage does not stop there. Telecommunications equipment manufacturers such as Lucent Technologies, Nortell Networks, and Corning, while benefiting initially from WorldCom's groundless predictions, suffered in the end with layoffs and depressed share prices. Perhaps most significant, in December 2005, the venerable AT&T Corporation ceased to exist as an independent company.

The Impact on Individuals

The WorldCom fiasco had a permanent effect on the lives of its key players as well. Cynthia Cooper, who spearheaded the uncovering of the fraud, went on to become one of Time Magazine's 2002 Persons of the Year. She also received a number of awards, including the 2003 Accounting Exemplar Award, given to an individual who has made notable contributions to professionalism and ethics in accounting practice or education. At present, she travels extensively, speaking to students and professionals about the importance of strong ethical and moral leadership in business (Nationwide Speakers Bureau, 2004). Even so, as Dennis Moberg points out, "After Ebbers and Sullivan left the company, "...Cooper was treated less positively than her virtuous acts warranted. In an interview with her on 11 May 2005, she indicated that, for two years following their departure, her salary was frozen, her auditing position authority was circumscribed, and her budget was cut""(Moberg, 2006, 416).

As far as the protagonists are concerned, in April 2002, CEO Bernie Ebbers resigned and two months later, CFO Scott Sullivan was fired. Shortly thereafter, in August 2002, Sullivan and former Controller David Myers were arrested and charged with securities fraud. In November 2002, former Compaq chief Michael Capellas was named CEO of WorldCom and in April 2003, Robert Blakely was named the company's CFO.

In March 2004, Sullivan pleaded guilty to criminal charges (McCafferty, 2004). At that time, too, Ebbers was formally charged with one count of conspiracy to commit securities fraud, one count of securities fraud, and seven counts of fraud related to false filings with the Security and Exchange Commission (United States District Court - Southern District of New York, 2004). Two months later, in May of 2004, Citigroup settled class action litigation for $1.64 billion after-tax brought on behalf of purchasers of WorldCom securities (Citigroup Inc., 2004). In like manner, JPMorgan Chase & Co., agreed to pay $2 billion to settle claims by investors that it should have known WorldCom's books were fraudulent when it helped sell $5 billion in company bonds (Rovella, 2005).

On March 15, 2005, Ebbers was found guilty of all charges and on July 13th of that year, sentenced to twenty-five years in prison, which was possibly a life sentence for the 63-year-old. He was expected to report to a federal prison on October 12th, but remained free while his lawyers appealed his conviction (Pappalardo, 2005).

At the time of his conviction, Ebbers' lawyers claimed the judge in the case gave the jury inappropriate instructions about Ebbers' knowledge of WorldCom's accounting fraud (Pappalardo, 2005). By January of 2006, Reid Weingarten, Ebber's lawyer, was claiming that the previous trial was manipulated against Ebbers because three high level WorldCom executives were barred from testifying on Ebbers' behalf. At that time, too, Judge Jose Cabranes of the US Second Circuit Court of Appeals commented, "There are many violent criminals who don't get 25 years in prison. Twenty years does seem an awfully long time" (MacIntyre, 2006).

Weingarten went on to assert that the government "should have charged the three former WorldCom employees that could have helped exonerate Ebbers or let them go" (Reporter, 2006). He charged, too, that "the jury was wrongly instructed that it could convict Ebbers on the basis of so-called "conscious avoidance" of knowledge of the fraud at WorldCom" (Reporter, 2006). Perhaps most compellingly, Weingarten called into question the fairness of Ebbers' sentence that was five times as long as that given to ex-WorldCom financial chief Scott Sullivan (Reporter, 2006).

Weingarten's claims are not without merit. In August 2005, former CFO Sullivan was sentenced to five years in prison for his role in engineering the $11 billion accounting fraud. His relatively light sentence was part of a bargain wherein he agreed to plead guilty to the charges filed against him and to cooperate with prosecutors as they built a case against Ebbers. In doing so, Sullivan became the prosecution's main witness against Ebbers and the only person to testify that he discussed the WorldCom fraud directly with Ebbers (Ferranti, 2005). Others involved in the scandal were also treated less harshly than Ebbers. In September 2005, judgments were rendered approving settlement and dismissing action against David Myers and a number of others associated with WorldCom (United States District Court - Southern District of New York, Judgment Approving Settlement and Dismissing Action Against Buford Yates and David Myers, 2005, Judgment Approving Settlement and Dismissing Action Against James C. Allen, Judith Areen, Carl J. Aycock, Max E. Bobbitt, Clifford L. Alexander, Jr., Francesco Galesi, Stiles A. Kellett, Jr., Gordon S. Macklin, John A. Porter, Bert C. Roberts, Jr., The Estate of John W. Sidgmore, and Lawrence C. Tucker, 2005).

At the time of this update, Ebbers has been convicted by a court of law, but remains free on bail while he pursues an appeal. Although the extent of his punishment is under contention, one thing remains clear - that Ebbers and the other officers at WorldCom are guilty of presiding over what is to date, the largest corporate fraud in history.

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